Mutual entities in the IFRS 17 Draft Endorsement Advice - Issues Paper

Objective

1 The objective of this session is to receive comments on the wording to be included in the DEA on mutual entities based on previous discussions. The proposed wording below will be slotted in where appropriate in Appendix II of the DEA.

Background

2 The European Commission and the European Parliament did not ask any specific comments on mutual entities but asked EFRAG to analyse whether 'the different accounting methods properly reflect the different business models. 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'.

3 The EFRAG Secretariat however considered it important to assess the specific characteristics related to mutual entities in the context of this request.

4 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.

Appendix II - relevance

Mutual entities

Introduction

5 Mutual entities exist in different forms in Europe and not all use IFRSs.[1] There is no definition of a mutual entity in European law.[2] Van Hulle describes them, referring to a definition of the International Association of Insurance Supervisors, as follows:

[1] The scope of mutual entities (and other insurers) having to apply IFRS is currently changing 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. This would no longer require the application of IFRS for consolidated accounts in the insurance sector but become optional. 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 paragraphs 9 to 12 of this paper.

[2] 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.

"Mutual insurance undertakings have the specific characteristics that they are collectively and indivisibly owner by their member-policyholders."[3]

6 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]

7 Therefore, a fundamental difference between mutual entities and other corporate insurers is the absence of shareholders. Mutual entities may also have differences with respect to the contractual relationship between the policyholders/owners and the entity, as well as the role and set-up of collective buffer funds, and bonus allocation.

8 However, the legal form of the entity is not determinative of the types of contracts it issues, and a mutual entity may issue the same contracts as those by corporates[5]. These may include the following insurance contracts:

(a) Participating features meaning that all of the residual interest of the entity is <u>*due*</u> to policyholders (current or future); or

(b) Participating and non-participating features that do not give policyholders any rights to the residual interest.

In the latter case, there are also situations where any residual on liquidation will not accrue to policyholders but other parties, for instance charitable institutions.[6]

Technical endorsement criterion - Relevance[7]

9 A specific concern around relevance of IFRS 17 reporting for mutual entities relates to the fact that some of these entities will have no or less equity compared to the position under either IFRS 4 or Solvency II.

10 Under IFRS 4, contracts with discretionary participating features could give rise to an equity component to reflect the discretionary disbursements under these contracts. Under IFRS 17, the fulfilment cash flows include the expected discretionary payments based on estimates as at inception or period end. If the estimate of discretionary payment is changed, it will adjust the CSM.

11 Where the entity is contractually required to distribute profits to current and/or future policyholders, this forms part of the fulfilment cash flows at inception of the contract. This could mean that for these contracts there would be no CSM or profit for the year as these are all subsumed into the fulfilment cash flows.

12 EFRAG acknowledges that an accounting change that results in little or no equity may cause disruption and uncertainty while the market adjusts to the new requirements. Many co-operatives and similar entities experienced the same on the adoption of IFRS and specifically the requirements under IAS 32 which in many cases resulted in less equity than they were accustomed to previously. In this

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

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

[5] In this instance referring to entities with owners who may or may not also be clients of the entity.

[6] EFRAG notes that the IASB education material and IFRS 17 before any amendments are not helpful in distinguishing and acknowledging these varying structures and contracts but recognises that the proposed amendment to the basis for conclusions would be useful.

[7] 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.

regard, the disclosures in IAS 1 may provide useful information for users and regulators.

13 However, EFRAG notes that the issue of entities not having a residual interest under IFRSs is not new nor due to IFRS 17 specifically. EFRAG considers the requirements in IFRS 17 appropriate in providing relevant information about the best estimate of the amount to be paid under the insurance contract.

IAS 1

14 IAS 1 requires disclosures on objectives, policies and processes to manage its capital. This includes a description of what the entity considers to be its capital, quantitative information about such amounts as well as information about any externally imposed capital requirements. Many entities provide information about its capital under such requirements and how this compares with the equity under IFRS.

15 IAS 1 also requires an entity to present additional line items, headings and subtotals in the statement of financial position (IAS 1 paragraph 55) and in the statement(s) presenting profit or loss and other comprehensive income (IAS 1 paragraph 85) when such presentation is relevant to an understanding of the entity's financial position or financial performance. Furthermore, similar to the requirements in IAS 1, IFRS 17 paragraph 117 specifically requires insurers (including mutual entities) 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.

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

Reliability[8]

17 There are no specific concerns around reliability that is required to be covered by the DEA.

Comparability[9]

18 Under IFRS 17, the legal form of the insurer is not a determinant factor and 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. This means that the criterion with respect to mutual entities is met in general.

19 However, the interaction between the constitution of some of these entities and IFRS 17 may result in there being no CSM or profit recognised on some contracts as discussed in paragraph 11 above. However, EFRAG considers that this reflects the different contractual relationship between the policyholder and the mutual entity when compared to those where the insurer earns a variable fee.

Understandability[10]

20 Some are concerned that the results under IFRS 17 for some mutual entities (refer to paragraph 11 above) would not be understandable to users or regulators. EFRAG

[8] 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.

[9] 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.

[10] The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting and the willingness to study the information with reasonable diligence.

acknowledges that the change will require education and clear communication as well as time to be embedded. However, as discussed in paragraphs 14 to 16, there are several required disclosures that would assist in this regard. Overall, EFRAG considers that the information under IFRS 17 will be understandable.

Prudence[11]

21 There are no specific concerns around prudence that is required to be covered by the DEA.

Questions for EFRAG TEG

22 Does EFRAG TEG have drafting suggestions to be included in the draft endorsement advice?

23 Should a section be included in Appendix III on this topic? Please explain your answer.

[11] 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.

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).