IFRS 17 *Insurance Contracts* – Competition issues between different GAAPs

Objective

1 The objective of this paper is to consider whether differences between IFRS 17 *Insurance Contracts*, US GAAP, Japanese GAAP and local European GAAPs will are expected to affect the competitiveness of European insurers.

EFRAG Secretariat analysis

2 The implementation of IFRS 17 is expected to result in a more level playing field in some respects (by providing a common basis for financial reporting by listed insurers in Europe and by insurers outside Europe that apply IFRS). IFRS 17 may however result in greater differences in financial reporting between listed and unlisted insurers within member states, although the extent of this depends on how the options in the IAS Regulation will be exercised.

3 IFRS 17 differs in several respects from the financial reporting requirements of major non-European jurisdictions that do not apply IFRS (which is also the case for IFRS 4). Some of these differences might be considered as advantageous or disadvantageous to European insurers. However, EFRAG Secretariat assesses that any resulting impact on the competitiveness of European insurers in comparison to the situation today is expected to be minor and to diminish once the effect of the transition is overcome.

4 The costs of implementing IFRS 17 will impact European insurers in the short-term and may be compensated for by reductions in the cost of capital in the medium-term

5 Overall, it is not apparent from that IFRS 17 will place European insurers at any significant competitive advantage or disadvantage in comparison with the situation today.

6 Appendix 1 contains the technical analysis of the potential (dis)advantages for European insurers if IFRS 17 were to be endorsed in Europe.

Question for the EFRAG Board

7 Does the EFRAG Board have comments on the above analysis? Please explain.

Appendix 1: Technical analysis

1 One needs to consider both competition for customers and competition for capital as part of the competitive landscape. In general, accounting has little or no impact on competition for customers, except for the impacts of compliance costs. Therefore, apart from the impact of implementation costs on pricing, this analysis considers the competition for capital and how IFRS 17 impacts the 'investability' of the sector.

The current competitive landscape

Insurers vs insurers

Competition between European listed insurers

2 Listed European insurers are competing with each other in the European market. In the accounting they rely on IFRS 4 *Insurance Contracts*, which largely builds upon national GAAPs. These national GAAPs show differences that could create competitive (dis)advantages for the insurers involved.

3 Examples of current differences in European national GAAPs include the following[1]:

(a) Level of aggregation: In France, technical reserves for life contracts are calculated by risk or group of contracts; in Spain, they are calculated on a contract by contract basis;

(b) Discounting: In the UK, technical reserves for long-term insurance business are discounted using an approximation to the risk-adjusted yield for assets allocated to cover the liability; in Italy, technical reserves for life contracts are commonly calculated on a cost basis, using locked-in assumptions based on the initial pricing of the contracts.

(c) Options and guarantees: In Italy, technical provisions for life business include options and guarantees; in France, specific reserves are determined for options and guarantees.

4 Although significant differences between the accounting by listed insurers have persisted over time within Europe, EFRAG Secretariat is not aware of any evidence that these differences have creates significant competitive (dis)advantages for the insurers involved.

Competition between European listed insurers and European non-listed insurers

5 Listed European insurers also compete with non-listed insurers, which are generally smaller companies operating in only one or a few local jurisdictions. When a European insurer creates a subsidiary in a particular EU Member State the activities of that subsidiary will be subject to the same accounting requirements as the local non-listed insurers. However, if the consolidating entity enjoys a competitive advantage in its home country, the benefit received at consolidated level can free up additional capital supporting the expansion of the business by creating a subsidiary in a host Member State. As such, the European insurance market is composed of national islands of equal competition with regard to the application of GAAP. However, there is no overall consistency in the European accounting requirements.

European insurers vs third-country insurers

6 Finally, European insurers also compete with insurers from third countries, for example US-headquartered insurers, both in European markets and in other markets around the world. Based on the results of the [draft] economic study

[1] See the Appendix for a more detailed description.

commissioned by EFRAG, the degree of competition within European markets is relatively low.

Insurers vs other companies

Financial services: Insurers vs banks

7 Insurers offer investment products as do banks and as such the two types of companies are competing for the same clients.

Other services: Insurers vs other companies

8 Insurers also explore offering other services such as maintenance contracts for cars, in addition to the car insurance. In doing so, insurers come in direct competition with other companies offering this type of services.

Overall

9 Looking at today's landscape it can be concluded there is no 'level playing field' exists today, but rather a various landscape of applicable GAAPs. Given the persistency of this, it is likely that the range of GAAPs applied provides neither competitive advantages nor disadvantages to particular insurers.

Potential competition issues between IFRS 17 and US GAAP

10 In assessing the competition issues between US GAAP and IFRS 17, this paper has considered US GAAP ASC Topic 944 *Financial Services – Insurance* in addition to IFRS 17. Also, the changes for Long-Duration Contracts (issued on August 15, 2018 with an effective date of December 15, 2020 for public business entities) have been considered.

11 The requirements of IFRS 17 and US GAAP differ in many respects, although the US GAAP changes to the accounting for Long-Duration Insurance Contracts are more closely aligning the frameworks on a number of issues. EFRAG has considered whether any of these differences may result in European insurance entities being at a competitive disadvantage to companies reporting under US GAAP for competition for capital.

Discount rates

12 IFRS 17 requires discount rates used to reflect the characteristics of the cash flows arising from the insurance contracts. Under IFRS 17, investment returns are not included in the cash flows used in measuring the insurance liability under the General Model. Investments are recognised, measured and presented separately. However, for insurance contracts accounted for in accordance with the Variable Fee Approach, estimates of discount rates shall consider the variability of the returns on underlying items. For insurance contracts accounted for in accordance with the General Model, discount rates are determined by upwards adjusting a liquid risk-free yield curve (bottom-up approach) or downwards adjusting a yield curve using the current market rates of return of a reference portfolio of assets (top-down approach).

13 Under US GAAP, for short-duration contracts, liabilities for unpaid claims and claim adjustment expenses *can* be discounted at the same rate used to report the same claims liabilities to State regulatory authorities or discounting liabilities with respect to settled claims under particular circumstances. However, short-duration contracts will mostly not be discounted.

14 Under US GAAP, for long-duration contracts, at present the interest assumptions used in estimating the liability for future policy benefits are based on estimates of investment yields (net of related investment expenses) expected at the time insurance contracts are issued. For non-participating traditional and limited-payment contracts, the FASB has decided to change and require the use of a

current upper-medium grade (low credit risk) fixed-income instrument yield for those contracts. The effect of updating the discount rate assumption is to be recognised immediately in other comprehensive income.

15 For short duration contracts that are not discounted under US GAAP, US insurers would have generally larger liabilities than similar contracts of European insurers which may be discounted under the Premium Allocation Approach (i.e. either the liability for remaining coverage has a significant financing component or either the liability for incurred claims has a duration of more than one year). This difference could be considered as advantageous to European insurers.

16 For long-duration contracts in respect of US GAAP and which would not qualify for the Variable Fee Approach under IFRS 17, US insurers would be able to discount their insurance liabilities at a higher discount rate (considering expected investment yield) compared to European insurers (where the starting point to determine the discount rate would be a liquid risk-free yield curve – bottom-up approach). Hence, for those insurance contracts the insurance liabilities of US insurers would generally be lower than similar contracts of European insurers. This difference could be considered as disadvantageous to European insurers.

Reinsurance

17 Both frameworks rely on consistent assumptions for measuring reinsurance contracts and the related underlying insurance contracts.

18 Under US GAAP, reinsurance contracts do not result in immediate recognition of gains unless the reinsurance contract is a legal replacement of one insurer by another and thereby extinguishes the ceding entity's liability to the policyholder. Reinsurance recoverables are recognised in a manner consistent with the liabilities relating to the underlying reinsured contracts. The cost of reinsurance is amortised over the remaining life of the underlying reinsured contracts if the reinsurance contract is a long-duration contract, or over the contract period of the reinsurance if the reinsurance contract is a short-duration contract.

19 Under IFRS 17, the difference between the amount paid for the reinsurance cover and the expected risk-adjusted present value of the cash flows generated by the reinsurance contracts held represents the contractual service margin which is recognised over the reinsurance coverage period.

20 Although differences exist in the detailed treatment of reinsurance contracts between the two frameworks, no competitive (dis)advantage can be derived from these treatments.

21 The EFRAG Secretariat has been informed that the US GAAP treatment of reinsurance contracts could provide a competitive advantage for insurers as the accounting mismatch between reinsurance contracts and insurance contracts is smaller under present US GAAP than compared to IFRS 17. Calculations demonstrating this effect have been requested but have not yet been received.

22 The EFRAG Secretariat has also heard that US GAAP demonstrates a "tighter" link between reinsurance contracts and insurance contracts when compared to IFRS 17. It is noteworthy that IFRS 17 requires reinsurance contracts held to be measured using consistent assumptions for both reinsurance contracts held and the underlying insurance contracts.

23 IFRS 17 does not permit reinsurance contracts held and reinsurance contracts issued to be accounted for in accordance with the Variable Fee Approach. However, currently very few investment risk components of insurance contracts are reinsured. The EFRAG Secretariat therefore assesses that it is unlikely that this mismatch will create a material disadvantage.

Level of aggregation

24 IFRS 17 subdivides each portfolio into groups of (i) contracts onerous at initial recognition, if any, (ii) contracts at initial recognition having no significant possibility of becoming onerous subsequently, if any and (iii) remaining contracts in the portfolio, if any. Contracts issued more than one year apart shall not be included in the same group.

25 US GAAP require insurance contracts to be grouped consistent with the entity's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists. As part of the changes to the requirements for long-duration contracts (more particularly for non-participating traditional and limited-payment contracts), the FASB decided that contracts from different issue years should not be grouped together, instead contracts are to be grouped into quarterly or annual groups.

26 The IFRS 17 requirements for aggregating insurance contracts are more granular that the US GAAP requirements, although the recent changes to US GAAP bring US GAAP closer to the IFRS 17 requirements in relation to the use of annual cohorts for some contract types. Even when US GAAP requires accrual of a loss in excess of deferred premiums that probably will be incurred on insurance contracts in force, the IFRS 17 requirements seem more prudent than US GAAP. However, the greater level of granularity typically required under IFRS 17 might result in higher compliance costs for European insurers.

Sharing of risks

27 Under IFRS 17, entities should consider whether the cash flows of insurance contracts in one group affect the cash flows to policyholders of contracts in another group. This is to determine whether they result in policyholders subordinating their claims or cash flows to those of other policyholders, thereby reducing the direct exposure of the entity to a collective risk. This factor, sometimes referred to as 'mutualisation between contracts', is considered in the measurement of the fulfilment cash flows.

28 US GAAP does not describe the concept of risk sharing amongst groups for cash flows that affect the cash flows to policyholders in another group.

29 The fact that IFRS 17 considers the treatment of sharing of risks could be considered as advantageous for European insurers.

Deferred acquisition costs

30 Under IFRS 17, insurance acquisition costs form part of the fulfilment cash flows and are reflected as an immediate cash outflow at the start of the contract boundary. Under US GAAP, such costs are deferred and amortised based on different amortisation methods. As part of the changes to the requirements for long-duration contracts, deferred acquisition costs would be amortised on a constant basis over the expected life of the related contracts, independent of profit emergence. Deferred acquisition costs would be written off for unexpected contract terminations but would not be subject to impairment testing.

31 The treatment of deferred acquisition costs under IFRS 17 is an important contributor to the recognition of groups/cohorts of onerous contracts. This because the full impact of these costs is carried by the initial cohort of insurance contracts without consideration of potential renewals. Expensing the costs over the term of the initial contract and expected renewals would not necessarily lead to the recognition of insurance contracts being onerous under US GAAP. This difference could be considered as disadvantageous to European insurers in this respect. In contrast, the fact that deferred acquisition costs will no longer be subject to impairment testing leads to a less prudent treatment under US GAAP compared to IFRS.

Measurement of options and guarantees

32 Certain contracts may be sold with contract features that provide for benefits in addition to the account balance. IFRS 17 requires an entity to include all financial options and guarantees embedded in insurance contracts in the measurement of the fulfilment cash flows, in a way that is consistent with observable market prices for such options and guarantees. However, under US GAAP, some of those features are accounted for as embedded derivatives at fair value under ASC Topic 815 *Derivatives and Hedging* (ASC 815) or as insurance liabilities under ASC 944.

33 As part of the changes to the requirements for long-duration contracts, market risk benefits (such as guarantees embedded in variable contracts) are to be measured at fair value.

34 Although differences exist in the detailed treatments of options and guarantees between the two frameworks, it does not appear that any particular (dis)advantage arises from these different treatments.

Presentation and disclosure

35 In accordance with IFRS 17, the carrying amount of insurance contracts that are an asset and those that are liabilities are to be presented separately in the statement of financial position. The same is valid for reinsurance contracts held.

36 In the statement of financial performance, a disaggregation is to be made between the insurance service result and the insurance finance income and expenses.

37 Further, IFRS 17 requires disclosure of qualitative and quantitative information about:

(a) the amounts recognised in its financial statements from insurance contracts;

(b) the significant judgements, and changes in those judgements, made when applying IFRS 17;

(c) detailed reconciliations of opening and closing balances; and

(d) the nature and extent of the risks from contracts within the scope of IFRS 17.

38 US GAAP does not require that the carrying amount of insurance contracts that are an asset and those that are liabilities are to be presented separately and also does not require a disaggregation between insurance service result and insurance finance income and expenses.

39 US GAAP requires various disclosures of qualitative and quantitative information that are applicable to the different types of products. In some cases, the disclosure requirements include similar information across contract types; however, in many instances disclosure requirements are not consistent across products or benefit features. For these reasons, the FASB decided to improve the consistency of information being provided by requiring disclosure of the following information across products (however, there will be some instances that, due to the nature of the product or benefit feature, only certain disclosures will be applicable):

(a) Insurance entities would be required to provide disaggregated rollforwards/reconciliations of the beginning to ending balances of the liability for future policy benefits, policyholder account balances, market risk benefits, separate account liabilities, and deferred acquisition costs

(b) Insurance entities would be required to disclose information about significant inputs, judgments, assumptions, and methods used in measurement, including changes in those inputs, judgments, assumptions, and methods, and the effect of those changes on the measurement.

40 As part of the changes to the requirements for long-duration contracts under US GAAP, the presentation and disclosure requirements are being changed.

41 As for presentation, insurers are required to separately present the carrying amount of market risk benefit liabilities in the statement of financial position. Also, the changes in the fair value related to the market risk benefits are presented separately in the statement of operations, except for changes in instrument-specific credit risk, which are presented separately in other comprehensive income. Additionally, the adjustment relating to updating the liability for future policy benefits measurement assumptions is presented separately in the statement of operations.

Overall

42 It is clear that the introduction of IFRS 17 will impose costs on European insurers and these costs (net of benefits accruing to insurers) will have to be borne either by policyholders or shareholders. Costs and benefits are considered in detail in a separate paper. The one-off costs of implementing IFRS 17 are likely to be greater that the costs imposed on insurers applying recent changes to US GAAP, given the relatively limited changes to US GAAP.

Potential competition issues between IFRS 17 and Japanese GAAP

43 Japanese insurance companies do not apply financial reporting standards issued by the Accounting Standards Board of Japan. Instead they report under regulatory requirements issued by the Financial Service Agency.

44 Japanese GAAP for insurance companies is considered to have a different objective than IFRS Standards as it set by the Japanese regulator. Achieving a regulatory objective is different than achieving a financial reporting objective. Comparing differences between the two frameworks is not considered useful to identify potential competition issues.

45 Japanese insurance companies can prepare additional financial statements in accordance one of the three bases available in Japan for insurance companies:

(a) IFRS Standards – where no competition issues would arise;

(b) Japanese modified adapted IFRS (J-MIS); and

(c) US GAAP.

46 The comparison with US GAAP has been discussed in the section above. As of today, no companies apply J-MIS, and so no competition issue can be identified in this respect.

Overall

47 Insurers applying Japanese GAAP will not incur implementation costs because, at present, there is no indication that Japanese GAAP will change in the short-term.

How will the introduction of IFRS 17 affect the existence of competition issues?

Within Europe

48 In accordance with article 4 of the IAS Regulation, the endorsement of IFRS 17 would directly affect the consolidated financial statements of companies that are listed on a regulated market.

49 However, Member States can decide, in accordance with article 5 of the IAS Regulation, to apply IFRS 17 to the annual accounts of publicly traded companies and/or the consolidated and/or annual financial statements of other companies.

Application of article 4 of the IAS Regulation

50 When IFRS 17 is applied in accordance with article 4 of the IAS Regulation, it would increase the level playing field between insurance companies at group level compared to today. EFRAG acknowledges that level playing field would not be

absolute given the existence of accounting policy options, or the use of judgement in the standard. However, EFRAG notes that:

(a) The differences occurring when applying IFRS 17 are smaller than when comparing different national GAAPs, for example, the fact that two insurance companies would apply a different discount rate to a particular set of insurance liabilities is more comparable than one company applying a discount rate and the other one not applying a discount rate;

(b) The accounting policy options and the use of judgement in a principles-based standard as IFRS 17 allows companies to reflect the specificities of their own business model.

51 If IFRS 17 is endorsed publicly listed companies would incur the cost of implementing the Standard (over a number of years). In contrast, unlisted companies that do not apply IFRS would not have to bear these costs. However, these unlisted companies are mostly smaller local players that do not have the economies of scale that allows them to compete today on an equal level with the publicly listed companies (which are active mostly across multiple Member States and internationally). Accordingly, the implementation of IFRS 17 would in some respects make the existing playing field more level within Europe despite resulting in greater differences in financial reporting between listed and unlisted insurers within some member states.

52 The existing competition issues between different national GAAPs would remain in existence.

Application of article 5 of the IAS Regulation

53 The use of IFRS is extended in some member states through the use of member state options (Article 5 of the IAS Regulation). When this applies, the use of IFRS 17 could be extended to the parent-entity individual statutory accounts of publicly listed companies alone or the statutory accounts of all insurance companies in a Member State.

54 In case only the statutory accounts of publicly listed companies would be affected, the impact on competition is similar as described in paragraphs 51 and 52 above.

55 In case the statutory accounts of all insurance companies in a Member State would be affected, all insurance companies in that Member State would bear the implementation cost and would thus be treated equally from this perspective.

56 The existing competition issues between different national GAAP would be reduced as many of the companies that are active cross border would be publicly listed companies subject to IFRS 17 also. Insofar local companies (from a Member State that did not use article 5 of the IAS Regulation) are active cross border, the existing competition issues between different national GAAP would remain in existence.

Between Europe and the rest of the world

57 EFRAG has collected data on the implementation cost of IFRS 17, but EFRAG has no information available on the implementation cost of US GAAP or Japanese GAAP. Costs and benefits are discussed in a separate paper.

58 Some European companies that apply US GAAP today in their US subsidiaries do so on a “frozen”-basis i.e. using the US GAAP requirements as they stood on 1 January 2005 (first-time adoption of IFRS 4 *Insurance Contracts*) with no use of updates since then. However, these third country GAAPs also evolve causing implementation costs of their own, for example the FASB has published its Targeted Improvements to the Accounting for Long-Duration Contracts in August 2018. As the extent of these particular changes are smaller than IFRS 17, EFRAG expects that the costs to comply with these particular requirements could be lower than applying IFRS 17.

59 EFRAG notes that the implementation of IFRS 17 could have some effect on today's competitive equilibrium. Differences between national GAAP and third country GAAP will be replaced with differences between IFRS 17 and third country GAAP. As the overall differences in GAAP are reduced, EFRAG expects the overall number of competition issues to decrease.

60 Based on the results of the [draft] economic study, EFRAG notes the degree of competition between European based insurers and third country-based insurers is relatively low.

How will the introduction of IFRS 17 affect the cost of capital?

61 On the impact on the cost of capital, the outreach with users provided the following views:

(a) 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.

(b) 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.

62 EFRAG Secretariat assesses that any impact on competitiveness will be minor for many European insurers over the medium term. This is because the direct implementation costs may be compensated for by reductions in the cost of capital due to the more detailed and comparable information presented in financial statements.

Appendix 2: Examples of differences in European national GAAP

1 Hereafter some differences in European national GAAP existing today are illustrated:

(a) **Level of aggregation**: in France insurance liabilities are measured at different levels. Technical reserves are calculated on individual level while the additional reserves are calculated by risk or group of contracts. In Spain, for life contracts, the provision is calculated policy by policy, with a system of individual capitalisation and applying a prospective method. For non-life, the provision for unconsumed premiums is reflected as a fraction of the premiums accrued in the year.

(b) **Discounting**: in UK, for general insurance business provisions should be made for the expected ultimate cost for settling the claims. Discounting is permitted *subject to* the conditions set in the law. For long-term insurance business, the method to measure the insurance liabilities is the modified statutory solvency basis[2]. The discount rates used must not exceed 97.5% of the risk-adjusted yield for assets allocated to cover the liability. In Italy, non-life insurance contracts are not discounted. Life insurance contracts are calculated using so called “technical basis orders”. Under the most commonly used technical basis order, provisions are calculated on a cost basis, using locked-in assumptions for the initial pricing of the contracts. Under the less used method, insurers apply a prudent evaluation of the provisions on the basis of assumptions considered to be more likely and on the basis of ensuring a reasonable margin for unfavourable trends in the items measured.

(c) **Options and guarantees**: In Italy, for the life business, the technical provisions are calculated using a sufficiently prudent prospective actuarial method which considers all the future obligations including guaranteed benefits and all options provided to the policyholder. In France, specific reserves are determined for options and guarantees.

[2] Modified Statutory Solvency Basis: The basis for determining insurance liabilities which is the statutory solvency basis adjusted for the following items:

(a) to defer new business acquisition costs incurred where the benefit of such costs will be obtained in subsequent reporting periods; and

(b) to treat investment, resilience and similar reserves, or reserves held in respect of general contingencies or the specific contingency that the fund will be closed to new business, where such items are held in respect of long-term insurance business within the long-term fund, as reserves rather than provisions. These are included, as appropriate, within shareholders’ capital and reserves or the fund for future appropriations (FFA).