IFRS 17 and Mutual insurance entities
Decision Document

Objective

1 The objective of this paper is to address the questions of the European Commission and the European Parliament in respect of the interaction between IFRS 17 and Mutual insurance entities (hereafter 'Mutuals').

2 The Commission asked EFRAG to analyse whether 'the different accounting methods properly reflect the different business models'.

3 The Parliament 'called on … EFRAG to consider concerns relating to the level of aggregation, including requirements on how the business is run in practice' and 'to consider, furthermore, concerns relating to the level of aggregation insofar as the disaggregation of a portfolio on profitability criteria and annual cohorts may not reflect how the business is run'. Please consider that discussing the topic of annual cohorts is not the purpose of this session nor of this paper and the reference to the level of aggregation has to be referred to the assessment of the implications for the mutual entities.

4 Since, as is explained below, Mutuals have a different business model than other insurers, EFRAG Secretariat analysed whether this should result in different assessments of the endorsement criteria than for other insurers.

What is a Mutual?

5 There is no definition of a Mutual in European law.[1] Van Hulle describes them, referring to a definition of the International Association of Insurance Supervisors, as follows: "Mutual insurance undertakings have the specific characteristics that they are collectively and indivisibly owner by their member-policyholders."[2]

6 Folksam described, in a comment letter to the IASB,[3] a mutual entity "as a grouping of persons (natural persons or legal entities). The primary purpose of a mutual entity is to satisfy the needs of these persons (such as the need for insurance) and this not to make profits or provide return on capital. … The mutual entity is owned by its members. … As a consequence of the members being the owners of the organisation, the profits are used for the benefits of the members. … Mutual entities can be differentiated from co-operatives by the fact that they operate with their own, collective and indivisible funds, and not with share capital." And "the policyholders

[1] Directive 2009-138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) provides, in Annex III, a list of the legal forms of undertakings under the scope of this Directive, that includes Mutuals.

[2] Karel van Hulle, Solvency Requirements for EU Insurers - Solvency II is good for you, 2019.

[3] Folksam, Comment Letter on the IASB Insurance Contracts Exposure Draft ED/2013/7, 24 October 2013.

in a mutual entity are both customers and owners. They have a contractual relationship with the mutual entity which entitles them to insurance benefits and they provide 'equity', which may lead to future benefits resulting from any surplus of the mutual entity, depending on the results of the operations of the mutual entity." Finally, "the mutual entity is owned by its members (in mutual insurance companies the policyholders) and subject to democratic governance (i.e. each member has one vote)."

7 AMICE/ICMIF stated that "the fundamental distinguishing feature of mutual and cooperative insurers, setting them apart from listed insurance companies, is that they operate for the benefit of their members/policyholders rather than for the benefit of external investors."[4]

What does IFRS 17 require?

8 IFRS 17:33 requires an entity to include in the measurement of a group of insurance contracts all the future cash flows within the boundary of each contract in the group.

9 IFRS 17:B65 specifies that cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including cash flows for which the entity has discretion over the amount or timing. The cash flows include, among others, payments to (or on behalf of) a policyholder that vary depending on returns of underlying items (IFRS 17:B65(c)).

10 IFRS 17:B68 describes contract that affect the cash flows to policyholders of contracts in other groups, and specifies that the fulfilment cash flows for a group include payments arising from the terms of existing contracts to policyholders of contracts in other groups, regardless of whether those payments are expected to be made to current or future policyholders.

11 In the Basis for Conclusions accompanying IFRS 17, the IASB specifically discussed the consequences of this standard for mutual entities (BC264 to BC 269).[5]

12 BC265 explained that a defining feature of a Mutual is that the most residual interest of the entity is due to a policyholder and not to a shareholder: payments to policyholders form part of the fulfilment cash flows regardless of whether those payments are expected to be made to current or future policyholders. Thus, the fulfilment cash flows of a Mutual generally include the rights of policyholders to the whole of any surplus of assets over liabilities. This means that, for a Mutual, there should, in principle, normally be no equity remaining and no net comprehensive income reported in any accounting period.[6]

13 BC266 acknowledged that there may be accounting mismatches, since insurance contracts are measured at current value which, for a Mutual, incorporates information about the fair value of the other assets and liabilities of the entity.

14 BC267 noted that, as a consequence, Mutuals might report liabilities greater than recognised assets in their financial statements, even though those entities are solvent for regulatory purposes and economically have no equity (rather than negative equity).

[4] AMICE/ICMIF, Facts and figures: Mutual and cooperative insurance in Europe Vol 2, May 2018.

[5] It should be noted that neither a Basis for Conclusions, nor Illustrative Examples or Educational Material are part of the EU endorsement process, only the (amendments to) Standards count.

[6] In the Basis for Conclusions on the June 2019 Amendments to IFRS 17, the IASB proposed to add a footnote to this paragraph to explain that not all entities that may be described as mutual entities have the feature that the most residual interest of the entity is due to a policyholder. This footnote was developed to address the concerns on the description of a mutual entity, as described in paragraph 17 of this paper.

15 The IASB observed in BC268 that adjusting the measurement basis of insurance liabilities for Mutuals (for instance, retaining the mirroring approach proposed in the 2013 Exposure Draft) would create a difference between Mutuals and other insurers. In the IASB's view, comparability across entities would be enhanced if economically similar products are accounted for in a similar way regardless of the legal form of the entity holding or issuing the product. Furthermore, adjusting the measurement basis for Mutuals would mean that part of the fulfilment cash flows would not be measured at current value.

16 Finally, BC269 noted that to provide useful information about its financial position and financial performance, a Mutual can distinguish:

(a) In the statement of financial position, the liability attributable to policyholders in their capacity as policyholders from the liability attributable to policyholders with the most residual interest in the entity; and

(b) In the statement(s) of financial performance, the income or expenses attributable to policyholders in their capacity as policyholders before determination of the amounts attributable to policyholders with the most residual interest in the group.

Concerns expressed by Mutuals

17 During the development of IFRS 17 and its Amendments proposed in June 2019, two main concerns have been expressed about mutual entities:

(a) Some stakeholders think that the absence of equity and total comprehensive income is a misleading depiction of the financial position and financial performance of such an entity. Furthermore, in Solvency II the surplus funds of mutual is accepted and classified as capital of highest quality (Tier 1); and

(b) In practice, the term 'mutual entities' is used to describe some entities that do not issue insurance contracts under which the most residual interest of the entity is due to a policyholder and not a shareholder. The Basis for Conclusions that discuss 'mutual entities' might lead some to expect such entities also to have, in principle, no equity and no total comprehensive income in any accounting period.

18 Mutuals also issue simple insurance contracts which do not contain any participation feature giving rights to a surplus of the insurer's assets over its liabilities. In such cases, no residual interest is due to policyholders and the entity is expected to have net equity and net comprehensive income.

19 Finally, the cash flows that are not enforceable by policyholders are not 'due' to policyholders, since payments can only be made after a decision of the general assembly in which the policyholder act in their capacity as owners rather than as policyholders.

EFRAG Secretariat analysis

20 In this analysis, the EFRAG Secretariat assessed the IFRS 17 requirements for Mutuals applying the endorsement criteria in the IAS Regulation, focusing on those topics where the characteristics of a Mutual, in particular in respect of recognition and measurement of insurance liabilities, should justify a different approach for Mutuals than for other insurers. The result of the analysis are presented below.

Relevance

21 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations.

22 The EFRAG Secretariat learned in earlier discussions with the IAWG that Mutuals exist in different forms in Europe and that not all Mutuals use IFRSs.[7] Differences exist in respect to the dual role of policyholders, the constructions of the contractual relationship between the policyholders/owners and the company, the role and set-up of collective buffer funds, and the bonus allocation systems.

23 Under IAS 1, an entity is required to present additional line items, headings and subtotals in the statement of financial position (IAS 1:55) and in the statement(s) presenting profit or loss and other comprehensive income (IAS 1:85) when such presentation is relevant to an understanding of the entity's financial position or financial performance.

24 This requirement supports the IASB recommendation presented in paragraph 16 of this Decision Document, but is evenly applicable to other insurers than Mutuals.

25 Furthermore, IFRS 17:117 requires insurers (including Mutuals) to disclose the significant judgements and changes in judgement in applying this standard, including changes in estimates of (expected) future cash flows arising from the exercise of discretion.

26 Based on the above, the EFRAG Secretariat concludes that the conditions to meet the relevance criterion do not fundamentally differ between Mutuals and other insurers.

Reliability

27 Information has the quality of reliability when it is free from material error and bias and can be depended on by users to represent faithfully what is either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.

28 Since the requirements of IFRS 17 are similar for Mutuals and other insurers, the EFRAG Secretariat concludes that the conditions to meet the reliability criterion do not differ between these two groups.

Comparability

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

30 The EFRAG Secretariat notes that, under IFRS 17, the legal form of the insurer is irrelevant and that all entities in the scope of this standard have to measure and report their fulfilment cash flow (expected payments to existing and future policyholders) in a similar way.

31 Because of this requirement, the EFRAG Secretariat concludes that the comparability criterion for endorsement is met: Mutuals have to measure and report their insurance liabilities in the same way as other insurers.

Understandability

32 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business

[7] It should be noted that the scope of Mutuals (and other insurers) having to apply IFRS is currently changing, in particular in Sweden where the national regulator and supervisor announced, in late December 2019, that they will propose changes in the group accounting regulation for unlisted insurance companies, moving away from the current requirement to apply IFRS for consolidated accounts in the insurance sector. This requirement is expected to change into an option. The EFRAG Secretariat has been informed that a main reason for this change related to the absence of equity and total comprehensive income, described in paragraph 17(a) of this paper.

and economic activity and accounting and the willingness to study the information with reasonable diligence.

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

Prudence

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

35 Prudence is different from and unrelated to prudential reporting. The former is a qualitative characteristic used in accounting standard setting and is applicable to the financial statements of all companies. The latter refers to the reporting by individual insurers to regulators to meet the regulator's objectives (such as solvency).

36 The EFRAG Secretariat believes that the prudence criterion is sufficiently covered by the discussion about relevance and reliability.

EFRAG Secretariat recommendation

37 Based on the EFRAG Secretariat analysis stated above, the EFRAG Secretariat recommends no further activities in respect of Mutuals.

Questions for EFRAG TEG

38 Does EFRAG TEG have any comments on this paper and agree with the recommendation of the EFRAG Secretariat?