CFO Forum Presentation to the EFRAG Board

EFRAG testing results

3 July 2018

Introduction

- The CFO Forum remains committed to the development of high quality financial reporting standards that meet the needs of all stakeholders
- CFO Forum members have actively participated in EFRAG's full case study (9 CFO Forum members) and simplified case study (11 CFO Forum members) and have invested significant time and effort in this exercise
- We appreciate the support by the EFRAG staff throughout the process and are grateful for the opportunity to present today a summary of the key issues identified in our members' case study submissions
- Presenting to you today are:
  - Luigi Lubelli – Chair of the CFO Forum
  - Massimo Romano – Chair of the CFO Forum's Steering Committee
  - Harm van de Meerendonk – Chair of the CFO Forum's Insurance Accounting Group

Key Messages

1. Our members are putting significant effort into implementing IFRS 17 and committed significant resource to the EFRAG testing. The EFRAG testing has been insightful, although it has its limitations

2. The testing has provided us with further evidence of significant issues and their impact, including on measurement, operational complexity and implementation challenges

3. These issues need to be resolved in IFRS 17 before its endorsement

4. Given our findings we believe the implementation timelines are very challenging

Overview of what was tested in the full case study

- An overview of the portfolios that were tested by our members that participated in the full case study is presented on the following slide. The scope of testing has covered a wide range of products including those with complex features
- The overview of portfolios tested and the extensive results submitted (range of 63 to 118 pages per member) demonstrate the considerable effort devoted by our members to completing thorough and meaningful testing
- The full case study testing is not entirely representative as
  - it did not include all portfolios
  - it did not include all the jurisdictions represented by CFO Forum members
  - the representation in the Group consolidated financial information was not tested
  - small and medium-sized companies as well as 21 other EU countries have not participated
- However, a wide range of products and territories were subject to testing, providing good support for the findings

Overview of what was tested in the full case study

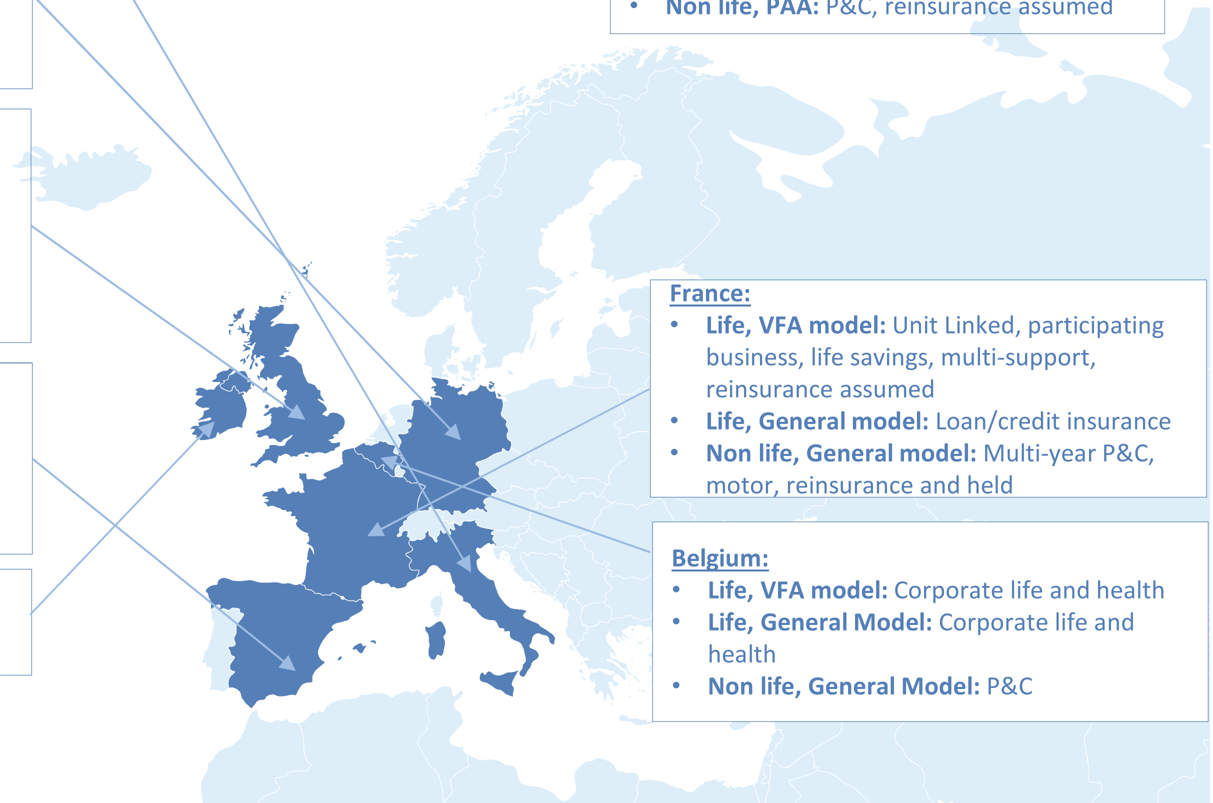
Italy:
- **Life, VFA model:** Participating business
- **Non life, PAA:** Motor

Germany:
- **Life, VFA model:** Participating business and corporate life & health
- **Non life, General Model:** Multi year P&C
- **Non-Life, PAA:** P&C, reinsurance held

UK:
- **Life, VFA model:** Unit linked, with profits
- **Life, General Model:**, Annuities (Individual and Bulk purchase), Individual protection, individual protection reinsurance ceded
- **Non life, PAA:** Motor, P&C, reinsurance held

Spain:
- **Life, VFA model**: Unit linked
- **Life, General model:** Annuities, life savings
- **Non life, General model:** Motor TPL, homeowners

Ireland:
- **Life, VFA model**: Participating business
- **Life, General model:** Loan/credit insurance



Non-EEA jurisdictions (Switzerland, US, Canada & Asia):
- **Life, VFA model:** Unit linked, variable annuities
- **Life, General model:** Individual protection, annuities, fixed index annuities, reinsurance assumed
- **Non life, General model:** Multi-year P&C
- **Non life, PAA:** P&C, reinsurance assumed

France:
- **Life, VFA model:** Unit Linked, participating business, life savings, multi-support, reinsurance assumed
- **Life, General model:** Loan/credit insurance
- **Non life, General model:** Multi-year P&C, motor, reinsurance and held

Belgium:
- **Life, VFA model:** Corporate life and health
- **Life, General Model:** Corporate life and health
- **Non life, General Model:** P&C

Overall context

- The findings on the following slides are a factual aggregation of individual member's submissions. All issues raised are a result of one or more findings from members' testing and are material for at least one participating member.
- Testing has focused on certain portfolios only and members have not yet had the opportunity to test the impact on their business as a whole. The key issue of whether IFRS 17 overall provides users with more relevant financial information was therefore not in the scope of this exercise.
- Testing had to be completed before key accounting policy and methodology decisions have been made and before system changes have been implemented. Not all participants have been able to complete all aspects of the case study due to the limited time available for testing
- As implementation and testing continues more issues may be identified.
- We note that Solvency II was subject to a much more extensive and iterative testing processes, resulting in improvements to the requirements which made them "safer" before releasing into the European market.

Findings from the case study testing (1/2)

We have grouped the findings of our members into 3 categories.
Each finding is explained in more detail in one or more of our members' submissions

(1) Measurement issues

Issues that impact the amounts reported in the income statement and balance sheet, including inconsistencies, accounting mismatches and issues impacting profit recognition

(2) Operational complexity

Requirements that are unnecessarily complex, increasing the one-off implementation and on-going application costs, without increasing the benefit to users

(3) Other implementation challenges

Other practical challenges with implementing the standard as illustrated by the testing, impacting the achievability of the current timelines

In addition, we have summarised the information submitted on **costs**

Findings from the case study testing (2/2)

(1) Measurement issues

- Acquisition cashflows
- CSM amortisation
- Discount rates
- Multi-component contracts
- Reinsurance
- Scope of hedging adjustment
- Scope of the VFA vs GMM and PAA
- Transition

(2) Operational complexity

- Business combinations
- Level of aggregation
- Presentational issues

(3) Other implementation challenges

- Pressure on implementation timeline

Costs

- EUR 50-320 million per member
- EUR 1,9 billion for 12 members that quantified

The findings are not prioritised, but presented in alphabetical order.

Findings from testing - Measurement (1/3)

Issue	Description of issue and evidence from testing	Implications
Acquisition cashflows	Acquisition cash flows on new business that is expected to renew cannot be allocated to future periods. This is inconsistent with other industries which capitalize acquisition costs over multiple contracts. This was particularly evidenced in the testing of P&C contracts.	This results in incorrect matching of income and expenses over time. The implications are intensified if the inability to allocate acquisition costs to future periods results in contracts being onerous in accounting (but not in economic reality).
CSM amortisation	The requirements on coverage units to be used for the CSM amortisation are not appropriate for all types of contracts. A key issue is that the CSM (of which the initial amount is impacted by investment spreads) cannot be amortised over the period in which investment services are provided. This issue was mainly identified in the testing for savings and participating contracts. It is acknowledged that this is a topic under discussion by the IASB for contracts in scope of the VFA. However, the issue is equally relevant for the general measurement model.	Profit recognition over the life of the contract is not appropriate. For certain contracts, profit recognition is strongly frontloaded or backloaded. For example, on a simple annuity contract profit is not appropriately recognised in the accumulation and deferral phases.
Discount rates	• The use of a locked in discount rate for the CSM in the general model. The impact of assumption updates is absorbed in the CSM at the locked-in rate. The BEL is measured at the current rate. The difference between the locked-in and the current rate is reflected in the P&L and will significantly distort the current period result. • In the situation where the BEL component of the insurance liability is an asset and the CSM component is a liability, inconsistencies arise due to the different discount rates for BEL (current rate) and CSM (locked-in rate). • There is currently uncertainty regarding whether changes in asset mix will result in changes to the discount rate when the discount rate is determined top down using actual assets as a reference portfolio.	The result is significantly distorted by the discount rate components of the impact of assumption changes that are otherwise absorbed in the CSM. The P&L and/or OCI is distorted by the use of different discount rates for different components of the insurance liability. This is particularly exacerbated when the BEL component is an asset. An interpretation of the reference portfolio that appropriately reflects the asset/liability matching strategy is key to avoid significant levels of spurious volatility.

Findings from testing – Measurement (2/3)

Issue	Description of issue and evidence from testing	Implications
Multi-component contracts	Certain contracts exposing the issuer to credit risk that are in substance loans (for example equity release mortgages in the UK) contain a small insurance element which causes the entire contract to be subject to insurance accounting under IFRS 17.	Including these products in the scope of IFRS 17 is inconsistent with the treatment of similar products in other industries
Reinsurance	The approach to reinsurance gives rise to several accounting mismatches. Examples include; • For an onerous contract a cedant has to recognize a loss component though P/L whereas the relief from an corresponding reinsurance contract held has to be deferred over the coverage period • Reinsurance held cannot be accounted for under the VFA model, even if the VFA model is applied to the underlying insurance contracts • Contract boundaries for reinsurance are inconsistent with those of the underlying insurance contracts, meaning that the reinsurance accounting requires including an estimate of underlying insurance business that is not yet written/recognised	The inconsistencies between insurance and reinsurance accounting creates a number of accounting mismatches, meaning that the financial statements do not appropriately reflect the net risk position after reinsurance and, as a consequence, a distorted profit recognition pattern.
Scope of hedging adjustment	Whilst IFRS 17 includes a specific hedging adjustment, its use is limited to specific circumstances: • It is only available for contracts in scope of the VFA • It cannot be applied retrospectively on from the date of initial application • It can only be used when derivatives are used as hedging instrument This was highlighted as part of the testing for a material book of business with guarantees that are hedged.	The inability to use the hedge adjustment outside the narrowly defined scope will result in accounting mismatches if the fair value changes on hedging instruments are not recognised in the same category (P&L, OCI or CSM) as the changes on the hedged items). This will significantly distort the net result and create misalignment between accounting results and risk management. Paradoxically, a perfect hedge would cause a comparatively higher income statement volatility than a partial hedge.

Findings from testing - Measurement (3/3)

Issue	Description of issue and evidence from testing	Implications
Scope of the VFA model vs General model and PAA	The testing has shown that the results are very different depending on the measurement model applied, whilst there is a continuum in the nature of insurance products. There are several elements in the VFA model that deal more appropriately with specific elements of insurance products but these are not available under the general model or premium allocation approach. These include the alignment between liability discount rates with (accounting for) asset returns and the transitional amount in OCI.	The result is that insurance contracts that are economically similar will be accounted for very differently, which does not reflect economic reality. The significant differences between the models create 'cliff effects' that are very dependent on the interpretation of the scope definitions of the different models.
Transition	Applying the fully retrospective approach to transition is expected to be impossible in many cases due to the need for detailed historical data for long historic periods. The modified retrospective approach is very restrictive and will not provide the simplifications that make retrospective application possible in practice. The option to set OCI to nil under the fair value approach is not available to assets accounted at fair value through OCI.	If the modified retrospective method is not improved, insurers will be forced into the fair value approach for many portfolios. Whilst the fair value approach is a helpful practical expedient in some cases, it may not provide an appropriate profit recognition pattern in all cases. Depending on the final interpretation of the fair value, this could be the case for portfolios with significant in-force and significant new business. Setting OCI on the liabilities to nil at transition, whilst maintaining the historical OCI on related assets will distort equity at transition and results going forward significantly.

Findings from testing – Operational complexity (1/2)

Issue	Description of issue and evidence from testing	Implications
Business combinations	There are several elements in accounting for insurance business combinations that add significantly to complexity, including: • the requirement to assess classification at the acquisition date instead of the original inception date • the treatment of claims in payment at the acquisition date	This will result in a significantly different accounting treatment between the group and subsidiary financial statements. This adds significant unnecessary complexity and costs, particularly for GI business which may require GMM capability only if a future acquisition takes place.
Level of aggregation	The prohibition to aggregate contracts that are issued more than one year apart is unduly complex. We believe that it should be replaced by a principle according to which the insurer determines based on its internal business and risk management the way it defines its cohorts. This determination should reflect mutualisation effects when they exist. In addition, the second profitability bucket (no significant possibility of becoming onerous) is highly subjective and adds to the complexity. On the contrary, the requirement to - in principle - group contracts in their entirety prohibits the insurer to group components of an insurance contracts (e.g. the host contract and individual riders) in line with how the business and risks are managed in some cases.	The standard's requirements on level of aggregation, including the annual cohorts, are too prescriptive and detailed, leading to an excessive level of granularity, major implementation challenges, as well as undue costs. The inability to group components of an insurance contract by relevant risks means contract aggregation will not reflect how the business and risks are managed. The requirement to report on an underwriting year basis (including analysis of change) is not aligned with management of reserves which is on an accident year basis.

Findings from testing – Operational complexity (2/2)

Issue	Description of issue and evidence from testing	Implications
Presentational issues	• The standard requires that groups of contracts be presented as asset or liability based on its entirety. In reality, different components, such as claims liabilities to be settled, unearned premiums, receivables/payables, etc are managed separately and administered in different systems. Groups of contracts may frequently switch from an asset to liability position. • The standard requires premiums and claims to be included in the insurance provision on a cash paid/received basis. In reality, these are reflected on an accrual basis and payments/receipts are managed and administered separately. • The standard requires, for presentation of revenue only, segregation of non-distinct investment components, even for contract that do not have a specified account balance or component. • In several reinsurance contracts, the cedent is obligated to provide funds withheld as collateral. IFRS 17 requires a presentation of reinsurance funds withheld on a net basis, i.e. the insurance contract liability is offset by the funds withheld.	These requirements, that impact only presentation, would require major system changes compared to the current approach, which is a well established industry practice. These changes will also lead to insurance receivables, policy loans and reinsurance collateral (funds withheld) no longer being separately visible in the balance sheet, which is a deterioration in relevance of the financial statements. Companies have considered the implications for implementation and maintenance of systems for these requirements and found that the complexity and costs will very significant

Findings from testing – Other implementation challenges

Issue	Description of issue and evidence from testing	Implications
Pressure on implementation timeline	A number of issues have been identified that put pressure on the implementation timetable, including: • Industry and auditor consensus on technical interpretation issues will take time to emerge, for example on interim reporting, application of judgement on discount rates, transitional approaches, etc. • The discussions in the TRG may lead to further clarifications and amendments; the TRG discussions are not planned to end before the end of 2018. • In general there are insufficient resources within the insurance market, for actuaries, accountants and IT specialists. • IT solutions, including those for the calculation of the CSM, are not yet available for purchase. • Stakeholder engagement, including with investors and analysts, will only be possible if real accounting impacts with sufficient accuracy are available well in advance of the "go live" date. To achieve that it will be necessary for systems, interpretations, dry runs etc. to have all been completed. Given the complexity of the requirements and the resulting financial information, stakeholder education will be key.	Given our findings we believe the implementation timelines are very challenging

Findings from testing – Implementation costs

- Testing confirmed the complexity and challenges expected. Costs are confirmed to be significant and will need to be justified to all stakeholders. For the majority of members the IFRS 17 effort is comparable to what they incurred in implementing Solvency II, though may be even greater for some members.
- Estimates of the IFRS 17 implementation costs range from **€ 50 - 320 million per member** depending on the size and complexity of each member's respective business; this represents **a total of €1.9 billion for the 12 companies** who have provided estimates (representing participants in both the full and simplified case studies).
- Costs estimates will need to be refined as implementation develops, for example as the cost of IT system solutions becomes available; this is likely to result in even higher cost estimates.
- Members expect that on-going operational costs post implementation will be significantly greater than current operating costs.
- Given the significant cost to the industry, it is important that this is spent on high quality financial reporting that improves information to users.

Key Messages

1. Our members are putting significant effort into implementing IFRS 17 and committed significant resource to the EFRAG testing. The EFRAG testing has been insightful, although it has its limitations.

2. The testing has provided us with further evidence of significant issues and their impact, including on measurement, operational complexity and implementation challenges

3. These issues need to be resolved in IFRS 17 before its endorsement

4. Given our findings we believe the implementation timelines are very challenging

Closing remarks

Thank you for the opportunity to present the findings of the testing.

The CFO Forum remains committed to an improved IFRS 17 with an appropriate implementation timetable and to working with the IASB and EFRAG to achieve this.