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Insurance team

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DEA IFRS 17 – Appendix 3.1
Issues Paper

Objective

1 The objective of this paper is to provide a draft text proposal of some parts of Appendix III of EFRAG's draft endorsement advice (DEA) of IFRS 17 for discussion.

2 In accordance with the workplan regarding the IFRS 17 DEA, discussion of all the topics to be included in the DEA are being spread over several months. The topics being discussed during this meeting are specified in the table of content below.

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Questions for EFRAG TEG

3 Does EFRAG TEG have comments on the proposed text?

Where to find issues raised by EC and European Parliament?

	EC/EP	Issue raised	Meeting
1	EC/Annex I	What is the problem?	Board Feb 2020
2	EC/Annex I	Objectives of the new standard	Board Feb 2020
3	EC/Annex I	True and fair view analysis	Board Feb 2020 Board March 2020
4	EC/Annex I	Impact analysis of the options	Board Feb 2020
5	EC/Annex I	European public good analysis • Impact and stakeholders affected (includes economic, environmental, social and financial reporting aspects) • Comparison between options in terms of effectiveness and efficiency (benefits and costs) • Financial stability • Impact on competitiveness of insurers	Board Feb 2020 Board Feb 2020 Board Feb 2020 Board Feb 2020
6	EC/Annex II, 1	• Benefits compared to current situation • Does IFRS 17 deliver consistent and understandable reporting • Does IFRS 17 consider specificities of insurance industry • Does accounting reflect business models • Is delineation between different accounting methods clear for investors and analysts • Is level of aggregation striking the right balance between usefulness and cost of implementation • Release pattern of CSM for direct participation features	
7	EC/Annex II, 2	Impact of financial stability	
8	EC/Annex II, 3	Impact on competitiveness	Board Feb 2020
9	EC/Annex II, 4	Impact on the insurance market	
10	EC/Annex II, 5	Cost/benefit analysis	
11	EP/2	SME's working in insurance	Board Jan 2020
12	EP/3	Cost of presentation	
13	EP/5	• Potential effects on financial stability, • Potential effects on competitiveness, • Potential effects on insurance markets, • Potential effects for SMEs, • Cost-benefit analysis • Effect on social guarantees	Board Feb 2020 Board Jan 2020

	EC/EP	Issue raised	Meeting
14	EP/6	• Interaction IFRS 17 and Solvency II, especially in relation to cost of implementation • EBA comments on inconsistent accounting for similar transactions	Board Jan 2020
15	EP/7	• ESMA comments on OCI allocation of discount rates • ESMA comments on discount rate and risk adjustment • EBA comments on top-down or bottom-up approach of discount rates	
16	EP/8	• Consider recommendations of 7 June 2016 and 6 October 2016 on IFRS 9 • Financial stability • Long-term investment • Pro-cyclical effects and volatility	
17	EP/9	Assess interaction IFRS 9 and IFRS 17	
18	EP/10	Assess whether application of IFRS 15 to some contracts is appropriate	Board Jan 2020
19	EP/11	Consider concerns on level of aggregation, including how business is run	
20	EP/12	Consider concerns relating to level of aggregation and effect of disaggregation of portfolio on profitability criteria and annual cohorts	
21	EP/13	Consider implications of transitional requirements	
22	EP/14	Consider benefits to all stakeholders	
23	EP/15	Consider impact on reinsurance	
24	EP/16[1]	Reporting Lab, consider best practices in corporate reporting for climate related financial disclosures	
25	EP/17	Consider implementation timeline	

[1] European Corporate Reporting Lab @EFRAG report published February 2020: for more information see http://www.efrag.org/Lab1?AspxAutoDetectCookieSupport=1

What is the problem, why it is a problem and what should be achieved

4 IFRS 4 *Insurance Contracts* (issued in 2004) was developed by the IASB as a temporary standard. One of the objectives of the IASB Board regarding IFRS 4 was to make limited improvements to accounting practices for insurance contracts, to avoid reversing major changes during the second phase of the project (which is IFRS 17).

5 As a consequence, IFRS 4 allows entities to carry on using local accounting standards when accounting for insurance contracts. This may result in different accounting for similar contracts which may impair comparability. For example, some local requirements do not allow the updating of assumptions in the measurement of insurance liabilities while others do. Furthermore, some current accounting requirements rely on expected asset returns to reflect the measurement of the insurance liabilities even when the assets are not directly linked to these insurance liabilities (mirroring). Paragraphs 7 to 17 provide a summary of some of the current practices under IFRS 4.

6 An overview of the IFRS 4 requirements is provided below.

IFRS 4 requirements

<u>Scope</u>

7 IFRS 4 applies to virtually all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds. It does not apply to other assets and liabilities of an insurer, such as financial assets and financial liabilities within the scope of IAS 39 *Financial Instruments: Recognition and Measurement*. Furthermore, it does not address accounting by policyholders.

<u>Definition of insurance contract</u>

8 An insurance contract is a "*contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder*".

<u>Accounting policies</u>

9 IFRS 4 exempts an insurer temporarily from some requirements of other IFRSs, including the requirement to consider IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in selecting accounting policies for insurance contracts. However, the standard prohibits certain provisions such as catastrophe provisions and requires a liability adequacy test.

<u>Changes in accounting policies</u>

10 IFRS 4 permits an insurer to change its accounting policies for insurance contracts only if, as a result, its financial statements present information that is more relevant and no less reliable, or more reliable and no less relevant. In particular, an insurer cannot start any of the following practices, although it may continue using existing accounting policies that involve them:

(a) measuring insurance liabilities on an undiscounted basis;

(b) measuring future investment management fees at higher than fair value; and

(c) using non-uniform accounting policies for the insurance liabilities of subsidiaries.

<u>Remeasuring insurance liabilities</u>

11 IFRS 4 permits the introduction of an accounting policy that involves remeasuring selected insurance liabilities consistently in each period to reflect current market interest rates (and, if the insurer so elects, other current estimates and

assumptions). Without this permission, an insurer would have been required to apply the change in accounting policies consistently to all similar liabilities.

Prudence

12 An insurer need not change its accounting policies for insurance contracts to eliminate excessive prudence. However, when already measuring its insurance contracts with sufficient prudence, it should not introduce additional prudence.

Future investment margins

13 There is a rebuttable presumption that an insurer's financial statements will become less relevant and reliable if it introduces an accounting policy that reflects future investment margins in the measurement of insurance contracts.

Asset classification under IFRS 9

14 For those insurers that have adopted IFRS 9 already, IFRS 9 allows reclassification of some or all financial assets associated with insurance based on assessment of the current business model or designation by choice on the adoption of IFRS 17.

Liability adequacy test

15 An insurer shall assess at the end of each reporting period whether the recognised insurance liabilities are adequate, using current estimates of future cash flows in its insurance contracts. In case the carrying amount of insurance liabilities is inadequate, the entire deficiency is to be recognised in profit or loss.

Other issues

16 IFRS 4:

(a) clarifies that an insurer need not account for an embedded derivative separately at fair value if the embedded derivative is an insurance contract;

(b) requires an insurer to unbundle (that is, to account separately for) deposit components[2] of some insurance contracts, to avoid the omission of assets and liabilities from its balance sheet;

(c) clarifies '*shadow accounting*' (i.e. use of an accounting policy so that an unrealised gain or loss on an asset affects the measurement of some insurance liabilities similar to a realised gain or loss);

(d) permits an expanded presentation for insurance contracts acquired in a business combination or portfolio transfer; and

(e) addresses limited aspects of discretionary participation features contained in insurance contracts or financial instruments.

Disclosures

17 IFRS 4 requires disclosure of:

(a) information that helps users understand the amounts in the insurer's financial statements that arise from insurance contracts; and

(b) information that helps users to evaluate the nature and extent of risks arising from insurance contracts.

Current practices

18 With the aim of documenting current practices amongst European insurers, EFRAG organised a questionnaire in May 2017. Respondents were requested to provide

[2] Deposit component in accordance with IFRS 4: a contractual component that is not accounted for as a derivative under IFRS 9 and would be within the scope of IFRS 9 if it were a separate instrument.

information on the European GAAPs that they used and whether or not they used US GAAP. Fifteen respondents participated in this questionnaire.

19 Most respondents to the questionnaire indicated using a range (two or more) of GAAPs in their consolidated financial statements. Insurers also indicated to use other GAAPS besides European GAAPs such as Swiss, Asian (including Japanese and Hong-Kong GAAP) as well as Russian GAAP.

20 For most GAAPs, respondents noted that they use the latest version of the GAAPs, except for US and UK GAAP. Some respondents using US GAAP used a version that was frozen in time on 1 January 2005 (at the moment of the first-time application of IFRS 4), i.e. "Frozen US GAAP". Some respondents applied UK GAAP similarly. In addition, respondents reported a number of changes to the local GAAPs resulting in different versions of the same local GAAP being reported.

21 The above is indicative of the diverse accounting practices for consolidated financial statements that exist today in Europe. This is because upon consolidation most insurers will combine the varying requirements of different GAAPs together (even including some non-European GAAPs).

Current requirements as per European National Standard Setters

22 EFRAG consulted both European National Standard Setters and preparers about current requirements in local GAAP as well as current non-codified practices. These can be found in Annex 1. As can be noted from there, the various differences among the national EU GAAPs as follows:

(a) **Level of aggregation**: Different units of account are used for measuring insurance liabilities. For example, measurement of the provision for life business is policy by policy in Spain while in UK, generalisations and approximations (which indicates a level higher than individual contract level) are permitted. In addition, different units of account are used for different purposes, in France additional reserves are calculated (for example for options and guarantees), while in Italy these are included in the overall measurement of the insurance liability.

(b) **When to recognise onerous contracts**: Some local GAAP do not refer to onerous contracts but rather require additional provisions. Local GAAP may require additional provisions to cover expected losses.

(c) **Presentation of components of revenue**: One of the main elements presented is premiums. However, differences exist in the way the premiums are presented, e.g. written premiums, gross written premiums, premiums recognised when due, etc.

(d) **Assumptions**: Some local GAAP requires the updating of assumptions for changes in circumstances whereas others allow the use of assumptions in place at inception of the contract.

(e) **Contract boundary**: In some cases, this is not explicitly defined while in others, the contract boundary reflects rights and obligations.

(f) **Discount rates:** In some jurisdictions, e.g. Italy, insurance accounting is more cost-based, therefore using locked-in assumptions while in others e.g. UK, it is more current-based, therefore using current discount rates. There could also be a mix of technical provisions being discounted and not being discounted, e.g. in France.

(g) **Treatment of options and guarantees**: The treatment of options and guarantees are taken into account by some national GAAPs while in others, there is no explicit treatment for these. Also, there are different accounting treatments, for e.g., in UK, a market value where possible is used while in Italy, a prudent prospective method is used. Finally, differences exist in how

the time value relating to the occurrence of options and guarantees is being considered.

Who is affected by the new standard and how

23 The IASB decided, similar to IFRS 4, that IFRS 17 should apply only to insurance contracts (and not insurance *entities*) and investment contracts with discretionary participation features. Insurance contracts include (i) insurance or reinsurance contracts that an entity issues; and (ii) reinsurance contracts that an entity holds.

24 The definition of an insurance contract under IFRS 17 determines which contracts are in the scope and as a result, entities with these insurance contracts have to apply the IFRS 17 requirements regardless of whether they are regulated as insurance entities or not. EFRAG notes that the definition of an insurance contract in IFRS 17 is the same as the definition in IFRS 4, with some clarifications.

25 In addition, users of financial statements, for e.g., analysts and investors, would need to be educated in order to understand the financial statements of entities applying IFRS 17.

26 In accordance with the EU IAS Regulation, IFRS are applicable to consolidated accounts of publicly listed entities only, or have been extended in some Member States to:

(a) the parent-entity individual statutory accounts of publicly listed entities alone; or

(b) the statutory accounts of all insurance entities in a Member State.

27 Subject to one of these choices, IFRS 17 may affect only listed entities (mainly insurers and reinsurers) but also local unlisted entities (mainly insurers and reinsurers).

Why should the EU act?

28 IFRS 4 was introduced in 2005 as a temporary standard and largely continues pre-existing accounting practices. Since then, the world has changed. The long period of low interest rates that is affecting insurers did start before 2005 but aggravated seriously after that date. National GAAPs may have evolved between 2005 and today to better reflect low interest yields. EFRAG has not documented these changes to local GAAP.

29 With investment returns declining and mature European insurance markets, insurers are looking at alternatives to increase revenue. This is done by looking at investments with higher yields, expanding the business into additional non-insurance services and providing more investment type of contracts such as unit-linked.

30 In short, since 2005 the insurance environment has undergone significant changes and accounting judged appropriate then, may not be appropriate anymore. The changed environment and the evolution in risks for investors in the insurance industry require new approaches that provide users of financial statements with updated information that may allow them to differentiate between the different revenue streams insurers are generating.

31 EFRAG expects that the improved financial information introduced by IFRS 17 will provide more insight into the risks associated with issuing insurance contracts and the financial performance of insurance companies. Also, EFRAG expects that the increased transparency about risks and profitability arising from insurance contracts introduced by IFRS 17 will make insurers' financial position and performance significantly easier to understand. This should make the insurance industry more attractive to non-specialised investors. Finally, EFRAG expects that transparent

information about risks faced by each insurance company will facilitate a more efficient allocation of capital. This is very important given the systemic importance of the insurance industry.

What should be achieved?

32 The ultimate objective of the endorsement process for any accounting standard is to improve the usefulness of financial information for users of financial statements at a reasonable cost to preparers. The endorsement should contribute to the European public good and not endanger financial stability.

What are the various options to achieve the objectives?

33 The options available to achieve the above objectives are the following:

(a) Do nothing, i.e. not endorse IFRS 17; and

(b) Endorse IFRS 17 as is.

Not endorsing IFRS 17

34 In case IFRS 17 is deemed not to improve the usefulness of financial information at a reasonable cost or would not contribute to the European public good or endanger financial stability, an alternative could be not to endorse IFRS 17. The current situation would then continue.

Endorsing IFRS 17

35 If IFRS 17 is deemed to achieve or largely achieve the objective of improving the usefulness of financial information at a reasonable cost, contributes to the European public good and does not endanger financial stability, an alternative is to endorse IFRS 17.

Is IFRS 17 an improvement compared to IFRS 4?

36 EFRAG has focused its assessment of whether the financial reporting required by IFRS 17 is an improvement over that required by IFRS 4 *Insurance Contracts* on the areas of changes it considers most significant.

What are the objectives of IFRS 17?

37 The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents insurance contracts. This information gives a basis for users of financial statements to assess the effect that insurance contracts have on the entity's financial position, financial performance and cash flows.

38 The detailed comparison between IFRS 4 and IFRS 17 is discussed in the chapters "*Weaknesses and Strengths of IFRS 4*" (paragraphs 40 to 54) and "*IFRS 4 and IFRS 17 compared in terms of effectiveness and efficiency*" (paragraphs 101 to 116).

39 Therefore, EFRAG considers that IFRS 17 will make:

(a) insurers' financial reports more useful and transparent; and

(b) insurance accounting practices consistent across jurisdictions.

Weaknesses and Strengths of IFRS 4

40 In explaining the weaknesses and strengths of IFRS 4, the following paragraphs focus on the application of IFRS 4 rather than the technical requirements.

Strengths of IFRS 4

41 *Flexibility:* IFRS 4 was written as a provisional standard, which explains the many options the standard offers as well as the continuance of existing accounting policies

even when non-uniform in a group context[3]. This also included non-elimination of intra-group balances. The standard allows insurers to tell the individual story of their company.

42 *Non-costly*: Due to its transitional nature, the IASB avoided that insurers had to change their existing IT-systems in order to comply with IFRS 4 (avoiding that insurers had to change their systems twice). Current systems could largely be re-used which benefitted the cost-benefit analysis.

43 *Allows considerations of specificities of insurance in each country*: Because the standard offers so much flexibility, it is easily malleable to address very different situations in different countries. This also created familiarity for users in their geographical areas for life products while there was broad consistency globally in dealing with general insurance.

44 *Simplicity*: As IFRS 4 does not provide any guidance on how to measure insurance contracts, insurers are not bound to a specific set of measurement guidance which could in some instances be overly complex and difficult to implement because of a lack of guidance.

Weaknesses of IFRS 4

45 The need for comparable financial statements for users' purposes is often cited as the most prominent reason for replacing IFRS 4 with IFRS 17. While this reason points to the heart of the problem with current financial statements of insurers, it encompasses a wider set of areas to be addressed. This is also important for non-executive directors who bring experience from outside the industry but are confronted with differences in financial statements of insurers making it more difficult to assess the performance of the company they adhered to.

46 *Leads to non-comparable accounting*: The downside of the flexibility of the standard is that it leads to accounting that is not uniform or comparable even within one insurer, as upon consolidation many insurers will combine the varying requirements of different GAAPs together.

47 Also, the liability adequacy test is a minimum requirement for which IFRS 4 provides two options and in addition it is not applied in a uniform way.

48 *Inconsistent framework*: Apart from comparability, IFRS 4 was an interim standard and did not include principles for measuring insurance contracts, making the standard incomplete. IFRS 4 does not define a measurement model for insurance contracts nor has a comprehensive approach how to recognise and present insurance contracts in either the statement of financial performance or the statement of comprehensive income.

49 *Provide insufficiently useful information to users*: Users need comparable information in order to assess the financial strengths and management stewardship of different insurers. The lack of comparability of the information hampers users in playing their assessment role and leads to inefficiency in the allocation of capital across the insurance industry.

How IFRS 17 responds to the problems identified

50 The objective of IFRS 17 is to ensure that an entity provides relevant information that faithfully represents insurance contracts. This information gives a basis for users of financial statements to assess the effect that insurance contracts have on the entity's financial position, financial performance and cash flows.

[3] In France, restatements upon consolidation are required when they are significant and can be done without undue cost.

Addressing comparability

51 IFRS 17 provides consistent principles for all aspects required to account for insurance contracts while providing separate models to cater to differing economic consequences of differing insurance products. This contrasts sharply with current practice where insurers may use several different principles to report their insurance contracts in their consolidated accounts, such as around the use of discount rates as well as the methodologies for profit recognition (see below). Doing so impairs comparability. This lack of comparability is even more obvious when looking at different insurers together.

52 The lack of comparability in current financial statements is evidenced by the measurement of insurance liabilities. Some insurers use historical discount rates, while others use current discount rates or do not apply discounting at all. In some cases, premiums accrued are recognised as revenue, in other cases deposit components are deducted from these premiums. Furthermore, profit recognition may take place upfront, over time or only at the end of the contract depending on the type of contract and/or the geography where it was issued.

53 As part of EFRAG's user outreach users indicated that the aggregation of data prepared under various financial reporting frameworks for consolidation purposes (rather than aligning accounting policies as in other industries) makes the data provided meaningless. Therefore, users rely on other measures to compare insurers.

54 In accordance with IFRS 17, a multinational insurer will have to apply consistent accounting policies across the group to its insurance liabilities. As a result, the insurance liabilities will be consolidated consistently. This is not undermined by the differing accounting models in IFRS 17 included to cater for different products types where required. For example, the methodology around interest rates and profit recognition remains comparable even though both may require significant judgement in practice.

55 Based on EFRAG's user outreach:

(a) Specialist and generalist users indicated that the requirements of IFRS 4 limits comparability between insurance entities. As a result, users need to rely on alternative measures and/or make analytical adjustments to the figures reported in the financial statements.

(b) Most specialist and generalist users expected an improvement in comparability among insurance entities under IFRS 17 for various reasons. Users appreciated that there would be only one framework applicable across countries and that they would benefit from the enhanced disclosures. A few users that expected an improvement in comparability also thought IFRS 17 did not go far enough in building a uniform reporting framework.

(c) A minority of users were not convinced that IFRS 17 would improve comparability. Those that raised comparability concerns provided examples such as the need to apply judgement, the standard being principle-based for some aspects and the availability of options.

56 In addition, in "*EIOPA's analysis of IFRS 17 Insurance Contracts*"[4], the introduction of IFRS 17 is described as a paradigm-shift to bring comparability to insurers' financial statements and to allow for consistent accounting practices beyond different jurisdictions, compared to its predecessor IFRS 4.

57 However, some stakeholders believe that IFRS 17 will still necessitate the use of non-GAAP measures to help investors in their assessments.

[4] EIOPA's analysis of IFRS 17 Insurance Contracts

Providing a complete accounting framework for insurance liabilities

58 IFRS 17 requires an insurer to measure insurance liabilities relying on current estimates and updated assumptions. This is a significant change from practices under IFRS 4 where some insurers measure their insurance contracts relying on outdated assumptions and not considering time value of money (discounting). Why is this important? Insurance contracts are mostly long-term contracts and economic assumptions made at the time of issuing the insurance contract may change over the course of a couple of years to an important extent. Not reflecting these changes in economic assumptions in the expected cash flows does not bring useful information to the readers of financial statements. The same is valid for the use of discounting. As expected claims and premiums can be spread over many years, the value of these expected cash flows today is not the same as at the date of issuance of the contract or the date of future settlement.

59 It may be argued that an independent measurement of the insurance liabilities could result in volatility. However, based on the results of the EFRAG user outreach, most users did not see volatility as a problem where it reflects real economic substance and the underlying causes are communicated clearly. Volatility is not useful when it is due to accounting mismatches.

60 The results from the EFRAG user outreach show that users place great importance on the ability to compare financial statements across countries. Some of the users even thought that IFRS 17 did not go far enough in building a uniform reporting framework.

61 IFRS 17 requires an insurer to recognise profits as it delivers insurance services, rather than when it receives premiums, as well as to provide quantitative information about when the remaining CSM is expected to be recognised in the future. This is very different from the many ways in which insurers provide information about the sources of profit today. The same divergence is witnessed when insurers report non-GAAP measures such as embedded value information. An explanation of when the entity expects to recognise the remaining CSM at the reporting date in profit or loss – this disclosure may be made quantitatively or qualitatively.

62 In the EFRAG user outreach users welcome the requirement to split the presentation between underwriting and investing activities in the statement of comprehensive income. Users also indicated the importance and usefulness of the required disclosures under IFRS 17.

63 Users in EFRAG's user outreach indicated financial statements as one of many sources of information they rely upon. In addition, they stressed the need to make changes to the financial information that is available. Furthermore, the economic study commissioned by EFRAG noted that there was general agreement among stakeholders interviewed about the difficulties that analysts currently face when evaluating the financial report of insurance entities (a top-tier level of difficulty).

64 Users from EFRAG's user outreach indicated the following hurdles regarding current financial reporting, i.e. IFRS 4:

(a) The existence of inconsistent accounting policies and profit recognition patterns;

(b) Limited comparability between insurance entities;

(c) The use of inconsistent consolidation policies;

(d) The wide range of (including the lack of using) discount rates for insurance liability measurement;

(e) The capital allocation within an insurer group cannot be understood as it is determined on profit recognition policies and liability measurement that vary across geographies; and

(f) Relating the accounting to the economics of the insurance industry is difficult.

Reflecting the economics of the insurance business

65 IFRS 17 contains a number of improvements to reflect the economics of the insurance business. Firstly, the assumptions and interest rates relating to the technical provisions is updated at each reporting period similar to other standards such as IAS 37.

66 Furthermore, the recognition of insurance revenue over the period that services are provided is an improvement to the current situation.

67 IFRS 17 requires an entity to report as insurance revenue the amount charged for insurance coverage when it is earned, rather than when the entity receives premiums. In addition, IFRS 17 requires that insurance revenue excludes the deposits that represent the investment of the policyholder and not an amount charged for insurance coverage. As a result, the requirements in IFRS 17 for the recognition of revenue are consistent not only with the recognition of revenue for most contracts with customers in other industries but also consistent among insurance entities.

68 In addition, IFRS 17 distinguishes between underwriting and investment results.

69 The disclosures that accompany IFRS 17 require insurers to provide various information about the insurance revenue and the insurance finance income or expenses in the reporting period.

70 In particular, insurers will have to explain the relationship between insurance finance income or expenses and the investment return on their assets to enable users to evaluate the sources of finance income or expenses recognised in profit or loss.

71 A last example of how IFRS 17 improves accounting is the accounting policy option to account for finance income or expenses in profit or loss or either in profit or loss or other comprehensive income allows insurers to reflect their insurance business model with their business models for invested assets.

Addressing the proper measurement of insurance liabilities

72 IFRS 17 notes that an insurance contract typically combines features of a financial instrument and a service contract in such a way that those components are interrelated. In addition, many insurance contracts generate cash flows with substantial variability over a long period. In order to provide useful information about these features, IFRS 17 represents an approach that:

(a) Combines current measurement of the future cash flows with the recognition of profit over the period that services are provided under the contract;

(b) Presents insurance service results (including presentation of insurance revenue) separately from insurance finance income or expenses; and

(c) Requires an entity to make an accounting policy choice at a portfolio level of whether to recognise all insurance finance income or expenses in profit or loss or to recognise some of that income or expenses in other comprehensive income.

73 As a result, IFRS 17 measures insurance contracts in a way that reflects the fact that entities generally fulfil insurance contracts over time by providing services to policyholders.

Addressing the need for useful information to users

74 During the 2018 EFRAG User outreach, users welcomed the following benefits of IFRS 17:

Specialist Users

75 Users made the following comments:

(a) Almost all users noted that profit earned based on services provided and the split between underwriting and investing result was useful information to them.

(b) Some users stressed the importance of the disclosures, e.g., disclosing the assumptions used in measuring insurance liabilities.

(c) One user noted that discount rates should reflect what is happening in the real world, and that Solvency II was not helpful in this regard. This because the discount rate determined by Solvency II differs from the one that can be derived from the assets that cover the liabilities considering any differences in expected duration.

(d) One user saw a potential for significant improvements in corporate governance which will lead to benefit for regulators through better understanding of pricing policies, onerous contracts and risks.

Generalist users

76 Users made the following comments:

(a) IFRS 17 will “fair value” insurance liabilities, which will reduce the “mismatch” between marked-to-market assets and liabilities. In this respect, IFRS 17 will move closer to the Solvency II approach, which is positive for the assessment from credit investors;

(b) There is an expectation that IFRS 17 may reduce the need to rely on non-GAAP measures;

(c) The identification of onerous contracts is not only useful information, it is also important in bringing discipline to the management of insurance companies to recognise past errors; and

(d) The split between underwriting and investing results is seen as very useful. In one user’s view, some insurers compensate poor underwriting with successful investing activities, thus overstating the success of their core business.

Weaknesses of IFRS 17

77 IFRS 17 does not resolve all issues. The following areas are considered as weaknesses of IFRS 17:

(a) Reinsurance contracts held and issue cannot apply the VFA for purposes of IFRS 17 irrespective of they meet the criteria of contracts with direct participating features or not; and

(b) Risk mitigation solution for VFA cannot be applied retrospectively at transition.

78 These issues are explained further in other parts of this endorsement advice. Please refer to Appendix 2 paragraphs xx as well as paragraphs xxx to xx of this appendix on the interaction between IFRS 17 and IFRS 9.

What are economic, social and environmental impacts

Economic impacts

Cost of capital

79 [To be updated with the new text of the economic study]

80 The education of external investors and analysts is a major concern for industry stakeholders interviewed (both life and non-life). The challenge will be to explain the balance sheets and underlying financial assumptions to the external investors in the transition time.

81 IFRS 17 could, at least temporarily, increase the cost of capital for European insurers while investors familiarise themselves with the new standard (FITCH, 2017).

82 In terms of rating, two major rating agencies (FITCH and S&P) commented that IFRS 17 is unlikely to directly affect insurers' ratings because the economic substance of their balance sheets will not change.

83 Users thought the following (source: EFRAG user outreach on IFRS 17):

(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 entities. With the benefit of more detailed information about the insurance business, the cost of capital for some insurance entities 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.

Pricing of insurance products and insurance product mix

84 [To be updated with new text of the economic study]

85 From EFRAG's extensive case study, a majority of respondents indicated that IFRS 17 is not expected to affect their current pricing methodology. Most respondents from EFRAG's extensive case study expected no impact on pricing from the use of cohorts or groups under IFRS 17. Few respondents clarified that the use of cohorts or groups would affect pricing and this was because of the attention of investors to the disclosures or the use of mutualisation.

86 From the responses to EFRAG's simplified case study, most of the respondents either did not expect that IFRS 17 will change their current pricing methodology or did not know. A few respondents expected a change in their current pricing methodology. These respondents indicated that IFRS 17 is expected to influence the decision on introduction of new products, with the focus on profitability and type of product, guarantees and options, duration of policies, etc. Similar to the response from the extensive case study, these respondents indicated that avoiding losses may be an additional factor in the pricing of insurance contracts.

87 In addition, the economic study commissioned by EFRAG stated that following the adoption of IFRS 17, products with high volatility exposure (such as participating contracts) may be redesigned, replaced or offered at a higher premium.

88 Respondents from EFRAG's extensive case study were split regarding the impact of products due to IFRS 17, with half expecting there would be an impact on their range of products offered to policyholders and the other half expecting there would be no or not a significant impact.

89 Of those respondents from EFRAG's extensive case study that expected an impact, the reasons included:

(a) Potential excessive granularity in the level of aggregation for the valuation may lead to a reconsideration of the strategic positioning in some lines of business, e.g., increase in prices or dropping out from certain lines of business, which show a considerable volatility in results over time;

(b) Impact mainly on long-term products offered and in the role of insurers as institutional long-term investors due to volatility and complexity under IFRS 17; and

(c) For life business, current measurement of insurance liabilities will make the cost of long-term guarantees transparent and this will require more discipline in product design and pricing and may drive management action on onerous legacy books.

90 Respondents from EFRAG's simplified case study were split as to whether IFRS 17 would affect product types being offered with slightly more respondents expecting this would not be the case. Respondents that expected a change noted, amongst others, there could be changes to the product design including changes to contractual conditions. Also, some types of contracts may be reduced or no longer be sold, e.g., products with discretionary participation features for savings and annuities and insurance cover to less favourable risk profiles.

91 Those respondents from EFRAG's simplified case study who stated that their product types are expected to change due to IFRS 17 provided reasons that include:

(a) the level of aggregation and identification of onerous contracts;

(b) product features would have to consider the contractual service margin and risk adjustment figures; and

(c) the significant operational impact and costs of IFRS 17.

92 Furthermore, some supervisory authorities that provided input to the economic study commissioned by EFRAG commented that most likely, new products with mixed features (e.g. insurance or service features) may be introduced and there may be more transparency in the way tariffs are calculated. This greater transparency may eliminate a number of redundancies in terms of reporting and costs associated with it (that could also lead to the shut-down of legacy systems) and probably lead to a more efficient way to run the business which eventually will absorb the short-term costs.

93 The above feedback indicates that entities may re-consider both their pricing methodologies and product offerings due to entities applying IFRS 17, the latter to a greater extent compared to the former. However, EFRAG does not have any quantification of the extent of changes to pricing or product design that would result.

Asset allocation

94 The economic study commissioned by EFRAG noted that a majority of stakeholders interviewed (i.e. supervisory authorities, insurers and external investors) agree on the fact that IFRS 17 alone will not impact the asset allocation of insurance undertakings, as this activity is more driven by risk management and/or asset/liability management. However, the majority of industry stakeholders interviewed expressed the view that the effect of applying IFRS 17 in conjunction with IFRS 9 may have an impact on asset allocation, with IFRS 17 making changes to the valuation of liabilities of insurers and IFRS 9 making changes to the valuation and income recognition of assets (Deloitte, 2017).

95 Insurance entities typically seek to match the characteristics of their assets with their liabilities to minimise economic mismatches between the two (IASB, 2017). Economic matching depends on several factors, such as: the availability of assets of sufficient duration, the uncertainty as to when pay-outs on insurance contracts will be required, and the company's desire to generate higher returns (IASB, 2017). If an insurer's liabilities and assets are economically matched the accounting shows less mismatches, whereas if they are not matched the economic mismatch will be apparent as a result of the changes introduced by IFRS 17 and IFRS 9 (IASB, 2017).

96 Indeed, the measurement of financial assets and insurance contract liabilities may change in applying the current value principles. When applying IFRS 9, the classification of financial assets will be driven by their cash flow characteristics and by the business models in which the assets are held (IASB, 2017) and consequently, some entities may decide to reassess how they carry out their asset and liability management. For example, financial assets can be held within a business model with the objective to both collecting contractual cash flows and selling financial assets or within a business model with the sole objective of holding financial assets in order to collect contractual cash flows.

97 Other stakeholders interviewed for this study (supervisory authorities and some non-life insurance undertakings), instead, indicated that risks related to asset-liability management are related to the extent to which asset and liability values respond differently to changes in economic conditions. The accounting will not have any impact, or it will not be significant enough to change the asset allocation. Some industry players commented that previous experiences in IFRS did not result in such impacts. Surplus assets will continue to be invested in a way to generate an acceptable return in light of other restrictions on capital and liquidity. Capital requirements, risk and liquidity are likely to continue to be the most important drivers.

Social and environmental impact

Social guarantees

98 [To be completed]

Environmental impact

99 EFRAG has not identified any environmental impacts from applying IFRS 17.

Financial reporting impact

100 With regard to the financial reporting impact, reference is made to the true and fair view analysis (Appendix II).

IFRS 4 and IFRS 17 compared in terms of effectiveness and efficiency

IFRS 4

101 For more information about the strengths and weaknesses of IFRS 4 accounting, please refer to paragraphs 40 to 49 above.

102 In assessing the effectiveness and efficiency of current accounting requirements, EFRAG bases itself on the results of its User Outreach. Users that participated in the EFRAG User Outreach noted the following about the current accounting under IFRS 4.

EFRAG's User Outreach

Specialist users

103 Fourteen specialist users indicated that current accounting under IFRS 4 does not allow for the comparison of financial information. These users also made the following comments:

(a) Six users noted that as a result of the comparability issue they make use of alternative measures;

(b) Four users stated that they make adjustments to the information reported in order to make it comparable between entities;

(c) Two of the users indicated that they were not in favour of shadow accounting under IFRS 4;

(d) One user stated that there was too much financial noise and moving parts, e.g. liabilities on statutory basis vs market values vs Solvency II vs US GAAP vs embedded value; and

(e) Another user indicated that: (i) inconsistent accounting policies and profit recognition patterns make comparative use of information overly complex and give rise to difficulty in assessing the dividend capacity; (ii) the wide use of discount rates for liability measurement leads to complications in assessing risk in models; (iii) permitted inconsistent consolidation policies are misleading (iv) capital allocations are based on policies relating to profit recognition and liability measurement that are differently applied and are not consistent across geographies; (v) it is difficult to make sense of some accounting policies used in light of the fundamental economics of industry.

104 In contrast to the above, one specialist user indicated that they use operating profit as defined and look at profit sources to exclude volatility in order to look at underlying earnings potential. This user was also in favour of using cash rather than accrual accounting.

Generalist users

105 Four generalist users indicated that the current application of IFRS 4 makes it very difficult to compare insurance entities. One user specifically indicated that the mere aggregation of data prepared under various financial reporting frameworks for consolidation purposes makes the data provided meaningless. Therefore, they are unable to analyse and compare the results from one company to another. In the absence of comparable financial reporting, these users indicated that they rely on other measures to make a comparison.

106 In contrast, one generalist user indicated that the flexibility of IFRS 4 did not have a significant impact on the life insurance market and on financial statement presentation. This user believed that the accounting principles used by insurance entities are uniform for the sector.

Economic study findings

107 The economic study commissioned by EFRAG noted that in Germany, France, and the UK, the global financial crisis increased the cost of capital in the insurance sector more than in any other of the comparator industries. The difference was particularly sizeable in the several months following the collapse of Lehman Brothers in September 2008, when the effect can be observed even in Italy.

108 Moreover, in Germany, France, and the UK, the comparatively higher capital costs in many cases did not fully reverse. The difference between the cost of capital faced by insurance entities and the other sectors was in 2017 still greater than the difference in 2005.

109 Based on the above findings, as well as the strengths and weaknesses of IFRS 4, EFRAG notes that, while providing flexibility and being non-costly to preparers, the IFRS 4 requirements are not entirely successful in providing useful information to users. This may contribute to the cost of capital currently borne by the insurance industry still being high. As a result, EFRAG is of the view that the effectiveness and efficiency of current IFRS 4 requirements is suboptimal.

IFRS 17

110 Apart from the benefits of IFRS 17 as highlighted in the chapter [relating to cost and benefits of IFRS 17] the main uncertainty about effectiveness with regards to the costs were:

(a) Operational complexity; and

(b) Volatility

Operational complexity

111 A number of concerns have been highlighted to EFRAG with regards to the operational complexity of IFRS 17. These concerns were raised with regards to:

(a) Business combinations;

(b) Level of aggregation;

(c) Presentational issues

(d) Transition;

(e) Use of the locked-in discount rate;

(f) Risk mitigation;

(g) Disclosures.

Business combinations

112 The concerns raised were that there are several elements in accounting for insurance business combinations that add significantly to complexity, including:

(a) *The requirement to assess classification at the acquisition date instead of the original inception date*. A qualitative concern was raised by a respondent to EFRAG's simplified case study. This respondent indicated that IFRS 17 has amended IFRS 3 paragraph 17 to remove an important exception that currently exists where insurance contracts are currently classified based on the factors at the inception date rather than acquisition date. The removal of this exception could result in a different contract classification (e.g. investment rather than insurance) between Group and the individual insurers financial statements (solo entity), where factors have changed since inception. In addition, due to the different dates of initial recognition between the Group and the respective individual insurer, this will result in a different CSM between these two.

This topic was not changed at the occasion of amending IFRS 17.

(b) *The treatment of claims in payment at the acquisition date in a business combination.* A respondent to EFRAG's simplified case study noted that the requirement reduced comparability and understandability given the differences in accounting by the group versus that of the acquiree.

When applying IFRS 17 for the first time, the Amendments to IFRS 17 allow to classify as a liability for incurred claims a liability for settlement of claims incurred for insurance contracts acquired in a business combination during in settlement.

113 Respondents noted that these concerns 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 (including the CSM engine not necessary for PAA regime) only if a future acquisition takes place.

Level of aggregation

114 [To be updated]

Presentational issues

115 Concerns have been raised that some requirements under IFRS 17, that impact only presentation would require major system changes compared to the current approach. 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.

Insurers have also considered the implications for implementation and maintenance of systems for these requirements and found that the complexity and costs will very significant. The concerns raised were the following:

(a) *Separate presentation of assets and liabilities* - 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 IASB decided to change IFRS 17 so that the presentation of insurance contracts can be done based upon portfolios of insurance contracts instead using groups of insurance contracts.

(b) *Separate presentation of receivables and payables* - 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.

This topic was not changed at the occasion of amending IFRS 17.

(c) *Separation of the non-distinct investment component of revenue* - The standard requires, for presentation of revenue only, segregation of non-distinct investment components, even for contracts that do not have a specified account balance or component.

This topic was not changed at the occasion of amending IFRS 17.

(d) *Insurance funds withheld* - In several reinsurance contracts, the cedant 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.

This topic was not changed at the occasion of amending IFRS 17.

(e) *OCI-option for insurance finance income or expenses* – IFRS 17 permits an entity to choose to present insurance finance income or expenses either in profit or loss or disaggregated between profit or loss and OCI. This choice is made on a portfolio-by-portfolio basis.

The IASB redeliberated this option and decided not to change it as users of financial statements may find that, for some contracts, the presentation of insurance finance income or expenses based on a systematic allocation in profit or loss would be more useful than the presentation of total insurance finance income or expenses in profit or loss.

Volatility

116 Based on the results of the EFRAG user outreach, most users did not see volatility as a problem to the extent it reflects real economic substance and the underlying causes are communicated clearly. In case volatility would be caused by accounting mismatches, users would not support it.

Transition

117 Transition is discussed in paragraphs 140 to 145. Insurers have noted that the application of the full retrospective method is very difficult to apply because in many cases data are lacking to fulfil the requirements. The same is valid for the modified retrospective method, which is a method that is seen as insufficiently flexible to deal with the lack in data. Also the use of the fair value approach is seen as complex to apply as there are no sufficient comparable market data available to determine the fair value at transition.

Use of the locked-in discount rate;

118 The use of locked-in discount rates is discussed in paragraphs [reference to February part of Appendix 3]. The complexity of applying locked-in discount rates relates to the storage of these rates for continuous use during the life of the insurance liabilities.

Risk mitigation

119 In absence of a risk mitigation solution for contracts other than the variable fee approach, insurers are obliged to rely on hedge accounting which is very complex in its application.

Disclosures

120 Stakeholders are also concerned about the complexity of preparing and understanding the prescribed disclosures. Furthermore, IFRS 17 requires that entities shall disclose the confidence level to determine the risk adjustment for non-financial risk. Insurers have noted that it may be difficult to assess whether setting a confidence level at a particular percentile was appropriate, especially if the risk adjustment has undergone changes in the past.

Potential industry impacts

121 In order to assess potential industry impacts, EFRAG has considered input from the user outreach conducted by EFRAG, the economic study commissioned by EFRAG, EFRAG's extensive case study results and EFRAG's simplified case study results.

122 Topics covered under this section are the following:

(a) Potential impact on products and pricing;

(b) Potential impact on competitiveness;

(c) Potential impact for users of financial statements;

(d) Potential impact for policyholders;

(e) Level of aggregation;

(f) Transition;

(g) Reinsurance contracts held;

(h) Scope of variable fee approach.

Potential impact on products and pricing

123 The potential impacts on products and pricing are discussed below the heading economic impacts in paragraphs **Error! Reference source not found.** to 93.

Potential impact on competitiveness

124 Although stakeholders disagree on the potential effect of IFRS 17 in terms of comparability, there is no evidence that the adoption of IFRS 17 will make comparability against US or Japanese peers worse compared to the existing Standard (IFRS 4). This is discussed in detail in paragraphs 201 to 236 .

125 Finally, the information provided by the insurance undertakings to EFRAG suggests that the on-going costs are unlikely to have a very marked impact on expenses, in contrast to the one-off costs which may have a more substantial impact on the total expenses of insurance undertakings subject to IFRS 17 in the period or periods in which such costs are incurred.

Potential impact for users of financial statements

126 EFRAG's user outreach and the economic study commissioned by EFRAG were used as the basis to assess the potential impact of the IFRS 17 requirements for users. The following paragraphs reflect these views.

Comparability

127 Most specialist and generalist users from EFRAG's user outreach are expecting an improvement in comparability between insurance entities for various reasons. Users appreciated that there would be only one framework applicable across countries and that they would benefit from the enhanced disclosures. A few users that expected an improvement in comparability also thought IFRS 17 did not go far enough in building a uniform reporting framework.

128 A minority of users from EFRAG's user outreach were not convinced that IFRS 17 would improve comparability. Those that raised comparability concerns provided examples of the source of their concerns, especially lack of comparability such as the need to apply judgement, the standard being principle-based for some aspects and the availability of options.

Presentation and disclosure

129 Specialist users from EFRAG's user outreach found the requirement to split the presentation between underwriting and investing activities, in the statement of comprehensive income, would provide useful information.

130 Also, both specialist and generalist users from EFRAG's user outreach indicated the importance and usefulness of disclosures under IFRS 17.

Volatility

131 Most of the specialist and generalist users from EFRAG's user outreach did not see volatility as a problem as long as it reflects real economic substance and the underlying causes were communicated clearly. One user stated that volatility is seen by users as an opportunity to learn more about the capabilities of the management in steering their company. Also, specialist users indicated that they can adjust their figures for volatility.

Transition

132 Many specialist and generalist users from EFRAG's user outreach were uncomfortable with the range of transition approaches offered by IFRS 17 and that it would cause comparability concerns. It is feared that these will create confusion. Further, specialist users note the possibility of window dressing, e.g. double counting of profits, at transition. It should be noted that change in accounting policies lead to re-recognition of profits previously recognised or the non-recognition of profits.

Expected impact on cost of capital/investability of insurance sector

133 Based on the EFRAG's user outreach, a majority of the specialist and generalist users expected the cost of capital to decrease or not to change while a minority expected 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.

134 Also, from the EFRAG user outreach, it was noted that the decrease in cost of capital would not be for all insurance entities. With the benefit of more detailed information about the insurance business, the cost of capital for some insurance entities 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.

135 The economic study commissioned by EFRAG indicated that according to some external investors, theoretically the model will be a step forward for users of insurance's financial statements, particularly for assessing the profitability by product line (BlackRock, 2017) and this may have consequences on the costs of funds (i.e. the cost of equity and the cost of debt). Most external investors (86%) who replied to the online survey agreed that the costs of funds will change following the adoption of IFRS 17.

136 Also, as per the economic study commissioned by EFRAG, as explained in paragraph 82, two major rating agencies (FITCH and S&P) commented that IFRS 17 is unlikely to directly affect insurers' ratings.

Potential impact for policyholders

137 As explained in paragraphs **Error! Reference source not found.** to 93, entities may re-consider both their pricing methodologies and product offerings due to entities applying IFRS 17, the latter to a greater extent compared to the former. However, EFRAG does not have any quantitative information on how that would affect the policyholders.

138 As per the economic study commissioned by EFRAG, IFRS 17 is expected to have a noticeable impact on the product mix for "Life" and "Credit Suretyship" insurance. Therefore, this in turn may potentially impact these products offered to policyholders.

Level of aggregation

139 [To be completed.]

Transition

140 In the extensive case study EFRAG conducted, respondents were asked to apply the transition methods to their portfolios that were selected for the case study. The approaches indicated by respondents represents the following percentage of the total IFRS 17 liability for the respective portfolios:

Proposed approach	**Percentage**
Fair value approach	30.46%
Modified retrospective approach	63.21%
Full retrospective approach	5.50%
Not applicable	0.83%
Total	100.00%

Variations of approaches used:

141 For the purposes of the case study, some respondents applied variations to the approaches in IFRS 17 such as:

(a) An approximation of the modified retrospective approach. The modifications were not specified.

(b) The new business value method (NBV) under the EEV framework as equivalent to the full retrospective approach.

142 Respondents had the following remarks on why they have not applied the full retrospective approach in the case study:

(a) The lack of historical data or outdated systems;

(b) Resource and timing constraints;

(c) Impracticability due to the:

(i) existence of a number of long-term contracts still in place;

(ii) elimination of hindsight; and

(iii) application of judgments and assumptions.

143 The case study provides the following insights into the difficulties in applying the requirements of the modified retrospective approach:

(a) IFRS 17, paragraph C6 should permit the use of approximations and simplifications when determining the initial cash flows and roll them forward using an approach that could be characterised as a fair value approach but using modified retrospective modifications in other areas such as discount rate, risk adjustment, etc (one respondent).

(b) The requirement in IFRS 17 paragraph C9(a) to split portfolios by profitability group (onerous, no significant possibility of becoming onerous, other) is likely to mean that they need to identify cash flows at a lower level than the portfolio level (i.e. individual contract or sub-groups within portfolios). This significantly increases the granularity of the data required (two respondents).

(c) The requirement in IFRS 17 paragraphs C8, C10 to produce transition figures by annual cohort is potentially significantly more onerous than if cohorts can be grouped together (two respondents).

(d) The requirements in IFRS 17 paragraphs C12, C17(c)(i) and C17(c)(ii) to make adjustments for amounts between initial recognition and transition (or earlier) date will prove to be very difficult (two respondents).

(i) Whilst it may be possible to identify actual cashflows for more recent years it will get progressively more difficult when progressing back in time. Application of the modified retrospective approach to more recent years and the fair value approach to later years would require the respondent to be able to split the actual cashflows between those arising on contract where the modified retrospective approach is being applied and those arising from contract where fair value approach is being applied.

(ii) *UK with profits business*: To be able to comply with IFRS 17 paragraph C17(c)(i) and (c)(ii) it is necessary to be able to identify the amount of the following items that have occurred between initial recognition and transition:

- The charges deducted from the unit fund
- Benefit payments in excess of the unit fund (in respect of the sum assured on the base policy and the benefits under each rider)
- Costs incurred (e.g. commissions and expenses)

(iii) *Unit-linked business with protection riders*: To be able to comply with IFRS 17 paragraph C17 (c)(i) and (c)(ii) it is necessary to be able to identify the amount of the following items that have occurred between initial recognition and transition:

- The charges deducted from the unit fund
- Benefit payments in excess of the unit fund (in respect of the sum assured on the base policy and the benefits under each rider)
- Costs incurred (e.g. commissions and expenses)

(iv) Historically these amounts are only available for a limited number of past years and only in aggregate.

(e) The simplifications in respect of loss components in IFRS 17 paragraphs C11-C17 should be consistent between the VFA and general model (one

respondent). The requirements in IFRS 17 paragraphs C13 should include an option allowing, at inception, that the discount rate can be set the same as the transition date discount rate.

(f) One respondent noted that the modified retrospective approach under IFRS 17 paragraph C6 would require taking into account the past margins, therefore it would not reflect a simple prospective vision of the insurance contracts profitability. This respondent considered the valuation of such past margins to be extremely heavy to perform precisely, looking at the reduced time available to implement IFRS 17.

144 In addition to the identification of the issues relating to applying the transition methods, respondents also estimated the impact of transition on opening retained earnings and other components of equity under current GAAP.

Transition method	**Examples of reasons for the impact**
Fair value approach	• Different valuation of insurance liabilities • Impact of IFRS 9
Modified retrospective approach	• Elimination of deferred acquisition costs • Elimination of day-one profit or deferred recognition of profit • Impact of IFRS 9
Full retrospective approach	• High interest rate guarantees recognised differently under IFRS 17 than under current GAAP • Slower recognition of results before transition • Impact of IFRS 9

145 [To be updated with the results of the Amendments.]

Reinsurance contracts held

Overview of issues being raised

146 With regard to reinsurance contracts held several issues have been raised. Hereafter a short overview of these issues is being provided.

<u>Initial recognition when underlying insurance contracts are onerous</u>

147 IFRS 17 treats insurance contracts issued and reinsurance contracts held as separate contracts with different counterparties. For insurance contracts issued the contractual service margin (CSM) represents unearned profit. The CSM cannot be negative, as a result, expected losses on a group of insurance contracts issued are recognized immediately in profit or loss. For reinsurance contracts held, the insurer is receiving services rather than providing them. Hence the CSM represents the net cost of purchasing reinsurance and can be in a net cost or a net gain position and is recognized over the coverage period as services are received.

148 At the end of each reporting period, the carrying amount of the contractual service margin for a group of reinsurance contracts held is adjusted to reflect changes in estimates relating to future service, similarly to a group of insurance contracts issued. There is one exception that relates to adjusting the contractual service margin for reinsurance contracts held. The exception relates to situations when an underlying group of insurance contracts becomes onerous after initial recognition because of adverse changes in estimates of fulfilment cash flows.

149 In those circumstances, to the extent that there are corresponding changes in estimates of fulfilment cash flows for the reinsurance contract held, those changes do not adjust the contractual service margin of the reinsurance contract held but are instead recognised in profit or loss. The result is that the entity recognises no net effect of the loss and gain in the profit or loss for the period to the extent that the change in the fulfilment cash flows of the underlying group of insurance contracts is matched with a change in the fulfilment cash flows of the group of reinsurance contracts held.

150 Concerns were raised that the above exception, which is intended to avoid accounting mismatches, was not wide enough because:

(a) it applies when an underlying group of insurance contracts become onerous after initial recognition because of adverse changes in estimates of future cash flows; but

(b) does not apply:

(i) when an underlying onerous group of insurance contracts is initially recognised; and

(ii) when underlying insurance contracts are reflected in the measurement of the reinsurance contract held before they are issued and are later issued as expected.

151 In order to address this concern the IASB decided to amend IFRS 17 requiring an insurer to adjust the contractual service margin of a group of reinsurance contracts held, and as a result recognise income, when the insurer recognises a loss on initial recognition of an onerous group of underlying insurance contracts, or on addition of onerous contracts to that group.

152 [To be updated with the results of the Amendments.]

Ineligibility for the variable fee approach

153 In accordance with IFRS 17 reinsurance contracts held (and issued) cannot be insurance contracts with direct participation features (i.e. they fall out of the scope of the variable fee approach). Insurance contracts with direct participation features are insurance contracts that are basically investment-related service contracts under which an insurer promises an investment return based on underlying items.

154 For reinsurance contracts held, the insurer and the reinsurer do not share in the returns on underlying items, and so the criteria for the scope of the variable fee approach are not met. EFRAG has been informed that for Solvency II optimization, internal reinsurance contracts may qualify for the variable fee approach requirements.

155 This topic was not changed during the Amendments to IFRS 17.

Reinsurance contracts held – recovery of losses

156 Additional concerns were raised that the treatment of the CSM for reinsurance contracts held should be the same as the treatment of the CSM for the underlying insurance contracts issued. This to avoid mismatches that result when the pattern of recognition of the CSM for reinsurance contracts differs from the pattern of recognition of the CSM for the underlying insurance contracts written.

157 [To be updated with the results of the Amendments.]

Expected cash flows arising from underlying insurance contracts not yet issued

158 The contract boundary of reinsurance contracts held and insurance contracts issued are determined in a similar way. As a result, if an insurer has a substantive right to receive services from the reinsurer in respect of underlying insurance contracts it issues that are covered by the reinsurance contract, the cash flows within the

boundary of the reinsurance contract held include all the cash flows expected to arise from those underlying insurance contracts expected to be covered by the reinsurance contract. This includes a substantive right relating to underlying contracts expected to be issued in the future even if the enforceability of performance under the reinsurance contract is dependent on the issuance of underlying contracts.

159 Concerns have been raised with this approach because of its complexity and the fear that a mismatch is created between the insurance contract liability and the reinsurance contract asset because the latter will be grossed up with the cash flows for future underlying contracts that have not yet been issued. A final concern related to the difference in recognition of the CSM of the reinsurance contracts held compared to the recognition of the CSM of the underlying insurance contracts issued.

160 The IASB rejected the above arguments and decided not to change the standard. Reasons provided were:

(a) cash flows of uncertain timing and amounts are included in the measurement of all insurance contracts are not a unique feature of reinsurance contracts held;

(b) future underlying insurance contracts are reflected in the cash inflows, cash outflows, risk adjustment for non-financial risk and contractual service margin included in the measurement of the reinsurance contract held. Those amounts sum to nil up until the point that one of the following events occurs:

(i) the entity pays or receives amounts relating to the reinsurance on those future underlying contracts (for example, the entity pays reinsurance premiums); or

(ii) those underlying contracts are issued and the entity starts receiving reinsurance services relating to those contracts.

When one of those events occurs, the amounts included in the measurement of the reinsurance contract held relating to those contracts will no longer sum to nil; and

(c) the CSM recognised in a reporting period is determined considering the services received in the current period and expected to be received in future periods under the reinsurance contract held. This is consistent with the requirements for insurance contracts issued. In circumstances that the service the entity receives from the reinsurer is proportionate to the service that the entity provides to the policyholder, the identification and allocation of coverage units for reinsurance contracts held will result in a pattern of contractual service margin recognition which reflects that symmetry.

Scope of variable fee approach

161 IFRS 17 distinguishes between insurance contracts with and without direct participation features. The general model for insurance contracts without direct participation features is modified for insurance contracts with direct participation features (described as the variable fee approach).

162 The IASB developed the variable fee approach for contracts with direct participation features because some insurance contracts are substantially investment-related service contracts. In these contracts, the entity is promising an investment return based on underlying items, in effect providing an asset management service. The obligation to the policyholder can be regarded as a promise to return the underlying items to the policyholder, after deducting a variable fee.

163 As a result, insurance contracts with direct participation features are identified as:

(a) the contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items;

(b) the entity expects to pay to the policyholder an amount equal to a substantial share of the fair value returns from the underlying items; and

(c) the entity expects a substantial proportion of any change in the amounts to be paid to the policyholder to vary with the change in fair value of the underlying items.

164 Concerns were raised that the scope of the variable fee approach is too narrow, resulting in economically similar contracts being accounted for differently. These concerns related to insurance contracts with the following features:

(a) the relationship between investments and the insurance contract arises from a constructive rather than contractual obligation; and

(b) the contractual terms do not specify a clearly identified pool of underlying items

165 The IASB did not change the scope of the variable fee because:

(a) the relationship between investments and the insurance contract arises from a constructive rather than contractual obligation —a fundamental aspect of the variable fee approach is that the entity's share of the underlying items is regarded as a variable fee. For this to be the case, the contract needs to specify the fee, and

(b) the contractual terms do not specify a clearly identified pool of underlying items—such contracts cannot be regarded as in effect providing asset management services if there are no specified assets.

166 This topic was not changed at the occasion of the Amendments to IFRS 17.

167 Another concern raised related to the recognition of the contractual service margin in profit or loss over only the period in which insurance coverage is provided, rather than a longer period in which other services might be provided.

168 [To be updated with the results of the Amendments.]

Broader economic impacts

169 The topics that have arisen in this regard are the following and these are discussed below:

(a) Potential effect on the long-term business model;

(b) What factors affect the decisions to invest in equity instruments or other classes of assets;

(c) Potential effect of IFRS 17 on SME's;

(d) Stress testing;

(e) Sensitivity testing;

(f) Is IFRS 17 likely to endanger financial stability in Europe; and

(g) Potential effects on competitiveness.

Potential effect on the long-term business model

170 [See different workstream.]

What factors affect the decisions to invest in equity instruments or other classes of assets

171 [See different workstream.]

Potential effect of IFRS 17 on SME's

172 [See different workstream.]

Sensitivity testing

173 For purposes of sensitivity testing, participants to the extensive case study were requested to compare the quantitative impact of specified changes to certain inputs under IFRS 4 and IFRS 17.

174 Respondents did not apply all the sensitivities in their responses and the feedback below has been based on the most prominently used sensitivities. Not all portfolios evaluated in other parts of the case study were completed by the respondents in this section.

175 For purposes of the case study, respondents were asked to include allocated assets when considering sensitivities or stress testing. However, where assets were not allocated, respondents had to consider a cross-section of the general or undedicated assets reflecting the structure of the assets.

176 When assessing the outcome and obtaining explanations for anomalous outcomes, it emerged that at least in some cases, some surplus assets were included which means that the discount rates and impacts are not a reflection of the true outcomes under IFRS 17. This also reflects the difficulties for respondents when answering the case study while systems and processes for the new standard is still under development.

177 Metrics that showed the highest sensitivity in a number of portfolios were the financial risk metrics such as equity risk, the sensitivity to an increase or decrease of the interest yield curves and the increase of the corporate bond spreads. In few portfolios the impact of insurance risk was important.

178 *Sensitivity to equity risk*: Some of the savings and unit linked portfolios that are accounted in accordance with the VFA had a high sensitivity to equity risk. Given the overall low degree of investments in equity instruments, the EFRAG Secretariat asked further information from respondents to clarify the impact. One of the clarifications received is the inclusion of surplus assets in the sensitivity analysis which can be considered as a shortcut to apply the case study.

179 *Sensitivity to yield curve risk*: The second biggest sensitivity related to yield curve risk for some of the savings and unit-linked portfolios.

180 Sensitivity to corporate spread: Many of the annuity portfolios accounted for in accordance with the General model were highly sensitive to a change in corporate bond spreads, with either a positive or negative impact on profit.

181 *Sensitivity to insurance risk*: Considering that not all sensitivities were being answered, few of the portfolios submitted were highly sensitive to one of the insurance risks that were reported upon. Exceptions include policyholder lapses for one of the savings portfolios and death risk for one of the credit insurance portfolios.

182 Preparers consider that a conclusion on the appropriateness of the level of sensitivity of the results under IFRS 17 requires consideration of both the business model as well as the economic environment. If accounting alone drives sensitivity that would be inappropriate and it is therefore important to consider these and the stress testing results in the context of volatility [refer once completed] as well as accounting mismatches as considered in the relevance section of Appendix 2 (see paragraphs xx to xx).

Stress testing

183 The request from the EC asked for stress testing information in so far as practically possible. As the development of stress testing scenarios is a complex science which takes considerable time and resources, it was agreed to ask participants to apply

the 'Double hit' stress test scenario as set out in the EIOPA 2016 stress test exercise and compare the quantitative impact for each of the portfolios on net profit before tax as well as other components of equity where relevant under current GAAP and IFRS 17. The EFRAG Secretariat notes the difficulties of the participants to complete this section in the time allocated given the status of systems development and overall preparedness for IFRS 17 at that time.

184 Six respondents completed the stress testing questions for IFRS 17 but not for current GAAP, with one completing it for both. Furthermore, not all portfolios evaluated in other parts of the case study were considered in this section. It is therefore very hard to draw conclusions or comparisons on the information received.

185 Under the stress impacts reported, the initial negative impact varied between 0% impact on a unit-linked portfolio accounted for under the VFA and 400% impact on a combination of individual and bulk purchased annuities under the General Model. Most of the impacts resulted in a negative impact on the result between 20% and 30% for portfolios under the VFA. For general insurance the impacts reflect the changes in asset prices and reflected a similar range to those under the VFA and under current GAAP.

Is IFRS likely to endanger financial stability in Europe

186 [See different workstream.]

Potential effects on competitiveness

187 Please refer to paragraphs 201 to 236 .

What are the implications for the EU of not endorsing IFRS 17?

188 This section focusses on what are the implications for the EU of not endorsing IFRS 17.

IFRS 4 continued to be applied

189 If IFRS 17 are not endorsed within the EU, IFRS 4 will still continue to be applied. Therefore, allowing for the grandfathering of different and inconsistent accounting practices within the consolidated financial statements of insurers in Europe. These diverse accounting practices in Europe have been confirmed when EFRAG organised a questionnaire in May 2017 asking European insurers to provide information on the different GAAPs and variations thereof that are currently used to compile their financial statements. In the user outreach performed by EFRAG this were also confirmed by users where they noted that they rely on alternative measures and/or make analytical adjustments to figures reported in their financial statements in order to compensate for the lack of comparability introduced by IFRS 4.

190 EFRAG noted that these continued different accounting practices will not only impact comparability amongst European insurers but also amongst European insurers with branches and subsidiaries outside the EU as entities outside the EU will apply IFRS 17 from its effective date.

191 In EIOPA's analysis of IFRS 17 it has been noted that IFRS 17 financial statement are expected to be clearer and more transparent easier to understand than current IFRS 4 financial statements. Some consider that while there may be an improvement in transparency under IFRS 17, especially at transition and while users and preparers get acclimatized to the new requirements, the resulting numbers may be more complex and difficult for the market to understand.

192 Apart from the lack of comparability and transparency all the strengths and weaknesses with regards to IFRS 4 will continue to prevail.

193 Also, should IFRS 17 not be endorsed and IFRS 4 will continue to be applied than there will be no impact on the scope exceptions due to the fact that they are similar to those under IFRS 4. However, the fixed-fee service option will no longer be applicable as IFRS 4 does not include such an option. The result is that entities will most probably have to account for such contracts under IFRS 4 increasing complexity for entities who issue both insurance and other types of contracts together for the same purpose.

IFRS 9 and IFRS 17

194 As investing activities are important for insurance entities, insurers and financial conglomerates undertaking insurance activities have been granted the option to defer the application of IFRS 9 until 1 January 2021, which would coincide with the effective date of IFRS 17 (temporary exemption from applying IFRS 9). Therefore, if IFRS 17 is not endorsed within the EU it will have knock-on effects on the temporary exemption of IFRS 9 as the option was included for insurers to apply the two Standards together.

195 [To be updated with the results of the Amendments.]

196 This leads to the question of whether the temporary exemption from applying IFRS 9 which is applicable to insurers and financial conglomerates will have a fixed expiry date of 1 January 2021 or whether the date should be deferred until IFRS 17 will become applicable.

197 [To be updated with the results of the Amendments.]

198 If the effective date of the temporary exemption from applying IFRS 9 is not deferred, EFRAG acknowledges that insurers will apply IFRS 4 together with IFRS 9. When applying IFRS 4 together with IFRS 9 (i.e. before IFRS 17 is applied), insurers can decide to adopt the overlay approach[5]. EFRAG notes that the overlay approach is a temporary measure that has been introduced to enable insurers to address the accounting mismatches and the volatility that might arise when an insurer applying IFRS 4 also applies IFRS 9. However, if an insurer decides not to adopt the overlay approach, EFRAG notes that additional volatility that might be caused by some changes in the measurement of financial assets will go through profit or loss.

Implementation costs incurred

199 Another aspect to be considered is that if IFRS 17 will not be endorsed, insurers will have to write off all implementation costs incurred up until now. EFRAG does not have any evidence of cost incurred to date with the implementation of IFRS 17.

Financial stability

200 [See separate workstream].

Impact on competitiveness of insurers

The current competitive landscape

Insurers vs insurers

Competition between European listed insurers

201 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.

[5] Under such an approach, insurers are allowed to remove from profit or loss the additional volatility that might be caused by some changes in the measurement of financial assets.

202 Examples of current differences in European national GAAPs include, but are not limited to the following:

(a) *Level of aggregation*: In France GAAP a combination of level of aggregations is used depending on the risks considered and the contractual terms; 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 and the United Kingdom, technical provisions for life business include options and guarantees; in France, specific reserves are determined for options and guarantees.

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

Competition between European listed insurers and European non-listed insurers

204 Listed European insurers also compete with non-listed insurers. Listed European insurers rely in their consolidated accounts often on multiple GAAPs and/or use changes to the GAAP's they are using (see Chapter on current practices, paragraph 18 to 20 above). As a result, there is a lack of comparability of consolidated financial statements between insurers, listed and/or non-listed.

205 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 when both are not subject to IFRS. 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.

206 European insurers can also operate through branches in other EU Member States which are subject to local financial reporting requirements in line with the requirements of the Member State involved.

European insurers vs third-country insurers

207 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 EFRAG IAWG Questionnaire, some European insurers use Frozen US GAAP (see paragraph 20 above), enjoying a competitive advantage compared to US insurers as they did not had to bear the costs of changes to US GAAP in the recent decade. This competitive advantage will be lost when applying IFRS 17, although some consider it unlikely that this advantage will continue indefinitely in the context of current changes to US GAAP.

Insurers vs other entities

Financial services: Insurers vs banks

208 Insurers offer investment products as do banks and as such the two types of entities are competing for the same clients. They also compete with each other in the market of savings products.

Financial and insurance services: Insurers vs private equity firms

209 Private equity firms buy insurance companies which are then competing with other insurers. Both types of companies are competing for the same clients.

Other services: Insurers vs other entities

210 Insurers also explore offering other services such as maintenance contracts for cars or extended warranty agreements, in addition to the car insurance. In doing so, insurers come in direct competition with other entities offering this type of services.

Overall

211 Looking at today's landscape it can be concluded no 'level playing field' exists today, but rather a various landscape of applicable GAAPs. IFRS 4 contributes to this fragmented landscape by grandfathering existing accounting policies which lead to consolidated IFRS statements that are based on several different local practices, making each consolidated IFRS statement unique in its kind and thus not comparable with other consolidated IFRS statements. EFRAG is however not aware of any evidence that these differences have creates significant competitive (dis)advantages for the insurers involved.

212 When looking at competition issues with third country insurers (in particular US GAAP), the introduction of IFRS 17 may lead to the loss of an existing competitive advantage for those insurers currently using Frozen US GAAP. The further impacts seem minor as the degree of competition within European markets (from third country insurers) is relatively low.

Potential competition issues between IFRS 17 and US GAAP

213 In assessing the competition issues between US GAAP and IFRS 17, EFRAG 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.

214 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 entities reporting under US GAAP for competition for capital.

Overall

215 IFRS and US GAAP are two different frameworks resulting in different detailed accounting treatments between IFRS 17 and ASC Topic 944. In many cases, these differences balance each other out. I.e. a competitive disadvantage for European insurers in one area for a particular insurance contract type is balanced by a competitive advantage for European insurers for another insurance contract type or in another area. No quantitative estimates exist whether one difference is larger or smaller than another. Examples here are the use of discount rates or certain requirements in the area of the level of aggregation. In this latter area the very different approach relating to impairment testing between the two frameworks is to be kept in mind.

216 In other areas no competitive (dis)advantages could be identified such as the measurement of options and guarantees, presentation and disclosures and the requirements for reinsurance. For the latter issue EFRAG has been informed that the US GAAP treatment provides a competitive advantage for US insurers, but also here quantitative estimates are lacking.

Potential competition issues between IFRS 17 and Japanese GAAP

217 Japanese insurance entities 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.

218 Japanese GAAP for insurance entities 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.

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

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

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

(c) US GAAP.

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

Overall

221 The above options being available to all entities in Japan, EFRAG expects that entities will choose that option that is optimal from their perspective. Hence no competition issues arise in this regard.

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

Within Europe

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

223 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 entities and/or the consolidated and/or annual financial statements of other entities.

Application of article 4 of the IAS Regulation

224 When IFRS 17 is applied in accordance with article 4 of the IAS Regulation, it would increase the level playing field between insurance entities 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 entities 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 entities to reflect the specificities of their own business model.

225 If IFRS 17 is endorsed publicly listed entities would incur the cost of implementing the Standard (over a number of years). In contrast, independent unlisted entities that do not apply IFRS Standards would not have to bear these costs. However, some of these independent unlisted entities are 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 entities (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.

226 Unlisted entities that do not apply IFRS Standards but that are part of a listed group may be obliged to provide IFRS reporting packages to their group level in addition to continue to follow the local accounting requirements.

227 The existing competition issues between different national GAAPs would largely remain in existence, except for the unlisted entities which would incur a competitive disadvantage when required by their listed group level to provide additional IFRS reporting packages in addition to their local accounting requirements.

Application of Article 5 of the IAS Regulation

228 The use of IFRS Standards may be 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 entities alone or the statutory accounts of all insurance entities in a Member State.

229 In case only the statutory accounts of publicly listed entities would be affected, the impact on competition is similar as described in paragraphs 225 and 227 above.

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

231 The existing competition issues between different national GAAPs would be reduced as many of the entities that are active cross border would be publicly listed entities subject to IFRS 17 also. Insofar as local entities (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 GAAPs would remain.

Between Europe and the rest of the world

232 EFRAG has collected data on the implementation cost of IFRS 17, but EFRAG has no information on the implementation cost of US GAAP or Japanese GAAP. Costs and benefits are discussed below [to be completed].

233 Some European entities 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) with no updating. However, US GAAP has evolved causing implementation costs. For example, the FASB has published its *Targeted Improvements to the Accounting for Long-Duration Contracts* in August 2018. As the extent of these changes are smaller than IFRS 17, EFRAG expects that the costs to comply with these requirements would be lower than applying IFRS 17.

234 EFRAG notes that the implementation of IFRS 17 could have some effect on today’s competitive equilibrium. Differences between national GAAPs and third country GAAPs 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.

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

236 EFRAG 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.

Annex 1: Information about local GAAPs

1 EFRAG also consulted some European National Standard Setters, in June 2017, on current accounting requirements for insurance contracts. The National Standard Setters were from France, Germany, Italy, Spain and UK. Hereafter a summary is provided from these responses:

Level of aggregation:

2 **France** – When applying IFRS 4, the insurance undertakings measure their insurance liabilities at different levels:

(a) The "technical reserves" corresponding to individual rights at reporting date are calculated at individual level;

(b) "Additional reserves" are calculated by risk or group of contracts;

(c) The technical provisions must be sufficient for complete payment of the commitments at the entity or group level.

3 **Germany** – In particular circumstances, the premium reserve is to be set up at individual contract level. Group assessment/valuation for underwriting reserves is possible, if similar or almost similar liabilities can be grouped together otherwise approximation methods are allowed.

4 **Italy** – There is no requirement on the level of aggregation at initial recognition for insurance contracts. At the end of the reporting period, with regards to life technical provisions, insurance entities are required to calculate technical provisions individually and may group contracts with risk sharing if similar results are produced.

5 **Spain** – Two of the main provisions are:

(a) Provision for unconsumed premiums: The provision of premiums not consumed will be calculated policy by policy.

(b) Provision for life insurance: The calculation will be made policy by policy. In collective policies this calculation will be made separately for each insured.

6 **UK** – As per the Prudential Sourcebook 2004, provisions for insurance liabilities on long-term insurance business, including with-profit funds should be determined on a contract by contract basis. Approximations or generalisation are permitted (meaning an insurer can aggregate contracts) if the provision is likely to be the same or higher than if determined on a contract by contract basis. As per FRS 103 and ABI SORP, assessments for unexpired risks provisions are based on groups of business which are managed together.

When to recognise onerous contracts:

7 Some National Standard Setters mentioned the liability adequacy test which is a mandatory requirement as per IFRS 4. Other current practices are the following:

8 **France** – For life contracts, (i) provision for administration expenses (ii) provision for financial yield deficiency. For non-life contracts, unexpired risk reserve, in addition to unearned premiums reserve to cover future expected loss.

9 **Germany** – For contracts with guaranteed values, the difference between the premium reserve as declared in the business plan and the unlimited zillmerised[6] premium reserve is recognised in profit or loss.

10 **Italy** – At the end of the reporting period, insurers are required to account for additional reserves in case technical provisions are not sufficient to settle the

[6] Zillmerisation relates to the valuation of a life insurance company by an actuary whereby the amount of future net premiums allowed for are increased due to new business strains to hold day one capital reserves that are higher than the initial premium payments from customers.

expected amount to be paid to policyholders both in life and non-life business. These additional reserves are based on homogeneous groups of contracts, subject to the same type of risk.

11 **Spain** – Not applicable.

12 **UK** – Unexpired risks provision recognised when claims and expenses exceed unearned premiums provision less deferred acquisition costs.

Presentation of components of revenue:

13 **France** – Main inputs to profit or loss: premiums written, investment results, claims, claims relating to other technical provisions, acquisition costs, equalisation provision.

14 **Germany** – Gross written premiums; outward reinsurance premiums; and an allocated investment return, net of reinsurance.

15 **Italy** – Undertakings are required to prepare the statement of profit or loss according to the layout published by IVASS (The Institute for the Supervision of Insurance) and includes gross written premiums.

16 **Spain** – Presentation of a detailed profit and loss statement for Insurance entities distinguishing between life and non-life insurance business.

17 **UK** – Long-term insurance business: premiums recognised when due; general insurance contracts: written premiums recognised as earned premiums over the policy period.

Contract boundary:

18 **France** – The cash flows considered in the measurement are based on the substantive rights and obligations as per the contractual terms.

19 **Germany** – The calculation of the provisions for claims outstanding gives some information on which elements are included but generally the term contract boundary is not defined.

20 **Italy** – In life business, the undertakings shall take into account all the future obligations, among which, all the guaranteed benefits, the undertaking's future expenditures including commissions.

21 **Spain** – Not applicable.

22 **UK** – Not explicitly defined.

Discount rates:

23 **France** – Technical provisions are based on current assumptions but not all are discounted. For life reserves, the discount rate could be the discount rate included in the pricing at inception, with an option to update to a more current rate.

24 **Germany** – In general, German insurance accounting is an amortised cost model. For insurance contracts that offer a guaranteed rate of interest, the maximum interest rate used to calculate the premium reserve shall be 2.25%.

25 **Italy** – Non-life and life (i.e. traditional contracts) technical provisions are calculated on a prudent and cost-based approach. Under the most commonly used technical basis, if assets covering technical provisions are accounted for on a cost-basis, the insurance reserves can be calculated using the locked-in assumptions. Under the less used method, the provisions are based on assumptions considered to be more likely and on the basis of ensuring a reasonable margin for unfavourable trends of the items examined.

26 **Spain** – For insurance policies expressed in local currency, the interest rate may not exceed 60% of the weighted average arithmetic mean over the last three years

of the average interest rates of the last quarter of each year on loans denominated in government bonds and liabilities (or of loans materialised in bonds and obligations of the respective State for insurance dominated in foreign currency) of five or more years.

27 **UK** – For long-term business, the rates of interest for the calculation of the present value must not exceed 97.5% of the risk-adjusted yield for assets allocated to cover the liability.

Treatment of options and guarantees:

28 **France** – Separate reserves are determined such as reserves for guaranteed yields. “Code des assurances” does not define a specific provision for options and guarantees.

29 **Germany** – No direct equivalent to IFRS 17 found although several texts seem to imply that guarantees are within the contract boundary (the latter which is not defined).

30 **Italy** – For life business, the technical provisions are computed using a sufficiently prudent prospective actuarial method which takes into account all the future obligations, among which: guaranteed benefits and all options provided to the policyholder.

31 **Spain** – Not applicable.

32 **UK** – For all entities with long-term insurance business, the best basis for measuring policyholders’ options and guarantees is one that includes their time value. Stochastic modelling techniques to evaluate the range of potential outcomes should be used unless a market value for the option is available.

Annex 2: Glossary

Liability adequacy test: In accordance with IFRS 4, paragraph 15, an insurer shall assess at the end of each reporting period whether its recognised insurance liabilities are adequate, using current estimates of future cash flows under its insurance contracts. In case the carrying amount of insurance liabilities is inadequate, the entire deficiency is to be recognised in profit or loss.
New business value method: RO for definition

Separation: Some insurance contracts contain one or more components that would be accounted for in accordance with another Standard than IFRS 17 if they were separate contracts. Separation of these components is required depending on certain conditions being fulfilled (IFRS 17, paragraph 11) It is not possible to separate insurance components, with one exception, the amendments relating to credit and other similar cards that include insurance components

Unbundling: Account for the components of a contract as if they were separate contracts. Unbundling is required or permitted depending on certain conditions being fulfilled. Unbundling is applied to both deposit and insurance components. (IFRS 4, paragraph 12)