This paper provides the technical advice from EFRAG TEG to the EFRAG Board, following EFRAG TEG's public discussion. 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.

# IFRS 17 – *Insurance Contracts* – DEA – Procyclicality Issues Paper

## Objective

1 The purpose of this session is to provide comments on the chapter relating to procyclicality in the IFRS 17 DEA.

2 This paper was discussed by EFRAG IAWG on 25 June 2020 and by EFRAG TEG on 2 July 2020. The paper has been updated for comments received during these meetings.

**Question for EFRAG Board members**

3 Does EFRAG Board have comments on the text below to be included in the DEA?

4 The motion of the EP asks to EFRAG to consider the recommendations outlined in its resolutions of 7 June 2016 on IAS evaluation and 6 October 2016 on IFRS 9 for the endorsement of IFRS 17, most notably regarding the impact of new standards on financial stability and long-term investment in the EU, but also the risks entailed by the propensity of accounting provisions to cause pro-cyclical effects and/or higher volatility, particularly as IFRS 17 will shift the focus from historical cost to current values.

5 There are two possible meanings when looking at cyclical behaviour of economic variables and the following analysis deals with both. The first defines procyclicality mainly in terms of financial variables moving together with and in the same direction as the financial cycle, as opposed to countercyclicality (which implies that the variables move in the opposite direction). The second approach sees procyclicality as embedding the idea of amplifying the financial cycle, i.e. not merely going in the same direction, but reinforcing it. The second approach is associated with behaviours that can affect the depth and duration of financial crises[1].

6 It is noted that the request addressed to EFRAG focuses on the insurance liabilities (impact of discount rates) while the request addressed to the EC focuses on the investments of insurers (assets and treatment of unrealised gains on these). EFRAG acknowledges that there are inherent links between the procyclical effect on assets and on liabilities. While discount rates for the insurance liabilities reflect in the first place the characteristics of those liabilities, they are influenced by the interest rates that are valid for the assets.

7 In order to focus the analysis, hereunder only the procyclical effects of the accounting treatment of insurance liabilities are being discussed. As such, the analysis does not address the question whether changes in market conditions affect the (type) of investments insurers do throughout the economic cycle (this relates to the application of IFRS 9). Instead, the question addressed is whether a current

[1] ESRB 2019, The cyclical behaviour of the ECL model in IFRS 9.

measurement of insurance liabilities impacts the availability of insurance solutions to the economy. The treatment of assets may also play a role, to the extent that economic and residual accounting mismatches may arise. For a discussion on the treatment of assets relating to insurance contracts, please refer to the section on asset liability management and the interaction of IFRS 9 and IFRS 17 [see paragraphs XXXX of Appendix 2 and XXXX of Appendix 3].

*Analysis*

8 In accordance with IFRS 17, insurance liabilities are discounted using current rates, which implies that when interest rates go down, the recognised amount of the insurance liabilities increases and vice-versa. In this sense, the standard is pro-cyclical in so far the value of the liabilities increases (with negative impact on profits and/or total comprehensive income) when interest rates go down with monetary expansion (normally in a downturn).

9 An important feature in reducing procyclicality is the availability of the OCI-option to account for insurance finance income or expenses. The standard allows entities to make an accounting policy choice between i) including insurance finance income or expenses in profit or loss or ii) disaggregate insurance finance income or expenses between other comprehensive income and profit or loss. By doing the latter, entities are able remove volatility from profit or loss, thereby reducing the procyclical effects of market movements.

10 Insurance business is characterised by the receipt of premiums (often far) in advance of payments of claims are due. This steady stream of cash inflows makes insurers less dependent on short-term funding. It also has the effect of disconnecting the current measurement of the liability from the actual moment of when the claims need to be paid (i.e. the moment when the liability is due).

11 Also, in contrast to banks, liquidity risk is less prominent for insurers although in some countries, the right to withdraw amounts or surrender policies may increase the risk. In addition, there are also specific regulatory requirements to prepare insurers for periods of strained liquidity, such as investments in high quality marketable investments; this reduces the average remaining liquidity risk on balance sheet. Therefore, insurers are generally able to prepare better the funding required to absorb the claims. For the same reason, insurers are far less likely to suffer from ‘a run on the company’ than banks.

12 The main risk from a financial stability point of view will therefore be solvency risk (does an insurer have sufficient capital available to cover the risks created by its activities) which is addressed through the Solvency II requirements. A critical transmission mechanism for a standard that is pro-cyclical in the second meaning of the definition illustrated above, would be to disincentivise the retention of profits matured in the positive phases of the cycle, such as overstating profits and thus allowing dividends and bonus distributions in good times. As there is no linkage between the accounting equity (cumulative retaining earnings) and the Solvency ratios and the distribution of dividends is subject to limits defined under Solvency II, the transmission mechanism through the distribution of profits is not in place. In other terms, irrespective of what any local accounting standard would require, an insurer will not be allowed to pay dividends that bring its reserves below the requirements of Solvency II. In addition, it is noted that the distribution of dividends is determined at national level and is independent from the IFRS accounting.

13 The Solvency II requirements foresee a number of measures to dampen procyclical effects. Two of these relate to discount rates: the volatility adjustment and the matching adjustment. The difference between Solvency II and IFRS 17 discount rates is discussed in paragraph [XXX].

14 The volatility adjustment allows insurers to adjust the relevant risk-free interest rate term structure for the calculation of the best estimate of technical provisions to

mitigate the effect of exaggerations of bond spreads. The matching adjustment seeks to avoid changes of asset spreads from impacting on the amount of own funds of insurers. Subject to supervisory approval, insurers are allowed to adjust the relevant risk-free interest rate term structure for the calculation of the best estimate in line with the spread movements of their assets. Both measures protect the regulatory capital from insurers from extreme procyclical effects.

15 EFRAG considers that the use of a current measurement is not new. In fact, already today some insurance business in some Member States apply current discount rates, while in other Member States and insurance business historical rates are being used. Thus, in the current situation of applying IFRS 4 and IAS 39 together, pro-cyclical effects may occur and would not per se be worsened by current measurement. Current practices on discount rates are being discussed in paragraphs xx to xx in Annex 1. EFRAG has no indication that – as a result of those differences in accounting treatment between insurance business – the availability of insurance solutions between Member States has been affected or what the incremental pro-cyclical effect of applying IFRS 17 is when compared to the current situation.

16 Furthermore, the procyclical implications of IFRS 17 should be assessed taking into account also the comparison with a situation of a less transparent standard (e.g. IFRS 4) and the fact that less transparency may be regarded as less procyclical or even anti-cyclical by some, but in fact it may result in sudden adjustments in market prices with significant financial stability consequences. In particular, when assessing the behavioural effects of IFRS 17, it shall also be taken into account that the added transparency provided by the new requirements prevents the risk that investors will have the possibility to more timely react to how the current market conditions impact the value of insurance liabilities (and the related assets), as well as the performance of insurance undertakings. In this respect, timely and transparent information on insurance liabilities is expected to improve the quality of investors' expectations and estimates, thus avoiding cliff effects and abrupt adjustments in market prices which would occur when less transparent disclosure is provided to market participants.

17 Finally, EFRAG notes that thanks to their current measurement basis under IFRS 17 insurance liabilities can be at least partially aligned with the current measurement of [financial] assets, to the extent that they are not measured at amortised cost under IFRS 9. Similarly, the finance expenses relating to the insurance liabilities reduce the finance income created by the financial assets. Only the net effect of both affects profit or loss and subsequently equity. Under the variable fee, the discount rate incorporates an estimated asset return, the unwinding of the insurance liability as services are provided to the policyholder compensates partly the actual effect that is affecting profit or loss in the period. So the net effect is creating volatility, the degree to which will partly depend on the ability of the insurer to reliably estimate future asset returns. This is not so when applying the general measurement model as here the discount rate can be based on a yield curve that reflects the current market rates of return of a reference portfolio of assets but that yield-curve is to be adjusted to eliminate any factors that are not relevant to the insurance contracts. Hence, when applying the variable fee approach the current measurement of the insurance liabilities has the result, at least partially, of dampening potential procyclical effects.

18 In addition, the contractual service margin is allocated to profit or loss over the coverage period of the insurance contracts involved, instead of being recognised when the insurance contract is underwritten. This deferral has an anti-cyclical effect on the profit recognition. In addition to this, the deferral of profit through the CSM mechanism has also a smoothening effect. It avoids overstating revenues in good times when many premiums are written and spreads the effects over a longer term,

thereby mitigating pro-cyclicality. The interaction between the application of annual cohorts and pro-cyclicality is discussed in paragraphs [XX].

19 Finally, EFRAG notes that certain events may have knock-on accounting effects beyond the use of IFRS 17. If adverse effects are so large (e.g. in case of natural catastrophe or a heavy terror attack) that the CSM is absorbed leading to operational losses, the procyclical effects go beyond the application of IFRS 17. In such cases additional balance sheet items such as goodwill or intangible assets may be affected.