IFRS 17 *Insurance Contracts* as amended in June 2020

Draft Final Endorsement Advice

Appendix III[1]

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Introduction

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

1 IFRS 17 was issued by the IASB in 2017 to replace IFRS 4 *Insurance Contracts*, issued in 2004. IFRS 4 was developed by the IASB as a temporary standard. One of the objectives of the IASB regarding IFRS 4 was to make limited improvements to accounting practices for insurance contracts, to avoid reversing any major changes as a result of the second phase of the project (which is now IFRS 17).

2 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 measure the insurance liabilities even when the assets are not directly linked to these insurance liabilities.

Who is affected by the new Standard and how

3 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 provided the entity also issues insurance contracts. Insurance contracts include (i) insurance or reinsurance contracts that an entity issues; and (ii) reinsurance contracts that an entity holds.

4 The definition of an insurance contract under IFRS 17 determines which contracts are in the scope of the Standard 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.

5 In addition, users of financial statements, e.g., investors, would need to be educated in order to understand the financial statements of entities applying IFRS 17. However, EFRAG notes that many of those analysts/investors covering insurance undertakings have followed the prolonged process of developing IFRS 17 for quite a while and as a result have already some familiarity with the Standard.

6 In accordance with the EU IAS Regulation, IFRS Standards 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 consolidated and/or statutory accounts of all insurance entities in a Member State (including unlisted entities).

7 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?

8 IFRS 4 was introduced in 2004 as a temporary standard and largely permits continuing pre-existing accounting practices. Since then, major changes have occurred to the economic environment. 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. Such changes are out of the scope of EFRAG's assessment.

9 With investment returns declining and mature European insurance markets, insurers are looking at alternatives to increase revenue and manage risk. 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 contracts.

10 In short, since 2005 the insurance environment has undergone significant changes. 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 and the associated risks.

What should be achieved?

11 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?

12 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

13 In case IFRS 17 is deemed to not improve the usefulness of financial information at a reasonable cost or were to not contribute to the European public good or endanger financial stability, the conclusion would be not to endorse IFRS 17. The current accounting regimes permitted by IFRS 4 would then continue.

Endorsing IFRS 17

14 If IFRS 17 is deemed to achieve or largely achieve the objective of improving the usefulness of financial information at a reasonable cost, or were to contribute to the European public good or to not endanger financial stability, the conclusion would be to endorse IFRS 17.

Properties of the accounting standards

Is IFRS 17 a better standard than IFRS 4?

15 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.

16 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.

17 EFRAG's observations on the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts are in the Cover Letter. For all the other requirements in IFRS 17, EFRAG considers that the requirements in IFRS 17 will make insurers' financial reports more useful and transparent and insurance accounting practices consistent across jurisdictions.

Weaknesses and Strengths of IFRS 4

18 In explaining the weaknesses and strengths of IFRS 4, the following paragraphs focus on the application of IFRS 4 rather than on the technical requirements as EFRAG considers this more relevant for the analysis.

Strengths of IFRS 4

19 *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[2]. This also included non-elimination of intra-group balances.

20 *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 again when phase 2 of the insurance project was completed – which is the case now with IFRS 17). Current systems could largely be re-used which benefitted the cost-benefit analysis.

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

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

Weaknesses of IFRS 4

23 The need for globally 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. For example, some users believe that globally comparable financial statements are also important for non-executive directors who bring experience from outside the industry but are

[2] For example, EFRAG understands that in some countries for example France, restatements upon consolidation (i.e. changes to the amounts at statutory level) are required when they are significant and can be done without undue cost.

confronted with differences in financial statements of insurers making it more difficult to assess the performance of the company they adhered to.

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

25 In addition, the liability adequacy test is a minimum requirement for which IFRS 4 provides two options. In addition, this test is not applied in a uniform way due to a lack of specificity on how to perform the test.

26 *Incomplete framework*: Apart from comparability, IFRS 4 was designed as an interim standard which neither defines a measurement model for insurance contracts nor has a comprehensive, consistent approach on how to recognise and present insurance contracts in either the statement of financial position or the statement of comprehensive income. This makes the standard incomplete.

27 *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.

Feedback on the usefulness of IFRS 4

28 In assessing the effectiveness and efficiency of current accounting requirements, EFRAG relies on the results of its User Outreach run in 2018. Users that participated in the EFRAG User Outreach noted the following about the current accounting under IFRS 4.

EFRAG's User Outreach: 2018 with users specialised in the insurance sector

29 Fourteen specialist users (out of 24 users that participated) indicated that current accounting under IFRS 4 does not enable to compare financial information. These users also made the following comments:

(a) Six users noted that they use alternative performance measures (or non-GAAP measures) owing to the lack of comparability of financial information;

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

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

(d) One user stated that there are too much measurement inconsistencies and non-coordinated regulatory changes, 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 use by many parties of discount rates for liability measurement leads to complications in assessing risk in models; (iii) permitted inconsistent consolidation policies are misleading (iv) capital allocation decisions 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 currently used, in light of the fundamental economics of industry.

30 In contrast to the above, one specialist user indicated that they use operating profit as defined by entities 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.

2018 EFRAG's User Outreach: generalist users

31 Four generalist users (out of 24 users that participated) 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.

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

Economic Study findings

33 The Economic Study commissioned by EFRAG noted that in Germany, France, and the UK, the 2008 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 could be observed even in Italy.

34 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 some other sectors was in 2018 still greater than the difference in 2005.

35 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 successful in providing comparable and transparent 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.

How IFRS 17 responds to the problems identified

36 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.

Addressing comparability

37 IFRS 17 provides common principles for all aspects required to account for insurance contracts while providing separate models to reasonably 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 the use of various methodologies for determining discount rates or for recognising profit (see below). Doing so impairs comparability.

38 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 may be recognised 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.

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

40 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 for determining discount rates and profit recognition will be consistent even though such determinations may require significant judgement in practice.

41 Based on the 2018 EFRAG's User Outreach:

(a) 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.

(b) 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 principles-based for some aspects and the availability of policy elections.

42 In addition, in "*EIOPA's analysis of IFRS 17 Insurance Contracts*"[3], the introduction of IFRS 17 is assessed as a paradigm-shift to bring comparability to insurers' financial statements and to enable consistent accounting practices across different jurisdictions, compared to its predecessor IFRS 4.

43 For completeness, EFRAG notes that some stakeholders believe that IFRS 17 will still necessitate the use of non-GAAP measures to help investors in their assessments and consider that this is to some extent inevitable considering the complexity of the insurance business.

Providing a complete accounting framework for insurance liabilities

44 IFRS 17 requires an insurer to measure insurance liabilities relying on current estimates and updated assumptions. Economic assumptions of insurance contracts made at the time of issuing the insurance contract may change over the course of one or two 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 premiums are often paid over years and claims might occur 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.

45 It may be argued that a current measurement of the insurance liabilities could result in volatility. However, based on the results of the 2018 EFRAG User Outreach, most users did not see volatility as a problem whenever it reflects real economic

[3] EIOPA's analysis of IFRS 17 *Insurance Contracts*

substance and the underlying causes are communicated clearly. Volatility is not useful when it is due to accounting mismatches.

46 The results from the 2018 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.

47 IFRS 17 requires an insurer to recognise revenue as it delivers insurance contract services, rather than when it receives premiums, as well as to provide quantitative information about when the remaining contractual service margin (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.

48 Based on the feedback from the participants to EFRAG's User Outreach, users welcomed the requirement to present separately the underwriting and investing activities in the statement of comprehensive income. Users also indicated the importance and usefulness of the required disclosures under IFRS 17.

49 Users in the 2018 EFRAG 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 as the information provided by IFRS 4 financial statements was not sufficiently informative. 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).

Reflecting the economics of the insurance business

50 IFRS 17 contains several improvements to reflect the economics of the insurance business. Firstly, the assumptions and discount rates relating to the technical provisions are updated at each reporting period similar to other standards such as IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

51 Furthermore, the recognition of insurance revenue over the period during which the insurance contract services are provided is an improvement to the current situation.

52 IFRS 17 requires an entity to report as insurance revenue the amount charged for insurance contract services 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. 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.

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

54 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.

55 In particular, for insurance contracts without participating features, 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.

Specifying measurement requirements that reflect the specific features of insurance contracts

56 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 provides for an accounting 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 present all insurance finance income or expenses in profit or loss or to present some of that income or expenses in other comprehensive income.

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

Addressing users' need for useful information

58 During the 2018 EFRAG User Outreach, users welcomed the following benefits of IFRS 17 as described below

59 Specialist users made the following comments:

(a) Almost all users noted that profit earned based on services provided and separate presentation of underwriting and investing result were 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.

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

60 Generalist users made the following comments:

(a) IFRS 17 will measure insurance liabilities at fulfilment value which is a current measurement and hence, this 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 acknowledge past errors;

(d) Separate presentation of 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.

Potential impact for users of financial statements

61 EFRAG's 2018 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

62 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 that IFRS 17 did not go far enough in building a uniform reporting framework.

63 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, range and impact of transition approaches and the availability of policy elections.

Presentation and disclosure

64 Specialist users from EFRAG's User Outreach thought that the requirement to present separately underwriting and investing activities, in the statement of comprehensive income, would provide useful information.

65 Also, both specialist and generalist users from EFRAG's User Outreach indicated the importance and usefulness of notes to the financial statements under IFRS 17.

Volatility

66 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 could adjust their figures for volatility. Some preparers express a preference for the use of shadow accounting. Also, reference was made to the use of IFRS 9 and IFRS 17 together as a source of volatility. This is discussed in paragraphs 77 to 190 below.

Transition

67 Many specialist and generalist users from EFRAG's User Outreach were uncomfortable with the range of transition approaches offered by IFRS 17 and expressed concerns about comparability issues that may result therefrom. It is feared that the existence of several transition approaches might create confusion. Further, specialist users noted the possibility of window dressing, e.g. double counting of profits, at transition. It should be noted that a change in accounting policies leads to re-recognition of profits previously recognised or the non-recognition of profits. Preparers note that depending on the transition method used, the equity at transition date will differ.

Relationship between IFRS 17 and other standards

IFRS 17 compared with IFRS 15

Fixed fee service contracts

68 Some contracts meet the definition of an insurance contract but have as their primary purpose the provision of services for a fixed fee. An entity (including insurers) may choose to apply IFRS 15 *Revenue from Contracts with Customers* instead of IFRS 17 to such contracts that it issues if, and only if, specified conditions are met. The insurer may make that choice contract by contract, but the choice for each contract is irrevocable. The conditions are:

(a) the insurer does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer;

(b) the contract compensates the customer by providing services, rather than by making cash payments to the customer; and

(c) the insurance risk transferred by the contract arises primarily from the customer's use of services rather than from uncertainty over the cost of those services.

69 EFRAG notes that there are differences between IFRS 17 and IFRS 15, such as the separation of receivables when applying IFRS 15, the recognition of onerous contracts, and the aggregation or portfolio requirements.

70 EFRAG notes that entities could have been required to apply IFRS 15 to fixed-fee service contracts. However, it has been acknowledged that if IFRS 17 were to apply, entities would generally apply the premium allocation approach to such contracts, which would result in accounting similar to that which would result from applying IFRS 15, subject of applying the requirements described in paragraph 69.

71 EFRAG assesses that the option to apply IFRS 15 would be probably made by those entities that do not operate the insurance business, but that due to the specific contractual and pricing terms of a contract that regulate primarily a service obligation, enter into contracts that meet the definition of insurance contract of IFRS 17. For these entities the practice of accounting for these contracts in the same way as other contracts with customers would provide useful information for the users of their financial statements. Hence, EFRAG assesses that applying IFRS 17 to these contracts would impose costs for no significant benefit.

72 EFRAG also notes that the option to apply IFRS 17 for fixed-fee service contracts allows insurers to simplify operationally the accounting process, extending IFRS 17 accounting to these contracts.

Assessing whether the boundary in applying IFRS 15 and IFRS 17 is appropriate

73 EFRAG notes that the fixed-fee scope exclusion is limited to contracts whose primary purpose is the provision of services for a fixed fee. However, it is noted that some entities issue both fixed-fee service contracts and other insurance contracts. For example, some entities issue both roadside assistance contracts and insurance contracts for damage arising from accidents.

74 EFRAG assesses that the choice to allow entities to apply either IFRS 17 or IFRS 15 to fixed-fee service contracts would enable such entities to account for both types of contracts in the same way.

Assessing the boundary of IFRS 17 and IFRS 15 in a financial group

75 EFRAG notes that under IFRS 17, consistent with IFRS 15, an insurer depicts revenue for the transfer of promised coverage and other services at an amount that

reflects the consideration to which the insurer expects to be entitled in exchange for the services. This means that the insurer:

(a) excludes from insurance revenue any investment components; and

(b) recognises insurance revenue in each period as it satisfies the performance obligations in the insurance contracts.

76 EFRAG also acknowledges that, depending on the measurement model under IFRS 17, the accretion of interest is accounted for differently. However, such interest is not within the scope of IFRS 15.

Interaction of IFRS 17 with IFRS 9

77 This part comprises:

(a) Overview;

(b) Measurement;

(c) Equity investment;

(d) IFRS 17 promotes fair value measurement of assets;

(e) Locked-in discount rate;

(f) Impact on the investment horizon;

(g) Asset and liability management; and

(h) Transition.

Overview

78 *Assets:* As a result of applying IFRS 9, financial assets are measured on balance sheet at either amortised cost or fair value. When financial assets are measured at fair value, gains and losses are recognised either in profit or loss (fair value through profit or loss, FVPL), or in other comprehensive income (fair value through other comprehensive income (OCI)). Derivative financial instruments (when not used in hedge accounting) equity instruments and financial assets that do not meet the SPPI test is measured at FVPL. Equity instruments not held for trading may be designated at FVOCI without recycling (in the remainder of this document 'FVOCI without recycling is used as a wording convention to indicate the equity instruments for which entities make this optional designation). Financial assets that meet the SPPI test when held in a business model whose objective is to hold financial assets in order to collect contractual cash flows are measured at amortised cost and when held in a business model whose objectives are achieved by both collecting contractual cash flows and selling financial assets are measured at FVOCI with recycling. Irrespective of the business model, financial assets may be designated at FVPL when doing so reduces accounting mismatches.

79 *Liabilities:* IFRS 17 requires insurers to discount insurance contract liabilities using a current interest rate and the effect of changes in that interest rate can be reported in profit or loss or in other comprehensive income. Thus, the income and expenses reported in profit or loss or in other comprehensive income, as a result of changes in current interest rates, are expected to offset at least partially, to the extent the insurance liabilities are economically matched with the relating assets, the volatility in profit or loss or in other comprehensive income that may arise from financial assets accounted for at fair value through profit or loss or at fair value through other comprehensive income. The extent of this offsetting will also reflect the investments of premiums over different years and the type of investment done, e.g. equity investment.

Measurement

80 Measurement and presentation possibilities of financial assets and insurance liabilities could be illustrated as follows:

Financial assets (in accordance with IFRS 9)	**Insurance liabilities (in accordance with IFRS 17)**
Amortised cost (if it passes both the business model whose objective is to hold financial assets in order to collect contractual cash flows and the SPPI test) – subject to impairment	
FVPL	Fulfilment value (a current value measurement)
FVOCI (with recycling – SPPI instruments, business model whose objective is achieved by both collecting contractual cash flows and selling financial assets) -subject to impairment	OCI-option for insurance finance income or expenses
FVOCI (without recycling and subject to no impairment test – equity instruments)	

81 Both IFRS 9 and IFRS 17 include options to reduce accounting mismatches. Whereas IFRS 9 allows entities to elect to measure financial assets at FVPL when this addresses an accounting mismatch, IFRS 17 allows entities to make an accounting policy choice between:

(a) including insurance finance income or expense for the period in profit or loss; or

(b) disaggregating finance income or expense between profit or loss and OCI.

82 In the Economic Study commissioned by EFRAG, it has also been noted that:

(a) Although there is considerable discussion about insurers moving away from debt securities towards new asset classes and/or equity instruments, the aggregate data from EIOPA on the investments of EU insurers do not show a significant movement out of the debt securities at the EU wide level.

(b) The majority of stakeholders interviewed (i.e. supervisory authorities, insurers and external investors) agree 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.

(c) However, industry stakeholders expressed the view that the combined effect of applying IFRS 17 and IFRS 9 may have an impact on asset allocation.

Evidence from the case studies:

Under the extensive case study, respondents were asked to identify the related assets of the portfolios included and how these are accounted for today and under IFRS 17/IFRS 9. Some respondents indicated the measurement bases they are using.

Half of the respondents did not know whether IFRS 17 would result in a change in their investment strategy. The remaining respondents had split views about the issue.

Respondents to the simplified case study were divided as to whether IFRS 17 would affect their current investment strategy. It was noted that, economically, risks are unchanged by the introduction of IFRS 17, but the accounting would make these risks visible. For those that expected an impact on their investment strategies, it was due to the intent to reduce capital requirements under Solvency II as well as volatility in profit or loss.

83 Participants in the case studies did not expect many changes to their asset allocation[4] under IFRS 9 and indirectly under IFRS 17. However, for the income statement EFRAG assesses that, when measuring the insurance liability in a way that is consistent with observable market information:

(a) The income and expenses reported in profit or loss under IFRS 17 as a result of changes in current interest rates are expected to offset, at least to some extent, the volatility in profit or loss that may arise from financial assets accounted for at FVPL under IFRS 9.

(b) The insurer can:

(i) elect the fair value option under IFRS 9 in order to reduce accounting mismatches; or

(ii) elect the option under IFRS 17 to disaggregate financial income or expense between profit or loss and OCI.

84 Also, changes in insurance contract liabilities may be the consequence of changes in financial assumptions (i.e. discount rates and other financial variables). When applying IFRS 17, an insurer will recognise the effect of some changes in financial assumptions in the period in which the changes occur. However, the insurer will choose whether to present this effect:

(a) in profit or loss, or

(b) disaggregated between profit or loss and OCI.

85 The choice will be made individually for each portfolio of insurance contracts. Portfolios are determined based on risk characteristics of insurance contracts and how these are managed, rather than on any relationship with assets held. The flexibility in the presentation of the effects of changes in financial assumptions provided by IFRS 17 will allow an insurer to align the accounting treatment of each portfolio of insurance contracts with the accounting treatment of the assets that back that portfolio.

86 From the Economic Study commissioned by EFRAG, it is noted that: (i) a significant shift in investments in bonds is not expected, because insurers determine their assets mostly based on the expected return, the risks and cost in regulatory capital; (ii) accounting does only play a limited role in the asset determination; (iii) nevertheless, the measurement category might change due to the SPPI test under IFRS 9. Some respondents to the extensive case study noted that they are currently classifying assets [e.g. bonds, equities] as AFS under IAS 39.

87 In summary, EFRAG notes that IFRS 17 in itself is not expected to change the insurers' investment strategy, but IFRS 17 is the triggering event for application of IFRS 9 and that the Standard might have an impact either directly or indirectly.

88 IFRS 9 requires measuring equity instruments at FVPL and permits the presentation of the fair value changes in OCI. Measuring equity instruments at FVPL result in reporting in profit or loss the changes in the fair value in these instruments. However, when the presentation in OCI is elected, the amount in OCI will never be recycled in profit or loss, apart from dividends received which are recognised in profit or loss directly[5]. In turn, equity instruments measured at fair value through OCI are not

Evidence from the case studies:

As part of evidence received, concerns have been raised by insurers that in the case of contracts with participation features, the share of profit of the policyholder is recognised in profit or loss over the total contract term, while for equity instruments at FVOCI the investment income will never be recognised in profit or loss. The lack of recycling of OCI on the assets is therefore creating an accounting mismatch with the measurement of insurance liabilities.

[4] However, in contrast to the participants in t to their asset allocations some respondents ind ts may be classified and measured differently u

[5] The reasons for this is that the IASB concl ld be recognised once only; therefore, recognis nd subsequently transferring it to profit or loss at

subject to impairment. If these instruments back insurance liabilities, an accounting mismatch will arise, as over time the changes in the insurance liabilities will be recognised in profit or loss, whereas the changes to any equity instruments backing those liabilities will never be recycled through profit or loss. The extent of this accounting mismatch will depend whether the change in the insurance liability relates to financial risks or not and whether the changes in the fulfilment cash flows relate to past of future service; also, changes in discretionary cash flows may be reported through the CSM (so, impacting profit or loss during the coverage period).

Puttable financial instruments under IFRS 9

89 Certain types of assets (such as investments in funds) expose investors to equity risk without meeting the definition of equity instruments because they are puttable. The option under IFRS 9 to present the fair value changes through other comprehensive income is not available for such assets and, because they do not meet the contractual cash flow test, they have to be measured at fair value through profit or loss. This measurement basis may not reflect the way the assets are managed in a long-term investment business model, which may limit the relevance of the information.

EFRAG's analysis

~~89~~90 EFRAG notes that the share of profit for the shareholders will be recognised in P&L over the period via the release of CSM to profit or loss. Some note that this relates to the shareholders share of profit while the accounting mismatch described in the previous paragraph refers to the policyholders' share of profit. EFRAG notes that this view relates to a more analytical accounting perspective that goes beyond the application of IFRS 17.

~~90~~91 Furthermore, the option to measure equity instruments at FVOCI is an option and not a requirement under IFRS 9 and excludes dividends which are accounted for through profit or loss. However, EFRAG notes that the reason for exercising this choice is to mitigate the volatility of the effect of strategic investments within the income statement.

~~91~~92 The equity issue is further discussed in the chapter on the long-term business model (paragraphs 96 to123).

IFRS 17 promotes fair value measurement of assets

~~92~~93 IFRS 17 is using a fulfilment value to measure the insurance liabilities. It is noted by some that the use of a current value creates a disincentive for insurers to choose another measurement of assets than fair value if they want to avoid accounting mismatches.

~~93~~94 EFRAG however is of the view that the accounting for financial assets will be determined based on the business models in managing these financial assets. In accordance with IFRS 9, business models are a matter of fact and not an assertion. Nevertheless, EFRAG expects the managerial aspects determining the business models to be chosen in function of support by the financial assets to the insurance liabilities. For example, choosing the FVOCI business model for bonds would allow

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recycling of gains and losses to profit or loss would create something similar to the available-for-sale category in IAS 39 and would create the requirement to assess the equity instrument for impairment, which had created application problems. That would not significantly improve or reduce the complexity of the financial reporting for financial assets. [IFRS 9 BC5.25(b)]

to reduce mismatches with an FVOCI option for insurance finance income or expenses.

Locked-in discount rate

9495 The accounting for insurance contracts not meeting the VFA criteria will have to follow a “locked-in” discount rate, in addition to the current rate, for the purpose of the CSM calculation. At the same time, this accounting treatment might generate temporary volatility in OCI; the OCI-balance is unwound overtime.

9596 The reasoning that supports the IFRS 17 treatment is that accreting interest on the CSM for an accounting period at a current rate differs from measuring cash flows at a current rate. The CSM is more accrual-accounting than valuation, i.e. the CSM does not represent future cash flows; it represents the unearned profit in the contract, measured at the point of initial recognition and adjusted only for specified amounts. For insurance contracts without direct participation features, the CSM is not adjusted (remeasured) for changes in interest rates. Accreting interest for a period at a current rate without also remeasuring the CSM at the start of the period would create an internally inconsistent measurement of the CSM. EFRAG acknowledges that some commentators disagree with this.

Impact on the investment horizon of insurers

9697 The request for Endorsement Advice by the European Commission to EFRAG asks "*EFRAG to analyse the potential impact of IFRS 17, taking into account its interaction with IFRS 9, on long-term investment including the investments held by insurance groups".*

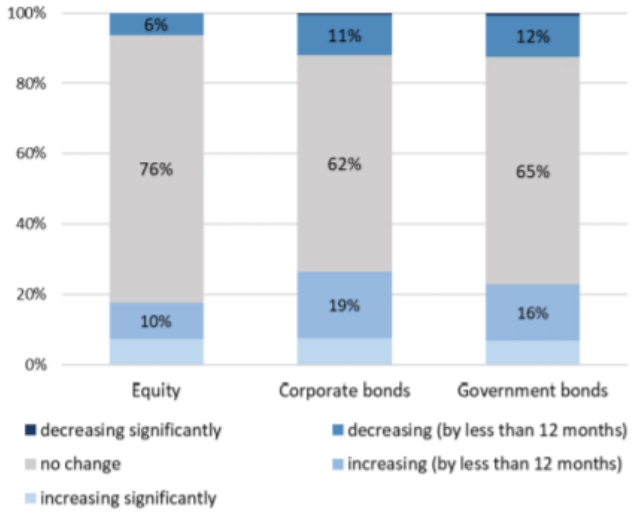
9798 EFRAG notes the results of a recent investigation carried out by the European Supervisory Authorities (including EIOPA and ESMA), performed to collect evidence and stakeholders' views on undue short-term pressure from financial markets on corporations. In its advice issued in December 2019, EIOPA observes that the financial literature often describes short-termism as the tendency to prioritise near-term shareholder interests and profitability at the expense of the long-term growth of the firm. EIOPA notes that short-term behaviour cannot be simply associated with a short investment horizon; instead, it is the tendency to focus on short-term profits without ensuring sufficient investment for long-term needs and development.

9899 In its Advice to the European Commission issued in December 2019, EIOPA observes that the lack of an appropriate framework and a commonly accepted definition of excessive or undue short-termism prevents the authorities from pointing out and clearly analysing insurance institutions' term behaviours and makes it harder to find clear evidence from which to draw conclusions. In addition, EIOPA concludes that the investigation has not found strong evidence for practices or trends that could be considered undue short-term behaviour. In addition, EIOPA in its Advice presents the results of a survey of a sample of entities:

(a) the top three determinants for the time horizon underlying the business activity, are the profitability aspects, the shareholders' interest and the prudential regulation. The top five include the monetary policies and macroeconomic factors and then the client demand. Reporting requirements, which are not included in the top five determinants, have high relevance according to 12% and medium relevance for the 31% of the sample, 34% attaching low relevance and the rest no relevance to reporting requirements;

(b) the top three determinants for the holding periods are the liability structure (which naturally reflects the business strategy and the client demand), the profitability aspects and the monetary policies and macroeconomic factors. The top five also include the prudential regulation and the shareholders' interest. Reporting requirements, which are not included in the top five determinants, has high relevance according to 7% and medium relevance for the 22% of the sample, 32% attaching low relevance and the rest no relevance to reporting requirements;

(c) several participants mentioned that they enforce 'buy and hold' strategies, but this does not imply a 'buy and forget' strategy: the necessary cash flows, policyholders' behaviour and market developments determine adjustments to the portfolios. In more detail, the holding strategy aims to match the assets with the long-term liabilities, and only a small portion of the portfolio is usually subject to active trading and characterised by a shortened horizon to be able to react to sudden pay-outs. In the next 2 years, the participants expect to keep the holding periods of their portfolios rather stable (see Figure below). In more detail, investments in equity instruments were revealed to be the most stable: more than three quarters of the participants are planning to keep the holding period constant in the near future.



Source: EIOPA, ad hoc survey 2019.

~~99~~100 ESMA in its Advice to the European Commission issued in December 2019 summarises findings on how fair value may impact the capacity of financial reporting to provide relevant and reliable information on equity instruments held for long-term investment purposes. ESMA observes that neither the public survey, nor the collection of evidence from literature have highlighted that fair value measurement results in distortions of the investment process that trigger undue short-term pressures in financial markets. Fair value is deemed to be a relevant measurement basis for both managers and investors, and there is no evidence (or at least, no evidence yet) on the consequences of the implementation of IFRS 9 on long-term investment practices. This lack of evidence may also be due to the recent application of IFRS 9 by most issuers in Europe. Moreover, it was highlighted that the selection of investment horizons does not depend fundamentally on fair value measurement for equity and equity-like instruments as provided for in IFRS 9. ESMA therefore considered that on the basis of the evidence collected, no need for amending the existing requirements for fair value measurement has been identified to address concerns with undue short-termism.

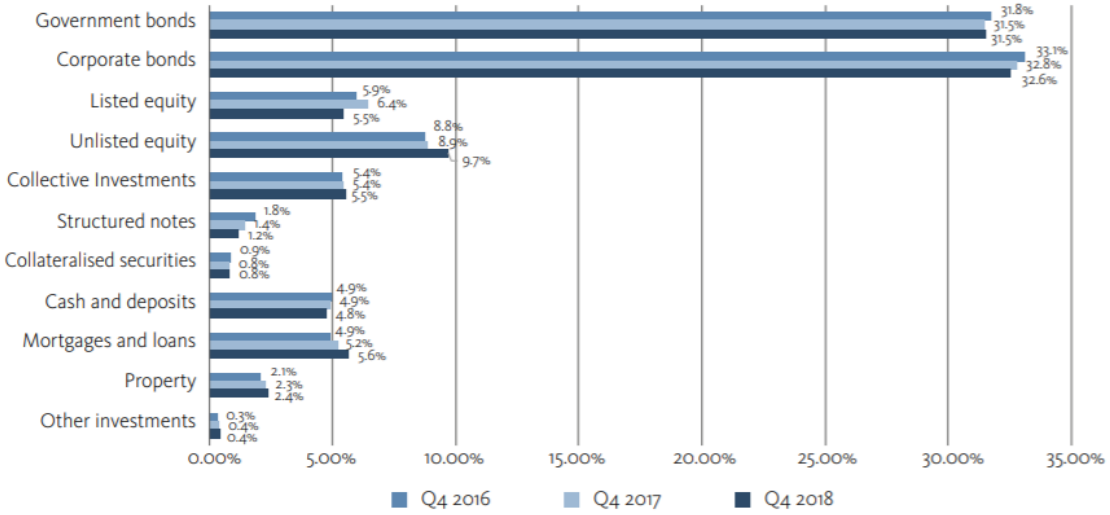
~~100~~101 The broad overall pattern of asset allocation among the key investment categories by European insurers has remained fairly stable over the past decade, despite significant changes in regulation and economic conditions over this time horizon. Asset allocation decisions are driven by a plurality of factors, among which external financial reporting requirements might play some part but do not appear to be a key driver.

~~101~~102 There is no indication that IFRS 17 in isolation would lead to any significant changes in European insurers' decisions on asset allocation or holding periods. However, some insurers have indicated that the combination of IFRS 17 and IFRS 9 may lead to changes as they see a connection between the application of both standards together. The main explanation provided relates to the removal of IAS 39's Available for Sale (AFS) category in relation to equity and equity-type instruments. Entities are concerned the combination of IFRS 17 and IFRS 9 may not always portray the economic linkage between their holdings of equity investments and some of their liabilities. For EFRAG's assessment on the possibilities of hedge accounting, please refer to Annex 5.

~~102~~103 EFRAG's previous investigations on the use of the AFS category in 2018 based on 2017 financial results found that there is a high level of concentration of holdings of instruments classified as AFS in a relatively small number of entities. Some insurers make little or no use of the AFS classification and classify most or all of their equity instruments at FVPL: such entities should not be affected by IFRS 9's requirements (on the assumption that the classification does not change because of IFRS 17).

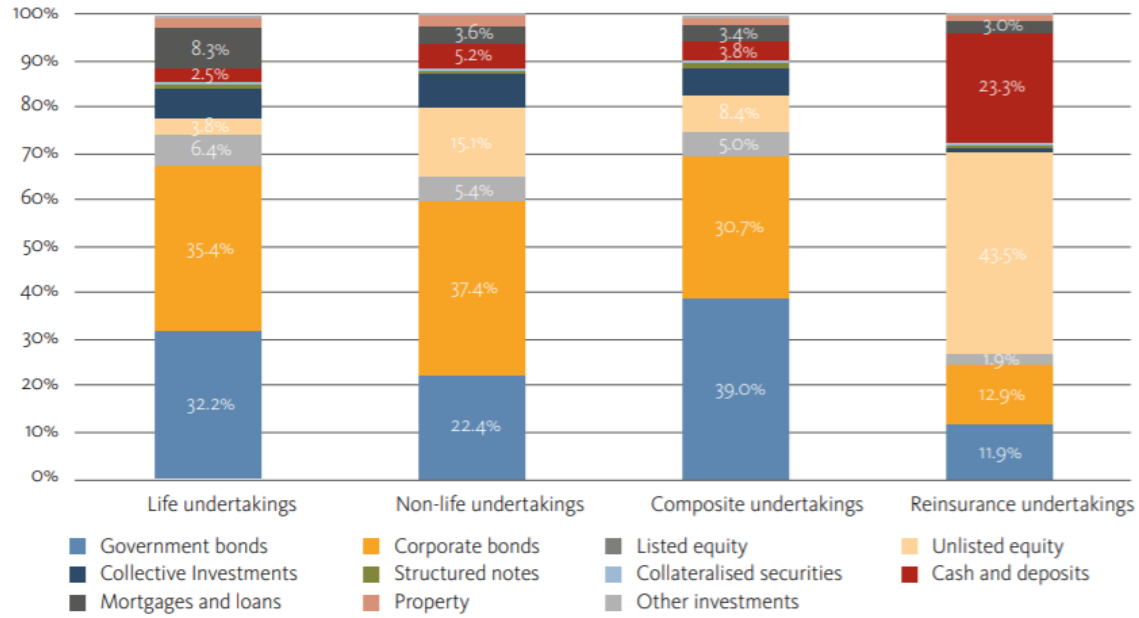
~~103~~104 EIOPA has provided some information about investments by the insurers in Europe on a Solvency II basis. Not all insurers in this population prepare financial statements on an IFRS basis and these figures would not include the investments of those subsidiaries outside the supervision of EIOPA. However, EIOPA's data still provide useful information.

~~104~~105 Analysis by type of assets:



Source: EIOPA Quarterly Solo
Reference Date: Q4 2018
Note: Look-through approach applied. Assets held for unit-linked business are excluded. Equities include holdings in related undertakings.

~~105~~106 Type of assets by type of insurer:



Source: EIOPA Quarterly Solo
Reference Date: Q4 2018
Note: Look-through approach applied. Equities include holdings in related undertakings, which account for most equities held by reinsurers. Assets held for unit-linked business are excluded.

Information from the extensive case study

~~106~~107 In the case study that was carried out in 2018, it is reasonable to assume that preparers had focused on the details of IFRS 17 and had not yet necessarily considered all the implications of IFRS 9 *Financial Instruments* and its interaction with IFRS 17.

~~107~~108 However, respondents to the extensive case study from France, Italy and Spain indicated concerns that given the new requirements of IFRS 9, more items will have to be carried at FVPL rather than Available for Sale (AFS) under IAS 39 today. Few details were provided, but these seem to centre around equity-like investments such as UCITs[6] and structured or complex bonds. Presumably, for the latter, any embedded derivative was separated with the host then classified separately. This option is not available under IFRS 9. Some respondents also briefly commented that FVOCI would be more appropriate for equities, but without providing further reasons or explanations.

EFRAG's project on the accounting treatment of equity instruments under IFRS 9 from a long-term investment perspective

~~108~~109 In 2019, EFRAG was requested by the European Commission to advice on possible alternative accounting methods to be applied to equity instruments held in a long-term investment business model.

~~109~~110 During the public consultation on the assessment phase of this project, eleven insurance entities responded.

~~110~~111 The top reasons for investment in equity instruments were strategic asset mix/allocation and economic return/risk expectation; asset liability management (mainly duration and liquidity but also currency and inflation); and Solvency II capital requirements and accounting rules.

~~111~~112 Seven insurance entities expect to use the FVOCI election mainly for strategic or long-term investments.

Expected classification of equity instruments under IFRS 9:

% of equity instruments for which the FVOCI election is expected to be used	**Nr. of respondents**
Less than 1%	1
5%-10%	1
25%-35%	-
60%-80%	1
100%	3
Not specified percentage	2
Not applicable	3
Total	***11***

~~112~~113 The respondents indicated that the main factors impacting holding periods are asset/liability management/matching (duration, currency, and sensitivity to inflation)

[6] Undertakings for the Collective Investment of Transferable Securities

and the rebalancing needs for investment strategies (for tactical reasons or passive benchmark tracking) of asset managers.

~~113~~114 Eight insurance entities expect because of the introduction of IFRS 9 to modify their asset allocation decisions, although most did not specify to what extent. They referred mainly to contracts with participation features under the VFA whilst some indicated possible shifts of significant parts of their equity portfolio from listed to non-listed/private equity entities. Some observed that returns from non-listed investments are mostly collected as dividends which are recognised in profit or loss. One insurance entity suggested that unlisted investments are less volatile. One respondent noted that it will invest less in small caps/growth stocks and other classes of alternative assets mentioned were real estate, infrastructure, and entities in the renewables industry, as less volatile than other equity instruments.

~~114~~115 Some insurance entities also expect to replace part of their investments in equity instruments with credit investments, loans, or bonds. One insurance entity reported that its asset allocation decisions are not affected by accounting requirements.

~~115~~116 The EFRAG letter to the European Commission[7] refers to other available sources that indicate that asset allocation is changing for a variety of reasons that do not relate to accounting, notably the search for yield in the prevailing economic environment.

EIOPA's Investment Behaviour Report

~~116~~117 EIOPA published an *Investment Behaviour Report* in November 2017, which analyses the investment behaviour of European insurers over the previous five years based on the submissions of supervisory data from 87 large insurance groups and four solo undertakings across 16 EU Member States. These groups are not necessarily reporting under IFRS Standards. The report identifies the following trends in Europe:

(a) a trend towards lower credit rating quality fixed income bonds with lower credit rating quality, while at the same time, there were many sovereign and corporate downgrades during the period;

(b) a trend towards more illiquid investments such as non-listed equity instruments and loans excluding mortgages and a decrease in (the value of) property investments;

(c) an increase of the average maturity of the bond portfolio;

(d) an increase of the weight of new asset classes, such as infrastructure, mortgages, loans, real estate;

(e) a small decrease in the debt portfolio and a small increase in 'other investments' between 2015 and 2016. Equity allocation has remained unchanged. Changes in all three main investment categories from 2011 to 2016 have only been marginal; and

(f) the volume of insurance contracts that are not unit linked and not related to index linked assets has significantly increased in the last years. The majority of the insurers mentioned the intention to further extend the product range and the selling of more of such products in the next three years.

[7] https://www.efrag.org/News/Project-303/EFRAGs-report-to-the-European-Commission-on-the-assessment-of-the-impact-of-IFRS-9-on-long-term-investments-in-equity-instruments

Economic Study

~~117~~118 Most stakeholders interviewed by the economic consultants (i.e. supervisory authorities, insurers and external investors) thought that IFRS 17 alone will not affect the asset allocation of insurance undertakings as this activity is more driven by risk management and/or asset/liability management. However, industry stakeholders expressed the view that the effect of applying IFRS 17 together with IFRS 9 may have an impact on asset allocation The changes introduced by IFRS 17 and IFRS 9 are not expected to involve significant changes in accounting and investment practices to manage accounting volatility in those jurisdictions (Denmark and the UK) where existing accounting practices tend to measure insurance contract liabilities on a current value basis.

~~118~~119 Some insurers thought that investments in equity instruments and structured funds will become less attractive following the adoption of IFRS 17 and IFRS 9, as assets characterised by higher volatility will expose a company's profit or loss to market fluctuations. This may create a friction with the "risk appetite" of insurance undertakings with a focus on short term investment.

EFRAG's advice on alternative accounting treatment for long-term equity investments

~~119~~120 Pursuant to the concern expressed in its IFRS 9 endorsement advice, EFRAG has been requested by the European Commission ('EC') to consider alternative accounting treatments to measurement at FVPL for equity instruments. Possible accounting treatments should properly portray the performance and risks of long-term investment business models, in particular for those equity and equity-type investments that are much needed for achieving the UN Sustainable Development Goals and the goals of the Paris Agreement on Climate Change.

~~120~~121 In its letter of 30 January 2020 to the EC, EFRAG noted the following:

(a) In a context where IFRS 9 has been recently implemented and is substantially still not applied by the insurance sector, its potential impact on long-term investment cannot be assessed based on actual data. Therefore, no compelling evidence has come to the attention of EFRAG that IFRS 9 is an impediment or not to long-term investment.

(b) Asset allocation decisions are driven by a plurality of factors and that it is difficult to disentangle the impact of accounting requirements from that of other factors, such as expectation on future returns by class of assets or other regulations, including taxes and prudential requirements.

(c) In the 2019 public consultation, respondents expressed mixed views on whether an alternative accounting treatment is needed to portray the risks and performance of equity and equity-type instruments held in a LTIBM (long-term investment business model). Seventy percent (70%) of respondents considered that an alternative accounting treatment was relevant to meet the objective to reduce or prevent detrimental effects on long-term investments. However, 30% of respondents did not consider that an alternative accounting treatment is needed. Seventy-eight percent (78%) of those who supported an alternative treatment (corresponding to 52% of the total respondents) favoured a model based on fair value through other comprehensive income ('FVOCI'), with a scope that is similar to the FVOCI option under IFRS 9. EFRAG notes that the concerns expressed by these respondents are not new and that similar concerns were highlighted in its endorsement advice on IFRS 9. Nearly all respondents from the insurance and asset management industry, together with a large majority of the banks and non-financial corporates, supported the need for an alternative accounting treatment. Users and National Standard Setters (NSS) had mixed views. The users who

supported an alternative treatment (half of the users who responded) mainly supported the FVPL model for all equity instruments. NSS who supported an alternative prefer FVOCI model with recycling; NSS who did not support an alternative, mainly believed that more evidence is needed before a change is proposed. Respondents from the accounting/audit profession and regulators did not consider that an alternative treatment is needed, mainly because at this stage there is no evidence to support such a need.

(d) 25% of respondents concluded that the requirements in IFRS 9 could discourage investment in equity instruments. Quantitative evidence is still lacking at this stage to determine if this view is correct or not.

(e) The feedback the from 2019 public consultation summarised above, shows an expectation from the financial sector, including the insurance sector, that the applicable accounting treatment is relevant to the objective of reducing or preventing detrimental effects on long-term investment. In addition, the feedback has shown that there is a strong view from insurance entities, banks, asset managers and self-defined long-term investors, but also from non-financial corporates, that an alternative accounting treatment is needed for equity instruments under IFRS 9 to properly portray the performance and risks of equity instruments held in a long-term-investment business model. As mentioned above, the views of users of financial statements and NSS were split. Actual impact data do not exist at this point in time to confirm whether the views reported above are correct or not, in particular as European entities from the insurance sector, which are also institutional investors, do not apply IFRS 9 yet. However, most respondents are justifying their views on the basis of conceptual, managerial and strategic reasons.

~~121~~122 EFRAG advised, in particular, that the EC recommend to the IASB an expeditious review of the non-recycling treatment of equity instruments within IFRS 9, testing whether the revised Conceptual Framework for Financial Reporting (March 2018) (‘Conceptual Framework’) would justify the transfer to profit or loss (‘recycling’) of fair value gains and losses accumulated in other comprehensive income (‘FVOCI gains and losses’) on such instruments when realised. If recycling was to be reintroduced, the IASB should also consider the features of a robust impairment model, including the reversal of impairment losses.

In summary:

~~122~~123 In EFRAG's view:

(a) Asset allocation decisions are driven by a plurality of factors, among which external financial reporting requirements might play some part but do not appear to be a key driver;

(b) There is no indication that IFRS 17 in isolation would lead to any significant changes in European insurers' decisions on asset allocation or holding periods. However, some insurers have indicated that the combination of IFRS 17 and IFRS 9 may lead to changes. The main explanation provided relates to the removal of IAS 39's AFS category in relation to equity and equity-type instruments. Those insurers are concerned that the combination of IFRS 17 and IFRS 9 does not always portray the economic linkage between their holdings of equity investments and some of their liabilities. Feedback from the insurance sector, expressed in the survey that EFRAG has performed in 2019 to gather evidence for its Advice to the European Commission on alternative accounting treatments for equity instruments, confirms such concerns;

(c) EFRAG's previous investigations on the use of the AFS category found that there is a high level of concentration of holdings of instruments classified as AFS in a relatively small number of entities. Some insurers make little or no use of the AFS classification and classify most or all of their equity instruments at FVPL: such entities should not be affected by IFRS 9's requirements (on the assumption that the classification does not change because of IFRS 17);

(d) There is anecdotal evidence that investments in structured funds may become less attractive due to more significant profit or loss volatility whilst some consider the non-recycling of equity instruments measured at FVOCI under IFRS 9 to be detrimental (while FVPL would lead to volatility).

~~123~~124 At this stage, EFRAG notes that asset allocation is driven by a number of factors such as return of the invested assets, their cost in regulatory capital and accounting. However, EFRAG understands that showing volatility in profit or loss could reduce preparers' willingness to invest in equity instruments; in contrast investors have noted in the first EFRAG User Outreach on IFRS 17 that volatility was not a problem if it was explained to the market.

Asset and liability management ('ALM')

Introduction

~~124~~125 EFRAG expects insurers to define business models under IFRS 9 for financial assets that are consistent with their insurance business. Insurers invest the proceeds from premiums into different asset categories, such as bonds, equities, or collective investment undertakings, with the aim of achieving a target investment return. The Economic Study commissioned by EFRAG notes that the application of IFRS 17 alone will not impact the asset allocation of insurers as this is more driven by risk management and/or asset and liability management.

~~125~~126 However, the combined application of IFRS 17 for the liability side in conjunction with IFRS 9 *Financial Instruments* for the asset side may have an impact on asset allocation. This is explained below.

~~126~~127 Typically, insurers seek to match the characteristics of their assets with those of their liabilities, to minimise economic mismatches between the two. The avoidance of economic mismatches has the effect of reducing volatility in the profit or loss statement. Avoidance of all economic mismatches is however not always possible or even desirable (as assets that minimise the economic mismatch may

have insufficient asset returns to cover the expected insurance expenses). In selecting the assets, the asset liability management of the insurer will therefore consider not only the characteristics of the liabilities, but also the return of the assets and the solvency requirements related to it (different asset categories are more or either less "expensive" in terms of regulatory capital depending on their nature, e.g. investments in equity instruments require the insurer to hold more regulatory capital than investments in bonds).

~~127~~128 The asset and liability management function will consider all of the above criteria in order to select the optimal asset portfolio(s). Nevertheless, it is noted by insurers that the application of IFRS 17 and IFRS 9 together will increase the volatility in profit or loss. Why is that?

~~128~~129 The main reason for this is that IFRS 17 measures the insurance liability at current value which makes the economic mismatches between the insurance liabilities and the supporting assets visible. These could be caused because the insurer may take some economic risks– in accordance with their business model – in order to be able to fulfil their obligations to the policyholders.

~~129~~130 When economic mismatches exist between the asset and the liability side, the accounting will have to reflect this with resulting volatility in the profit or loss statement. In addition the application of IFRS 17 and IFRS 9 also creates some accounting mismatches like the ones described in paragraphs 160 and further. In many cases accounting and economic mismatches will overlap making it difficult to distinguish the one from the other (and thus also identifying the source of volatility).

~~130~~131 Hence, it is stated by some insurers that the application of IFRS 17 and IFRS 9 together may lead to changes in asset allocation. However, such re-allocations would have to consider other factors, such as the ones described in paragraph 126 above.

~~131~~132 The Economic Study commissioned by EFRAG notes that some insurers are of the view that investments in equity instruments and structured funds (i.e. funds that invest in a diversity of equity investments) may become less attractive as holding such investments result in higher volatility in the profit or loss. Similarly as for potential re-allocations, such divestments would have to consider other factors, such as the ones described in paragraph 126 above.

The use of a dedicated fund or a general fund of assets

~~132~~133 The degree to which matching insurance liabilities and assets backing those liabilities can be successfully matched[8] depends on a number of factors:

(a) The use of a dedicated fund of assets or a general fund of assets;

(b) The existence of economic mismatches between the assets and the liabilities; and

(c) The existence of accounting mismatches between the assets and the liabilities.

Evidence from the case studies:

The extensive case study showed that of the nineteen portfolios, eleven were funded through a general fund of assets, while eight were funded through a dedicated fund of assets.

Whereas in the simplified case study, half of the respondents held assets that back specific liabilities whilst the other half generally held assets in a general fund.

~~133~~134 Some insurers invest in a dedicated fund, where a direct

[8] The words 'successfully matched' mean that the economic and accounting mismatches between assets and liabilities are reduced to a minimum while the assets at the same time provide a sufficient return to fund these liabilities.

economic link exist between the assets and the liabilities, whilst others make use of a general fund where there is no direct link between the assets backing the liabilities.

Economic mismatches

~~134~~135 Insurance entities typically seek to match the characteristics of their assets with their liabilities to the extent possible, in order to minimise economic mismatches[9] between the two. Economic matching depends on several factors (for example, the unavailability of assets of sufficient duration, the deviation between expected and actual when pay-outs on insurance contracts, and the insurer's intent to generate higher returns).

Evidence from the case studies:

From the extensive case study respondents provided information on the following economic mismatches:

(a) Currency mismatches;

(b) Credit spread risk mismatches within the same currency (euro); and

(c) Duration mismatches.

For three portfolios currency mismatches were quantified. For one portfolio, backed by a dedicated fund, the mismatch was small. The two other portfolios backed by a general fund showed much bigger differences, however no conclusions can be drawn as information on the size of the general fund compared to the tested portfolio was not received.

One the sources of economic mismatches (leading to volatility in profit or loss because these credit spreads, while part of the fair value of the assets are excluded from the discount rate in determining the insurance liability) is the existence of credit spread mismatches. In the case study, many of the reported credit spread risk mismatches were significant reflecting the credit spreads of each Eurozone Member State. As an illustration of the potential effect of credit spread risk mismatches, consider the following market interest rates.

Euro member state	**Interest rates on 30-year government bonds**
France	0,43%
Germany	-0,10%
Italy	1.78%
Spain	1.05%

[1] As at 25 September 2020

The portfolios that were backed by a general fund of assets showed a significant average duration mismatch of 20%. In contrast, portfolios that were backed by a dedicated fund of assets showed a much smaller average duration mismatch of 4%.

EFRAG's analysis

~~135~~136 Economic mismatches are more prevalent in cases where portfolios are backed by a general fund as opposed to a dedicated fund. As a clear link between insurance liabilities and underlying assets is not needed under the general model, it is more difficult to align the characteristics of the assets and the insurance liabilities in order to mitigate volatility.

~~136~~137 Although the VFA could be applied in cases where entities do not hold the underlying assets, EFRAG is of the view that in such cases another economic mismatch arises, as changes in assumptions of the IFRS 17 liability will be recognised in profit or loss over time without the recognition of similar changes in assets.

~~137~~138 Consequently, EFRAG is of the view that the mismatches identified above do not arise solely from the application of IFRS 17 and IFRS 9 but are economic in nature.

~~138~~139 EFRAG considers that reporting in profit or loss the extent of the economic mismatches is useful information, as it provides information about the possible future ability of the entity to generate sufficient cash flows from the assets to cover

[9] Defined as differences arising if the values of assets and liabilities respond differently to changes in economic conditions.

the liability obligations. It also provides information about the residual risks to which the entity is exposed.

Expected credit losses in accordance with IFRS 9

~~139~~140 The purpose of the following paragraphs is to explain the application of the expected credit loss model in IFRS 9. Insurers generally invest in high quality investment grade bonds but situations on the market may change quickly, affecting the long-term investments from insurers and thus the expected credit losses that are to be recognised. For example, consider the situation of bonds issued by airline or travel agency companies and how these are affected by Covid-19.

~~140~~141 IFRS 9 includes an expected credit loss model for financial assets that are measured at amortised cost and or at FVOCI. The question arises how the application of this expected credit loss model interacts with IFRS 17.

~~141~~142 When applying discounting in determining the measurement of the insurance liabilities, the following applies:

(a) When the cash flows from the insurance contracts vary based on the returns on any financial underlying item, the discount rate will reflect that variability;

(b) When the cash flows from the insurance contracts do not vary based on the returns of underlying items, the discount rate is determined starting either from a risk-free yield curve (bottom-up approach) or reference portfolio of assets (top-down approach) thereby eliminating any factors that are not relevant to the insurance contracts.

~~142~~143 When financial assets are derecognised (or are held till maturity) and the credit risk did not realise (i.e. the financial asset is paid back in full), the initial loss allowance is reversed at derecognition.

~~143~~144 EFRAG assesses that for contracts under the general model and the variable fee approach the expected credit-loss loss allowance may affect the measurement through the discretionary cash flows that may reflect expected credit losses on these assets.

Credit risk in accordance with IFRS 17

~~144~~145 Non-performance risk or own credit risk is not included in the measurement of the fulfilment cash flows of insurance contracts. In contrast, the measurement of reinsurance contracts held shall include the non-performance risk of the issuer of the reinsurance contracts, including the effects of collateral and losses from disputes.

~~145~~146 Credit risk arising from the underlying assets is excluded from the measurement of the insurance liabilities (excluded from the discount rate). It is noted that the non-performance risk or own credit risk has a different nature than the credit risk from the underlying assets.

~~146~~147 The different treatment of credit risk on the asset and the liability side leads to mismatches (and thus volatility) that are economic in nature.

~~147~~148 IFRS 17 requires disclosing the maximum exposure to credit risk, separately for insurance contracts issued and reinsurance contracts held. In addition, IFRS 17 requires disclosure about the credit quality of reinsurance contracts held as assets.

Transition

Setting OCI to nil – introduction

~~148~~149 As part of the transition requirements, entities have the possibility of setting OCI on the insurance liabilities to nil:

(a) Under the modified retrospective approach; and

(b) Under the fair value approach.

~~149~~150 In both situations, entities have the possibility of setting OCI on the insurance liabilities to nil when the insurance contracts have direct participation features and the entity holds the underlying items and applies the current period book yield to them. An option to set the OCI-balance to nil such as the one that is available for the liability is not available to assets accounted for at FVOCI under IFRS 9.

OCI under the modified retrospective approach

~~150~~151 Some note that under the modified retrospective approach from an economic standpoint, at transition, changes in discount rate have not yet been recognised on the asset side (which are measured at amortised cost or FVOCI), whereas the insurance liability would be recognised on transition at a current value, e.g. implicitly considering that past changes in discount rate have been recorded in retained earnings. Not considering any impact of the OCI carried forward on the liabilities could significantly impact the result of future periods and then undermine credibility of the transition.

~~151~~152 In the view of those stakeholders, transition requirements should provide a solution for all participating contracts (not only for direct participating contracts) where there is direct linkage between insurance liabilities and assets. That link could be based on a constructive obligation to a general pool of assets insofar that pool is larger than the group of insurance liabilities. The adjustment to the OCI balance would only take into consideration the policyholders' share not the shareholders' share. Assessing that adjustment may require an estimation of historical flows / changes in the fulfilment cash flows to estimate the proper amount of OCI to be adjusted. Fulfilment cash flows could be discounted at the rate the entity is expecting to be committed to against its policyholders (the "crediting rate"). Accordingly, accretion of the liability would reflect the returns transferred to policyholders. From an economic standpoint, the difference between that rate (estimated at transition date) and the current date on transition could be a proxy of what would have been put in OCI, be IFRS 17 applied from inception.

OCI under the fair value approach

~~152~~153 In this case the amount that would have been accumulated as a liability OCI balance is immediately transferred to retained earnings. However, the OCI balance on the assets may only be transferred to retained earnings over time. As a result, this would affect the financial result in the profit or loss statement in future years subsequent to transition. Hence, entities applying this approach would prefer to have the possibility to also set the asset OCI balance to nil at transition.

~~153~~154 EFRAG has been made aware that this asymmetrical treatment may significantly distort equity at transition and future results: assets will generate a yield based on the historical effective interest rate, whilst liabilities will unwind at the market rate at transition date. Also this asymmetrical treatment may affect the dividend capacity of these entities if dividends are determined on the basis of IFRS accounting.

EFRAG's assessment

OCI under the modified retrospective approach

~~154~~155 EFRAG notes that in this situation, the issue relates to broadening the possibility of using the current period book yield to the liability OCI balance at transition, beyond what is foreseen in the Standard (IFRS 17, C18 (b) (ii)) i.e. insurance contracts with direct participation features where the entity holds the underlying assets.

155156 The 'current period book yield' is the change in the carrying amount of assets -regarded as backing the insurance contracts - recognised in profit or loss for the period. EFRAG notes that the IASB limited the current period book yield to contracts where the insurer applies the variable fee approach and holds the underlying assets because in these situations there can be no economic mismatch between the insurance contracts and the assets held. EFRAG supports this approach.

156157 EFRAG acknowledges that adapting the liability OCI balance where the underlying assets are linked through a constructive rather than through a contractual obligation and using a "proxy" crediting rate has informative value in the view of some stakeholders. However, EFRAG assesses that such informative value is not the same as the one provided by the Standard. EFRAG acknowledges that some commentators disagree with this.

OCI under the fair value approach

157158 EFRAG identifies a number of issues in setting the OCI balance to zero for underlying assets when applying the fair value approach at transition:

(a) Setting the asset OCI balance to nil overrides the (long-term) business model of holding the related bonds which is based on collecting cash flows and selling. However, on transition there is no selling or derecognition of the bonds;

(b) As there is a duration mismatch between (shorter term) assets and (longer term) liabilities the fair values of both have a different sensitivity to interest rate risk. Hence, even applying the same rate for both assets and liabilities at transition date results in different changes in the OCI balances for respectively assets and liabilities at transition date +1;

(c) When the assets are held in an FVOCI business model, assets are occasionally sold. Given the shorter duration of the assets compared to the liabilities, recycling of the OCI balance post transition may be difficult as it has been moved to retained earnings at transition;

(d) As the OCI balance of a bond pulls to par over the life of the bond (over and beyond the date of transition), the (subsequent to transition) asset OCI balance may have a different sign than the one of the corresponding insurance liabilities. It leads to desynchronisation between the asset-OCI balance and the liability OCI balance;

(e) Permitting entities to deem the cumulative amount in OCI related to corresponding assets to nil at transition to IFRS 17 would involve an amendment to IFRS 9;

(f) Permitting entities to deem the cumulative amount in OCI related to corresponding assets to nil would involve hindsight in order to determine which assets have been supporting the insurance liabilities. This would result in a loss of useful information and a loss in comparability between entities.

Aligning the OCI balance of the assets to the OCI balance of the liabilities by means of the locked-in (or alternatively a market yield) rate at transition

158159 EFRAG has identified the following issues in applying this methodology:

(a) As there is a duration mismatch between (shorter term) assets and (longer term) liabilities the fair values of both have a different sensitivity to interest rate risk. Hence, even applying the same rate for both assets and liabilities at transition date results in different changes in the OCI balances for respectively assets and liabilities at transition date +1.

(b) Permitting entities to adjust the cumulative amount in OCI related to corresponding assets to the OCI balance of the liabilities would involve hindsight in order to determine which assets have been supporting the insurance liabilities. This would result in a loss of useful information and a loss in comparability between entities.

~~159~~160 EFRAG understands the wish to match insurance finance income and expenses from assets and liabilities at transition and beyond and notes this may be helpful for a number of entities as they can match their asset OCI balance with their liability OCI balance (avoiding mismatches). However, from a conceptual point of view, EFRAG notes there are a number of concerns as explained above that may affect the usefulness of the information that results from applying these methods. EFRAG acknowledges that some commentators disagree with this view.

Accounting mismatches

~~160~~161 When applying IFRS 17 and IFRS 9 together, accounting mismatches could arise from insurance liabilities measured at a risk-adjusted present value while assets backing the liabilities are measured differently. A theoretical overview of these accounting mismatches is provided below:

	VFA		General model		PAA (in case of existence of a significant financing component)	
	w. OCI-option	without OCI-option	w. OCI-option	without OCI-option	w. OCI-option	without OCI-option
Amortised cost	X[10]	X	X	X	X	X
FVOCI	√[11]	X	√	X	√	X
FVPL	X	√	X	√	X	√

~~161~~162 Some background is necessary in order to read this overview. For example, holding assets at amortised cost while using the OCI-option for the insurance liability results in an accounting mismatch. However, this theoretical set-up does not clarify the reasons why the insurer chooses an asset business model to hold and collect, while choosing the OCI option for the insurance liabilities. As a result, this example may be more theoretical than practical.

~~162~~163 Applying FVPL to the assets when applying the OCI-option for the insurance liability also results in an accounting mismatch. Here further clarifications about the credit spread, currency or the duration of the assets are required in order to determine which part of the mismatch is due to accounting and which part is economic in nature.

~~163~~164 As also described in paragraph 79 above, applying FVOCI for financial assets when applying the OCI-option for the insurance liability offers a mitigation to the accounting mismatch. However, there may be an economic mismatch as a result of the credit spread, currency or duration of the assets compared to that of the insurance liabilities.

[10] X means “an accounting mismatch exists”

[11] √ means “no accounting mismatch”

~~164~~165 Other particular accounting mismatches are:

(a) OCI option for non VFA participating contracts under the modified retrospective approach (MRA);

(b) Risk mitigation cannot be applied retrospectively;

(c) Interaction with IFRS 9 – Comparative information in 2022;

(d) Use of a locked-in discount rate under the general model; and

(e) Measurement differences between reinsurance and insurance contracts.

OCI option for non VFA participating contracts under the modified retrospective approach (MRA)

~~165~~166 For an entity that chooses to disaggregate insurance finance income or expenses between profit or loss and OCI in accordance with IFRS 17, the MRA requirements indicate that the cumulative OCI relating to non-VFA contracts at the transition date may be assessed as nil.

~~166~~167 From an economic standpoint, there is an issue as the yield from assets at amortised cost or FVOCI are reported using the effective interest rate at the date of initial recognition, whereas the insurance liability would be discounted on transition at a current value.

Risk mitigation option

~~167~~168 EFRAG notes that insurers applying the VFA for contracts with direct participation features that use derivatives and financial instruments measured at FVPL to manage financial risks are permitted, but not required, to apply IFRS 17's 'risk mitigation solution'. Using this solution, the effects of changes in the effect of financial risks that would otherwise adjust the CSM under the VFA approach are instead recognised in profit or loss. One of the conditions for applying this option is to document the risk management objective and the strategy for mitigating the risk. This is in principle similar to IFRS 9's documentation requirement to be eligible for hedge accounting, however the conditions for hedge accounting, including testing every reporting period the hedge effectiveness, are more operationally complex to apply than the risk mitigation[12].

~~168~~169 Therefore, EFRAG notes that the recognition of changes in that financial risk in profit or loss partially offsets the effect of fair value changes in the relevant derivatives that are recognised in profit or loss and reduces potential accounting mismatches.

Risk mitigation cannot be applied retrospectively

~~169~~170 Risk mitigation provisions in IFRS 17 enable to recognise in profit or loss instead of as an adjustment to the CSM some or all the changes in the effect of the time value and financial risks, in order to match the corresponding changes in the derivatives or non-derivative risk mitigating financial instruments. IFRS 17 prohibits a retrospective application of the risk mitigation option. In some stakeholders' view, permitting retrospective application of the option would be needed, to achieve comparability between the information provided about risk mitigation activities that took place before and after the transition date. In particular those stakeholders mention that it would affect the CSM and retained earnings at transition and as a result also the profit recognition in the years after transition.

[12] Refer to Annex 5 to this Appendix for further information about hedge accounting in the context of insurance.

~~170~~171 The IASB noted that if an entity were permitted to apply the option retrospectively, it could decide the extent to which to reflect risk mitigation activities in the CSM based on a known accounting outcome. The entity could do this in a way that would not reflect how the entity would have applied the option in previous periods, had it always applied IFRS 17. Such a risk would affect the credibility of information presented on transition to IFRS 17 and in subsequent periods in which those groups of insurance contracts continue to exist. In the IASB's view, these costs would outweigh the benefits of permitting retrospective application of the option - particularly considering feedback that the amendments described in paragraph 171 made by the IASB help to addressed the concerns about the prohibition from applying the option retrospectively.

~~171~~172 The IASB decided to change the risk mitigation requirements to permit:

(a) an entity to apply the risk mitigation option prospectively from the transition date, rather than the date of initial application; and

(b) an entity that can apply IFRS 17 retrospectively to a group of insurance contracts to instead apply the fair value approach subject to specific conditions.

~~172~~173 Other arguments that were considered by EFRAG are described below:

~~173~~174 There is no conceptual reason for excluding the retrospective application of risk mitigation as long as the same documentation requirement applies. Risk mitigation is derived from a corporate strategy and does not result from a deliberate choice. Moreover, some consider that the reference to the use of 'reasonable and supportable information available without undue cost or effort' should be a general principle ensuring an adequate financial information in the very specific and temporary situation of a transition.

~~174~~175 Also, some consider the possibility to apply the fair value approach is not a solution to preferable retrospective application and the possibility to apply the risk mitigation on transition date is limited to the effect during the comparative period, but not addressing the opening effect on CSM and retained earnings.

~~175~~176 On balance EFRAG is of the view that not applying the risk mitigation option retrospectively will not negatively impact the usefulness of the information. EFRAG's detailed assessment of the risk mitigation option is discussed in Appendix II.

~~176~~177 Hedge accounting is discussed in Annex 5. In concluding on hedge accounting it can be stated that there is no conceptual barrier against the application of hedge accounting in the context of IFRS 17. However, given the lack of experience and systems by the industry, it would require significant investment both in time and systems development to achieve hedge accounting in this context.

~~177~~178 Finally, even with the application of hedge accounting, there is no guarantee that there will be no profit or loss volatility, because events may happen differently than expected or not all the risk types have been hedged. All of the above may also require further judgement and may only be suitable for some but not all cases or instruments.

Interaction with IFRS 9 – Comparative information in 2022

~~178~~179 The concerns described hereafter arise when an entity first applies IFRS 9 and IFRS 17 at the same time.

~~179~~180 In contrast to IFRS 17 which requires one year of comparative information, IFRS 9 permits, but does not require, an insurer to restate prior periods if it is possible without using hindsight. When an insurer does not restate prior periods (either as a matter of choice or because restatement without use of hindsight is not possible), the financial statements in which IFRS 17 is first applied will include

restated comparative information for insurance contracts but the associated financial assets will be reported in accordance with IAS 39.

~~180~~181 In addition, an entity is required to apply IFRS 9 retrospectively. However, the retrospective application does not extend to items that have already been derecognised at the date of initial application of IFRS 9.

~~181~~182 Restating the comparative period provides more relevant information. However, it is noted by some that applying both standards [IFRS 9 and IFRS 17] would be operationally burdensome and conceptually inconsistent: these constituents want to apply IFRS 9 to all financial instruments, including those derecognised in the comparative period, in order to strengthen comparability with the 2023 figures.

~~182~~183 EFRAG disagrees with these views for the following reasons. EFRAG notes that IAS 39 can be applied by insurers up until the moment of transitioning to IFRS 17. Hence, EFRAG does not support the operational burdensome argument as insurers are well experienced in applying IAS 39. EFRAG further notes that retrospectively assigning business models to derecognised financial assets would create a risk of hindsight and therefore EFRAG also disagrees with the fact that there is no conceptual argument to support the application of IAS 39.

Use of a locked-in discount rate under the general model

~~183~~184 The impact of assumption updates is absorbed in the CSM at the locked-in rate. The BEL[13] is measured at the current rate. Some stakeholders have stated that the difference between the locked-in and the current rate is reflected in the profit or loss and will significantly distort the current period result. In addition, the use of a locked-in discount rate (compared to all other components being based on current rates) would give rise to a material accounting mismatch.

~~184~~185 In the situation where the BEL component of the insurance liability is an asset and the CSM component is a liability, some stakeholders have stated that inconsistencies arise due to the different discount rates for BEL (current rate) and CSM (locked-in rate) again giving rise to accounting mismatches. EFRAG notes the CSM is a “cost-based” deferral that avoids a day 1 gain and provides a mechanism to allocate profit over the insurance coverage period.

~~185~~186 In the extreme example where only interest rates change (with no other changes), the CSM and related amortisation would change if the CSM were to be accreted at current rates instead of locked-in rates. This would also mean that the changes in discount rate that ought to be treated as investment result would be reported in the underwriting result through the release of the CSM.

~~186~~187 This above view is contrasted by another view that is reported hereafter. Alternatively, when a change in non-financial assumptions occurs when the current interest rate is different from the locked-in interest rate the following would happen. The CSM would be impacted at the locked-in rate while the insurance finance income and expenses would be affected by the difference between the current and locked-in rate on the amount of those non-financial assumptions, creating volatility in the results.

~~187~~188 The situations described in the paragraphs 185 and 186 above are extremes but EFRAG notes mixed scenarios of both extremes are more likely to exist.

Measurement differences between reinsurance and insurance contracts

~~188~~189 Reinsurance contracts do not qualify for the variable fee approach. EFRAG’s assessment on this issue can be found in Appendix II. As a result, when reinsurance

[13] Best Estimate of the Liability

contracts are compared to insurance contracts with direct participation features under the variable fee approach there is to some extent an accounting mismatch.

Conclusion on asset-liability management

~~189~~190 In EFRAG's view, the following qualitative observations can be done:

(a) Currently, under IFRS 4 important accounting mismatches exist: assets are measured at fair value whereas some liabilities at cost (no discounting at all or at locked in rates), this mismatch is only partially solved by shadow accounting;

(b) As mentioned in the chapter relating to the long-term business model, asset allocation decisions are driven by a plurality of factors and disentangling the impact of accounting requirements from other factors such as expectation of future returns or assets, regulations, taxes and prudential requirements is difficult;

(c) When defining the accounting for financial assets under IFRS 9, an insurer would not apply business models determined in isolation, but rather business models that are supportive of or complementary to their business model for managing insurance contracts;

(d) The choice of financial assets will continue to be driven by the ALM-function and will be defined considering more the degree of risk, liquidity, the expected return and cost in regulatory capital of these financial assets than their accounting measurement (i.e. with the aim to build of an economic neutral position);

(e) The ALM-function may opt to introduce an "optimisation window" or "Strategic Asset Liability Mismatch" in the balance sheet, i.e. ensuring that asset revenues not only cover expected insurance expenses but also provide a degree of extra return to the shareholders of the insurer;

(f) Financial assets – whether they are directly related to particular liabilities or not – can get reallocated over time. Reallocation is the situation whereby, as from a particular date, the return of an asset is no longer assigned to liability A, but to liability B instead. EFRAG's extensive case study showed that although reallocation of (financial) assets does not happen often, it does occur; and

(g) The accounting may rely on a number of policy options in both IFRS 9 and IFRS 17 to reduce accounting mismatches.

~~190~~191 The interaction between each of the above internal policy decisions will determine the importance of any accounting mismatches remaining in the financial statements and this may differ largely from one insurer to another.

Key features of IFRS 17

Concerns raised with IFRS 17

~~191~~192 IFRS 17 does not resolve all issues as described below. The following areas are concerns raised with IFRS 17:

(a) Reinsurance contracts do not qualify for the VFA (paragraphs 206 to 209);

(b) Inability to reflect and recognise the mutual nature of some insurance contracts providing an accounting rule that does not necessary reflect the economic substance of the contracts (Annex 1 to the Cover Letter);

(c) Risk mitigation solution for VFA cannot be applied retrospectively at transition (paragraphs 169 to 175) ;

(d) Annual cohorts requirement for intergenerationally-mutualised and cash-flow matched contracts (Annex 1 to the Cover Letter);

(e) Transition (paragraphs 221 to 226);

(f) Hedge accounting (Annex 5);

(g) Locked-in discount rate for the CSM in the general model (paragraphs 94 to 95 and 184 to 187);

(h) Granularity for CSM assessment under the VFA approach (paragraph 196);

(i) Complexity and intelligibility of the Standard (Appendix II, chapter on Understandability); and

(j) Presentation (paragraph 199).

~~192~~193 These issues are explained further in other parts of this endorsement advice. Please also refer to paragraphs 77 to 190 of this appendix on the interaction between IFRS 17 and IFRS 9.

Operational complexity

~~193~~194 A number of concerns have been highlighted to EFRAG with regard to the operational complexity of IFRS 17. These concerns were raised with regard to:

(a) Business combinations;

(b) Granularity for CSM assessment under the VFA approach;

(c) Level of aggregation;

(d) Presentational issues;

(e) Transition;

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

(g) Risk mitigation; and

(h) Disclosures.

Business combinations

~~194~~195 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 of the acquired insurance contracts at their acquisition date instead of their 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 *Business Combinations* paragraph 17 to remove an important exception that currently

exists. Applying this exception to the general principles in IFRS 3, insurance contracts are 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 by the Amendments to 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 usefulness of the information 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.

~~195~~196 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 general insurance business which may require general model capability (including the CSM engine not necessary for premium allocation approach) only if a future acquisition takes place.

Granularity for CSM assessment under the VFA approach

~~196~~197 Concerns have been raised that the determination and allocation of coverage units under the VFA approach is too granular. In accordance with IFRS 17 preparers need to allocate every reporting period an amount of the CSM to profit or loss to reflect the services provided in that period. This is done by identifying coverage units in the group of insurance contracts. For contracts under the VFA approach, the preparer needs to identify two kinds of service that are provided: i) the insurance coverage and ii) the investment related service that is provided to the policyholders.

~~197~~198 One stakeholder noted that this granularity is equally valid for contracts under the general model.

Annual cohorts for intergenerationally-mutualised and cash-flow matched contracts

~~198~~199 Content relating to the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts is in Annex 1 to the Cover Letter.

Presentational issues

~~199~~200 Concerns have been raised that some presentation requirements in IFRS 17 would require major system changes compared to the current approach due to disclosure requirements related to groups in asset or liability position. These changes will also lead to insurance receivables, policy loans and reinsurance collateral (funds withheld) no longer being presented separately from the liability, which some consider to be a deterioration in relevance of the financial statements. Insurers have also considered the implications for implementation and maintenance of systems for some of 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 as published in 2017 required that groups of contracts be presented as asset or liability based. 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* - IFRS 17 requires an entity to measure a group of insurance contracts on the basis of all the cash flows expected to arise from fulfilling the contracts in the group, including premiums receivable and claims payable. Some stakeholders think that the nature of premiums receivable and claims payable would be better reflected if entities were to measure and present them separately to alleviate implementation challenges.

This topic was not changed by the Amendments to 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 by the Amendments to IFRS 17.

(d) *Insurance funds withheld* - In several reinsurance contracts, the reinsurer 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 by the Amendments to IFRS 17.

Volatility

~~200~~201 Based on the results of the EFRAG User Outreach, most users see volatility as not being a problem to the extent volatility reflects real economic substance and the underlying causes are communicated clearly. Should volatility be caused by accounting mismatches, users would not support it.

Transition

~~201~~202 Transition is discussed in paragraphs 221 to 226. 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

~~202~~203 The use of locked-in discount rates is discussed elsewhere in this DEA. The complexity of applying locked-in discount rates relates to the calculation and storage of these rates for continuous use during the life of the insurance liabilities.

Risk mitigation

~~203~~204 In absence of a risk mitigation solution for contracts that are not accounted for in accordance with the variable fee approach, insurers have to rely on hedge accounting which is very complex in its application. For EFRAG's assessment on risk mitigation, please refer to Appendix II.

Disclosures

~~204~~205 Stakeholders are also concerned about the complexity of preparing and understanding the required 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 is operationally complex and costly if an entity uses a technique other than the confidence level technique for determining the risk adjustment, to disclose a translation of the result of that technique into a confidence level. For EFRAG's assessment on the disclosures, please refer to Appendix II.

Reinsurance contracts held

Overview of issues being raised

~~205~~206 Several issues have been raised with regard to reinsurance contracts held. A summary of these issues is provided hereafter.

Ineligibility for the variable fee approach

~~206~~207 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.

~~207~~208 For some of the 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 for these contracts. On the other hand, EFRAG has been informed that internal and external reinsurance contracts may qualify for the variable fee approach requirements. For these contracts the fact that reinsurance contracts cannot apply the variable fee approach is considered an issue.

~~208~~209 The IASB did not change the prohibition because it concluded that reinsurance contracts are not substantially investment-related service contracts. The variable fee approach was designed specifically so that profit earned by an entity issuing insurance contracts that are substantially investment-related service contracts would be accounted for similarly to the profit earned by an entity issuing asset management contracts.

~~209~~210 Most but not all preparers saw this as a shortcoming of IFRS 17, however.

Expected cash flows arising from underlying insurance contracts not yet issued

~~210~~211 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 and 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. 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.

~~211~~212 Concerns have been raised with this approach because of its complexity and the fear that a mismatch might be 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 relates to the difference in the recognition of the CSM of the reinsurance contracts held and the recognition of the CSM of the underlying insurance contracts issued.

~~212~~213 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 CSM 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 CSM recognition which reflects that symmetry.

Scope of variable fee approach

~~213~~214 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).

~~214~~215 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.

~~215~~216 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.

~~216~~217 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.

~~217~~218 The IASB decided 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 determine a minimum profit share of the policyholder, which indirectly affects the variable fee of the shareholders; 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 items.

~~218~~219 Another concern raised related to the recognition of the CSM 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.

~~219~~220 The IASB changed this by requiring an entity to identify coverage units for insurance contracts without direct participation features by considering the quantity of benefits and expected period of investment-return service, if any, in addition to insurance coverage.

Contract boundaries requirements to reinsurance contracts held

221 Measuring an insurance contract requires determining which cash flows are within the contract's boundary. IFRS 17, paragraph 34 specifies that cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums, or in which the entity has a substantive obligation to provide the policyholder with services. The paragraph does not include specific requirements for reinsurance contracts.

222 Concerns were raised that the determination of contract boundaries to reinsurance contracts held will result in accounting mismatches because entities will:

(a) apply different discount rates when measuring the contracts--accordingly, there will be accounting mismatches in entities' insurance finance result;

(b) measure differently the contracts' CSM and determine differing coverage periods and coverage units--accordingly, there will be accounting mismatches in entities' insurance result (notably because of the difference in timing on the assessment of future cash flows between the reinsurance contracts (at inception) and the underlying direct insurance contracts (when those contracts are eventually recognised), or changes in the key assumptions used for the estimation of cash flows);

(c) apply differing risk adjustments and retain different release patterns for that risk—leading to accounting mismatches in entities' insurance finance result.

223 Those that raise these concerns acknowledge that the requirement to assess separately the contract boundary for reinsurance contracts held would enable to reflect, in the CSM of the group of reinsurance contracts held, the expected gain or cost arising from the reinsurance of future underlying contracts not yet issued. However, it is noted this may result in extensive use of judgement and in estimates with significant measurement uncertainty. As a result, those that raise these

concerns question whether the benefits of the requirements for contracts boundaries for reinsurance contracts held will outweigh their costs.

Annual cohorts applied to intergenerationally-mutualised and cash-flow matched contracts

220224 As emerged in the extensive case study and confirmed in the comment letters to the EFRAG draft comment letter on the IFRS 17 Amendments of September 2019 and in the Limited Update of the 2018 Case Studies, the annual cohorts requirement (IFRS 17 paragraph 22) leads to additional cost in some fact patterns, in particular for contracts with cash flows that affect or are affected by cash flows to policyholders of other contracts. Feedback from EFRAG's constituents confirms that the issue relates to contracts with the characteristics described in paragraphs B67 - B71 of IFRS 17 that have 'substantial' risk sharing. Most of these contracts that prevail in European jurisdictions are eligible for the variable fee approach (VFA). In some jurisdictions, the issue relates to contracts eligible for the general model including contracts without the characteristics described in B67 – B71 of IFRS 17 for which cash flow matching techniques are applied across generations. Some stakeholders have proposed to the IASB standard setting solutions including wording for an exception. The IASB rejected these proposals. Content relating to the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts is in Annex 1 to the Cover Letter.

Transition

221225 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%

222226 For EFRAG's assessment of the transition requirements please refer to Appendix II.

Variations of approaches used:

223227 For the purposes of the case study, some respondents applied variations to the approaches specified 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 European Embedded Value framework as equivalent to the full retrospective approach, i.e. the historic new business values, with adjustments, were used as the day-1 CSM in a retrospective approach;

224228 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.

225229 The case study provides the following insights into the difficulties in applying the requirements of the modified retrospective approach:

(a) The use of approximations and simplifications should be permitted when determining the initial cash flows (one respondent).

(b) The requirement 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 to produce transition figures by annual cohort is potentially significantly more onerous than if cohorts were grouped together (two respondents).

(d) The requirements to adjust 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 respondents 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 contracts where the fair value approach is being applied.

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

- The charges deducted from the unit fund and asset shares, i.e. the policyholders' share of the with-profit 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 requirements, it is necessary 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 should be consistent between the VFA and general model (one respondent). The requirements in

IFRS 17 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 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~~burdensome to perform precisely, looking at the reduced time available to implement IFRS 17.

~~226~~230 In addition to the identification of the issues relating to applying the transition methods, respondents also provided qualitative descriptions of 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 • Setting the OCI-balance to nil
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

Impact of IFRS 17 on the insurance industry

Impact on competitiveness of insurers

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

~~227~~231 In EFRAG's view competitive (dis)advantages arise out of economic differences in particular areas. Differences in accounting do not necessarily lead to competition (dis)advantages. In the analysis below, EFRAG has evaluated whether there are causal effects between a different treatment in accounting due to IFRS 17 and the occurrence of a competition (dis)advantage.

~~228~~232 In assessing competitiveness EFRAG has looked whether and how:

(a) measurement of the insurance liabilities with a current value approach;

(b) added volatility in the statement of comprehensive income; and

(c) implementation costs

interact with the cost of economic capital, the pricing of insurance contracts, the offering of insurance services and/or financial products.

Current measurement of the insurance liabilities and cost of capital

~~229~~233 IFRS 17 requires a current measurement of the insurance liabilities, i.e. cash flows are being discounted at a rate that reflects current market conditions. This implies that the carrying value of the insurance liabilities is not only determined by their volume or the cash flow pattern of the insurance contracts sold but also depends on the evolution of market interest rates.

~~230~~234 Current market interest rates also influence the cost of capital of insurers at any given moment, but that is due to how the weighted average cost of capital is being calculated than a consequential change resulting from the measurement of insurance liabilities. The influence is based upon how the capital asset pricing model function works which integrates both the risk-free rate and the beta of the company. The risk-free rate is evolving over time along with the current interest rates. The beta represents whether a company's stock price is more (beta higher than 1) or less (beta lower than 1) variable than the overall market return. Hence, it could be stated that by lowering the beta of a company, one could lower the cost of equity and overall the weighted average cost of capital.

~~231~~235 The Economic Study commissioned by EFRAG shows that insurers have been subject to a high beta over the past fifteen years (when using IFRS 4 requirements). When applying IFRS 4 some insurance liabilities are measured at current market interest rates, some are measured at historical rates (at inception of the insurance contracts).

~~232~~236 EFRAG notes that figure 32, page 66 of the Economic Study commissioned by EFRAG represents the weighted average cost of capital of insurers by country (France, Germany, Italy and UK) over the past 15 years. When combining this with the information gathered about local GAAP (see Annex 2 of Appendix III) the following can be derived.

~~233~~237 The graph shows that insurers in Germany and Italy where current GAAP relies more on historical rates have an overall lower WACC than their peers in France and UK who rely more on current discount rates. This shows that there is insufficient evidence to derive a relationship between the use of current discount rates and the cost of capital. For example, even if in France not all insurance liabilities are discounted, the WACC of French insurers has shown over time some significant increase compared to their UK peers. Hence, the data do not

undisputedly demonstrate that a current measurement has a direct relationship to the cost of capital.

Impact of prudence on cost of capital

~~234~~238 Another element that is often mentioned to have an influence on the cost of capital is prudence. Examples of including prudence in the accounting framework are establishing generic reserves or including a prudence factor in the discount rates. EFRAG notes that IFRS 4 already forbids the use of particular reserves such as catastrophe provisions and equalisation provisions.

~~235~~239 Also, IAS 1 *Presentation of Financial Statements* requires the disclosure of an entity's objectives, policies and processes for managing capital. These disclosures allow readers of financial statements to assess the adequateness of capital buffers both in normal economic times as well as in times of stress.

Impact of accounting on pricing of products

~~236~~240 A further question is whether accounting may have an impact on the pricing of insurance products. The impact on pricing has been analysed in the Economic Study commissioned by EFRAG. The Economic Study commissioned by EFRAG notes that the overall price of insurance grew faster than the general consumer price index over the period 2005 to 2019. EFRAG notes that this increase in price has happened (long) before the introduction of IFRS 17 and in a stable accounting environment. EFRAG further notes that the increase in price coincides with the economic event of a decline in overall market interest rates in Europe, a subsequent increase in reinvestment risk and pressure on the profitability of insurance portfolios because of financial guarantees that increasingly come into the money.

~~237~~241 Most industry stakeholders interviewed in the Economic Study commissioned by EFRAG agree the new financial reporting requirements will inevitably bring closer pricing and underwriting with more careful consideration of segment profitability. Therefore, a majority of industry stakeholders interviewed [as input to the Economic Study commissioned by EFRAG] believe that the new external reporting requirements might have an impact on some features (guarantees) of the products offered (rather than on pricing). For instance, because IFRS 17 is expected to make the performance of insurance products more transparent, in the view of those industry stakeholders, some companies might decide not to continue offering specific guarantees.

Impact of accounting on the offering of services or products

~~238~~242 EFRAG does not see a significant direct causal effect between the accounting and the offering of particular services or products. EFRAG is of the view that companies generally offer services and products whenever there is business to be gained. Some have reported that they expect more transparency in accounting (e.g. more volatile financial performances) to influence the appetite to continue providing a given product/service. EFRAG acknowledges this view and observes that at this stage there is no evidence of such a behavioural implication, also because IFRS 17 has not yet been applied.

~~239~~243 In addition, more transparency also helps to make more visible onerous products and, in this way, may have a mitigation on adverse economic impact deriving from offering product types that are onerous.

~~240~~244 In conclusion, EFRAG believes that no evidence exists at this stage of a direct competitive (dis)advantage due to the current measurement approach introduced by IFRS 17, in particular:

(a) EFRAG observes that the available data do not confirm a causal relationship between applying a current measurement and a change in the cost of capital.

Over the past 15 years it seems that rather the beta (stock market volatility of listed insurance companies) has been a main driving factor of the cost of capital of insurers;

(b) On pricing, EFRAG acknowledges the views of those that expect to see changes in the offering of particular services or products as a result of the added transparency and volatility in the performance reporting, but observes that for now there is no evidence of such an impact, because IFRS 17 has not yet been applied;

(c) Content relating to the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts is in Annex 1 to the Cover Letter; the above conclusions have been reached for all the other requirements of IFRS 17.

Volatility in the statement of profit or loss

~~241~~245 The joint application of IFRS 17 and IFRS 9 is expected by some industry stakeholders to create more volatility in profit or loss as economic mismatches will become more visible.

~~242~~246 EFRAG is of the view that the above premise – that the joint application of IFRS 17 and IFRS 9 would lead to more volatility – disregards the role of the asset and liability management function. As mentioned in the chapter relating to applying IFRS 17 and IFRS 9 together, EFRAG expects the managerial aspects determining the business models to be chosen in function of support by the financial assets to the insurance liabilities. Insofar both assets and liabilities are exposed to the same risk [e.g. interest rate risk] the changes in their fair value will move in the same direction. Thus, insofar [financial] assets are measured at FVPL [and not at amortised cost under IFRS 9], EFRAG expects the asset measurement to generally move in the same direction as the insurance liabilities [without being identical as their characteristics may differ]. This because they would be subject to the same economic cycle [and the related movement across the economic cycle of interest rates]. As a result, the finance expenses relating to the insurance liabilities reduce the finance income created by the financial assets. EFRAG notes this would lead, at least partially, to a net effect in the profit or loss account and subsequently equity.

~~243~~247 This net effect in profit or loss would be partly due to economic mismatches and partly due to accounting mismatches. Based upon the case study outcomes and their update EFRAG notes the term accounting mismatch is often interpreted very broadly by some industry stakeholders thereby also covering economic events. EFRAG considers that reporting in profit or loss the extent of the economic mismatches is a useful information, as explained in more detail in the chapter of applying IFRS 9 and IFRS 17 together. In contrast, EFRAG is more concerned about the accounting mismatches that may occur as such mismatches may lead to volatility without representing useful information. EFRAG's overall view of the mismatches that may occur can be found in the chapter on applying IFRS 9 and IFRS 17 together.

~~244~~248 In accordance with the Economic Study commissioned by EFRAG the impact of recognising profit as services are provided on the cost of capital has received little debate in academic literature. A small part of the empirical academic research has discussed the influence of recognising profit over time on stock prices and the cost of debt, however with inconclusive results. Hence, a causal effect between recognising income over time and the cost of capital has not been undisputedly demonstrated.

~~245~~249 EFRAG further notes that the volatility in profit or loss will also be determined by:

(a) The level of guarantees in legacy portfolios, i.e. the degree of presence of (high level compared to current market rates) old guarantees that need to be honoured with investments at the current rates; and

(b) The quality of the underlying portfolios (i.e. how strict were the selection criteria for policyholders being contracted at inception).

~~246~~250 According to the majority of industry stakeholders interviewed in the Economic Study commissioned by EFRAG, financial reporting (whether or not it results in more volatile results) does not play a big role in product mix and pricing. Instead, capital requirements, taxes and regulation do. In particular, changes in capital requirements would impact insurance pricing. The majority of the respondents to the Economic Study commissioned by EFRAG also agree that "capital charges" (imposed by Solvency II) have been one of the main factors that have impacted their product mix and pricing strategies in the last 5 years. In contrast, "financial reporting requirements" are considered relevant but not as a key driving factor. Claims frequency, severity and operating costs are considered by respondents much more relevant factors considering that they drive a company's underwriting earnings.

~~247~~251 In conclusion, volatility in profit or loss may in some industry stakeholders' view represent a competitive disadvantage for insurers relating to their cost of capital. However, EFRAG observes that no causal effect has been demonstrated between the use of recognising income over time and the cost of capital. EFRAG also notes that the academic material on which the assertion is based is inconclusive. In addition, EFRAG is of the view that volatility that is economic in nature represents useful information, in contrast to volatility that is solely caused by accounting mismatches.

Implementation costs

~~248~~252 It is noted that insurers that apply IFRS Standards will have to bear the implementation cost of IFRS 17, while other insurers that stay on local GAAP will not have to bear this cost. EFRAG has heard the argument that this creates a competitive disadvantage for IFRS applicants. EFRAG disagrees with this view as it ignores a number of essential steps in determining competitive positions, such as whether insurers target the same market, issue the same products or rely upon the same funding sources.

~~249~~253 Hence, EFRAG assesses that, generally, the implementation costs of IFRS 17 does not have a causal effect on competition for particular products or markets.

Summary and overall assessment

~~250~~254 EFRAG believes that no evidence exists at this stage of a direct competitive (dis)advantage due to the current measurement approach introduced by IFRS 17.

~~251~~255 EFRAG observes that no causal effect has been demonstrated between the use of recognising income over time and the cost of capital. EFRAG also notes that the academic material on which the assertion is based is inconclusive. In addition, EFRAG is of the view that volatility that is economic in nature represents useful information, in contrast to volatility that is solely caused by accounting mismatches.

~~252~~256 Also, EFRAG assesses that generally the implementation cost of IFRS 17 does not have a causal effect on competition for particular products or markets.

~~253~~257 EFRAG has considered whether some of the above competitive disadvantages may be sufficient for insurers to arbitrage between an IFRS environment and a local GAAP environment. This includes situations where international insurance groups can set up local subsidiaries benefitting from local GAAP requirements (with the caveat that these local subsidiaries will need to report IFRS packages to the parent company).

254258 EFRAG notes that this is a rather theoretical consideration as large listed insurers are expected to remain on IFRS. EFRAG acknowledges that exceptional situations exist where smaller insurers have relisted their shares in an unregulated market so as to not having to apply IFRS Standards.

255259 However, and as indicated above, the direct causal effect of an accounting arbitrage (for the few companies that have the real possibility to do so) on competitiveness is still to be proven. Hence, EFRAG is generally of the view that the underlying economics and profitability will always be more decisive in taking up a business in a particular region or taking up a particular insurance product than the changes to the accounting that is used to report on it.

The current competitive landscape

Insurers vs insurers

Competition between European listed insurers

256260 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 in theory create competitive (dis)advantages for the insurers involved.

257261 Examples of current differences in European national GAAPs include, but are not limited to the following:

(a) *Level of aggregation*: In France 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.

258262 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 in practice created significant competitive (dis)advantages for the insurers involved.

Competition between European listed insurers and European non-listed insurers

259263 Listed European insurers also compete with non-listed insurers. Listed European insurers in their consolidated accounts use different anchors for establishing their accounting policies. As a result, there is a lack of comparability of consolidated financial statements between insurers, listed and/or non-listed.

260264 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 of that jurisdiction when none of them are subject to IFRS.

261265 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.

~~262~~266 EFRAG acknowledges that insurers operating in several Member States will have to apply different accounting requirements. However, these accounting differences are simply accounting differences and nothing more. Based on the analysis provided in paragraphs 227 to 255 above, EFRAG did not identify any competitive (dis)advantages due to the accounting of IFRS 17.

European insurers vs third-country insurers

~~263~~267 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 feedback from European insurers, some European insurers use a so-called frozen US GAAP regime [for an explanation please refer to Annex 1 of this appendix paragraph 14] and did not had to bear the costs of changes to US GAAP in the recent decade (except for the individual accounts and supervisory reporting of the US subsidiaries of these European insurers which rely on updated US GAAP).

~~264~~268 Based on the analysis provided in paragraphs 227 to 255 above, EFRAG did not identify any competitive (dis)advantages in this situation.

Insurers vs other entities

Financial services: Insurers vs banks

~~265~~269 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. Currently, many insurers use the deferral of IFRS 9, as insurers are allowed to defer the implementation of IFRS 9 in order to align it with the implementation of IFRS 17, and instead apply IAS 39 to their financial instruments.

~~266~~270 EFRAG acknowledges these insurers will have to apply different accounting requirements. However, these accounting differences (such as recycling for equity instruments under IAS 39 or the level of aggregation under IFRS 17) are simply accounting differences and nothing more. Based on the analysis provided in paragraphs 227 to 255 above, EFRAG did not identify any competitive (dis)advantages in this situation.

Financial services: Insurers vs mutual funds

~~267~~271 Insurers offer savings products as do mutual funds and the two types of entities are competing for the same clients. Currently, many insurers apply the deferral of IFRS 9 and apply IAS 39 to their financial instruments.

~~268~~272 EFRAG acknowledges these insurers will have to apply different accounting requirements. However, these accounting differences (such as recycling for equities under IAS 39 or the level of aggregation under IFRS 17) are simply accounting differences and nothing more. Based on the analysis provided in paragraphs 227 to 255 above, EFRAG did not identify any competitive (dis)advantages in this situation.

Other services: Insurers vs other entities

~~269~~273 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.

~~270~~274 EFRAG acknowledges there may be accounting differences that occur in this situation, for example between IFRS 15 and local GAAP for such service contracts. However, these accounting differences are simply accounting differences and nothing more. EFRAG has not identified any competitive (dis)advantages that could be identified between insurers and other entities.

Overall

~~271~~275 Looking at today's accounting landscape it can be concluded no 'level playing-field' exists today, but rather a diverse 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 set of consolidated IFRS statements unique in its kind and thus not fully comparable with other consolidated IFRS statements. EFRAG is however not aware of any evidence that these differences have created significant competitive (dis)advantages between insurers.

~~272~~276 In the cases assessed, EFRAG concludes that there will be differences in accounting between particular groups of entities. However, these differences are what they are: differences in accounting and nothing more. In accordance with the analysis provided in paragraphs 227 to 255 above, EFRAG did not identify any competitive (dis)advantages.

Potential competition issues between IFRS 17 and Japanese GAAP

~~273~~277 European insurers also compete with insurers from third countries, for example Japanese-headquartered insurers, both in European markets and in other markets around the world.

~~274~~278 Based on the analysis provided in paragraphs 227 to 255 above, EFRAG did not identify any competitive (dis)advantages in this situation.

Application of article 4 of the IAS Regulation

~~275~~279 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 (in particular because IFRS 17 requires the disclosure of the approaches used to determine the discount rates);

(b) The accounting policy options and the use of judgement in a principles-based standard as IFRS 17 enable entities to reflect the specificities of their own business model even though some aspects of mutual nature of insurance contracts would not be appropriately presented; content relating to the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts is in Annex 1 to the Cover Letter.

~~276~~280 In order to prepare for IFRS 17 application, publicly listed entities will 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).

~~277~~281 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.

~~278~~282 Based on the analysis provided in paragraphs 227 to 255 above, EFRAG did not identify any competitive (dis)advantages in this situation.

Application of Article 5 of the IAS Regulation

~~279~~283 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's separate statutory accounts of publicly listed entities alone or the statutory accounts of all insurance entities in a Member State.

~~280~~284 In case only the statutory accounts of publicly listed entities would be affected, the impact on competition is similar as described in paragraphs 277 and 278 above.

~~281~~285 In case the statutory accounts of some or all insurance entities in a Member State would be affected, the insurance entities affected in that Member State would bear the implementation cost and would thus be treated equally from this perspective.

~~282~~286 EFRAG notes that at the end of 2018, 500 out of 2945 insurers in Europe applied IFRS. Not all Member States require the use of IFRS for the insurers located in their country. A detailed overview of the exercise of Member State options can be found in Annex 6. EFRAG does not opine on the exercise of Member State options.

~~283~~287 In contrast, where insurers have the choice of applying IFRS, EFRAG can provide a view on the competitive (dis)advantages that could arise. In doing so, EFRAG has considered two situations:

(a) Competition issues within a Member State; and

(b) Competition issues across Member States.

Competition issues within a Member State

~~284~~288 EFRAG did not identify particular competition issues in this situation. Please refer to paragraphs 259 to 262 above.

Competition issues across Member States

~~285~~289 Here the effects can be split in two groups: i) competition between an insurer applying IFRS and an insurer applying local GAAP (of another Member State) and ii) competition between 2 different local GAAPs.

~~286~~290 In the first case, the issues identified in paragraphs 259 to 262 above remain valid as well as the conclusion , i.e. based on the analysis provided in paragraphs 227 to 255 above, EFRAG did not identify any competitive (dis)advantages due to the accounting of IFRS 17. In the second case, it is recalled that although significant differences between the accounting by 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.

Other potential industry impacts

Pricing of insurance products and insurance product mix

Input from the Economic Study

~~287~~291 *The key fact to note in terms of the evolution of the product mix in the EU insurance market since 2005 is the decline of the market share of life-insurance in the total insurance market (measure by gross premiums) from 2005 to 2008 and the increase in the market share of non-life. Life insurance, however, remains still by far the largest insurance segment.*

288292 *The overall price of insurance grew faster than the general consumer price index over the period 2005 to 2019. In particular, the annual rate of growth of price of insurance connected with health was markedly higher than overall inflation while the price of insurance connected with transport increased only marginally faster than the overall consumer price index.*

289293 *Stakeholders reported that, in general, financial reporting does not play a big role in product mix and pricing. IFRS 17 is not expected to have significant impacts on short-term insurance contracts. The main changes for short-term insurance contracts will depend upon entities' existing insurance accounting practices. Long-duration contracts (such as life insurance) or product features which expose the profit or loss to market fluctuations (such as participating contracts evaluated using the general model), instead, may be affected by the adoption of the new Standard.*

290294 *Most stakeholders interviewed (industry players and supervision authorities) welcomed the improvements introduced by the IFRS 17 Amendments, in particular regarding reinsurance. However, there are still some concerns about implementation of the annual cohort requirement, especially for the segment "Life".*

Analysis

291295 The Economic Study reported that, according to the majority of industry stakeholders interviewed, financial reporting does not play a big role in product mix and pricing. Instead, capital requirements and regulation do. In particular, changes in capital requirements would impact insurance pricing.

292296 Most industry stakeholders interviewed agree that, as IFRS 17 is an accounting framework based on current value, the new financial reporting requirements will inevitably bring closer pricing and underwriting with more careful consideration of segment profitability.

293297 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 on the use of mutualisation.

294298 Some insurers note however that interest rate sensitive products are expected to be more affected by the introduction of IFRS17 due to the onerous contract test and the impact of measuring those portfolios with risk-free rates. This might affect the entities´ ability to offer certain life insurance products.

295299 From the responses to EFRAG's simplified case study, most of the respondents either did not expect that IFRS 17 would 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. EFRAG acknowledges these comments and is of the view that pricing is to appropriately reflect the risks inherent in these products.

296300 Respondents' views from EFRAG's extensive case study were split about whether IFRS 17 would affect the range of insurance products offered, with half of the respondents expect an impact on the range of products they offer to policyholders and the other half expecting no or no significant impact.

297301 Those respondents from EFRAG's extensive case study that expected an impact, provided the following reasons:

(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.

~~298~~302 Respondents' views from EFRAG's simplified case study were mixed 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.

~~299~~303 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 CSM and risk adjustment figures; and

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

~~300~~304 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.

~~301~~305 The above feedback indicates that entities may re-consider both their pricing methodologies and product offerings due to entities applying IFRS 17 for the first time, 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 from the application of IFRS 17.

Other views: survey of National Competent Authority (NCA) by the International Monetary Fund (IMF) (July 2020)

~~302~~306 Views of supervisors are mixed on the potential impact of IFRS 17 on policyholders, ranging from no material impact to higher premiums and withdrawal of certain product types. Some supervisors expect insurers to change their product range due to the technicalities of IFRS 17. For example, IFRS 17 requires insurers to separately identify portfolios of insurance contracts that are managed together and bear similar risks. Within each portfolio, insurers should group contracts according to their expected level of profitability. The valuation is then conducted on each group of contracts. Crucially, contracts issued more than a year apart should not be included in the same group. This could require a significant change in the way insurers design and price their products. For instance, life insurers typically price their products by spreading fixed expenses across different generations of

policyholders to be able to offer competitively priced policies. They may need to change such a pricing approach to reflect the constraints imposed by IFRS 17. Products that rely heavily on cross-subsidisation between different generations of policyholders (e.g. participating or with-profits contracts) may need to be redesigned or repriced to fit within the IFRS 17 framework.

303307 While there may be short-term adverse implications for insurers' measured profitability, there could be a positive impact on the sustainability of their business model in the longer term as they discontinue economically unprofitable products that relied on upfront profit recognition. Once IFRS 17 comes into force, insurers are likely to renegotiate contractual terms of certain types of insurance products and change their product range to maintain profitability targets. This is mainly driven by a significant change in how profits emerge under IFRS 17, the definition of the contract boundary, and improved disclosure and data availability to track the profitability of different groups of insurance policies. In general, any losses must be recognised upfront when a policy is underwritten, but profits should be recognised gradually as the insurance coverage is provided over the policy's duration. This effect is achieved through the CSM component of IFRS 17. Under previous accounting models allowed under IFRS 4, profit could emerge significantly on day one of recognition of the contract and more modest profit recognition in subsequent years.

Asset allocation

304308 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).

305309 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).

306310 As a result of changes introduced by IFRS 17 and IFRS 9, some entities may decide to reassess how they carry out their asset and liability management. This is because the measurement of financial assets and insurance contract liabilities may change in applying IFRS 9 and IFRS 17 (IASB, 2017). 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 under IFRS 17, insurance contract liabilities are measured under the current value principles.

307311 The extent to which hedge accounting can be applied is discussed in Annex 5. There is no conceptual barrier against the application of hedge accounting in the context of IFRS 17. However, given the lack of experience and systems by the industry, it would require significant investment both in time and systems development to achieve hedge accounting in this context.

~~308~~312 Finally, even with the application of hedge accounting, there is no guarantee that there will be no profit or loss volatility, because events may happen differently than expected or not all the risk types have been hedged. All of the above may also require further judgement and may only be suitable for some but not all cases or instruments.

~~309~~313 Other stakeholders interviewed for this study (supervisory authorities and some non-life insurance undertakings), 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.

Other views: survey of NCA by the IMF (July 2020)

~~310~~314 In a few jurisdictions, insurers may need to review their asset-liability management strategy and the associated internal controls. As a result, they could potentially shift their investments towards longer-duration assets to manage profit emergence, which will take longer. Some insurers could adjust their reinsurance arrangements to minimise accounting asymmetries that could arise due to differences in the valuation approach for reinsurance contracts held compared with the underlying insurance contracts. From an operational perspective, insurers may start to fine-tune key performance indicators based on the new performance metrics under IFRS 17. The reason for this is that the traditional measure using premiums will no longer be a key feature as a performance metric in the statement of profit and loss under IFRS 17 and will only be secondary information available in the notes.

Cost of capital

~~311~~315 According to the Economic Study, there are differing views on the potential impact of IFRS 17 on the cost of capital for EU insurance undertakings.

~~312~~316 Most stakeholders interviewed (i.e. the majority of supervisory authorities and some insurance undertakings) agreed on the fact that in the long run, the new accounting Standard will bring increased transparency on the financial reporting practices of European insurance companies, improving their ability to raise capital on the market. Furthermore, it was stressed this change could make the insurance industry more attractive to a generalist investor, which would reduce the cost of equity in the long run.

~~313~~317 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.

~~314~~318 IFRS 17 could, at least temporarily, increase the cost of capital for European insurers before investors familiarise themselves with the new Standard (FITCH, 2017).

~~315~~319 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.

~~316~~320 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 attractiveness of the insurance sector for investors 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.

Input from the Economic Study

~~317~~321 *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.*

~~318~~322 *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 companies and the other sectors was in 2017 still greater than the difference in 2005. An exception is the banking sector, where the difference in WACC between insurance and banking returned broadly to its 2005 levels.*

~~319~~323 *Among the stakeholders interviewed and surveyed, there was a general agreement about the difficulties that analysts face when evaluating the financial report of an insurance company. Almost all the respondents indicated a level of difficulty in the top tier of the scale.*

~~320~~324 However, there are differing views on the potential impact of IFRS 17 on the cost of capital for EU insurance undertakings.

~~321~~325 *Most stakeholders interviewed (i.e. the majority of supervisory authorities and some insurance undertakings) agreed on the fact that in the long run, the new accounting standard will bring increased transparency on the financial reporting practises of European insurance companies, improving their ability to raise capital on the market. Furthermore, it was stressed this change could make the insurance industry more attractive to a generalist investor, which would reduce the cost of equity in the long run.*

~~322~~326 *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.*

~~323~~327 *It is possible that IFRS 17 could lead to a perceived weakening of the financial strength of companies. IFRS 17 could, at least temporarily, increase the cost of capital for European insurers while investors familiarise themselves with the new standard.*

~~324~~328 *Supervisory authorities and auditors commented that the insurance industry is still in the process of developing an understanding of the implications of the standard and forming common accounting practices. Many concerns are interpretational and will only be solved in practice following the adoption of the standard.*

325329 *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.*

Specificities of insurance business models

326330 In this section EFRAG refers to the publication issued by Insurance Europe "*How insurance works*" issued in 2012: insurance exists to transfer risk and as such "a means of reducing uncertainty. In return for buying an insurance policy for a smaller, known premium, the possibility of a larger loss is removed. By pooling premiums and insured events, the financial impact of an event that could be disastrous for one policyholder is spread among a wider group."

327331 Insurance business models differ from other businesses in that it receives money early in the business-cycle rather than at the end. Furthermore, like banks, it manages duration mismatches between assets and liabilities although the duration mismatch is more extreme in the case of insurers. This is also the reason for the stringent prudential framework around insurance entities that are designed to protect the interests of policyholders.

328332 Insurers are not as vulnerable as banks to liquidity crashes or collapses due to liquidity risk. As premiums are received earlier than the related claims, insurers have large portfolios of investments, either as support for future claims, in terms of its regulatory framework or on behalf of its shareholders.

329333 The insurance business is centred around pricing risk and taking on risk for the price it considers sufficient in terms of its risk and pricing strategy in the context of its regulatory environment. The policyholders that benefit from this are both individuals as well as businesses with commercial insurance.

330334 The action of taking on various risks from various policyholders means that it is pooling the risk as described above. The pooled risk may be shared amongst policyholders only (sometimes referred to as mutualising risk) or shared between policyholders and capital providers.

331335 Insurers manages their remaining risk by entering into reinsurance contracts where some of the risks are transferred to reinsurers. The insurer also has to consider asset liability management as there is often a duration gap between the assets it holds and its liabilities – for instance an insurer may have to pay claims 50 years into the future based on policies written today, but it is often not able to find low risk assets for the same period. Lastly, insurers often engage in hedging activities to minimise some of their remaining risks to acceptable levels.

332336 IFRS 17 deals with the taking on of risks at specific prices, the sharing and reinsuring of such risks. The investment of assets and hedging are covered mostly by IFRS 9. For further information please refer to the sections on asset-liability management, the interaction between IFRS 9 and IFRS 17 and hedge accounting in the context of insurance.

333337 While there are various business models such as global composites or specialist insurers as IFRS 17 focusses on insurance contracts, this discussion focusses on the product related business models in the insurance sector. Risk management activities including reinsurance held are discussed further below. Product related business models include:

(a) Longer-term contracts such as annuities, commercial insurance as well as life insurance contracts without participation (refer below) and general insurance with a longer coverage period than allowed for the PAA (see below).

(b) Short-term business such as theft or telephone coverage as well as certain commercial contracts where the coverage period is short with usually annual renewals.

(c) Contracts with participation such as savings contracts with and without insurance coverage where policyholders participate in the return on the assets underlying the insurance contracts. Examples may include annuities and life insurance.

(d) Reinsurance issued.

~~334~~338 These corresponds to Lines of Business per EIOPA reporting (excluding reinsurance) as follows:

Business models discussed	EIOPA lines of business
Longer-term contracts	Health annuities Non-health annuities (can also be short-term) Health insurance (can also be short-term) Health reinsurance Index-linked Unit-linked insurance Life insurance Other life insurance General liability insurance
Short-term contracts	Assistance[14] Credit and suretyship insurance Casualty non-proportional reinsurance Fire and other damage to property insurance General liability insurance Health non-proportional reinsurance Income protection insurance Legal expenses insurance Marine, aviation and transport insurance Marine, aviation and transport reinsurance Medical expense insurance Miscellaneous financial loss Motor vehicle liability insurance Other motor vehicle insurance Property non-proportional reinsurance Workers' compensation insurance
Contracts with participation	Insurance with profit participation Non-health annuities Credit and suretyship insurance Index-linked

~~335~~339 Please note that even if not specified by EIOPA, it is generally possible to purchase reinsurance for all the products above. Over time, hybrid contracts have developed where a contract may exhibit characteristics from more than one category.

~~336~~340 The products above do not include contracts issued by insurers that do not have an insurance component. These generally fall under IFRS 9 except for those savings contracts with discretionary participating features which may be treated under IFRS 17.

[14] In some cases, IFRS 15 *Revenue from Contracts with Customers* may apply.

IFRS 17 recognition of insurance liabilities

337341 Overall, such as financial instruments, insurance contracts are about cash inflows and outflows subject to certain contractual terms. However, it was decided in order to capture the special characteristics of insurance contracts to deal with them in a separate standard rather than with other financial instruments in IFRS 9.

338342 In general, IFRS 17 reflects all the cash flows related to the contracts based on the contract boundary as defined. IFRS 17 also measures and presents the underwriting decisions and underwriting results separately from the investment decisions for the related assets. The returns on the financial assets are governed by IFRS 9.

339343 IFRS 17 uses fulfilment value which reflects that insurers normally fulfil obligations under the contract rather than transferring contracts to another party. Fulfilment value has the aim to achieve consistent measurement with current market information when possible. IFRS 17 does not use fair value for ongoing measurement as stakeholders indicated that such an approach would put too much emphasis on hypothetical transactions that rarely happen.

Longer-term contracts

340344 Firstly, the base model from an accounting perspective is the general model with some modifications for the models described below. The principle is that changes due to changes in financial factors do not affect the CSM. The underwriting result is regarded separately from the result of financing activities and so the financial results reflect the gains/losses from investments and the change in the insurance contract liability related to changes in interest rate. The general model reflects the lack of a legally enforceable right to set off the liability with the investment portfolio even if the assets were perfectly matched. The business model test in IFRS 9, together with the presentation option in IFRS 17 and the possibility to apply hedge accounting, help to reflect the matching between assets and liabilities.

341345 IFRS 17 was amended to allow amortisation of CSM based on investment-return services combined with the insurance coverage. This would allow the allocation of CSM during the accumulation phase of annuities in some case where previously this was not possible. For further information on how the profit is reflected in profit or loss via the allocation of CSM please refer to Appendix II.

342346 Some contracts may have cash flows that are at the discretion of the insurer that fall under the general model rather than the VFA, also called indirect participation contracts. When the insurer exercises its discretion with respect to these discretionary cash flows, this impacts the CSM (i.e. the unrecognised profit) the insurer can recognise in the future. However, where the changes in assumptions relate to financial risk, these do not adjust the CSM, but rather the financial result. For more information about the boundary between the general model and the VFA, please refer to Appendix II.

343347 EFRAG acknowledges that some commentators disagree with this analysis with regard to contracts that change nature over time.

Short-term business

344348 EFRAG notes that the PAA is a simplified method of accounting (compared to the other models) whereby the profit is recognised over the coverage period and is well suited for contracts of a shorter duration. Please refer to Appendix I for the requirements of use of the PAA. It also has the benefit of being broadly similar with current practice for these types of contracts. IFRS 17 allows acquisition costs related to the PAA to be expensed to profit or loss immediately as a simplified proxy for these short-term contracts.

Contracts with participation

345349 This includes savings contracts with and without insurance coverage where policyholders participate in the return on the assets underlying the insurance contracts. Examples may include annuities and life insurance. These contracts may fall under the VFA measurement model which works on the basis that the insurer earns variable compensation for the services it provides rather than a share of returns from an investment which reflects a separate accounting for the investment portfolio and the group of insurance contracts. When the variable fee the insurer earns changes due to changes in financial factors (such as return in assets or the discount rate), this is not recognised in OCI or profit or loss but adjusts the unrecognised profit (the CSM). The CSM is then recognised in profit or loss over time. IFRS 17 was amended to allow amortisation of CSM based on investment-related services combined with the insurance coverage to better reflect the services provided. For further information about the recognition of CSM in profit and loss please refer to Appendix II.

346350 For these type of contracts, IFRS 17 also suspends the normal measurement rules in some other standards (such as IFRS 9, IAS 32 and IAS 40 related to own equity instruments and own debt issued as well as investment properties) to reflect the nature of these contracts. For further information please refer to Appendix II.

347351 Therefore, EFRAG considers that the VFA reflects the business model of these type of products reflecting the long-term nature of the contract duration as well as the economics of the contracts. EFRAG's assessment of indirect participating contracts can be found in Appendix II.

348352 EFRAG acknowledges that some commentators disagree with this analysis with regard to contracts that change nature over time.

Reinsurance issued

349353 Where a reinsurer issues reinsurance contracts, the requirements of IFRS 17 is *mutatis mutandis* applicable, except that any reinsurance contract does not qualify for the VFA. For further information about the concerns related to this, please refer to Appendix II.

Principles-based standard and use of judgement

350354 As other IFRS Standards, IFRS 17 is principles based and requires the use of judgement. In various cases, an appropriate balance has been struck to allow entity-specific accounting without significantly impairing comparability. Examples include the risk adjustment, the recognition of fulfilment cash flows, and the allocation of CSM. Please refer to Appendix II.

Examples of other options in IFRS 17 to accommodate the business models of insurance entities

351355 IFRS 17 provides a number of options, both on transition and post transition, in order to reflect the insurer's business models. Examples of these options are as follows:

Presentation of financial result

352356 An entity can choose to present the financial risk, such as interest rate, either in its entirety in profit or loss or disaggregated between profit or loss and other comprehensive income. This is done on a portfolio by portfolio basis.

353357 These two options represent two business approaches of European insurers for the following reasons:

(a) Those that would select the disaggregation between profit or loss and other comprehensive income consider it is effective to reduce short-term volatility

on long-duration contracts, and to distinguish market fluctuations from long-term trends.

(b) Those that would select financial risk to be presented fully in profit or loss currently use a form of current value measurement for insurance contracts and therefore would consider profit or loss to provide a better reflection of the extent to which they manage interest rate risk.

Either of these approaches may be considered appropriate for short term contracts.

Transition

~~354~~358 The transition requirements also acknowledge the long-term nature of insurance contracts and the related challenges such as data availability and technology in allowing for three methods to transition to IFRS 17. For further information on transition please refer to Appendix II.

IFRS 17 on risk management techniques

Reinsurance held

~~355~~359 Insurers have various techniques to manage the risks in their portfolios, the most important of which is reinsurance held that is covered by IFRS 17. The main principle in IFRS 17 is that reinsurance contracts are measured separately from the related issued insurance contracts. This gives rise to differences compared to current accounting as discussed in Appendix II. Furthermore, IFRS 17 prohibits the classification of reinsurance contracts as VFA contracts which is further discussed in Appendix II. Finally, the recognition of a gain on reinsurance contracts held offsets the related onerous contract losses on underlying contracts as discussed in Appendix II.

Risk mitigation option

~~356~~360 For contracts with direct participating features, IFRS 17 allows a risk mitigation option for derivatives, reinsurance contracts held and non-derivative financial instruments at FVPL covering the related financial risks. This means that where changes would be recognised in CSM under the VFA, these are recognised in profit or loss in order to avoid accounting mismatches introduced by the VFA. For further information about the risk mitigation please refer to Appendix II.

Hedge accounting

~~357~~361 Although hedge accounting was discussed in the previous letters of endorsement advice, please refer to Annex 5 which discuss the application of hedge accounting to insurance liabilities.

Other aspects in IFRS 17

Mutual entities

~~358~~362 Please refer to Appendix II for further information how IFRS 17 relates to mutual entities.

Level of aggregation with respect to balance sheet measurement

~~359~~363 IFRS 17 takes into consideration the pooling of risk by allowing the recognition and measurement of insurance contracts not on an individual basis as is the case in other IFRS Standards. For example, some contracts may have more claims than others and the outcome is only visible later in the cycle or period. Measuring contracts individually may result in reflecting some contracts as onerous with a resulting loss in the profit or loss whereas the claims may have developed as expected and the overall group is not onerous. Therefore, IFRS 17 allows the measurement of the liability at a level of aggregation that is most appropriate practically with allocations as needed.

Annual cohorts

360364 The requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts has been criticised by many stakeholders as conflicting with the purpose to properly portray the legal contents of the contracts and business model applied. Content relating to the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts is in Annex 1 to the Cover Letter.

Acquisition costs

361365 Acquisition costs for long term contracts may mean that contracts would appear to be loss making in the early periods after inception if such costs were recognised as expenses when incurred. IFRS 17 recognises this and do not reflect such losses unless the contract group is overall in a loss position. IFRS 17 was also amended specifically to reflect acquisition costs related to expected renewals of contracts as assets. This is discussed in Appendix II.

Disclosures

362366 As insurers accept and manage risk, there are various disclosures to provide information for users about the insurance risk retained. For further information refer to Understandability under Appendix II.

Conclusion

363367 EFRAG's observations on the application of annual cohorts to intergenerationally-mutualised contracts and cash-flow matched contracts are discussed in the Cover Letter. With reference to all the other requirements of IFRS 17, EFRAG believes that they take into account the broad categories of products offered by European insurers with relevant modifications to the general model to capture the specificities of the different types of products. They also cater also for risk management in as far as this is not covered by other standards. Criticisms against IFRS 17 discussed elsewhere in Appendix II and III are often relevant in the debate about business models as well.

Potential effect of IFRS 17 on small and medium enterprises (SME's)

364368 In assessing the impact of IFRS 17 on insurers, that are SMEs (Small insurers) EFRAG has used the thresholds included in Article 4 of the Solvency II Directive 2009-138/EC to define this population. The most important thresholds refer to gross written premium income (lower than EUR 5 million) or gross technical provisions (lower than EUR 25 million).

365369 EFRAG has chosen this threshold because:

(a) The EU Recommendation 2003/361/EC when determining whether an entity is a SME, was not specifically developed with insurers in mind. The factors in this EU Recommendation are staff headcount, turnover, and balance sheet total, which may not fully fit the financial position and performance of insurers; and

(b) EFRAG has not found any other thresholds in EU accounting legislation that could be applied to define the population of insurers in the scope of small insurers.

366370 According to EIOPA, applying the thresholds in paragraph 364 above, there are, at the end of 2018, 573 Small insurers.

367371 Given their size, EFRAG considers it reasonable to assume that none of these insurers prepare consolidated financial statements.

~~368~~372 Based on the national regulations on the application of IFRS in individual financial statements at the end of 2018, 328 Small insurers are prohibited from, 3 Small insurers are required to and 242 Small insurers are allowed to apply IFRS. Outreach performed by EFRAG has learned that none or hardly any of the latter group uses the available option.

~~369~~373 EIOPA is currently reviewing the thresholds of Article 4 of the Solvency II Directive 2009-138/EC as per its Consultation Paper on the Opinion on the 2020 review of Solvency II. When any of the options to increase the quantitative thresholds, as proposed by EIOPA, would have been implemented at the end of 2018, the number of Small insurers would increase to between 27 and 35, depending on the option chosen.

~~370~~374 EFRAG concludes that the number of Small insurers that are affected by IFRS 17 in producing their individual financial statements is very limited.

~~371~~375 EFRAG notes that in case of small non-life insurers the impact of IFRS 17 will be more limited than for life insurers, because, generally, these non-life insurers will be able to apply the premium allocation approach. Under this system, insurance accounting is close to the practices currently applied under IFRS 4, and, for the purpose of measurement and performance reporting, less expenditures are required then is the case for life insurers.

~~372~~376 However, EFRAG also concludes if IFRS 17 is applicable to Small insurers, in particular to life insurers, that its impact is comparable to that on other (life) insurers, discussed in other parts of this endorsement advice. Furthermore, compared to the size of these Small insurers, the expenditures to implement IFRS 17 can be characterised as very significant, although the use of external software may have some mitigating impact.

377 Notwithstanding the above, EFRAG notes that proportionality measures should be considered in requesting insurance companies to apply IFRS 17, in particular through the application of art. 5 of the IAS Regulation.

Sensitivity testing

~~373~~378 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.

~~374~~379 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.

~~375~~380 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.

~~376~~381 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.

~~377~~382 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.

~~378~~383 *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 in some countries, EFRAG 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.

~~379~~384 *Sensitivity to yield curve risk*: The second biggest sensitivity related to yield curve risk for some of the savings and unit-linked portfolios.

~~380~~385 *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.

~~381~~386 *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.

~~382~~387 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.

Stress testing

~~383~~388 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. EFRAG 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.

~~384~~389 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.

~~385~~390 Under the stress impacts reported, the initial negative impact on profit 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.

Potential impact for policyholders

~~386~~391 As explained in paragraphs 287 to 301, the results of the Economic Study commissioned by EFRAG and the results of the case studies resulted in opposing messages whether IFRS 17 would have an effect on pricing methodologies and product offerings of insurers. However, EFRAG does not have any quantitative information on how that would affect the policyholders.

~~387~~392 As per the Economic Study commissioned by EFRAG, stakeholders reported that, in general, financial reporting does not play a big role in product mix and pricing. Thus, IFRS 17 is not expected to have a noticeable impact.

IFRS 17 and Solvency II

388393 As part of the endorsement advice activity, the European Commission asked EFRAG to assess the potential ability for the companies to benefit from the work undertaken in reporting under Solvency II regime. This assessment should follow the comparison of the estimated impact on the financial statements with the information provided under Solvency II to understand the size of the differences between IFRS 17 and Solvency II.

389394 Similarly, the European Parliament stressed the need to fully understand the interaction between IFRS 17, which uses a principles-based approach, and other regulatory requirements for insurance entities in the EU, in particular Solvency II, especially in relation to the cost of implementing IFRS 17.

390395 The following paragraphs are EFRAG's proposal to provide an answer to these requests.

Introduction

391396 Solvency II focuses on prudential supervision of insurance and reinsurance undertakings (in this section, jointly called (re-)insurers) in the European Union (EU). It was published in the form of two European Directives (in 2009 and 2014)[15] and two Delegated Regulations (in 2014 and 2015)[16]. Solvency II became fully effective on 1 January 2016.

392397 The main objective of insurance and reinsurance regulation and supervision is the adequate protection of policyholders and beneficiaries. An economic risk-based approach should be adopted, which provides incentives for (re-)insurers to properly measure and manage their risks. To achieve harmonisation the Solvency II framework provides specific rules for the valuation of assets and liabilities, including technical provisions.

393398 Solvency II consists of three main thematic areas, or 'pillars'. Pillar 1 includes the quantitative requirements (i.e. how much capital a (re-)insurer should hold, the so-called Solvency Capital Requirement or SCR), including rules for valuing assets and liabilities. Pillar 2 sets out requirements for the governance and risk management of (re-)insurers, as well as for their effective supervision. And the focus of Pillar 3 is on supervisory reporting, transparency requirements and reporting to the public. It includes a requirement to annually publish a Solvency and Financial Condition Report (SFCR), which describes, among others, the differences between the measurement of assets and liabilities under Solvency II and in the financial statements, and the amounts and composition of the available capital (called eligible Own Funds) and the SCR.

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[15] Directive 2009/138/EC of the European Parliament and of the Council on 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), hereafter the '2009 Directive'; Directive 2014/51/EU of the European Parliament and of the Council of 16 April 2014 amending Directives 2003/71/EC and 2009/138/EC and Regulations (EC) No 1060/2009, (EU) No 1094/2010 and (EU) No 1095/2010 in respect of the powers of the European Supervisory Authority (European Insurance and Occupational Pensions Authority) and the European Supervisory Authority (European Securities and Markets Authority) (hereafter the '2014 Directive').

[16] Commission Delegated Regulation (EU) 2015/35 of 10 October 2014 supplementing Directive 2009/138/EC of the European Parliament and of the Council on 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II) (hereafter the '2014 Delegated Regulation'); Commission Delegated Regulation (EU) 2016/467 of 30 September 2015 amending Commission Delegated Regulation (EU) 2015/35 concerning the calculation of regulatory capital requirements for several categories of assets held by insurance and reinsurance undertakings (hereafter the '2015 Delegated Regulation').

Comparison of frameworks

394399 All insurers and reinsurers in the EEA that would have to apply IFRS 17 in the future are currently subject to Solvency II and so can reap potential efficiency gains as identified, in the terms specified below[17].

395400 Comparing IFRS 17 and Solvency II on a high level, both frameworks adopt a current-value measurement approach. The differences that exist in the detailed requirements of the two frameworks reflect the objectives and scope of the two respective regimes. IFRS 17 deals with reporting the rights and obligations from insurance contracts in the context of general-purpose financial reporting, i.e. reporting of information to the capital markets. Solvency II focuses on the valuation of insurance obligations within a risk-based framework with the protection of policyholders and beneficiaries at its heart.

396401 Solvency II applies a balance sheet approach and focuses on measurement of the insurance liabilities at a point in time. IFRS 17 includes requirements for the measurement of insurance contracts as well as the accounting treatment of changes in the resulting assets and liabilities, whether within the balance sheet (in the form of changes to the risk adjustment or the contractual services margin CSM), in profit or loss, or in OCI.

397402 In other words, IFRS 17 deals with both measurement and performance reporting, while Solvency II focuses on measurement. That being said, it should also be noted that both regimes are based on current measurement of the (uncertain) future cash flows of insurance contracts, although starting from a different perspective (fulfilment under IFRS 17 and transfer to a third party under Solvency II). As both approaches use market inputs to the maximum extent, the starting point of inputs is the same or very similar in principle.

398403 When analysing the details of both sets of requirements, it can be observed that there are many similarities in the texts, but that they are not identical: a number of potential differences can be identified. As a result, key inputs and processes of Solvency II may be used but they may require adjustments to varying degrees. The nature and significance of the differences depends on the characteristics of the insurance contracts issued by insurers and on the technological approach taken in the implementation of both regimes and can vary between companies.

399404 In assessing the potential extent of synergies, EFRAG has used two sources of information:

(a) A publication issued by EIOPA in October 2018, covering the effects on competition, product availability and financial stability and EIOPAs views on using Solvency II inputs, approaches, and processes for an efficient implementation of IFRS 17[18]; and

(b) Outreach to industry experts (preparers and accounting advisors) in November/December 2019.

400405 Overall, respondents expect that the main differences relate to life insurance contracts, in particular to the need to run twice the calculations for the levels of aggregation, the allocation of expenses to insurance liabilities, the discount rate and the risk adjustment. The pervasiveness and quality of the approach taken for the implementation of Solvency II by entities differ. Some built structured databases of cash flow data on a contract-by-contract basis and have integrated the actuarial and financial systems, while others have applied work-around solutions such as

[17] EIOPA analysis of IFRS 17 *Insurance Contracts*

[18] EIOPA's analysis of IFRS 17 Insurance Contracts, EIOPA-18-717 dated 18 October 2018.

spreadsheet applications and manual activities. Still other insurers have built structured databases of cash flow data on a contract-by-contract basis, but they do not have integrated actuarial and financial systems. Depending on the significance of the implementation used for Solvency II these differences may lead to a higher or lower number of efficiency gains that can be finally achieved. For illustrative purposes, hereafter these main differences which could influence the extent of potential synergies are shortly explained.

(a) CSM: Under Solvency II the CSM is not an element of the measurement approach for insurance liabilities. Hence IFRS 17 introduces an element that is entirely new. The calculation engine necessary to identify the CSM is a main driver of measuring performance under IFRS 17.

(b) Level of aggregation: the level of granularity differs between IFRS 17 and Solvency II. At the highest level: under IFRS 17, the definition of a portfolio focuses on both similar risks and managing contracts together, while Solvency II only focuses on homogeneous risk groups; IFRS 17, the homogeneous risk groups may not be unbundled. Next, within these portfolios IFRS 17 requires the identification of three profitability groups (including a group of contracts that are onerous at initial recognition) and further segmentation into annual cohorts; such requirements do not exist in Solvency II.

(c) Allocation of expenses: under Solvency II, all overhead expenses incurred in servicing insurance obligations shall be taken into account. Under IFRS 17, expenses are allocated to groups of contracts if they are directly attributable to the portfolio of insurance contracts to which the group belongs;

(d) Discount rate: IFRS 17 has a principle-based approach and Solvency II a prescriptive approach, where the rate is determined by EIOPA. Under IFRS 17, an entity can apply a so-called bottom-up approach (starting from a liquid risk-free yield curve) or a top-down approach (starting from a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets). Under Solvency II, the EIOPA-determined discount rate can include two other factors, being the matching adjustment[19] or the volatility adjustment[20] that may or may not be consistent with the principle-based approach of IFRS 17;

(e) Risk adjustment: for Solvency II, this adjustment is determined and fixed in regulatory texts. IFRS 17 requires judgement, both in respect of the estimation technique as well as for the parameters that serve as input;

(f) Contract boundaries: the requirements of both regimes are different. Determining the contract boundary of an insurance contract is challenging under both reporting regimes, as both reporting regimes require a significant amount of judgement, in particular whether or not a price or levels of benefits can be set that fully reflect the risks. Differences in the unbundling/separation requirements of the two regimes can create different contract boundaries; and

(g) The preparation of two sets of information for accounting purposes and regulatory purpose increases the complexity of reporting process and related costs.

[19] The matching adjustment adjusts the risk-free rate where insurers hold qualifying long-term assets that match the liability cash flows. It reflects that long-term investors are not exposed to spread movements in the same way as those with trading portfolios.

[20] Under the volatility adjustment, insurers and reinsurers may adjust the risk-free rate to mitigate the effect of short-term volatility of bond spreads on their solvency position.

Are there implementation synergies between IFRS 17 and Solvency II?

401406 IFRS 17 and Solvency II are both based on current measurement of (uncertain) future cash flows of insurance contracts. Also, for both, the measurement is based on a probability-weighted estimate of future cash flows, time value of money and an allowance for risk.

402407 Respondents to the extensive case study, performed by EFRAG in early 2018, anticipated cost savings, however limited in size, in the implementation of IFRS 17 as a result of the investments made in Solvency II. EFRAG could not obtain any quantitative evidence for these assertions. Respondents mentioned the following differences between Solvency II and IFRS 17 that could influence the extent to which synergies can be harvested:

(a) Granularity: while the aggregation at portfolio level is broadly similar in the two regimes, current actuarial tools have to be upgraded to support IFRS 17 increased granularity compared to Solvency II;

(b) Calculation of the CSM and risk adjustment under IFRS 17, in particular for life insurance contracts;

(c) Differences between the discounted cash flows, e.g.:

(i) Allocation of expenses;

(ii) Discount rate;

(iii) Acquisition cash flows: Solvency II does not recognise such amounts as part of the technical provision or as a separate asset. IFRS 17 in contrast, requires the recognition of an asset of acquisition cash flows that are directly attributable to the insurance contracts. For insurance contracts with a coverage period not more than one year (a subset of the PAA), the acquisition cash flows can be expensed as under Solvency II.

(iv) Reporting: IFRS 17 requires the definition of an accounting model aimed at preparing a full balance sheet and profit or loss while Solvency II focusses on the statement of financial position and capital.[21]

403408 EFRAG acknowledges that any difference in the requirements of the two frameworks, no matter how insignificant, could result in significant implications from an operational perspective and lead for example to having to do similar, but different calculations twice as the two regimes have different goals and therefore differ in the detailed technical requirements. However, it is also true that the implementation of Solvency II in the EEA will benefit those entities that have to apply IFRS 17 compared to those entities that have not implemented Solvency II.

404409 The focus of this section is to support an understanding of the extent to which insurers are able to rely on synergies. A technical comparison of similarities and differences between IFRS 17 and Solvency II is as follows. This comparison of IFRS 17 and Solvency II does not have the intention to establish a full-fledged analysis of differences, but to facilitate the above- mentioned understanding.

(a) Comparing IFRS 17 and Solvency II on a high level, the respective primary objectives and the scope of the two regimes differ. IFRS 17 deals with reporting the rights and obligations from insurance contracts in the context of general-purpose financial reporting, i.e. reporting of information to the financial markets. Solvency II is part of a risk-based prudential regime and focuses on the total spectrum of prudential supervision on insurers for the protection of

[21] It is noted that no synergies can be expected from building blocks that are peculiar to IFRS 17.

the interests of policyholders and beneficiaries. To serve their respective objectives, both IFRS 17 and Solvency II adopt a current-value measurement basis, however with the methodological differences that are described below.

(b) Solvency II applies a balance sheet approach and focuses on measurement of the insurance liabilities at a point in time. IFRS 17 includes requirements for the measurement of insurance contracts as well as the accounting treatment of changes in the resulting assets and liabilities, whether within the balance sheet (in the form of changes in the risk adjustment or CSM), in profit or loss, or in OCI.

(c) In other words, IFRS 17 deals with both measurement and performance reporting, while Solvency II focuses on measurement. That being said, it should also be noted that both regimes are based on current measurement of the (uncertain) future cash flows of insurance contracts, although starting from a different perspective (fulfilment under IFRS 17 and transfer to a third party under Solvency II). As both approaches use market inputs to the maximum extent, the starting point for a number of inputs is similar in principle under both reporting regimes. Also, as mentioned by the EIOPA report, both Solvency II and IFRS 17 would recognise losses from onerous contracts immediately when they arise.

(d) When analysing the details of both sets of requirements, EFRAG observes many similarities. The detailed requirements of the two frameworks are, however, not identical and therefore a number of potential differences can be identified. The most relevant ones are described below, following the structure of IFRS 17.

(i) **Definition/contracts affected**: all contracts legally regulated as insurance activities fall under the scope of Solvency II. Under IFRS 17, contracts that do not include significant insurance risk (in particular investment contracts without Discretionary Participation Features (DPF) and some service contracts) are excluded while investment contracts with DPF (which also do not include significant insurance risk) are within the scope of this Standard only if the entity also issues insurance contracts. Contracts with significant insurance risk that are legally regulated as insurance activities represent the common scope of application of the two regimes. These two different formal scoping approaches capture a large common area and will translate in practice in differences only for those contracts legally regulated as insurance activities that do not have significant insurance risk.

(ii) **Scope of consolidation**: there can be, depending on the international composition of the reporting group, significant differences in the consolidation scope between the two reporting regimes.[22] Groups with significant subsidiaries outside the EU but in countries that, under Solvency II, qualify as 'equivalent'[23] do not have to implement Solvency II definitions and measurement to these activities, but do have to apply IFRS 17 to all subsidiaries in the group. Depending on the detailed regulations of the 'equivalent' regimes, this may or may not create other

[22] This difference is not the result of IFRS 17, but of IFRS 10 *Consolidated Financial Statements*.

[23] 'Equivalence' is defined in Articles 379 and 380 of the Commission Delegated Regulation 2015/35. One of the criteria is whether the assessment of the financial position of an insurer relies on sound economic principles and whether solvency requirements are based on the economic valuation of all assets and liabilities. At the end of November 2019, EIOPA has assessed as fully equivalent the supervisory systems of Switzerland and Bermuda, and as provisionally equivalent the systems of Australia, Brazil, Canada, Japan, Mexico and the USA.

differences than those identified when comparing IFRS 17 with Solvency II.

(iii) **Business combinations**: as IFRS 17 requires the creation of a CSM when acquiring a portfolio of insurance contracts, and Solvency II does not (under Solvency II, CSM is not an element of the measurement approach for insurance liabilities), business combinations will lead to a difference in measurement at acquisition date and subsequently.

(iv) **Separating components (unbundling**): the separation requirements of IFRS 17 differ from the Solvency II requirements, since the latter focuses on insurance risks only and IFRS 17 also focuses on financial and service components. The most important of these components will be embedded derivatives and, possibly, distinct investment components. Solvency II requires unbundling of insurance components within one contract between different lines of business.

(v) **Granularity/grouping of contracts**: the level of granularity differs between IFRS 17 and Solvency II. At the highest level: under IFRS 17, the definition of a portfolio focuses on both similar risks and managing contracts together, while Solvency II only focuses on homogeneous risk groups. Although in many cases the portfolios will likely be identical, differences could occur. Next, within these portfolios IFRS 17 requires the identification of three groups (including a group of contracts that are onerous at initial recognition) and annual cohorts; such requirements do not exist in Solvency II. This will not only have an impact on determining the CSMs, but possibly also on determining the future cash flows for measurement purposes: potentially there will be an impact on the contract boundaries and on the level of mutualisation/cross-subsidisation between contracts in one portfolio and/or group (see below).

(vi) **General measurement approach**: both IFRS 17 and Solvency II are based on a current-value approach that leverages on market-based data. IFRS 17 focuses on a fulfilment cash flow approach, while Solvency II focuses on an exit value. However, as is stated above, also Solvency II uses much entity-specific information (because of the lack of an active market in which insurance contracts can be transferred to another company), and, secondly, IFRS 17 requires a consistent check with market data. In practice, there could be a number of inputs that are similar under both reporting regimes.

(vii) **Future cash flows (including expenses)**: assuming no differences in the contract boundaries (see hereafter), the approaches IFRS 17 and Solvency II are quite similar but not identical. One difference concerns expenses: under Solvency II, all overhead expenses incurred in servicing insurance obligations shall be taken into account. Under IFRS 17, expenses are allocated to groups of contracts if they are directly attributable to fulfilling insurance contracts; this can mean that, under IFRS 17, in principle there may be expenses that cannot be allocated to the insurance liabilities (not directly attributable).

(viii) **Contract boundaries**: the requirements of both regimes are different. Determining the contract boundary of an insurance contract is challenging under both reporting regimes, as both reporting regimes require a significant amount of judgement, in particular whether or not a price or levels of benefits can be set that fully reflect the risks.

Differences in the unbundling/separation requirements of the two regimes can create different contract boundaries.

(ix) **Discount rates**: IFRS 17 has a principle-based approach and Solvency II a prescriptive approach, where the rate is determined by EIOPA. Both regimes aim at determining the risk-free interest rate term structure, consistent with market information and the characteristics of the insurance contracts. Under IFRS 17, an entity can apply a so-called bottom-up approach (starting from a liquid risk-free yield curve) or a top-down approach (starting from a yield curve that reflects the current market rates of return implicit in a fair value measurement of a reference portfolio of assets). Under Solvency II, the EIOPA-determined discount rate can (if certain conditions are fulfilled, to be approved by the national insurance supervisory authority) include two other factors, being the matching adjustment or the volatility adjustment that may or may not be consistent with the principle-based approach of IFRS 17. The differences in discount rates could also result in differences in projected earned rates for contracts with participating features.

(x) **Risk adjustment**: for Solvency II, this adjustment is determined and fixed in legislation. IFRS 17 requires judgement, both in respect of the estimation technique as well as for the parameters that serve as input in the determination of the risk adjustment. At the same time, it should be noted that the Solvency II cost-of-capital technique is explicitly mentioned by IFRS 17 and could be suitable for certain portfolios.

(xi) **CSM**: Under Solvency II, the CSM is not an element of the measurement approach for insurance liabilities, so this will lead to a difference in IFRS 17 and Solvency II reporting.

(xii) **Subsequent measurement**: in IFRS 17, this section mainly deals with how to account for changes in components of the fulfilment cash flows and the CSM; the general measurement approach described above is not changed. As under Solvency II subsequent measurement is completely aligned with initial measurement, any differences at initial recognition between IFRS 17 and Solvency II described above are applicable to subsequent measurement as well.

(xiii) **Options to the general measurement approach**: in respect of the general measurement approach, differences between IFRS 17 and Solvency II are created by the IFRS 17 simplifications for contracts under the premium allocation approach, reinsurance contracts held, and investment contracts with DPF; Solvency II does not include these simplifications.

- **Premium allocation approach**: the premium allocation approach (PAA) is a simplification of the general measurement approach under IFRS 17 and can be applied if certain conditions are met. In practice, the most important condition refers to the coverage period of each contract in a group (one year or less). Such simplification does not exist in Solvency II.
- **Reinsurance contracts held**: for reinsurance contracts held, Solvency II applies a 'net' approach for determining the risk margin of insurance contracts whereas IFRS 17 requires consideration of the compensation required for the uncertainty related to non-financial risk. As a result, the risk adjustment may differ between the reinsurance contracts held and the underlying insurance contracts. Furthermore, the contract boundaries may not be the

same and the CSM is determined differently for both sets of contracts.

- **Investment contracts with DPF**: the main difference between the two reporting regimes for these contracts refers to the CSM (and any subsequent changes therein).

(xiv) **Insurance acquisition cash flows:** Solvency II does not recognise such amounts as part of the technical provision or as a separate asset. IFRS 17 in contrast, requires the recognition of an asset of acquisition cash flows that are directly attributable to the insurance contracts. For insurance contracts with a coverage period not more than one year (a subset of the PAA), the acquisition cash flows can be expensed as under Solvency II.

(xv) **Balance sheet**: the requirements in respect of items to be presented in the balance sheet under both reporting regimes are similar but not completely identical. IFRS 17 requires the separation of both insurance contracts issued and reinsurance contracts held into assets and liabilities on a portfolio basis. As a result, there can be four categories: portfolios of insurance contracts issued that are assets, portfolios of insurance contracts issued that are liabilities, portfolios of reinsurance contracts held that are assets, and portfolios of reinsurance contracts held that are liabilities. Solvency II separates insurance contracts issued (liabilities) and reinsurance contracts held (assets). This difference is mainly caused, in practice, by the differences in the treatment of acquisition cash flows, which, under IFRS 17, can result in assets, while Solvency II does not recognise these cash flows in the balance sheet. On the other hand, IFRS 17 combines all cash flows from insurance contracts at portfolio level in one balance sheet item (an asset or a liability), while Solvency II requires, in the Solvency and Financial Condition Report (SFCR), separation of a number of components of this asset or liability (for example, premiums receivable or claims payable). In this respect, Solvency II is more detailed in its presentation requirements.

(xvi) **Profit or loss**: IFRS 17 requires the presentation of a profit or loss statement, whereas Solvency II does not.

(xvii) **Disclosures**: ignoring the disclosure requirements related to performance reporting, the requirements of IFRS 17 and Solvency II are quite similar (with differences in the details). Both provide further insight in financial amounts as well as in (managing) risks, for example by requiring the disclosure of the bases, methods and main assumptions/significant judgements in measuring the insurance liabilities.

(xviii) **Transition approach**: IFRS 17 offers three different transition approaches, while Solvency II offered only one: a point-in-time approach for measuring the insurance liabilities in the balance sheet. The main difference in practice will refer to the measurement of the CSM under IFRS 17 at transition date. This difference is another reflection of the fact that under Solvency II the CSM is not an element of the measurement approach for insurance liabilities, as mentioned above.

(xix) **Comparative amounts**: while IFRS 17 requires the presentation of comparative amounts at transition, Solvency II does not.

~~405~~410 In its October 2018 study, EIOPA remarked that for the actual implementation of IFRS 17 "crucial inputs and processes developed for Solvency II can be used but may need adaptation to varying degrees." Notwithstanding potential need for adaptation, it was expected that significant efficiency gains can be reaped. These efficiency gains are most prevalent in the building blocks of IFRS 17: cash flows, discount rate and risk adjustment.

~~406~~411 EFRAG observes that in a number of companies Solvency II has resulted in the development or improvement of the existing actuarial systems, able to perform cash flow calculations needed to determine the Solvency II liabilities. Without these investments and the steep learning curve that occurred for Solvency II, the implementation of IFRS 17 would be an even greater challenge than it already is today and would have reasonably resulted in higher costs to achieve the same implementation quality.

~~407~~412 Outreach performed by EFRAG in November/December 2019 revealed that, although stakeholders seem to expect that the level of granularity of calculations is to be different under IFRS 17 (requiring the storage of more data and adaptations to the systems) and despite the existence of other differences between the two reporting systems (reflecting their respective objectives and detailed methodologies), the availability of these actuarial systems provides a basis for re-using these systems and capitalising (at least, in part) on the Solvency II investments.

~~408~~413 At the same time, respondents noted that the existing actuarial systems used for Solvency II calculations are not yet sufficiently integrated with the financial reporting systems (for example, not producing the required journal entries). Respondents also observed that the control environment (in particular the establishment of automated internal controls normally embedded in the accounting environment) surrounding these systems would require improvements to meet the auditability requirements under IFRS 17 in time for approval of the financial reporting. This is particularly relevant because of the differences in reporting timelines: generally, reporting the required (audited) IFRS information occurs much earlier than the Solvency II information.

~~409~~414 The respondents also noted that, since there are adaptations in the parameters and assumptions to be used in calculating the liabilities for participating insurance contracts, re-using the actuarial cash flow models would mean, in practice, re-performing the calculations with these different parameters and assumptions, and under different scenarios. This was considered to be an important operational challenge. Yet synergies are possible in terms of building blocks for the measurement of the insurance liability with limitations due to differences in unbundling requirements that may result in different units of account.

~~410~~415 Solvency II focuses on measurement of the balance sheet at a point in time, while IFRS 17 is based on a 'roll-forward' approach, specifying where changes in the cash flows should be reported in the financial statements: as adjustments to the CSM or the risk adjustment, in profit or loss, or in OCI. Even when the balance sheet measurement would be similar or the same[24], respondents noted that the IFRS 17 focus on performance reporting requires at the same time adaptations of the actuarial systems and enhanced integration of them with the financial reporting systems, (the latter described as a main challenge). In particular, as the CSM is a

[24] It is noted that IFRS 17 uses a group of insurance contracts as a unit of account, which implies that lower units that are in an asset or liability position are offset against each other. Also, in contrast to IFRS 17, premiums receivable is shown separately in the balance sheet in Solvency II.

unique and vital part of IFRS 17, this requires the development of completely new systems.

411416 Overall, EFRAG concludes that in implementing IFRS 17, there are possible synergies with Solvency II, but the extent of such synergies varies between insurers. Synergy potential is available in areas that have a high degree of commonality under the two frameworks, i.e. the building blocks for the measurement of the insurance liability needed to establish the cash flow projections, and actuarial systems to measure insurance liabilities. The potential depends, to an extent, on the differences in the starting position of insurers and the investments already made in the implementation of Solvency II. And it also depends on the amount of effort to adapt existing actuarial systems, developed for the Solvency II environment, to the IFRS 17 reporting requirements.

412417 Also, no synergies may be expected for building blocks that are peculiar to IFRS 17, such as the CSM and the components of systems focusing on reporting financial performance.

Summary of the updated Economic Study

413418 The updated Economic Study addresses issues about competition, product mix and prices, asset allocation as well as investors' perception of the clarity of the financial reports of EU insurance undertakings. The study was developed in two steps, before and after the completion of the deliberation process of the IASB that led to the issuance of the Amendments to IFRS 17 in June 2020. The second (updated) Economic Study overcomes and encompasses the contents of the first. The following is a summary of the study – please refer to the hyperlink for the full report.

Competition faced by EU insurers from non-EU insurers

414419 The Economic Study concludes that in general, insurance undertakings from the EU face little competition from non-EU undertakings in EU insurance markets. However, for business focused on more niche insurance products, the market is worldwide, and, in such cases, EU insurance enterprises compete with undertakings from major insurance centres outside the EU. Insurance undertakings from the EU also face little competition from non-EEA undertakings in EU capital markets, but this changes when they raise funds internationally.

415420 Industry stakeholders mentioned that increased volatility in profit or loss as well as lack of comparability with countries not following IFRS may affect their competitive position in capital markets following the implementation of IFRS 17.

416421 However, the majority of supervisory authorities as well as some insurance undertakings indicated that, in the long run, IFRS 17 will bring increased transparency to financial reporting practises of European insurance companies, thus potentially improving their ability to raise funds in capital markets.

417422 Finally, the information from EFRAG's case studies in 2018 suggests that ongoing costs relating to IFRS 17 are unlikely to have a marked impact and that one-off costs for implementation will have a more substantial impact in those specific periods.

Development of EU insurance markets since 2005: product mix and prices

418423 The Economic Study emphasises the decline of the market share of life insurance in the total insurance market (measured by gross premiums) from 2005 to 2008 (and the concomitant increase in the market share of non-life insurance) and broadly stable shares thereafter. However, life insurance, remains by far the largest insurance segment.

419424 The overall price of insurance grew faster than the general consumer price index over the period 2005 to 2019 with the annual rate of annual rate of growth of price of insurance connected with health was markedly higher than overall inflation and the price of transport insurance increased only marginally faster than the overall consumer price index.

420425 According to stakeholders, in general, financial reporting does not play a big role in product mix and pricing and so IFRS 17 is not expected to have significant impacts on short term insurance contracts. The main changes for short term insurance contracts will depend upon companies' existing insurance accounting practices. However, long duration contracts (such as life insurance) or product features which expose profit or loss to market fluctuations (such as participating contracts under the general model) may be affected by the adoption of the new Standard. Due a general aversion against volatility, insurance undertakings may decide to focus more on products/lines of business with lower volatility impact on bottom line.

Developments in the asset allocation of European insurers

421426 The Economic Study underscores that although there is considerable discussion about insurers moving away from debt securities towards new asset classes and /or equity instruments, the aggregate data from EIOPA on the investments of EU insurers do not show a significant movement out of the debt securities at the EU wide level. Furthermore, the majority of stakeholders (i.e. supervisory authorities, insurers and external investors) note 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. Accounting is one of the factors but never the primary reason when it comes to the investment decisions.

422427 Some insurance undertakings reported that investments in equity instruments and structured funds may become less attractive following the adoption of IFRS 9, as IFRS 9 may prevent the proper performance reporting of equity instruments. Views are mixed on whether an alternative to IFRS 9 is needed to portray long term investments by insurers. To date there is insufficient evidence to confirm this as the large majority of insurers do not apply IFRS 9 due to the IFRS 4 amendments to defer the application of IFRS 9.

Investors' perception of the clarity of the financial reports of EU insurance undertakings

423428 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 (banks, basic resources, financial services other than banks, industrial goods & services, media, technology, telecommunications, travel and leisure). 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. Moreover, in Germany, France, and the UK, the comparatively higher capital costs in many cases did not fully reverse until 2018.

424429 Among stakeholders, there was a general agreement that analysts face great difficulties when currently evaluating the financial report of an insurance company. However, there are differing views on the potential impact of IFRS 17 on the cost of capital for EU insurance undertakings. Some insurers believe that IFRS 17 will translate into confusion in the market especially in the short term and a majority of supervisory authorities and some insurers note that, in the long run, IFRS 17 will bring increased transparency in the financial reporting of these entities and this should improve their ability to raise capital on the market. Furthermore, it was noted that IFRS 17 could make the insurance industry more attractive to a generalist investor, which would reduce the cost of equity in the long run.

425430 The education of external investors and analysts is a major concern for industry stakeholders (both life and non-life) and the challenge will be to explain the results and underlying financial assumptions to the external investors during the transition period. It is possible that IFRS 17 could lead to a perceived weakening of the financial strength of companies and, at least temporarily, increase the cost of capital for European insurers while investors familiarise themselves with the new Standard.

426431 Supervisory authorities and auditors commented that the industry is still in the process of developing an understanding of the implications of the Standard and forming common accounting practices. Many concerns are interpretational and will only be solved in practice following the adoption of the Standard.

427432 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.

Broader economic and societal impacts of IFRS 17

Potential impact on financial stability in Europe

Assessment of criteria

428433 In assessing whether IFRS 17 could affect financial stability, EFRAG has relied on the framework developed by the ECB "*Assessment of accounting standards from a financial stability perspective*", December 2006.

Criterion 1: reliance on principles-based accounting[25]

429434 *A rules-based approach allows for clear instructions on how to account for different contract types. However, rules become quickly obsolete in a fast-changing economic environment such as insurance. Also, rules can be easily worked around by means of financial engineering and accounting creativity, leading to the undermining of investors' confidence and subsequent negative effects on financial stability.*

430435 *In contrast a principles-based approach is more capable of being resistant to change in underlying markets and products. However, principles are by nature more general and therefore require additional vigilance whether they reflect the underlying economics.*

431436 IFRS 17 is a principles-based standard providing a common accounting treatment for insurance contracts. Yet in addition to the general measurement model, the Standard also describes a premium allocation approach, a variable fee approach and particular requirements for reinsurance contracts). IFRS 4 does not provide any measurement requirements and insurers rely on national GAAPs for this. This results in a large number of different measurement models.

432437 The premium allocation approach is a simplification of the general model that can be used for short-term insurance contracts when a simplified measurement would not differ materially from a measurement under the general model.

433438 The variable fee approach applies to contracts with direct participation features. This approach is a modification of the general model with significant differences. As discussed in Appendix II, it is argued by some that the dividing line between the general model and the variable fee approach leaves outside of the scope of the VFA some insurance contracts with indirect participation features share some of the economics as insurance contracts with direct participation features. EFRAG's assessment of this requirement is provided in Appendix II.

Criterion 2: Use of reliable and relevant values

434439 *As accounting figures form the basis upon which economic decisions are taken, it is necessary that the use of accounting requirements lead to reliable and relevant outcomes.*

[25] For each of the criteria, italic text is used to describe the criterion, while factors in assessing the criterion or the assessment itself are in normal text format.

435440 Insurance contracts are generally long-term contracts[26], not liquid[27] in nature and there is no deep market available providing daily mark-to-market values, although block transactions of sales of insurance business take place periodically.

436441 In accordance with IFRS 17 insurance contracts are measured using a fulfilment value, which is a current measurement based upon the insurers' own estimates of future cash flows relating to these insurance contracts. In determining the measurement, IFRS 17 requires an entity to make an unbiased probability-weighted estimate of the future cash flows.

437442 Measurement of insurance liabilities in IFRS 17 requires judgement in estimating the fulfilment value of an insurance contract. Judgement and interpretation may be required including accounting policy choices which may affect the reliability of information. In accordance with Appendix II, EFRAG acknowledges that judgement is inherent in the insurance business and in the complexity of the products and as a result, it is inherent in the measurement of insurance contracts. EFRAG's assessment on reliability can be found in Appendix II.

438443 Since the cash flows generated by insurance contracts are uncertain, entities will assess and capture a full range of foreseeable outcomes and their probabilities. In accordance with Appendix II, EFRAG is of the view that this estimate will result in reliable information. The differences in measurement between the national gaaps that are used when applying IFRS 4 limit their relevance on a cross-border basis.

Criterion 3: Recognition of the allocation and magnitude of risks

439444 *Financial statements are expected to provide clear information on i) the allocation of risks and ii) on their potential impact on the financial condition of the entity. The allocation of risks between different entities affects the shock resilience and efficiency of the financial system.*

440445 Insofar insurance contracts have cash flows that vary based on the returns of any financial underlying items, the discount rate used in measuring the insurance cash flows shall reflect that variability, otherwise not. Also, the discount rate reflects the financial risks related to the future cash flows. Under IFRS 4, some insurance liabilities are not discounted at all.

441446 For cash flows of insurance contracts that do not vary based on the returns of underlying items, a discount rate is used reflecting no or negligible credit risk and adjusted to reflect the liquidity characteristics of the group of insurance contracts. That adjustment reflects the difference between the liquidity characteristics of the insurance contracts and the liquidity characteristics of the assets used to determine the yield curve (bottom-up approach). When an insurer relies on a yield curve reflecting the current market rates of return of reference portfolio of assets (top-down approach), the insurer needs to adjust the yield-curve to eliminate any factors that are not relevant to the insurance contracts but is not required to adjust the yield curve for differences in liquidity characteristics of the insurance contracts and the reference portfolio.

442447 IFRS 17 also requires recognition of a risk adjustment, which reflects a compensation for the insurer for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk. In accordance with

[26] This is valid for both life insurance contracts and non-life insurance contracts (property and casualty). Life insurance contracts are long-term contracts by nature. Property and casualty contracts are mostly short-term, but the insurance liability can be extended over multiple years as a result of the claims related to these contracts.

[27] For EFRAG's assessment on the use of a liquidity premium in the discount rates see Appendix II.

IFRS 4 there is no explicit risk adjustment recognised, but based on EFRAG's consultation with some European National Standard Setters, some local GAAP implicitly incorporated prudence in the insurance liabilities measurement.

443448 In addition to the measurement requirements, the disclosures require insurers to provide information about the nature and extent of risks arising from insurance contracts. This includes information about concentration of risk and a sensitivity analysis to insurance and market risks.

Criterion 4: Provision of comparable financial statements

444449 *Harmonised accounting requirements permit to compare financial statements on a cross-border basis and in doing so enhance a rational allocation of capital across entities. This contributes to the economic development.*

445450 IFRS 17 provides consistent principles for all aspects required to account for insurance contracts while providing separate models for specific insurance products. This is an important improvement compared to IFRS 4.

446451 Depending on the transition method used, the impact on equity of an insurance entity will differ.

447452 In addition, as discussed in Appendix II, EFRAG assesses that differences between the accounting models available in IFRS 17 do not create a material reduction in comparability, but rather reflect the characteristics of different types of insurance contracts. EFRAG acknowledges that the possible use of three different transition methods may affect comparability among entities and, in the case of very long-term contracts, over a considerable period. Furthermore, the comparability between contracts measured at fair value on transition and similar contracts issued after transition will be impaired. However, for long-term insurance contracts, it may be difficult to gather the necessary data to apply a retrospective method without undue cost or effort or entities may not have the necessary data. Therefore, EFRAG notes that the benefits in terms of practicability may justify the reduced comparability. In addition, in order to help with or mitigate the reduced comparability, separate disclosures are required for each transition approach that an entity applies.

448453 EFRAG's assessment on the transition requirements in general (not limited to the OCI-balance) can be found in Appendix II.

Criterion 5: Provision of clear and understandable financial statements

449454 *A sound accounting framework fosters market discipline by enhancing transparency through the presentation of self-evident and understandable financial statements.*

450455 *In order for market discipline to work effectively, financial statements are to be clear and understandable for all readers, specialised and non-specialised readers.*

451456 IFRS 17 requires a company that issues insurance contracts to report them on the balance sheet as the total of:

(a) the fulfilment cash flows—the current estimates of amounts that the company expects to collect from premiums and pay out for claims, benefits and expenses, including an adjustment for the timing and risk of those amounts; and

(b) the CSM —the expected profit for providing insurance contract services.

452457 This contrasts with current practices under IFRS 4 where insurers use a wide range of different accounting practices to report the key aspects of their business.

453458 Hence, the use of a clear measurement principle under IFRS 17 will lead to more understandable financial statements.

454459 In profit or loss insurance service result is to be presented separately from insurance finance income or expenses which also contributes in an important way to the understanding of users of financial statements.

455460 IFRS 17 provides a very different accounting approach to insurance contracts when being compared to current accounting practices. As a result, the challenge for readers of financial statements will be to come to grips with the new requirements. This will require time and hence the same may be true for the market discipline to work effectively.

Criterion 6: Portrayal of the financial situation of insurers

456461 *Financial statements should provide an accurate representation of the financial condition of the entity. The solvency, profitability and liquidity are considered important from a financial stability perspective. In particular when market decisions consider ratios based on accounting figures (e.g. return on equity).*

457462 IFRS 17 does not deal with the solvency of insurers. Instead a separate regulatory framework exists for this purpose in Europe which is Solvency II relying on own measurement principles.

458463 On liquidity, IFRS 17 requires particular disclosures that provide readers of financial statements of an analysis of the liquidity risk of the insurance contracts.

459464 In contrast to banks, liquidity risk is less prominent for insurers insofar non-life contracts are involved. Due to the inverted business cycle (i.e. cash comes first), insurers are in a position to to prepare better the funding required to absorb the claims. For the same reason, insurers are far less likely to suffer from 'a run on the company' than banks. In contrast, for life contracts, there may be significant liquidity risks. For example, in case such life insurance contracts offer permanent surrender options.

460465 IFRS 17 provides an accounting policy choice at portfolio level which is irrevocable, to apply IFRS 17 or IFRS 9 to contracts that meet the definition of an insurance contract but limit the compensation for insured events to the amount required to settle the policyholder's obligation created by the contract (for example, loans). Also, credit card contracts that meet the definition of an insurance contract are excluded from IFRS 17 under specific circumstances. These scope exclusions will help banks in applying IFRS 9 to the above contracts and thus avoid the impact of IFRS 17.

461466 At transition insurers will not be allowed to set the OCI balance of their assets at nil. This is being discussed in the chapter of applying IFRS 9 and IFRS 17 together.

462467 EFRAG's assessment on the transition requirements in general (not limited to the OCI balance) can be found in Appendix II.

Criterion 7: Alignment of accounting rules and sound risk management practices

463468 *Financial statements are to reflect sound risk management practices, thereby producing financial information that is economically meaningful and recognising the risks incurred by the insurer.*

464469 The fulfilment value of insurance liabilities includes a risk adjustment which reflects the uncertainty about the cash flows in relation to non-financial risk. The risk adjustment is, just as the other components of the fulfilment value, regularly updated resulting in a current measurement.

465470 Insurers often economically hedge the risks they have. IFRS 17 includes a risk mitigation option that allows to offset the related fair value changes with the effect which would otherwise be reflected in the CSM. However, the option is limited

to insurance contracts accounted for under the variable fee approach. At transition, risk mitigation is not applicable retrospectively which does not fit with a sound risk management practice.

466471 For contracts accounted for in accordance with the general model or the premium allocation approach, IFRS 9 hedge accounting could be used, but it is argued by some this is not feasible as the risks are not separately identifiable nor reliably measurable For EFRAG's assessment on the ability to apply hedge accounting, please refer to Annex 5.

Criterion 8: Promotion of a forward-looking recognition of risks

467472 *In order to reflect risks appropriately accounting should incorporate information not only from the past but also forward-looking elements. By considering such forward-looking information artificial pro-cyclical changes in valuations may be mitigated which are important to the financial stability.*

468473 Insurance contracts are measured using an explicit, unbiased and probability-weighted estimate (i.e. expected value) of the present value of future cash flows. As such the entire measurement of insurance contracts is based on future cash flows in such a way that extreme scenarios are mitigated by relying on a range of probable outcomes. In accordance with IFRS 4 some insurance liabilities are not discounted.

Criterion 9: Avoidance of negative and promotion of positive externalities, in particular regarding the behaviour of banks

469474 *Accounting requirements may create incentives to invest or divest from specific types of instruments (or to change the financial features of those instruments), which may have a long-term macro-economic impact. Hence it can be deemed preferable to achieve accounting neutrality in order to avoid distortion in the allocation of resources.*

470475 In accordance with the Economic Study relating to IFRS 17 conducted on behalf of EFRAG, stakeholders reported that in general financial reporting does not play a big role on the product mix and pricing.

471476 IFRS 17 is not expected to have significant impacts on short-term insurance contracts. Long-duration contracts (such as life insurance) or products which expose the profit or loss to market fluctuations (such as participating contracts evaluated using the general model), instead, may be affected by the adoption of the new Standard.

472477 Participants to the Economic Study noted that the adoption of a current value accounting approach would imply that the volatility of the market is to be reflected in the profit or loss. Industry stakeholders are concerned that this volatility would be higher for segments where the frequency of claims is high.

Criterion 10: Enhancement of market confidence and corporate governance

473478 *Accounting standards are to discourage and to the extent possible, prevent the manipulation of accounts and creative accounting. The reason for this being that creative accounting can damage market trust and have disturbing effects on both financial stability and economic development.*

474479 As discussed in Appendix II measurement of insurance liabilities in IFRS 17 requires judgement in estimating the fulfilment value of an insurance contract. Judgement may be required including accounting policy choices which may affect the reliability of information. EFRAG acknowledges that judgement is inherent in the insurance business and in the complexity of the products and as a result, it is inherent in the measurement of insurance contracts. Therefore, EFRAG considers that estimating future cash flows would not lead to reduced reliability.

~~475~~480 The implementation of IFRS 17 is expected to result in operational and technological changes, such as building of new databases, measurement and reporting tools, enhancing the documentation and the decision processes for exercising the judgement required by the Standard. EFRAG assesses that this transformation process will positively impact the internal control environment and the corporate governance.

~~476~~481 In addition, EFRAG considers that reliability would not be reduced because entities have experience in applying judgement when applying other IFRS Standards and in managing their business.

Conclusion

~~477~~482 Considering the paragraphs above, EFRAG assesses that on balance IFRS 17 meets the 10 criteria.

Other views: survey of NCA by the IMF (July 2020)

~~478~~483 Most of the surveyed jurisdictions expect that IFRS 17 will contribute positively to financial stability. Some jurisdictions have not established a view on this, while several smaller jurisdictions expect no positive or negative impact on financial stability. The IASB (2017) expects that improved transparency will contribute positively to financial stability by making useful information available to enable the relevant parties, including insurance supervisors, to take appropriate actions in a timely manner. More specifically, IFRS 17 can contribute positively to financial stability in the following ways (in order of consensus among the surveyed jurisdictions): (i) allows investors to judge the performance of an insurer more easily; (ii) provides better information on profitability trends and enables immediate recognition of an insurer's losses; (iii) provides proper and regularly updated measurement of insurance liabilities, including the cost of options and guarantees; (iv) ends upfront profit-taking and revenue recognition; and (v) provides comparable financial information on insurers reporting on an IFRS basis within and across jurisdictions.

~~479~~484 Overall, IFRS 17 is a welcome development. It is aimed at improving global comparability with respect to the structure of liability valuation and transparency in insurer balance sheets, thus benefiting policyholders, investors and, ultimately, financial stability. The current international accounting standards for insurance contracts permit a variety of approaches, which complicate comparison between insurers' financial results. Most of the 20 jurisdictions surveyed for this paper expect that IFRS 17 will contribute to financial stability through greater transparency.

~~480~~485 Most of the surveyed jurisdictions expect insurers to not significantly change their business strategy during the transitional period. Insurers are likely to select transition approaches that will have the least financial and operational impact.

~~481~~486 IFRS 17 is expected to contribute positively to enhancing insurers' enterprise risk management (ERM) frameworks mainly through stronger actuarial function and data governance controls.

Overall assessment on financial stability

Criterion	1	2	3	4	5	6	7	8	9	10
Assessment[28]	≈	√	√	√	√	√	≈	√	≈	√

[28] √ means the criterion is met; ≈ means the criterion is met for some aspects but not for all.

~~482~~487 On balance, EFRAG is of the view that IFRS 17 does not negatively affect financial stability.

Other broad impacts considered

Procyclicality

~~483~~488 The motion of the EP asks to EFRAG to consider the recommendations outlined in its resolutions of 7 June 2016 on IAS evaluation and 6 October 2016 on IFRS 9 for the endorsement of IFRS 17, most notably regarding the impact of new standards on financial stability and long-term investment in the EU, but also the risks entailed by the propensity of accounting provisions to cause pro-cyclical effects and/or higher volatility, particularly as IFRS 17 will shift the focus from historical cost to current values.

~~484~~489 There are two possible meanings when looking at cyclical behaviour of economic variables and the following analysis deals with both. The first defines procyclicality mainly in terms of financial variables moving together with and in the same direction as the financial cycle, i.e. as volatility as opposed to countercyclicality (which implies that the variables move in the opposite direction). The second approach sees procyclicality as embedding the idea of amplifying the financial cycle, i.e. not merely going in the same direction but reinforcing it. The second approach is associated with behaviours that can affect the depth and duration of financial crises[29].

~~485~~490 In its analysis below, EFRAG differentiates between effects that are due to solely volatility and effects that can be considered procyclical in accordance with the second approach described in the previous paragraph.

~~486~~491 Further, the analysis below refers to regulatory aspects that relate to Solvency II. These references are for illustrative purposes, as EFRAG in this endorsement advice doesn't opine on regulatory requirements.

~~487~~492 It is noted that the request addressed to EFRAG focuses on the insurance liabilities (impact of discount rates) while the request addressed to the EC focuses on the investments of insurers (assets and treatment of unrealised gains on these). EFRAG acknowledges that there are inherent links between how market movements affect both assets and liabilities. While discount rates for the insurance liabilities reflect in the first place the characteristics of those liabilities, they are influenced by the interest rates that are valid for the assets.

~~488~~493 In order to focus the analysis, hereunder only the procyclical effects of the accounting treatment of insurance liabilities are being discussed. As such, the analysis does not address the question whether changes in market conditions affect the (type) of investments insurers do throughout the economic cycle (this relates to the application of IFRS 9). Instead, the question addressed is whether a current measurement of insurance liabilities impacts the availability of insurance solutions to the economy. The treatment of assets may also play a role, to the extent that economic and accounting mismatches may arise. For a discussion on the treatment of assets relating to insurance contracts, please refer to the section on asset liability management and the interaction of IFRS 9 and IFRS 17.

Analysis

~~489~~494 In accordance with IFRS 17, insurance liabilities are discounted using current rates, which implies that when interest rates go down, the recognised amount of the insurance liabilities increases and vice-versa. In this sense, the Standard can lead to volatility in so far that the value of the liabilities increases (with negative impact

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

on profits and/or total comprehensive income) when interest rates go down with monetary expansion (normally in a downturn).

~~490~~495 An important feature in reducing volatility is the availability of the OCI-option to account for insurance finance income or expenses. The Standard allows entities to make an accounting policy choice between i) including insurance finance income or expenses in profit or loss or ii) disaggregate insurance finance income or expenses between other comprehensive income and profit or loss. By choosing the latter, entities are able to reduce volatility from profit or loss and transferring it into other comprehensive income, thereby reducing the procyclical effects of market movements in profit or loss. The equity will be impacted by this volatility.

~~491~~496 According to the above, the Standard has mixed effects on procyclicality defined in terms of financial variables moving in the same direction as the financial cycle. As illustrated in other sections of this DEA, IFRS 17 in combination with IFRS 9 may result in a more volatile reported financial performance than the accounting policies currently applied, as it will reflect the economic mismatches that exist in the books and as there are instances for which accounting mismatches remain, when requirements of IFRS 17 and IFRS 9 are considered together. Please refer to paragraphs 77 to 190 for more details. This volatility does not necessarily have the potential to play a specific role in producing pro-cyclical or anti-cyclical effects. EFRAG acknowledges that it may be one of the factors that may influence investment, risk management or business behaviours, which are further considered below.

~~492~~497 Insurance business is characterised by the receipt of premiums (often far) in advance of payments of claims are due (i.e. an “inverted” cycle), i.e. in the large majority of cases, policyholders pay the premium before they are entitled to benefit from the insurance coverage. This steady stream of cash inflows makes insurers less dependent on short-term funding. It also means that the higher or lower measurement [applying current rates] of the liability may occur at a different moment than the actual moment of when the claims need to be paid (i.e. the moment when the liability is due).

~~493~~498 Also, in contrast to banks, liquidity risk is less prominent for insurers although in some countries, the right to withdraw amounts at short notice or surrender policies may increase that risk. In addition, there are also specific regulatory requirements to prepare insurers for periods of strained liquidity, such as investments in high quality marketable investments; this reduces the average remaining liquidity risk on balance sheet. Therefore, insurers are generally able to prepare adequately the funding required to absorb the claims. For the same reason, insurers are far less likely to suffer from ‘a run on the company’ than banks.

~~494~~499 The main risk from a financial stability point of view will therefore be solvency risk (does an insurer have sufficient capital available to cover the risks created by its activities) which is addressed through the Solvency II requirements. A critical transmission mechanism for a standard that is pro-cyclical in the second meaning of the definition illustrated above, would be to disincentivise the retention of profits matured in the positive phases of the cycle, such as overstating profits and thus allowing dividends and bonus distributions in good times. As there is no linkage between the accounting equity (share capital, additional paid in capital, share premiums and cumulative retained earnings) and the Solvency ratios and the distribution of dividends is subject to limits defined under Solvency II, the transmission mechanism through the distribution of profits is not in place [i.e. paying out too many dividends in good times due to potential accounting overstatement, reducing the retained earnings of the insurer to a level below of is needed to support the business in bad times]. In other terms, irrespective of what the applicable standards, an insurer will not be allowed to pay dividends that bring its reserves

below the requirements of Solvency II. In addition, it is noted that the distribution of dividends is now determined at national level and is independent from the IFRS accounting.

~~495~~500 In addition, the Solvency II requirements foresee a number of measures to dampen procyclical effects. Two of these relate to discount rates: the volatility adjustment and the matching adjustment. The difference between Solvency II and IFRS 17 discount rates is discussed in paragraphs 401 to 412.

~~496~~501 The volatility adjustment allows insurers to adjust the relevant risk-free interest rate term structure for the calculation of the best estimate of technical provisions to mitigate the effect of exaggerations of bond spreads. The matching adjustment seeks to avoid changes of asset spreads from impacting on the amount of own funds of insurers. Subject to supervisory approval, insurers are allowed to adjust the relevant risk-free interest rate term structure for the calculation of the best estimate in line with the spread movements of their assets. Both measures protect the regulatory capital from insurers from extreme procyclical effects.

~~497~~502 EFRAG considers that the use of a current measurement is not new. In fact, already today some insurance business in some Member States apply current discount rates, while in other Member States and insurance business historical rates are being used. Thus, in the current situation of applying IFRS 4 and IAS 39 together, volatile effects may occur and would not per se be worsened by current measurement. Current practices on discount rates are being discussed in Annex 2 to this Appendix. EFRAG has no indication that – as a result of those differences in accounting treatment between insurance businesses – the availability of insurance solutions between Member States has been affected or what the incremental volatile effect of applying IFRS 17 is when compared to the current situation.

~~498~~503 Furthermore, the procyclical implications of IFRS 17 should be assessed taking into account also the comparison with a situation of a less transparent standard (e.g. IFRS 4) and the fact that less transparency may be regarded as less procyclical or even anti-cyclical by some, but in fact it may result in sudden adjustments in market prices with significant financial stability consequences. In particular, when assessing the behavioural effects of IFRS 17, it shall also be taken into account that the added transparency provided by the new requirements has the benefit that investors will have the possibility to more timely react to how the current market conditions impact the value of insurance liabilities (and the related assets), as well as the performance of insurance undertakings. In other words, it would avoid that accounting reflects the changes occurred in the underlying assets and liabilities "too little-too late". In this respect, timely and transparent information on insurance liabilities is expected to improve the quality of investors' expectations and estimates, thus avoiding cliff effects and abrupt adjustments in market prices which would occur when less transparent disclosure is provided to market participants.

~~499~~504 As mentioned in the chapter relating to applying IFRS 17 and IFRS 9 together, EFRAG expects the managerial aspects determining the business models to be chosen in function of support by the financial assets to the insurance liabilities. Thus, insofar [financial] assets are measured at current value [and not at amortised cost under IFRS 9], EFRAG expects the asset measurement to generally move in the same direction as the insurance liabilities [without being identical as their characteristics may differ]. This because they would be subject to the same economic cycle [and the related movement across the economic cycle of interest rates]. As a result, the finance expenses relating to the insurance liabilities reduce the finance income created by the financial assets. EFRAG notes this would lead, at least partially, to a net effect in the profit or loss account and subsequently equity. In the particular case of applying the current period book yield for the variable fee

approach and when holding the underlying assets, the insurer would be able to eliminate the volatility in finance income and expenses entirely.

~~500~~505 In addition, the CSM is allocated to profit or loss over the coverage period of the insurance contracts involved. This deferral has an anti-cyclical effect on the profit recognition. In addition to this, the deferral of profit through the CSM mechanism has also an effect of spreading impacts over time. It avoids overstating revenues in good times when many premiums are written and spreads the effects over a longer term, thereby mitigating pro-cyclicality.

~~501~~506 EFRAG is aware that some stakeholders have noted that an increase in volatility might have an impact on some features of the products offered or that some companies might decide not to continue offering specific product lines.

~~502~~507 This topic is further discussed in paragraphs 236 to 240, where EFRAG acknowledges this view, however observes that there is no evidence of such an impact, also because IFRS 17 has not yet been applied.

Financial conglomerates

~~503~~508 The analysis above focuses on insurers and does not provide special analysis of bancassurers. EFRAG notes that many effects that are common for both insurers and bancassurers, i.e. groups that provide both banking and insurance services (the OCI-balance at transition, the use of shadow accounting under IFRS 4, the locked-in discount rate in the general model, etc…) are discussed elsewhere in this DEA. However, in case of insurers that are part of a financial conglomerate, as the IFRS book values of equity of the banking parent company are the basis for the prudential ratios, market volatility would affect other comprehensive income and thus the basis of calculating regulatory capital requirements. As this finding is related to prudential regulation, EFRAG does not opine on it.

Overall conclusion

~~504~~509 EFRAG is of the view that IFRS 17 has mixed effects on procyclicality defined in terms of financial variables moving in the same direction as the financial cycle.

~~505~~510 IFRS 17 may result in more volatile financial performance measures however from the evidence collected, it is not likely that this volatility has the potential to play a specific role in producing pro-cyclical or anti-cyclical effects. In addition, as already reported in other sections of this DEA (see paragraphs 556 to 567), EFRAG assesses that notwithstanding more volatile financial performance measures IFRS 17 results in benefits for users and preparers.

~~506~~511 EFRAG also assesses that IFRS 17 does not have the potential to reinforce economic cycles, such as overstating profits and thus allowing dividends and bonus distributions in good times, as there is no linkage between the accounting equity (cumulative retaining earnings) and amounts available for distributions, which are defined within the requirements of Solvency II or national level, independently from IFRS accounting. For conglomerates such linkage exists, as the capital requirement are impacted by accounting, however this finding relates to prudential regulation, which is out of scope for EFRAG's assessment.

~~507~~512 Finally, it is noted that a current measurement is not new and therefore, EFRAG has looked at the incremental effect that can occur. EFRAG also notes that the transparent nature of the IFRS 17 information has the benefit for investors to be able to react timely to any changes at hand, thereby avoiding cliff-effects.

Social and environmental impact

Social guarantees

~~508~~513 Content relating to the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts is in Annex 1 to the Cover Letter.

Environmental impact

~~509~~514 EFRAG has not identified any environmental impacts from applying IFRS 17.

Covid-19 pandemic

~~**NOTE TO CONSTITUENTS**~~

~~510 The Covid-19 crisis is impacting all the sectors of the world economy and society, including the insurance sector, with unprecedented and unpredictable implications.~~

~~511 The analyses conducted in preparation of this DEA do not include an in-depth analysis of the possible effects of the Covid-19 crisis on the expected impacts of IFRS 17, as such an in-depth analysis would not be compatible with the timing of this endorsement advice (also considering the feasibility of a detailed stress test exercise) and its reliability would be strongly impaired by the high degree of uncertainty that still exists on how the crisis will have finally impacted the European economy and the insurance sector at the effective date (1 January 2023).~~

~~512 Nevertheless, EFRAG invites its constituents to report their feedback on whether and to what extent:~~

~~(a) the Covid-19 crisis may influence the expected impacts of IFRS 17 on the insurance market and, indirectly, on the European economy as a whole. In doing so, constituents may refer to the description of the main impacts of the Standard described below.~~

~~(b) they envisage reductions in the ambitions and objectives for the project, plans, multi-year budget or one-off investment spending and/or ongoing costs for the implementation of IFRS 17?~~

Macro-economic situation

~~513~~515 The Covid-19 pandemic and the response to it in the context of the aftermath of the previous financial crisis has led to an unprecedented situation that has far reaching impacts on everyday life and business activities.

~~514~~516 EFRAG notes that in its quarterly risk dashboard for ~~Q2~~Q4 2020[30], EIOPA has highlighted ~~continued~~that elevated macro risks decreased from very high to high in ~~macro, credit, market~~ the context of recovery observed in some territories as well as ~~profitability and solvency~~ expectations around the vaccine. GDP growth forecast rebounded in Dember while market risks ~~with trends~~ remain at a medium level while continuing ~~from Q1 or improving.~~a downward trend. The vaccine news also have a positive impact on the financial markets with volatility continuing to decrease in December, being close to pre-pandemic levels

[30] Please refer here for the full ~~Q2~~Q3 2020 Risk Dashboard (and ~~here~~here for ~~Q1 2020~~previous versions).

Risks	Level	Trend
1. Macro risks	Very high	↗
2. Credit risks	High	→
3. Market risks	High	↘
4. Liquidity and funding risks	Medium	↘
5. Profitability and solvency	High	→
6. Interlinkages and imbalances	Medium	→
7. Insurance (underwriting) risks	Medium	↘
8. Market perceptions	Medium	→

Risk Dashboard
January 2021

Risks	Level	Trend (past 3 months)	Outlook (next 12 months)
Macro risks	High	→	→
Credit risks	Medium	→	↗
Market risks	Medium	↘	↗
Liquidity and funding risks	Medium	→	→
Profitability and solvency	Medium	→	→
Interlinkages and imbalances	Medium	→	→
Insurance (underwriting) risks	Medium	→	↗
Market perceptions	Medium	↗	→

EIOPA Risk Dashboard ~~July 2020 (Q1~~January 2021 (Q3 – 2020 Solvency II Data)

~~515 For example, macro and market risk indicators deteriorated in March 2020 given the decreases in forecast GDP, increases in unemployment as well as volatility in bond and equity markets. The results were increases in risk premia, flight to quality behaviour by investors with credit risk has increased across all asset classes. Liquidity and funding risks as well as profitability and solvency risks for insurers along with insurance risk have been raised to a high level.~~

~~516 The assessment of macro risks remained at a very high level due to the impact of the pandemic in Q2. EIOPA queried whether market performance (which rebounded in Q2 2020) has been decoupled from underlying fundamentals as significantly lower expected GDP growth and inflation forecasts while 10 year swap rates remain low amidst increased unemployment. EIOPA forsees a further deterioration for SCR ratios in the light of the low yield environment and possible credit impairments due to the pandemic and remarked that while the net combined ratio reported has improved and insurance risks have decreased to a medium level, premium growth for life deteriorated.~~

517 ~~The current situation may have~~The outbreak in 2020 displayed some similarities to the scenarios of the EIOPA stress tests in recent years which has enhanced and strengthened the supervisory frameworks and the response of the industry to stress scenarios. However, EFRAG notes that this work focussed on investment behaviour rather than accounting. The ~~D~~FEA also considers the interaction between IFRS 17 and IFRS 9 as well as the impacts on financial stability elsewhere in this appendix.

518 However, the specificities of the situation merit to be considered against the backdrop of significant uncertainty as to the duration and extent of the crisis and its ongoing impacts.

Impacts of the new Standard

519 IFRS 17 is expected to increase transparency for the accounting for insurance contracts for the following reasons:

(a) It will standardise and streamline the different accounting across Europe for IFRS preparers and introduce current value fulfilment measurement on a consistent basis for insurance liabilities;

(b) It will increase visibility of risk exposure of insurers, due to the adoption of the current value measurement of the liabilities, as profit or loss and balance sheet will be more volatile reflecting the changes in financial and non-financial variables in the reporting period;

(c) It has significant additional disclosures, both qualitative and quantitative, that aims to improve the understanding of users of such liabilities; and

(d) The expectation is that the standardisation within the industry and compared to the rest of IFRS will also make it easier for non-specialist users to understand and analyse insurers' financial performance.

520 An increase in transparency under IFRS 17, would be positive for public good in the context of improving visibility of deteriorating risks and conditions and this would be beneficial to the efficient allocation of capital in Europe.

521 In times of high economic volatility however, the increase volatility seen in the profit or loss compared to the situation under current insurance accounting practices may require significant explanation to internal and external stakeholders. Preparers are concerned that users will regard such volatility in a negative light and penalise their share price. They also consider that such perceptions may increase cost of capital, restrict access to finance and decrease market capitalisation. This may be amplified during the pandemic. However, views on this are mixed as users have indicated (refer to the User Outreach elsewhere in this appendix) that where the accounting reflects economic volatility this is not regarded negatively.

522 There is also a concern that IFRS 17 in the context of the pandemic and lower or more volatile results may create or increase behavioural incentives. For example, ~~to modify~~modification of contracts such as offering a lower level of guarantees for contracts and this may reduce savings options for purchasers. Another example would be ~~to accept~~the acceptance of higher risk in exchange for higher asset returns. The latter could increase the risk profile for entities that are systemically important to the financial health of Europe. EFRAG has been informed that the adverse conditions in mid-March 2020 under IFRS 17 would have constrained the ability of insurers to support public mitigation measures in France.

523 As also illustrated in the section Procyclicality of Appendix III, moving from IFRS 4 to IFRS 17 may have limited implications in terms of procyclicality, while a key transmission mechanism of adverse effect (the distribution of dividends and/or bonuses for staff) would remain limited or prohibited as there is no direct link

between book value of equity and the distribution capacity due to the Solvency II regulatory framework.

(a) In terms of idiosyncratic movement of performance and financial market, the accounting value of equity and profit or loss tend to deteriorate in a downturn, reflecting lower interest rates and market returns and reduction in volumes of new business. Economically, cost of capital may increase in some cases (with consequential narrower access to financial capital) due to the highest perception of risk by the investors; however the expected increase in transparency would make the sector more understandable and support the confidence of the investors with positive impacts on the cost of capital.

(b) In addition, under IFRS 17, the CSM is allocated to profit or loss over the coverage period of the related insurance contracts in all cases rather than being recognised when the contract is underwritten, as is the case currently in some circumstances. This deferral of revenues from premia granted in better times would ensure the existence of revenues also in downturn periods, with positive impacts on profitability.

(c) In terms of behaviour incentives that may exacerbate the magnitude of financial or real economic cycles, during a downturn:

  (i) the lower returns will result in lower variable payments for saving products, deteriorating the financial prospects of policyholders. This impact however is not peculiar to IFRS 17 and was already in existence with IFRS 4 as it pertains to the contractual features of the products.

  (ii) facing a higher risk profile due to the general deterioration in asset quality (including of assets that back insurance liabilities and guarantees), the entities may reduce their exposures to the highest risk assets, with resulting trading losses and possible consequences on higher market liquidity premia required for these assets.

Accounting impacts

524 As the accounting treatment for insurance contracts currently are not the same, it is difficult to compare impact of the crisis on the results under IFRS 4 and IAS 39 versus that of IFRS 17 and IFRS 9 on an overall basis this would require a detailed quantitative assessment.

525 The relative benefits would vary depending on current measurement under IFRS 4. For those products or countries where current measurement is already applied, the benefits of IFRS 17 may be limited compared to those not using current measurement principles although some differences would remain. Similarly, where a current GAAP under IFRS 4 has significantly useful disclosures for users, the increased benefit of disclosures under IFRS 17 may be limited.

526 In “A potential macroprudential approach to the low interest rate environment in the Solvency II context” (available here) EIOPA highlights two aspects related to procyclicality as follows: “A first definition of procyclicality refers to the short term tendency to invest in a way that exacerbates market movements and contributes to asset price volatility, which can in turn contribute to asset price feedback loops. But there is also a second definition of procyclicality that refers to a medium-term tendency to invest in line with asset prices and economic cycles, so that willingness to bear risk diminishes in periods of stress and increases in upturns.”

527 EIOPA also identifies that the impact of a low yield environment has the potential impact on the balance sheet where herd behaviour would replace higher-risk by lower-risk asset classes in a double-hit scenario and increase the technical provisions (as interest rates may decrease).

528 EFRAG notes that IFRS 9 was designed to improve concerns that were raised by the Financial Crisis of 2008. Furthermore, apart from Solvency II, some GAAPs used under IFRS 4 already incorporates current measurement and this has not raised procyclicality concerns either in the prudential regime or from a standard-setting perspective.

Investment and resources available for IFRS 17 implementation plans

529 The ~~Covid-19 crisis~~pandemic may have an impact on the size of budgets available for transformational projects, with possible reductions in consultancy costs, new hiring of required skills, and investment in IT. This may result in a downsizing of the ambitions, such as moving from a transformational plan to a reduced compliance exercise, with implications on the robustness of the process and IT solutions adopted.

530 Covid-19 has had a significant impact in how entities do business and how staff work together with lockdowns and social distancing changing the corporate landscape. Obviously, this has meant significant changes to how people and teams work together and may have increased the workload given the consequences of the crisis.

531 Furthermore, during a complex exercise such as the implementation of IFRS 17 and IFRS 9 these changes may have specific implications on resources – both internal and external as well as co-operation between various external experts such as actuaries, accountants, and IT specialists. EFRAG has been informed that the pandemic has had an impact on the timeliness of solutions from third-parties.

532 However, there were no requests for delays to the effective date of IFRS 17 and even those indicating lags to their planned position indicated that this is expected to be resolved in a time manner.

Conclusion

~~532~~533 Covid-19 crisis may have a negative impact on the implementation projects dedicated to IFRS 17 transition and has had significant impacts in how entities do business and how staff work together. EFRAG notes that insurance companies have adapted seemingly well to the new situation that has been in place for more than six months now. ~~EFRAG is unaware of any specific concerns relating to~~Commenters indicated that they do not want the transition to IFRS 17 to be delayed. Furthermore, EFRAG notes that it may be very difficult to disentangle the financial impact of Covid-19 from other consequences of the pandemic.

~~Questions to Constituents~~

~~533 In your view, how will the Covid-19 pandemic affect the impacts of IFRS 17 on the insurance market (see a description of some expected impacts in paragraphs 519 to 528 above) and indirectly, on the European economy as a whole?~~

~~534 Is the Covid-19 pandemic affecting your implementation process for IFRS 17 and IFRS 9? Please explain in detail the impacts such as project ambitions, budget for implementation and ongoing costs, resources, speed of implementation. Please also explain whether this relates to the IT systems implementation, or rather the actuarial or accounting aspects of implementation.~~

~~535 Are there other aspects around the implications of Covid-19, not yet addressed in the DEA that you want to expand on?~~

Overall assessments of IFRS 17

Users' views

EFRAG's User Outreach 2018 [link to the report]

536534 EFRAG sent out a public call for users to be interviewed and also emails were sent out to investors. 31 users participated in this outreach.

537535 A majority of users anticipated greater benefits compared to costs. Benefits mentioned included the identification of onerous contracts, profit earned as services are provided, disclosure of the assumptions used and measurement being closer to Solvency II, split of the underwriting and investing results.

538536 Most users are expecting an improvement in comparability between insurance entities and appreciated that there would be only one framework applicable across countries and that they would benefit from the enhanced disclosures. However a few of them thought IFRS 17 did not go far enough in building a uniform reporting framework. A minority of users were not convinced that IFRS 17 would improve comparability, due to entities' use of judgement, the Standard being principle-based and the availability of options. In addition, many users were uncomfortable with the range of transition approaches offered by IFRS 17.

539537 A majority of users expect the cost of capital to decrease or not to change, while a minority expects an increase; some specialist users indicated that an initial rise in the cost of capital is expected due to the need for market participants to adapt to the new approach. Subsequently, a decrease in the cost of capital was expected but would not be for all insurance companies. With the benefit of more detailed information about the insurance business, the cost of capital for some insurance companies might rise.

540538 Some indicated that the attractiveness of the insurance sector to investors 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.

EFRAG outreach with users specialising in insurance, 2019 [link to the report]

541539 As part of the consultation on EFRAG's draft comment letter issued on 15th July 2019 and commenting on the proposed Amendments to IFRS 17, EFRAG sent out a public call for users/investors to be interviewed. 7 users participated to this outreach. This outreach was focused on specific topic of relevance for EFRAG draft comment letter on the Amendments.

542540 Five users indicated that the annual cohort requirement was not needed for the intergenerationally-mutualised contracts. Three users considered that the results of the mutualised business should be assessed at a level of aggregation that is aligned with how management manages the business. One user specified that the exemption from the annual cohorts should be for the variable fee approach. Conversely, two users favoured the IASB proposals, while one user had no preference as their analysis would not be as detailed. Three users would like to have the additional information if the annual cohort requirement is removed.

543541 Five users agreed with the separate balance sheet presentation of an assets and liability at portfolio level. One of them preferred presentation of portfolios consistent with lines of business because this would make reconciliation with Solvency II easier. Two users preferred group level rather than portfolio level.

544542 On deferral of effective date of IFRS 17 and IFRS 9, two users considered that the alignment of effective dates of IFRS 9 and IFRS 17 for insurers is important. However, one was concerned if IFRS 9 were to be delayed for more than one year

(beyond 2022). One user preferred a delay of maximum one year (no later than 2022)

~~545~~543 Three users agreed with the non-separation of receivables and payables. One user expressed concerns about less balance sheet information. One user asked for separate presentation of receivables and payables.

Users associations in their comment letters to the IASB (September 2019)

~~546~~544 In one international user's association's view, a timely implementation of IFRS 17 is far better than continued reporting under incompatible jurisdiction-specific GAAPs that do not reflect the more economically relevant insurance liability measurements under IFRS 17. IFRS 17 is expected to bring a new level of transparency and substantially improve comparability for the markets. This association appreciates the Board's intent to facilitate an effective and efficient transition to the new Standard, but if twenty plus years developing the Standard could not resolve all issues then users are concerned that tweaking and debating could go on forever. It considers that it is time to implement IFRS 17 and enable the capital markets to assess the impacts of the increased transparency. The association opposes additional delays, as they that come at the cost of enhancing transparency to investors. Finally, post-implementation review of the Standard could revisit and revise policy choices and use of management judgements at a later date.

~~547~~545 For another international network of users, IFRS 17 should take effect as soon as possible. It believes that the accounting approaches used across the insurance industry have lacked consistency for far too long, creating unnecessary challenges for the users of financial statements, and unnecessary costs in the capital markets.

~~548~~546 For one European federation of users' associations, the work done by the IASB and the insurance industry to improve IFRS 17 with the Amendments is an improvement but should not result in further delays of the effective date.

Preparers' views – Based on summary of costs and benefits EFRAG case studies

~~549~~547 EFRAG undertook a case study in 2018 with European insurers, including detailed feedback on the cost/benefit assessment. In May/July 2020 EFRAG ran a Limited Update of the 2018 Case Studies[31], focusing on how the initial assessment changed as a result of the Amendments to IFRS 17 (finalised in June 2020) and including an updated assessment of cost/benefit reflecting also the progresses in the implementation activities. Comments on the cost and benefits of IFRS 17 as amended were received from 21 participants.[32]

Estimated costs

~~550~~548 The following are the updated estimated costs of implementing IFRS 17 as amended in 2020. To put these figures into context we note that each of the listed participants to our case study has paid every year on average dividends in excess of € 1 billion for the past 5 years (excluding share repurchases)[33]:

[31] The listed participants to the Limited Update of the 2018 Case Studies represent in excess of 75% of the total assets and/or market capitalisation of all the listed EEA insurers based on the information gathered from Thompson Reuters Refinitiv Eikon.

[32] In July 2020 EFRAG organised an additional survey with the participants that made a negative initial assessment of the costs/benefits of IFRS 17, in order to better understand how those participants had assessed the benefits. In particular participants were asked to clarify how their opinion would be impacted when focusing on two scenarios: (i) a long-term perspective and (ii) IFRS 17 with an exception for annual cohorts for intergenerationally-mutualised and cash-flow matched contracts. Inputs from this are referred to as "Additional Survey".

[33] Based on information gathered from Thompson Reuters Refinitiv Eikon.

Estimated costs	€ millions	Range € millions (minimum – maximum)	No. of participants
Europe (excluding UK)			
One-off costs	2,332	10 - 395	15
Ongoing costs	180	4 - 50	8
Cost savings	(68)	(3) – (50)	4
UK			
One-off costs	744	38 – 326	4
Ongoing costs	13	0.1	1
Cost savings	(76)	(76)	1

551549 Mid 2020, on average, almost half of the budgets for the one-off costs had been spent, the costs incurred to that date were 42% of the updated one-off costs (one-off costs incurred to that date ranging from 13% - 70%).

552550 When comparing cost estimates of EFRAG's enquiries in 2018 and 2020, there is a significant increase in estimated costs reported. The main reason for the increase in costs related to the IT systems for accounting and reporting and the complexity of the related calculations (44% of the increase). Also, the change in the effective date also contributed to the increase in costs (21% of the increase). The IFRS 17 Amendments except the amendment for the effective date just mentioned had a neutral effect on implementation costs.

(a) On average, there is an increase of *one-off* costs by 42%;

(b) On average, there is an increase of *ongoing* costs by 27%;

(c) A large majority of the participants did not report any significant cost reduction.

Estimated cost savings

553551 Only 21% of the participants identified material estimated cost savings. This mainly related to internal changes made by entities, e.g., increased use of automation, switch to internal solution being developed interfaced between and group and local entities and operational efficiencies. Other estimated cost savings related to some changes made in the IFRS 17 Amendments, such as presenting a portfolio of contracts in an asset or liability position rather than at group level.

Balance sheet presentation

554552 The information in the following paragraph results from the first case studies before the Amendments to IFRS 17 which have changed the presentation requirements. In the Limited Update of the 2018 Case Studies no detailed figures about individual accounting requirements were being asked for.

555553 The new presentation requirements will lead to change existing systems. The requirements that having the most impact on costs are reported in the extensive case study as relating to the separate presentation of:

(a) insurance contracts in an asset position and in a liability position. One of the respondents from the extensive case study quantified the cost of compliance of this requirement as being between €21 and 27 million, representing between 9 and 12% of this respondent's one-off costs;

(b) receivables and payables. One respondent from the extensive case study estimated the cost to be in a three-digit million Euro range in order to link payment information with cash management systems or to change the mechanics of policy administration systems; and

(c) insurance funds withheld.

Benefits

556554 Participants were asked to agree or disagree with the statement whereby the introduction of the new Standard would result in better reporting than the current IFRS 4 regime. The table below reports scores for this assessment, comparing the benefits between IFRS 17 as issued in 2017 and IFRS 17 as amended in 2020 on a scale from 1: totally disagree to 5: fully agree. In general, the scores in the two columns are not significantly different. This means that the preparers that participated in the study saw limited incremental benefits introduced from the Amendments.

557555 This table represents preparer's views.

	Weighted average	
	IFRS 17 as issued in 2017	**IFRS 17 as amended in 2020**
Reflecting the economics of the business	2.4	2.4
Current accounting	2.4	2.5
More comparable financial reporting information	2.7	2.7
Enhanced integration between risk management and financial reporting	2.0	2.0
Reasonable approximation under the premium allocation approach	3.3	3.0
Resolving accounting mismatches	2.6	2.8
Availability of options	2.8	2.8
Specific measurement guidance	3.2	3.2
Reduced cost of capital	2.3	2.6
Uniform Chart of Accounts	1.7	1.8

558556 Overall, for IFRS 17 as amended, based on the table above, the following are the largest benefits:

(a) *Reasonable approximation under the premium allocation approach* as it enables to reduce implementation costs and complexity. However, one participant considered that the PAA implementation is more complex than anticipated;

(b) *Resolving accounting mismatches* –However, a few indicated that more quantitative assessments are needed and there is a lack of sufficient interaction between IFRS 9 and IFRS 17;

(c) *Availability of options* – However, a few participants noted that there is no option that both reflects economic substance and reduces costs;

(d) *Specific measurement guidance leading to more uniform measurement basis than IFRS 4* – however, some considered that under IFRS 17, there would be a lack of comparability because of multiple options, the complexity and also entities would also be reporting under local gaap; and

(e) *More comparable financial reporting information* – improvement in the accounting for reinsurance contracts. However, some indicated the potential lack of comparability between peers when judgement, different policies and accounting options are applied.

559557 In contrast, more than half of the participants considered that compared to IFRS 4, IFRS 17 as amended in 2020:

(a) *is unlikely to improve quality of information via disclosures and to increase other stakeholders' understanding of the insurance sector.* Preparers think this

is due to non-GAAP measures/alternative methods that may be used to explain performance. Also, due to entities adopting different approaches due to the principles-based nature of IFRS 17. Half of the participants in the Additional Survey were more positive and noted that quality of financial information would improve through the disclosures of IFRS 17. Notwithstanding this, participants found the disclosures burdensome, time consuming and detailed.

(b) *is unlikely to increase attractiveness of the insurance sector to investors*. Preparers think this is because IFRS 17 does not provide information on cash creation ; Investors would need many years to gain an in-depth understanding of IFRS 17 financial statements; and due to key metrics being inconsistent with other industries, e.g. Return on Equity. Half of the participants in the Additional Survey noted that IFRS 17 could lead to an increased attractiveness of the insurance sector but this would depend on a number of factors such as the increase in volatility or the application of annual cohorts.

(c) *is unlikely to have a significant positive effect on insurers' cost of capital*. Preparers think this is because cost of capital would mainly be driven by Solvency II and due to an increase in volatility in profit or loss and OCI. EFRAG notes the impact of Solvency II is outside the scope of this endorsement advice. The relation between the cost of capital and volatility is addressed in the Economic Study as well as in the chapter "Competitiveness".

~~560~~558 There were mixed views on whether IFRS 17 as amended is likely to have an increased understanding of the insurance sector by capital providers.

(a) 38% of the participants thought this is unlikely because general insurance business is currently well understood; challenging for non-specialists; not always depicting economics/busines model; while

(b) 33% of the participants thought this is likely because applying IFRS 17 would lead to greater comparability / transparency once the users have gained sufficient knowledge.

(c) Most of the participants in the Additional Survey noted that IFRS 17 was too complex to lead to an increased understanding of investors in the short term. But they were more positive when considering the long term.

~~561~~559 In addition, 67% of the participants considered an increased understanding of the insurance sector unlikely due to the complexity of IFRS 17 and calculations.

Overall consideration of costs and benefits – preparers' view

~~562~~560 Overall, 29% of the participants from the European participants (ie all participants excluding those from the UK) (which correspond to 38% of the participants from European participants that provided a specific answer to this question) considered that the benefits outweighed the expected costs. An additional 10% and 6% of European participants (respectively 13% and 8% of those that provided a specific answer to the question) from Europe considered that the expected benefits outweighed the costs respectively if (i) a solution was found for annual cohorts for intergenerationally-mutualised and cash-flow matched contracts and (ii) a long-term perspective were to be taken.

~~563~~561 In summary this brings to 46% the share of European participants that provided a specific answer concluding on a positive overall cost/benefit appreciation in the long term. This share would increase to 59% if the Standard were to have a solution for annual cohorts for intergenerationally-mutualised and cash-flow matched contracts.

564562 The perception was considerably more negative among UK participants than among their European peers. In the UK all participants expressed negative views. 41% of the European participants had negative views but a quarter of those participants (10% of the total number of participants) would change their view if there were a solution for annual cohorts. In addition, 6% of the participants were negative in the short term but could see a more positive perception on the mid to long term. The breakdown is as follows:

No. of participants	Benefits outweigh costs	Benefits do not outweigh costs	Depends	No response/ no overall view mentioned
Europe (excluding UK)	**29%**	**41% (10% would change the view because of annual cohorts)**	**6% (no in the short term- perhaps in the longer term)**	**24%**
Total (including UK)	24%	52%	5%	19%
UK	-	100%	-	-

565563 The outcomes if non-responses are excluded:

No. of participants	Benefits outweigh costs	Benefits do not outweigh costs	Depends
Europe (excluding UK)	**38%**	**54% (13% would change the view because of annual cohorts)**	**6% (no in the short term- perhaps in the longer term)**
Total (including UK)	29%	65%	6%
UK	-	100%	-

566564 The reasons for expected costs outweighing the expected benefits were mainly due to complexities arising from IFRS 17 and concerns still remaining.

567565 A large minority with Europe (excluding UK) considered that expected benefits outweighed the expected costs as even if the Standard is complex, in their view there is an improvement in quality / consistent and comparable accounting; and a global standard would increase uniformity in accounting.

Costs related to annual cohorts requirement

568566 Responses were received from 18 entities with headquarters in Denmark, France, Germany, Italy, Netherlands, Sweden, Spain, the United Kingdom.

Share of the intergenerationally-mutualised and cash-flow matched contracts

569567 Estimates of the percentage of business impacted ranged from nil (the entity has closed funds and given the age of these would use fair value approach on transition as they did not have sufficient data) to 100% of its health and Life business. Two responses indicated that mutualisation is not relevant for property and casualty insurance. Apart from the outliers on the bottom end, **the average for the range provided was 67% and the mean was: 66%.** There were 4 replies at 50% or below. Most did not distinguish between intergenerational mutualisation or cash flow matching techniques, but one preparer indicated that the depending on

the exact scope, the cash flow matching exception could apply to a sizeable part of the business while "VFA has little relevance".

Cost estimates

~~570~~568 Seven preparers indicated that they are unable to isolate the costs of the annual requirements as the implementation costs are determined overall and not for each separate requirement. The following information was received:

Number of preparers	**Total estimated cost related to IFRS 17 implementation (in millions of euro)**	**Range[34] for cost of annual cohort requirement as a % of total budget**
5	Below €25m	2.3 to 20,0%
2	Between €100m and €200m	3,0 to 8.6%
2	Between €200m and €300m	4,0 to 6,0%
2	Above €300m	9.1 to 15,0%

~~571~~569 Among the seven preparers that did not provide an estimate of the costs relating to annual cohorts, five were life insurers that had a total estimated implementation costs ranging between €38 million and €384 million. The two other preparers operate in property and casualty and so, did not provide information.

~~572~~570 Different entities appear to focus on different aspects of the solution for annual cohorts:

	A	**B**	**C**	**D**	**E**	**F**	**G**	**H**	**I**	**J**
CSM engine	10%	5%	90%	50%	25%	30%	<5%	5%		17%
Actuarial calculations	30%	70%		30%	30%	40%	<5%	67%		8%
Database	20%	10%		15%	20%	25%	Mostly	17%	Mostly	25%
Accounting ledger	40%	5%		5%	8%	5%	Recons			8%
Other		10%			17%			12%		42%

~~573~~571 Other costs related to manuals and operating models, definition of methodologies including asset management system, allocation of fair value of underlying items to annual cohorts as well as changes to actuarial models to collect and allocate mutualised profits to cohorts

~~574~~572 Several also referred to the ongoing costs such as data requirements, reporting systems as well as continued analysis and explanation of results as well as handling larger amounts of data.

~~575~~573 EFRAG received two responses indicating that the requirement on annual cohorts relating to cash flow matched portfolios would on average affect contracts

[34] Two outliers (0.58% and 40%) were excluded from the table. The average of the percentage of total costs was around 10%and the median 8.6%.

that represent 55% of the technical provisions. Both specifically mentioned the increased resources required to allocate underlying assets to cohorts as well as costs relating to data storage and sign-off of disclosure amounts and one is considered that ALM efficiency will be lost as their will be difficulties to justify the link between certain types of investments and the contracts of a specific cohort. It is also mentioned that the pricing and risk management techniques are done at a portfolio level and that cohorts would generate artificial variability in performance as the product is expected to provide a stable margin with no significant deviations from the longevity assumptions. One of the two participants also mentioned that its actuarial engine implementation plan includes the requirements relating to annual cohorts.

Overall conclusion on costs and benefits of IFRS 17

~~576~~574 EFRAG's observations on the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts are in the Cover Letter. For all the other requirements of IFRS 17, EFRAG assesses that the benefits of IFRS 17 exceeds the related costs.

Regulators' view

ESMA

~~577~~575 In its comment letter to the EFRAG dated 23 September 2019 on EFRAG draft comment letter on the IASB proposed Amendments to IFRS 17, ESMA reiterated the importance of a swift finalisation of the Amendments in order to proceed with a timely replacement of the current IFRS 4 which, in its view, does not provide for the necessary transparency and comparability in relation to insurance contracts.

~~578~~576 In its comment letter to the IASB dated 30 October 2013 relating to the IASB's Exposure Draft ED/2013/7 – *Insurance Contracts*, ESMA noted, amongst others, the following:

(a) "Should the IASB decide to retain in the final Standard the approach of recognising changes in the discount rates in OCI, ESMA believes it is crucial that the Standard requires adequate disclosures in the notes to enable users to have a comprehensive view on the performance of insurance contracts."

(b) "ESMA is concerned that the proposed Standard does not provide sufficient clarity in some specific areas without relying on the Basis for Conclusions or the illustrative guidance, for example in respect of the following areas:

(i) Presentation of revenue;

(ii) Determination of the discount rate; and

(iii) Risk adjustment."

~~579~~577 Upon request from EFRAG, in a letter dated 10 September 2018, ESMA indicated that its comments on the IASB's 2013 ED addressed a draft version of the requirements, which was further improved and was finalised with the publication of IFRS 17. IFRS 17 encompasses a better articulation of the key principles and provides for enhanced disclosures and application guidance. On that basis, ESMA noted that it would be inappropriate to retroactively read into the 2013 comments any indication of ESMA's current views on the final Standard.

578 ESMA's comment letter on EFRAG's draft endorsement advice on IFRS 17 can be found here.

EBA

~~580~~579 In its letter to the IASB of 25 October 2013 relating to the IASB's Exposure Draft ED/2013/7 – *Insurance Contracts*, EBA noted, amongst others, the following:

~~581~~580 "The proposed approach permits an insurance entity to determine a discount rate using either a top-down or a bottom-up approach […] such requirement might increase significantly the scope for judgement and inconsistency in the application of the requirements. The EBA is concerned that such accounting choice could reduce comparability of financial information and allow for earnings' management depending on the estimations of preparers, which might be subjective to a large extent."

~~582~~581 In its letter to EFRAG of 22 October 2018, EBA notes that: "In our view, some risks around (i) the possibility of similar transactions with similar economic substance being accounted for differently depending on the issuers' industry and (ii) the high level of judgement around the determination of discount rates, potentially leading to less comparable financial statements as well as increased subjectivity in earning's management, which both exist under IFRS today, are still present in the final Standard. We observe that the applicability of the insurance contracts Standard to financial guarantee contracts is substantially unchanged from IFRS 4, and that IFRS 17 introduces clear principles on discounting for the first time."

~~583~~582 The EBA stressed in addition that it did not carry out an overall evaluation of the Standard and that any analysis undertaken would focus only on issues that could have an impact on banking groups which include insurance entities.

EIOPA

~~584~~583 EIOPA assessed several aspects in its report[35] on IFRS 17: "potential effects on financial stability and the European public good, on product design, supply and demand of insurance contracts as well as IFRS 17's practical implementation in light of the applicable inputs and processes for Solvency II.

~~585~~584 "*Overall, EIOPA found that the increased transparency, comparability and providing insights into insurers' business models through IFRS 17 have the potential to strengthen financial stability in the EEA and therefore regards the implementation of IFRS 17 as beneficial for the European public good. IFRS 17's current, market-consistent and risk-sensitive measurement for insurance obligations reflects on economic reality. This supports efficient risk management and allows stakeholders to gain insights into the entity's business model, exposures and performance.*

~~586~~585 *The introduction of IFRS 17 can be described as a long overdue and positive shift of paradigm compared to IFRS 17's predecessor IFRS 4. Notwithstanding the significant improvements to the financial reporting applying IFRS 17, EIOPA has reservations on a few concepts that may affect comparability and relevance of IFRS 17 financial statements.*

~~587~~586 *There is certainly understanding for the challenges of a market-consistent valuation of insurance liabilities, where such liabilities are infrequently traded in mostly illiquid markets, which necessitates the consideration of entity-specific inputs and assumptions in the valuation. IFRS 17's requirements on determining the applicable discount rate and risk adjustment may have exceeded the appropriate level of entity-specific inputs and consequently may give rise to significantly different and potentially incomparable results.*

~~588~~587 *In other areas, EIOPA found that the solutions provided by IFRS 17 may not be perfectly designed to capture the economics of certain aspects of insurance and reinsurance contracts held[36] and therefore may lead to further complexity of the*

[35] For the full report, please refer to https://www.eiopa.europa.eu/content/eiopa-analyses-benefits-ifrs-17-insurance-contracts

[36] This referred to the treatment of these contracts covering onerous underlying contracts under IFRS 17 before the amendments.

financial statements. Issues such as level of contracts' aggregation or gains from reinsurance contracts held may require further consideration in the implementation of IFRS 17 and potentially amendments through targeted improvements by the IASB in the future.

~~589~~588 *The effects of IFRS 17 on insurers' investments and product availability have been considered in analogy to the studies conducted by EIOPA following the introduction of Solvency II. The market-consistent Solvency II balance sheet valuation can be regarded as a proxy to the application of IFRS 17 and IFRS 9 Financial Instruments. In its studies, EIOPA observed that developments in the economic environment, such as the recent, persistently low interest rates and yields, do shape the availability of certain contracts, the pricing of such contracts as well as the consumer demand and can affect investment decisions. So far, EIOPA has not found that changes in the regulatory environment, particularly the implementation of Solvency II, have had similarly clear effects.*

~~590~~589 *Finally, for the actual implementation of IFRS 17, EIOPA's analysis concluded that crucial inputs and processes developed for Solvency II can be used but may need adaptation to varying degrees. Notwithstanding potential need for adaptation, it is expected that significant efficiency gains can be reaped. These efficiency gains are most prevalent in the building blocks of IFRS 17: cash flows, discount rate and risk adjustment*." Requirements of IFRS 17 that can influence the extent to which efficiency gains can be reaped are discussed in paragraph 402.

590 EIOPA's comment letter on EFRAG's draft endorsement advice on IFRS 17 can be found here.

Auditors' view

591 One European association of auditors (September 2019) welcomes the introduction of IFRS 17. European audit professionals strongly believe that, compared to IFRS 4, the new accounting model for insurance contracts proposed under IFRS 17 will improve comparability, drive greater consistency of recognition and measurement criteria globally, and provide more insightful and relevant information to the intended users including on business model and profitability trends for investors.

IFRS 17 audit considerations

592 EFRAG had requested Accountancy Europe to provide it with feedback as to the auditability of IFRS 17. The following is a summary of their conclusions as presented to the EFRAG Board and EFRAG TEG in May 2020 based on IFRS 17 as issued in 2018 and the deliberations of the IASB with respect to the amendments.

593 Accountancy Europe also indicated that IFRS 17 is a highly complex accounting standard, but based on the methodology followed, it concluded that the Standard is auditable. It acknowledged that the quality of the audit and convergence of the financial reporting under IFRS 17 will depend on time, experience, transparency, and quality of data.

594 Auditor judgement and professional scepticism will especially be required in the areas of significant management judgement similarly to the other topics under Solvency II. The same is true for the assessments of the adequacy and reliability of disclosures of significant estimates as the disclosures may drive convergence and transparency over time. The determination of materiality and the evaluation of audit adjustments will require additional judgement in the application of IFRS 17.

595 Accountancy Europe identified that in relation to potential challenges linked to estimates and actuarial matters, for the promotion of consistent interpretation of the Standard, institutional stakeholders and regulators should promote thematic reviews (similar to the ones on IFRS 9 for banks). Furthermore, those charged with

governance should be continuously encouraged to be involved with respect to technical education, communication to the market and oversight on implementation projects. It is also necessary to continue developing shared views on the application of IFRS 17 as well as prepare educational material, best practices and guidelines for the audit profession (e.g. related to ISA 540 (revised) *Auditing accounting estimates and related disclosures*, ISA 530 *Audit sampling*, ISA 200 *Overall Objectives of the Independent Auditor and the conduct of an audit in accordance with ISA*).

596 On timing, Accountancy Europe emphasised that aside from preparing for the effective date, insurers would need to ensure that judgement is supported by documentation, processes, and controls. Closing timelines of the financial statements may need to be redefined by preparers and they would also need to involve auditors on a timely basis to assess and review the implementation programmes of IFRS 17 and IFRS 9. All of this is necessary against the backdrop of the impact of Covid-19.

597 It is also necessary to establish a dialogue between the audit and actuarial professions, integrate auditing programmes as well as guidelines to carry out consistent high quality and effective audits. It is important that the auditing and actuarial professions leverage each other's skills and competencies with extensive training required for auditors and the audit approach to be adapted. Auditors will require more awareness and understanding of actuarial techniques and this may involve more senior members of both the audit team as well as specialists. It is also important to allocated additional actuarial and IT audit resources as both of these become significantly more important in audit engagements.

598 Audits of IFRS 17 will require consistent exercise of professional judgement and scepticism throughout the audit. It will also require closer collaboration or integration of audit team with actuaries, technology auditors and regulatory experts.

599 Furthermore, it demands significant investments in technology such as digital auditing platforms, big data analysis and the required computational capabilities in actuarial models.

600 Accountancy Europe also described the new aspects of IFRS 17 and the related auditing considerations as follows:

What is new	**Auditing considerations**
Level of aggregation and identification of onerous contracts	Greater degree of granularity: – Significant and complex professional judgement by preparers and auditors; – Appropriate disclosures and education of users Judgement in this area will require: – Vigilance and consistent application by auditors, building on audit of stochastic modelling (Solvency II); – Guidance to ensure consistent application
Contractual Service Margin	Release of the CSM is a key driver to understand profitability of the company Concept of coverage units requires the exercise of judgment Auditors to assess: – if identification and application of coverage units is appropriate and consistent – guidance is understood and applied consistently
Transition	Measurement of CSM on transition requires:

	– analysis of significant volumes of historical data – use of practical expedients – significant judgment Direct impact on the determination of future profits and the subsequent pattern of their release Sufficient time needed to audit, ahead of results being published Requires significant auditors' vigilance
Contract boundaries and estimation of future cash flows	Payment of future premiums may be at the discretion of the policyholder requiring judgment to determine contract boundary Greater difficulty for auditors when requirements are new e.g. comparing 'actuals' against estimates – Vigilance required – Disclosure of estimation uncertainties
Contract classification and applying VFA	The majority of life with profits contracts have: – significant investment management component – terms and conditions vary significantly Auditors to exercise professional judgment if contracts have been appropriately classified
Cash flows that affect or are affected by cash flows to policyholders of other contracts ('Mutualisation')	Contractual cash flows could be affected by certain variable benefits. Complexity arises when different lines of businesses are involved The impact of these changes is not yet known: – on preparers – on the reactions of users – if auditor's need to adapt their assessment of audit risk and audit procedures
Discounting	Exercise of professional judgment to determine discount rates reflecting the characteristics of the liabilities being discounted Vigilance will be needed to assess if discount rates are being correctly applied
Risk adjustment	IFRS 17 requires determination of the risk adjustment through the eyes of management – judgements may be difficult to challenge IFRS 17 vs IFRS 4 provides: – a more coherent framework – more disclosures
Reinsurance contracts held	Many reinsurance contracts contain investment components that will need to be unbundled These new effects will require: – education for preparers, users and auditors – vigilance by auditors
Presentation and disclosure	Integrated statement of financial performance and supporting notes under IFRS 17 Current profit and loss account perceived as an aggregation of the effects of movements in balance sheet items The impact of these changes is not yet known: – on preparers – on the reactions of users

	– if auditors need to adapt their assessment of audit risk and audit procedures
Balance sheet presentation	Separate disclosure of portfolios that are assets and groups that are liabilities, is different in concept from current reporting Most insurers still need to: – understand systems implications and potential cost – find a vision how to operationalize the requirements Auditors will need to adapt their audit procedures to address the final solutions adopted

Conclusion

601 EFRAG notes the conclusions of the audit profession that IFRS 17 is auditable and that it has not received any evidence to the contrary. EFRAG also notes that:

(a) The application of a new and complex standard requires significant interpretation especially on transition and possible alignment of such interpretations may be required over time; and

(b) The significant investment by the audit profession related to the audit of IFRS 17.

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

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

IFRS 4 continued to be applied

603 If IFRS 17 is not endorsed within the EU, IFRS 4 will 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 users' outreach performed by EFRAG this were also confirmed by users. These users 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.

604 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. I.e. in third countries that endorse IFRS 17, branches and subsidiaries of European insurers are compared to local third country insurers.

605 In EIOPA's analysis of IFRS 17 it has been noted that IFRS 17 financial statements are expected to be clearer, more transparent and 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.

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

IFRS 9 and IFRS 17

607 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.

608 The application of IFRS 9 is further deferred until 1 January 2023 by the Amendments to IFRS 17 (June 2020), aligning it with the revised first application of IFRS 17. The deferral of IFRS 9 is valid for insurers that meet particular conditions. A further extension of the so-called top-up for financial conglomerates is not part of this endorsement advice.

Implementation costs incurred

609 Another aspect to be considered is that if IFRS 17 will not be endorsed, insurers will have to consider all implementation costs incurred up until now as sunk costs. As discussed in the chapter on costs and benefits, mid 2020, almost half of the budgets for the one-off costs have already been spent, on average: the costs incurred to date are 42% of the updated one-off costs ranging from 13% - 70% of the one-off costs.

Effective date

610 The effective of IFRS 17 is 1 January 2023 with earlier application being permitted. EFRAG considers that this date is a realistic effective date which will enable preparers to prepare the implementation in a timely way.

611 As per the Limited Update of the 2018 Case Studies, three participants said they considered early adoption and the final decision would depend on a combination of the following factors:

(a) A common effective date across all entities in the group;

(b) Deferral would increase the implementation costs as the IFRS 4 systems would need to be maintained in addition to the IFRS 17 systems;

(c) A clear tendency within its peer group to early adopt or not;

(d) Level playing field: first mover advantages and disadvantages;

(e) Readiness of the organisation and alignment with auditors;

(f) Progress of standard-setting process and delivery of software.

612 One participant said it contemplates an early adoption, as it has to follow its parent and has already adopted IFRS 9 . Therefore, IFRS 17 is expected to mitigate current accounting mismatches.

613 Other outreaches indicated that insurers in Belgium and Germany want the option to early adopt. All other markets reported that adoption is planned for 2023.

614 EFRAG's advice on the deferral of IFRS 9 can be found in the endorsement advice that was published on 6 July 2020.

Annex 1: Summary of IFRS 4 *Insurance Contracts*

Scope

1 IFRS 4 applies to all insurance contracts (including reinsurance contracts) that an entity issues and to reinsurance contracts that it holds, except for specified contracts covered by other IFRS Standards. 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* (or of IFRS 9 *Financial Instruments* for insurers that have already applied this standard). Furthermore, it does not address accounting by policyholders.

Definition of insurance contract

2 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".

Accounting policies

3 IFRS 4 exempts an insurer temporarily from some requirements of other IFRS Standards, 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 and equalisation provisions and requires a liability adequacy test.

Changes in accounting policies

4 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.

Remeasuring insurance liabilities

5 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

6 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

7 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

8 For those insurers that have already adopted IFRS 9, IFRS 17 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

9 An insurer shall assess at the end of each reporting period whether the recognised insurance liabilities are sufficient, 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

10 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[37] 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

11 IFRS 4 requires the 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

12 With the aim of documenting current practices amongst European insurers, EFRAG prepared a questionnaire in May 2017. Respondents were requested to provide information on the European GAAPs that they used and whether or not they used US GAAP. Fifteen respondents participated in this questionnaire.

13 Most respondents to the questionnaire indicated using use different anchors for establishing their accounting policies. Insurers also indicated they use other GAAPs besides European GAAPs such as Swiss, Asian (including Japanese and Hong-Kong GAAP) as well as Russian GAAP.

14 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.

[37] 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.

In addition, respondents reported a number of changes to the local GAAPs resulting in different versions of the same local GAAP being reported.

15 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

16 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 2. 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 require 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.

Annex 2: 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 the 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 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 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** –The provision of ongoing risks complements the provision of unearned premiums as long as their amount is not sufficient to show the valuation of all risks and expenses to be covered by the insurance entity that corresponds to the period of coverage not elapsed by the end of the year. In the case of life insurance, the calculation will be determined based on biometric variables and the interest rate. In the event that the return on the assets assigned to them is less than the interest rate to be applied in their update, it would cause an expense for the entity (onerousness of the contract), as well as possible variation in the unfavourable biometric variables for the entity.

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 and between technical account and non-technical account.

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 discount 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 Entities that have assigned investments to certain insurance operations, provided that they are appropriate to them, may determine the provision of life insurance by applying a type of interest determined based on the internal rate of return of said investments, subject to particular conditions.

28 **UK –** For long-term business, the discount rates 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:

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

30 **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).

31 **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.

32 **Spain** – Not applicable.

33 **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 3: Comparison IFRS 17 – US GAAP

1 The US GAAP requirements for insurance contracts differ from the requirements of IFRS 17. The main differences between the two frameworks are related to the following areas:

(a) Scope;

(b) Different types of insurance contracts – overall view;

(c) Measurement of insurance contracts;

(d) Level of aggregation;

(e) Risk sharing;

(f) Recognition of onerous contracts;

(g) Reinsurance;

(h) Deferred acquisition costs;

(i) Revenue recognition;

(j) Accounting treatment of income on day one;

(k) Measurement of options and guarantees;

(l) Separation of embedded derivatives within insurance contracts; and

(m) Presentation and disclosure.

Scope

2 Unlike IFRS 17, US GAAP establishes industry-specific accounting and reporting guidance for insurance companies, as opposed to accounting for insurance contracts. For entities other than insurance companies, any contract issued that would meet the definition of an insurance contract under IFRS Standards is accounted for in accordance with other applicable US GAAP literature because the specific contract has not been issued by insurance, reinsurance, or certain financial guarantor companies.

Different types of insurance contracts - overall view

IFRS 17	**US GAAP**			
General model, simplified or modified for • premium allocation approach • variable fee approach • investment contracts with discretionary participation features • reinsurance contracts	Short-duration	Long-duration • Traditional • Universal Life • Participating Contracts • Guarantee benefits embedded in certain contracts	Reinsurance ceded	Financial Guarantees

3 Both IFRS 17 (through the premium allocation approach) and US GAAP distinguish between short-term and long-term insurance contracts. Also, both IFRS 17 and US GAAP use modified requirements for particular subcategories of long-term insurance contracts. However, the subcategories used in both frameworks are different as shown in the table below.

Short-duration contracts

4 Under IFRS 17, an entity may use the premium allocation approach when, at inception of a group of insurance contracts:

(a) The measurement would not materially differ from the one when using the general model or the variable fee approach; or

(b) The coverage period of the insurance contracts is one year or less.

5 Under US GAAP short-duration contracts are defined as providing insurance protection for a fixed period of short duration and enabling the insurer to cancel the contract or to adjust the provisions of the contract at the end of any contract period, such as adjusting the amount of premiums charged or coverage provided.

6 The US GAAP definition is perceived to be broader than the one under IFRS 17. In addition, short-duration contracts are adjusted to reflect changes in assumptions while this is not the case for the PAA. However, the carrying amount of PAA contracts is adjusted to reflect the time value of money and the effect of financial risk when these contracts have a significant financing component.

Measurement of insurance contracts

	IFRS 17	**US GAAP**		
		Short-duration	Long-duration (Traditional life)	Long-duration (Universal life)
Cash flows	Required to fulfil the contracts	Same as IFRS	Same as IFRS	Same as IFRS
Assumptions	Updated	Updated	Updated	Updated
Discount rates	To reflect the characteristics of the cash flows arising from the insurance contracts	Typically, not discounted (except for some contracts for which the settlement of claims may take many years)	Upper-medium grade (low credit risk) fixed-income instrument yield that maximises the use of current market observable inputs. Also, for Limited-Payment Long-Duration Contracts	Contract rate or upper-medium grade (low credit risk) fixed-income instrument yield
Risk margin	Explicit risk margin	Risk margin is not applicable (implicit)	Risk margin is not applicable (implicit)	Risk margin is not applicable (implicit)

7 The *Targeted Improvements to the Accounting for Long-duration Contracts* require that an insurance entity measure all market risk benefits associated with deposit (or account balance) contracts at fair value. The portion of any change in fair value attributable to a change in the instrument specific credit risk is required to be recognised in other comprehensive income.

Cash flows

8 For insurance contracts that do not include complex features such as options and guarantees, both frameworks use expected cash flows required to fulfil the insurance contracts in the liability measurement. For insurance contracts that include complex features such as options and guarantees, please refer to paragraph 50.

Assumptions

9 In accordance with IFRS 17, assumptions used in measuring the insurance liability are updated. For short-duration, traditional life and universal life long-duration contracts under US GAAP, an insurance entity has to review and if necessary, update the assumptions used to measure future cash flows at least annually. For traditional and limited-payment contracts, cash flow assumptions are reviewed—and if there is a change, updated—on an annual basis, or in interim reporting periods if evidence suggests that cash flow assumptions should be revised; however, an insurance entity may make an entity-wide election not to update the expense assumption. The discount rate assumption is updated for each reporting period, as of the reporting date.

Discount rates

10 IFRS 17 requires discount rates used to reflect the characteristics of the cash flows arising from the insurance contracts.

11 Under IFRS 17, investment returns are not included in the cash flows used in measuring the insurance liability. Investments are recognised, measured, and presented separately. Consequently, in order to avoid double counting or omissions, cash flows that do not vary based on the returns on any underlying items shall be discounted at rates that do not reflect any such variability. Cash flows that vary based on the returns on any underlying items are discounted using rates that reflect that variability or are adjusted for the effect of that variability and discounted at a rate that reflects the adjustment.

12 Under US GAAP, for short-duration contracts, liabilities for unpaid claims and claim adjustment expenses can be discounted at the same rate used to report the same claims liabilities to State regulatory authorities or discounting liabilities with respect to settled claims under the following circumstances: (i) if the payment pattern and ultimate cost are fixed and determinable on an individual claim basis, and (ii) the discount rate used is reasonable on the facts and circumstances applicable to the registrant at the time the claims are settled.

13 For traditional, limited-payment and universal life contracts, US GAAP requires the use of a current upper-medium grade (low credit risk) fixed-income instrument yield that reflects the duration characteristics for those contracts. The effect of updating the discount rate assumption is to be recognised immediately in other comprehensive income. The discount rate assumption is locked for purposes of determining the interest accretion rate (or interest expense).

Risk margin

14 The general requirements in IFRS 17 prescribe the recognition of a risk adjustment in order to address uncertainty in non-financial risk. The risk adjustment is also applied to investment contracts[38].

15 The *Targeted Improvements to the Accounting for Long-duration Contracts* have eliminated the provision for risk of adverse deviation.

[38] This refers to investment contracts with discretionary participation features that are within the scope of IFRS 17.

Level of aggregation

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

17 For non-traditional products US GAAP indicates that insurance contracts shall be grouped consistent with the entity's manner of acquiring, servicing, and measuring the profitability of its insurance contracts to determine if a premium deficiency exists. For traditional, limited payment and universal life contracts, contracts from different issue years should not be grouped together.

Risk sharing

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

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

Recognition of onerous contracts

20 US GAAP does not prohibit (and, in fact, requires) accrual of a net loss (that is, a loss in excess of deferred premiums) that probably will be incurred on insurance policies that are in force, provided that the loss can be reasonably estimated. A probable loss on insurance contracts exists if there is a premium deficiency relating to short-duration or long-duration contracts.

Short-duration contracts

21 A premium deficiency is recognised if the sum of expected claim costs and claim adjustment expenses, expected dividends to policyholders, unamortised acquisition costs, and maintenance costs exceeds related unearned premiums. A premium deficiency shall first be recognised by expensing any unamortised acquisition costs to the extent required to eliminate the deficiency. If the premium deficiency is greater than unamortised acquisition costs, a liability is accrued for the excess deficiency.

Long-duration contracts

22 For traditional and limited-payment contracts, no premium deficiency testing is required because the liability is updated for current assumptions, but loss recognition testing is retained for universal life-type contracts. For all long duration contracts deferred acquisition costs are not subject to impairment testing as they are considered debt issuance costs and effects of interest expenses.

23 Actual experience with respect to investment yields, mortality, morbidity, terminations, or expenses may indicate that existing contract liabilities, together with the present value of future gross premiums, will not be sufficient to both:

(a) Cover the present value of future benefits to be paid to or on behalf of policyholders and settlement and maintenance costs relating to a block of long-duration contracts; and

(b) Recover unamortised present value of future profits.

24 The premium deficiency is recognised by a charge to income and either of the following:

(a) A reduction of unamortised present value of future profits; or

(b) An increase in the liability for future policy benefits.

25 A premium deficiency, at a minimum, shall be recognised if the aggregate liability on an entire line of business is deficient. In some instances, the liability on a particular line of business may not be deficient in the aggregate, but circumstances may be such that profits would be recognised in early years and losses in later years. In those situations, the liability shall be increased by an amount necessary to offset losses that would be recognised in later years.

26 Under IFRS 17, an entity shall recognise onerous contracts:

(a) At initial recognition: an entity shall recognise a loss in profit or loss if the fulfilment cash flows allocated to the contract, any previously recognised acquisition cash flows and any cash flows arising from the contract are a net outflow; and

(b) On subsequent measurement: insurance contracts can become onerous when adjustments to the CSM exceed the amount of the CSM (‘CSM’). Such excess is recognised immediately in profit or loss. The losses are allocated to a loss component of the liability for remaining coverage for an onerous group.

27 Another (more theoretical than practical) difference between US GAAP and IFRS Standards lies in the definition of "probable" which is used to determine whether a contingent loss or provision should be recognised. Paragraph 23 of IAS 37 Provisions, Contingent Liabilities and Contingent Assets defines probable as "more likely than not to occur" (i.e., "the probability that the event will occur is greater than the probability that it will not"). ASC 450 Contingencies subsection 450-20-20 defines "probable" as "likely to occur."

Reinsurance

28 Under US GAAP, reinsurance contracts do not result in immediate recognition of gains unless the reinsurance contract is a legal replacement of one insurer by another and thereby extinguishes the ceding entity’s liability to the policyholder. Reinsurance recoverables shall be recognised in a manner consistent with the liabilities relating to the underlying reinsured contracts. Assumptions used in estimating reinsurance recoverables shall be consistent with those used in estimating the related liabilities.

Short-duration contracts

29 Under US GAAP, amounts paid for prospective reinsurance shall be reported as prepaid reinsurance premiums and amortised over the remaining contract period in proportion to the amount of insurance protection provided.

30 Amounts paid for retroactive reinsurance that meets the conditions for reinsurance accounting shall be reported as reinsurance receivables to the extent those amounts do not exceed the recorded liabilities relating to the underlying reinsured contracts.

If the recorded liabilities exceed the amounts paid, reinsurance receivables shall be increased to reflect the difference and the resulting gain deferred. The deferred gain shall be amortised over the estimated remaining settlement period.

Long-duration contracts

31 Under US GAAP, the amortisation of the estimated cost of reinsurance of long-duration contracts that meets the conditions for reinsurance accounting depends on whether the reinsurance contract is long-duration or short-duration. The cost shall be amortised over the remaining life of the underlying reinsured contracts if the reinsurance contract is a long-duration contract, or over the contract period of the reinsurance if the reinsurance contract is a short-duration contract. The assumptions used in accounting for reinsurance costs shall be consistent with those used for the reinsured contracts.

32 The difference, if any, between amounts paid for a reinsurance contract and the amount of the liabilities for policy benefits relating to the underlying reinsured contracts is part of the estimated cost to be amortised.

33 Similar to US GAAP, IFRS 17 utilises consistent assumptions as the underlying insurance contracts for measuring the estimates of the present value of future cash flows for a group of reinsurance contracts held. However, under IFRS 17, the effect of any risk of non-performance by the reinsurer, including the effects of collateral and losses from disputes, is considered when determining such estimates. In US GAAP the cost of non-performance is considered as part of expected credit losses.

34 The difference between the amount paid for the reinsurance cover and the expected risk-adjusted present value of the cash flows generated by the reinsurance contracts held, represents the CSM which is recognised over the reinsurance coverage period.

Deferred acquisition costs

35 Differences may occur between deferred acquisition costs as defined under IFRS 17 and in accordance with US GAAP.

36 IFRS 17 defines insurance acquisition cash flows as cash flows arising from the costs of selling, underwriting and starting a group of insurance contracts that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.

37 US GAAP defines acquisition costs as those that are related directly to the successful acquisition of new or renewal insurance contracts. In addition, US GAAP provides detailed guidance about how to identify costs that directly relate to the successful acquisition of new or renewal insurance contracts.

38 Under IFRS 17, the IASB has proposed that insurers would be required to allocate part of the insurance acquisition costs directly attributable to newly issued contracts to expected contract renewals. Under US GAAP, for long-duration contracts, acquisition costs are deferred and amortised on a constant basis over the expected life of the related contracts. Deferred acquisition costs would be written off for unexpected contract terminations but would not be subject to impairment testing.

Revenue recognition

39 Under IFRS 17, entities are required to report as insurance revenue the consideration for services on an earned basis. As a result, when applying IFRS 17, insurance revenue will exclude deposit components which represent policyholders' investments that are not consideration for services. The said revenue is then recognised as described in paragraph 45 below.

40 US GAAP has different methods of premium revenue recognition: short-duration contracts, three methods of long-duration contract accounting: traditional, universal life and participating contracts, foreign property and liability reinsurance contracts and financial guarantee insurance contracts.

41 For short-duration contracts, premiums are recognised over the period of the contract in proportion to the amount of insurance protection provided. For few types of contracts where the period of risk differs significantly from the contract period, premiums are recognised as revenue over the period of risk in proportion to the amount of insurance protection provided.

42 For long-duration contracts, premiums are recognised as revenue over the premium-paying periods of the contracts when due from policyholders.

(a) Traditional long-duration contracts: Premiums are recognised as revenue over the premium-paying periods of the contracts when due from policyholders;

(b) Limited-payment contracts: Any gross premium received in excess of the premium is deferred and recognised in income in a constant relationship with insurance in force (life insurance) or with the amount of expected future benefit payments (annuities);

(c) Universal life type contracts: Premiums collected are not reported as revenue. Revenue from those contracts represents fees charged to policyholders and is reported in the period that the amounts are assessed unless evidence indicates that the amounts are designed to compensate the insurer for services to be provided over more than one period. Amounts assessed that represent compensation to the insurance entity for services to be provided in future periods are not earned in the period assessed. Such amounts are recognised as unearned revenue and recognised in income over the period benefited using the same assumptions and factors used to amortise capitalised acquisition costs.

43 For foreign property and liability reinsurance contracts: depending on the circumstances, either the periodic method or the open year method are to be used.

(a) Under the periodic method, premiums are recognised as revenue over the policy term, and claims, including an estimate of claims incurred but not reported are recognised as they occur.

(b) Under the open year method, premiums, claims, commissions and related direct taxes are not reported as income, instead they are reported in the open underwriting balances to which they pertain. The underwriting balances are aggregated and kept open until sufficient information becomes available to record a reasonable estimate of earned premiums.

44 Financial guarantee insurance contracts: At inception a liability for the unearned premium revenue is recognised. The premiums from a financial guarantee

insurance contracts are recognised as revenue over the period of the contract in proportion to the amount of insurance protection provided with a corresponding adjustment (decrease) in the unearned premium revenue. The premium revenue for each reporting period is determined by multiplying the insured principal amount for that period by the ratio of the following components:

(a) The total present value of the premium due or expected to be collected over the period of the contract; and

(b) The sum of all insured principal amounts outstanding during each reporting period over the period of the contract (either contract period or expected period).

Accounting treatment of income on day-one

45 The accounting treatment under IFRS 17 for the unearned profit (CSM) as determined on day-one depends on whether the CSM arising from a primary insurance contract is in a gain or loss position or whether the entity incurred a cost or gain resulting from purchasing reinsurance coverage.

46 For traditional life insurance, limited-payment, universal life and participating life insurance contracts under US GAAP, the net premium model is used to measure the liability for future policyholder benefits. The liability for future policy benefits for traditional life insurance, limited-payment, and participating life insurance contracts is calculated as the present value of estimated future policy benefits and expenses to be paid to or on behalf of policyholders less the present value of estimated future net premiums to be collected from policyholders and shall be accrued as premium revenue is recognised.

47 The net premiums are the portion of the gross premiums required to provide for all benefits and expenses, excluding acquisition costs or costs that are required to be charged to expense as incurred. The net premium ratio is calculated at contract inception by dividing the present value of the total policyholder benefits and expenses, excluding acquisition costs or costs that are required to be charged to expense as incurred, by the present value of total gross premiums. Therefore, the net premium ratio remains a constant percentage of the gross premium for the duration of the contract. The model results in profits being recognised as a level percentage of premiums over the entire life of the contracts.

48 Further, the unlocking of net premiums, by applying the catch-up approach is required. Under this approach, the insurance entity uses its updated net premium ratio to discount future cash flows to derive an updated liability measurement; the difference between the updated liability measurement and the previous liability measurement is referred to as the “catch-up” adjustment.

49 For reinsurance contracts under US GAAP, refer to paragraphs 30 and 32.

Measurement of options and guarantees

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

51 For long-duration contracts, market risk benefits (such as guarantees embedded in variable contracts) are measured at fair value.

Separation of embedded derivatives within insurance contracts

52 Insurance contracts typically create a number of rights and obligations that together generate a package of cash inflows and cash outflows. They can include features in addition to the transfer of significant insurance risk, such as derivatives. IFRS 17 paragraph 11(a) requires an entity to apply IFRS 9 *Financial Instruments* to determine whether an embedded derivative should be accounted for separately from an insurance host contract.

53 U.S. GAAP requires entities to first evaluate whether such contracts or contract features should be accounted for as a market risk benefit. For benefits that are not determined to be market risk benefits, an insurance entity should then determine whether such benefits should be accounted for under Derivative and Embedded Derivative guidance in ASC Topic 815. All other benefits should be accounted for under the provisions of ASC Topic 944.

Presentation and disclosure

54 In accordance with IFRS 17, the carrying amounts of portfolios of insurance contracts that are an asset and those that are liabilities are to be presented separately in the statement of financial position. The same requirement applies to reinsurance contracts held.

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

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

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

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

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

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

57 US GAAP requires various disclosures of qualitative and quantitative information that are applicable to the different types of products. For instance, insurers are required to provide:

(a) disaggregated rollforwards of the beginning to ending balances of the liability for future policy benefits, policyholder account balances, market risk benefits, separate account liabilities, and deferred acquisition costs

(b) information about significant inputs, judgments, assumptions, and methods used in measurement, including changes in those inputs, judgments, assumptions, and methods, and the effect of those changes on the measurement.

Effective date

58 The effective date for the long-term insurance contracts standard for SEC filers excluding eligible smaller reporting companies will be financial years beginning after

15 December 2021, and interim periods within those fiscal years. For all other entities, the effective date will be financial years beginning after 15 December 2023 and interim periods within the financial years thereafter.

59 The effective date of IFRS 17 (as amended in 2020) is 1 January 2023 with earlier application permitted.

Annex 4: Further extracts from EIOPA report on IFRS 17 on financial stability

Criterion 1: reliance on principles-based accounting[39]

60 A rules-based approach allows for clear instructions on how to account for different contract types. However, rules become quickly obsolete in a fast-changing economic environment such as insurance. Also, rules can be easily worked around by means of financial engineering and accounting creativity, leading to the undermining of investors' confidence and subsequent negative effects on financial stability.

61 In contrast a principles-based approach is more capable of being resistant to change in underlying markets and products. However, principles are by nature more general and therefore require additional vigilance whether they reflect the underlying economics.

62 EIOPA concluded the following on the topic in its analysis of IFRS 17 Insurance Contracts[40]:

63 "*Principle-based accounting standards are generally regarded as being more resilient to changes in the economic environment, so that, for example, new features of contracts can be clearly accounted for following the principle or the logic of the accounting standard. In comparison to rules-based accounting standards, principle-based standards are more accommodative of interpretation and exercise of expert judgement. Surely, there is a trade-off and balance to be struck in order to determine a clear principle to allow appropriate interpretation and to avoid a vaguely formulated principle that is prone to be inconsistently applied."*

64 *"The principles underlying the valuations in IFRS 17 (use of market inputs to the maximum extent, current assumptions, explicit assessment of risk and profit allocation in line with services provided) are expected to reflect the economic substance of insurance contracts fairly and accommodate a consistent treatment of different types of insurance contracts and risks*."

Criterion 2: Use of reliable and relevant values

65 As accounting figures form the basis upon which economic decisions are taken, it is necessary that the use of accounting requirements lead to reliable and relevant outcomes.

66 EIOPA commented as follows on this criterion:

67 "*The accounting standards should foster transparent, relevant and consistent information about the economic substance of the business activities and consequently should be based on reliable and relevant values. The measurement and changes in values over time should fairly reflect the underlying economic phenomenon, and so build trust about the relevance and reliability of the reported figures in the financial markets.*

68 *The use of current market inputs generally generates relevant information. However, in markets with infrequent market transactions and low liquidity, the use of market data may skew the reflection on the underlying economics of the transactions. That is a particular challenge for the insurance sector, as insurance*

[39] For each of the criteria, italic text is used to describe the criterion, while factors in assessing the criterion or the assessment itself are in normal text format.

[40] For the full report, please refer to https://www.eiopa.europa.eu/content/eiopa-analyses-benefits-ifrs-17-insurance-contracts

risk is rarely traded in a deep and liquid market. Both mark-to-market and mark-to-model modelling will be needed for IFRS 17, which naturally limits the reliability of the eventual information reported yet is needed and appropriate in the absence of adequate market information."

Criterion 3: Recognition of the allocation and magnitude of risks

69 Financial statements are expected to provide clear information on i) the allocation of risks and ii) on their potential impact on the financial condition of the entity. The allocation of risks between different entities affects the shock resilience and efficiency of the financial system.

70 In its analysis EIOPA concluded as follows on the allocation and magnitude of risks:

71 "*From a financial stability perspective, it is a major concern that the risk exposure of the entity is fairly presented. IFRS 17 provides for an explicit measurement of the insurance risk inherent in insurance contracts – measured from the perspective of the entity, considering all market inputs. Further, reinsurance contracts held shall explicitly reflect the risk transferred to the reinsurer.*

72 *The allocation of the risk between different economic actors will be visible for the financial markets through IFRS 17's requirements. However, the magnitude of the risk remaining with the insurer and the risk transferred to the reinsurer is conceptually entity-specific, which certainly introduces some subjectivity in the measurement*."

Criterion 4: Provision of comparable financial statements

73 Harmonised accounting requirements permit to compare financial statements on a cross-border basis and in doing so enhance a rational allocation of capital across entities. This contributes to the economic development.

74 On comparability, the report of EIOPA comments extensively:

75 "*The insurance sector is widely perceived as subject to diverse accounting practices should benefit most from a harmonised accounting framework that ensures comparable information amongst different insurers within the EEA and globally. Global comparability of financial information fosters cross-border activities and efficient allocation of capital.*

76 The introduction of IFRS 17 can be described as a shift in paradigm to bring comparability to insurers' financial statements and to allow for consistent accounting practices beyond different jurisdiction, compared to its predecessor IFRS 4.

77 Notwithstanding that and whilst IFRS 17 regulates the accounting relatively prescriptively in a number of areas, its principle-based nature allows scope for interpretation and judgment in other cases, which may affect the comparability of the financial statements. Most prominently, the determination of the applicable discount rate appears to be relatively loosely defined. EIOPA believes that a relevant risk-free interest rate term structure should be used to reflect the characteristics of the insurance contract liability. However, IFRS 17 allows entities to use either a top down or bottom up approach to calculate the discount rate. The guidance on applying the top down and bottom up approaches seems broad and potentially inconsistent. Theoretically, both approaches should arrive at the same result; practically that cannot be certain. Due to the importance of the relevant discount rate for interest-rate sensitive assets and insurance liabilities, the comparability of insurers' financial statements may be significantly impaired. The required disclosure of the applied, underlying yield curve may not suffice to allow for appropriate comparability."

Criterion 5: Provision of clear and understandable financial statements

78 A sound accounting framework fosters market discipline by enhancing transparency through the presentation of self-evident and understandable financial statements.

79 In order for market discipline to work effectively, financial statements are to be clear and understandable for all readers, specialised and non-specialised readers.

80 EIOPA described its conclusions as follows:

81 "*For the stakeholders to trust and understand financial information, the accounting should provide clear and comprehensible information. Financial analysts should be able to understand the sectoral specificities.*

82 The principles underlying the valuations in IFRS 17 (market consistency, current assumptions, explicit assessment of risk and profit allocation in line with services provided) are expected to reflect the economic substance of insurance contracts fairly and accommodate a consistent treatment of different types of insurance contracts and risks. IFRS 17 financial statements therefore are expected to be clearer and easier to understand than the current IFRS 4 financial statements. Of course, the performance and functioning of underwriting insurance business is relatively complex, so that the accounting is supposedly relatively complex as well.

83 Further, IFRS 17's principle-based nature, a number of accounting options and room for judgment may affect the clarity and potentially the understandability of the IFRS 17 financial information. Also, the disclosure requirements cannot fully mitigate the risk of partially ambiguous information.

84 *The most controversial area with regards to this criterion is IFRS 17's risk adjustment for non-financial risk, which is a key input to the appropriate valuation of insurance obligations. Due to the marginal, observable market transactions, the inputs will mostly be entity-specific and subject to the insurer's own view on the risk. The IFRS 17 requirement to disclose the implicit confidence level, in case an approach different to the confidence level approach is used, may not in itself create clarity on the risk adjustments' basis or the understandability of differences between insurers' financial information and risk appetite. The confidence level is just one, yet an important one, of the building blocks of a risk margin. The required disclosure of the confidence level that 'corresponds' to the results of the technique means translating the results of other methods than the confidence level approach into the implicit confidence level. For example, Solvency II uses a cost of capital approach with a 99.5% confidence level over a 12 month period with a 6% cost of capital rate over the total timespan of the liabilities, which means that the underlying 99.5% confidence level has to be re-calculated into the implicit confidence level, whereas the horizon of the calculation is unclear*."

Criterion 6: Portrayal of the financial situation of insurers

85 Financial statements should provide an accurate representation of the financial condition of the entity. The solvency, profitability and liquidity are considered important from a financial stability perspective. In particular when market decisions consider ratios based on accounting figures (e.g. return on equity).

86 EIOPA's commentary on this criterion is as follows:

87 "*Financial information should fairly reflect on the financial position of an entity. The information should be accurate and relevant for the current, short-term and long-term assessment of the entity's financial situation. IFRS 17's underlying current, market-consistent valuation of insurance obligations, the appropriate allocation of gains and losses, as well as transparency about written onerous contracts are certainly most relevant for that assessment.*

88 *One of IFRS 17's building blocks is the consideration of the time value of money, which means that expected future cash flows have to be discounted. As current rates should be used to reflect on the actual economic environment and as current rates change over time, the valuation of the liabilities will be affected by changes in interest rates. For that, IFRS 17 provides for the option to present the effects of changes in interest rates either in the statement of profit or loss or in other comprehensive income (OCI). Even though there are disclosure requirements around this accounting policy choice, it is unclear if, and if so how comparable or relevant, the information about liquidity and profitability would be*."[41]

Criterion 7: Alignment of accounting rules and sound risk management practices

89 Financial statements are to reflect sound risk management practices, thereby producing financial information that is economically meaningful and recognising the risks incurred by the insurer.

90 On alignment between accounting rules and sound risk management practices, EIOPA commented as follows:

91 "*Risk management is crucial to an insurers' business and an insurer's accounting should fairly reflect its risk management. To some extent that means that the risk management perspective shall be the starting point for the accounting of the transaction in question. By comparison, it would be counterproductive - from a financial stability perspective - if financial information drove risk management practices to achieve beneficial financial results. Such an outcome may lead to suboptimal risk management and impair the sustainability of the business.*

92 IFRS 17's measurement model is - in principle - following an entity's own view on its risks and therefore the entity can apply the principles of its risk management to fulfil the requirements with regards to market inputs and entity-specific inputs.

93 *Insurers' risk management processes are closely linked to asset-liability management. IFRS 17 takes that into consideration by providing, for example, the 'variable fee approach', which acknowledges the specificities of insurance contracts, in which the policyholder directly shares the investment risk of the underlying asset portfolio. In line with IFRS 17's conceptual approach to define the scope of the variable fee approach, EIOPA supports that the scope of the approach is fairly limited to properly represent the economics of those specific contracts*."

Criterion 8: Promotion of a forward-looking recognition of risks

94 In order to reflect risks appropriately accounting should incorporate information not only from the past but also forward-looking elements. By considering such forward-looking information artificial pro-cyclical changes in valuations may be mitigated which are important to the financial stability.

95 On forward-looking recognition of risks, EIOPA concluded as follows:

96 "*To assess risks adequately, the objective of the financial information needs to be forward looking. A current valuation approach, using actual market inputs, inherently has a forward-looking perspective. From a financial stability perspective, it is indeed preferable to take a forward-looking perspective, and so to allow for a current appreciation of market volatility in the short run and expectations about longer-term developments. It is important that changes in the economics of the contracts and changes in the economic environment are reflected in the valuation of insurance obligations, as the reported volatility and changes in the expected performance adequately reflects economic reality.*

[41] The paragraph relating to the accounting treatment of onerous contracts and the related re-insurance is not reproduced in the light of the amendments to IFRS 17.

97 IFRS 17 sets out that changes in assumptions and experience adjustments, which change fulfilment cash flows relating to future services, adjust the expected profit margin (contractual service margin) instead of being recognised as an immediate profit or expense. This approach consistently reflects that the profit of an insurance contract is earned over the service of the contract yet is subject to future conditions and may change accordingly."

Criterion 9: Avoidance of negative and promotion of positive externalities, in particular regarding the behaviour of banks

98 Accounting requirements may create incentives to invest or divest from specific types of instruments (or to change the financial features of those instruments), which may have a long-term macro-economic impact. Hence it can be deemed preferable to achieve accounting neutrality in order to avoid distortion in the allocation of resources.

99 EIOPA's commentary was as follows:

100 "*Financial information shall fairly reflect the financial situation and the risk exposures of an entity. The valuation of balance sheet items should be consistent with the risk profile of the assets and liabilities in a neutral manner, so not to incentivise or disincentivise specific asset classes or business activities. That approach supports sound risk management and appropriate allocation of resources within the entity and in the capital markets.*

101 IFRS 17 is expected to improve the transparency of insurers' business activities and profitability patterns, as IFRS 17 aims to neutrally present the underlying economics of insurance contracts. In the context of so far divergent accounting practices within and amongst different legislation, the added insights, in particular regarding sources of profitability, profit and risk margins in a comparable manner, may lead to reassessing premiums, contract features and pricing practices. In case there are such effects, the development can actually strengthen both the sustainability of the business model and consumer protection and overall may contribute to a more efficient capital allocation in the European capital markets."

Criterion 10: Enhancement of market confidence and corporate governance

102 Accounting standards are to discourage and to the extent possible, prevent the manipulation of accounts and creative accounting. The reason for this being that creative accounting can damage market trust and have disturbing effects on both financial stability and economic development.

103 EIOPA stated the following on the topic of enhancement of market confidence and corporate governance:

104 "*Accounting standards should be sufficiently clear and rigid to avoid manipulation or 'creative accounting', which would disturb financial stability due to mistrust or second-guessing of actors on financial markets. Most importantly, IFRS should reflect the economic reality of the transaction and insurance contracts, so as to prevent any manipulation. Also, standards should be sufficiently precise and clear in their objectives in order to limit the extent to which malicious interpretations are possible. Even though IFRS 17 provides for a number of options and room for judgement, due to its principle-based nature and requirement of market-consistent valuation, it would not be comprehensible to describe IFRS 17 as particularly prone to encourage 'creative accounting'*."

Annex 5: Application of hedge accounting to insurance liabilities

Hedge accounting

1 The introduction of IFRS 9 combined with IFRS 17 has raised concerns that risk mitigating instruments such as derivatives may create volatility in profit or loss. Because of the lack of a risk mitigation option for contracts under the general model, this part of the endorsement advice considers the impact of hedge accounting and some other solutions specifically for contracts under the general model only. The risk mitigation option for contracts under VFA is discussed in paragraphs 169 to 175.

2 As discussed in the chapter on applying IFRS 9 and IFRS 17 together, there are measurement options available for non-derivative financial instruments. Furthermore, measuring both assets and liabilities with changes related to financial risk in profit in loss (i.e. not using the OCI option in IFRS 17 or FVOCI in IFRS 9) can be a useful alternative for some insurance portfolios with limited residual or unhedged duration mismatches. Insurers could consider that this may result in a similar outcome to the application of hedge accounting (due to ineffectiveness) but with a significantly lower operational burden.

IFRS 9 vs IAS 39

3 For hedge accounting, an entity has a choice between applying the requirements in IFRS 9 or those in IAS 39 for the hedge accounting. Under IFRS 9, entities can also apply the portfolio fair value hedge of interest rate risk under IAS 39, including the European carve-out.

4 There may be specific advantages to the use of IFRS 9[42] or IAS 39[43] . This needs to be evaluated by each entity.

5 However, both standards require measuring and recognising ineffectiveness in profit or loss (subject to the lower of test for a cash flow hedge). Causes of ineffectiveness include counterparty credit risk, different payment dates or foreign exchange basis risk, lapses, extensions, variability of hedged amounts and/or timing of inflows and outflows without extension or lapses.

Hedge accounting for assets backing insurance liabilities

6 As has already been implemented by some insurers , the hedging of the interest rate risk or the reinvestment risk of the related assets may be used as a proxy for hedging the insurance liabilities for financial risk. This reduces complexity as assets do not contain insurance risks and are not directly affected by lapses and surrenders. However, it may add constraints on the asset allocation process, for example the highly probable criterion may require a commitment to purchase specified instruments with specified maturities at predetermined futures dates.

Hedging of components: separately identifiable and reliably measurable

7 A key challenging area relates to hedges of an interest rate risk component in insurance liabilities. The concept of this relating to financial instruments is explained in further details in IFRS 9.

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[42] When hedging with options, the cost of hedging model can be applied to account for the time value of the option (this spreads the initial premium paid for an option in profit or loss. Under IAS 39 this required to be measured at FVPL), and IFRS 9 does not require 80%-125% effectiveness as qualifying criterion for hedge accounting.

[43] Some entities find some aspects simpler under IAS 39 such as for foreign currency hedges where for example currency basis spread are allowed to be excluded from the hedging relationship and be recognised in OCI under IFRS 9 which requires the need to measure them separately whereas IAS 39 didn’t allow that separation, which some find more simple .

8 IFRS 9 states that an explicit risk component in a contract (i.e. contractually specified, such as a specified rate or formula) can be a hedged item.

9 When a risk component is not contractually specified but is implicit in the fair value or cash flows of an item, it needs to be separately identifiable and reliably measurable (‘SIRM) to qualify as a hedged item. The time value component derived from the use of discounting does not satisfies the SIRM conditions in the standards. Whether interest rate risk qualify as a SIRM component requires an assessment of the market structure to which the risks relate and in which the hedging activity takes place. Appropriate evidence of an economic link between the pricing of insurance liabilities and any underlying interest rate benchmark[44] would be necessary, given the lack of a secondary market for insurance liabilities to demonstrate the effect interest rates has on its fair value.

Portfolio fair value hedging of interest rate risk and EU carve-out

10 Once the risk component has been identified, IAS 39 offers the portfolio fair value hedge of interest rate risk (and its carved-out version in the EU) which can be used for open and closed portfolios of insurance liabilities. For this type of hedge, the designated hedged item is expressed as an 'amount of currency' (e.g. an amount of euros, sterling, US dollars etc.) rather than as individual assets or liabilities.

11 The carved-out version of the portfolio fair value hedge of interest rate risk allows the introduction of a bottom layer[45] for the purposes of measuring ineffectiveness. Lapses and surrenders[46] are modelled and stressed. This is done to identify a stream of cash flows that, on portfolio level, is unaffected (i.e. affected with a very low statistical probability) by those timing impacts. This provides the ground for identifying an eligible hedged item. Once the unhedged top layer is exhausted, further maturities, lapses and surrenders affect the bottom layer resulting in ineffectiveness and profit or loss volatility. Therefore, it may be prudent to reduce the bottom layer at inception of the hedge to alleviate this risk.

Implementation activities needed

12 Insurers will have to set up particular systems to get the information required for setting up the required hedging documentation, to designate hedged items as well as to perform the calculations necessary to measure ineffectiveness and to do the necessary amortisation and recycling. Insurers may be able to leverage information or data prepared for regulatory purposes to determine fair value changes due to the hedged risk. Further work may still be required to determine a fair value determined in accordance with IFRS 13 *Fair Value Measurement*.

13 Such information (including other internal information) may be useful to demonstrate whether/how changes in timing of cash flows in each time bucket (including due to lapses and the exercise of contractual options by policyholders) are impacted by interest rate risk for example. Actuarial information may also provide information about lapses/surrenders that may be useful during hedge designation.

14 The set-up of a dynamic hedge of an interest rate risk component at group or portfolio level requires due consideration as such hedges can be operationally

[44] A possible approach would be to assess whether an economic link may be established via either transfers of pre-existing books of insurance contracts in the secondary market or pricing between insurers and customers in the primary market.

[45] From a variable amount rather than a bottom layer from a defined nominal amount per IFRS 9.

[46] The standards literally refer to prepayment risk rather than these terms. Therefore, the treatment of a termination of a party per the terms of the contract before maturity has to be assumed to be significantly similar to the prepayment risk in order for these sections to apply in the insurance world.

complex, including when IAS 39's fair value macro hedge is used. However, such a strategy may significantly improve the effectiveness of the hedging relationship and the additional cost and effort would have to be considered in this context.

Insurance specific considerations

15 While there has been significant experience of application under IAS 39 and the IASB has indicated that the additional guidance in IFRS 9 on this topic should not result in a different outcome for financial instruments under IAS39, the application of this in the context of insurance liabilities is new. Preparers and auditors will have to consider how the practice that exists for hedging strategies in the banking sector (in particular the macro fair value hedge under the IAS 39 carve-out) can be tested and applied to the insurance sector.

16 As the durations involved in the insurance model are generally longer than under the banking model, an insurer will have greater exposure due to variability as a result of both insurance and financial risk. Furthermore, the calculations and models may be more complex to implement as both insurance risk (timing of claims) and non-insurance risk (such as the exercising of extension cancellation options (lapses)) may create variability in timing of payments.

Conclusion

17 There is therefore no conceptual barrier against the application of hedge accounting in the context of IFRS 17. However, given the lack of experience and systems on hedge accounting by the insurance industry, it would require significant investment both in time and systems development to implement hedge accounting in this context.

18 Finally, even with the application of hedge accounting, there is no guarantee that there will be no profit or loss volatility. This is because events may unfold differently than expected or not all the risk types have been hedged. All of the above may also require further judgement and may only be suitable for some but not all cases or instruments.

Annex 6: Insurance statistics based on the present legislation

1 The analyses presented below have been derived from data provided by Insurance Europe (regarding the accounting regime for insurers and the number of insurers reporting under IFRS), and from data included in the EIOPA Consultation Paper on the Opinion on the 2020 review of Solvency II, BoS-19/465 dated 15 October 2019. Because of these two separate sources, unexplained differences can occur.

Table 1: Insurance statistics based on the present legislation

Country	IFRS in non-listed consolidated financial statements of insurers	IFRS in individual financial statements of insurers	Number of EU insurers at the end of 2018			Number of EU insurers reporting under IFRS at the end of 2018[47]
			Total	Below present Article 4 thresholds	Subject to Solvency II[48]	
Austria	Permitted	Prohibited	84	49	35	2
Belgium	Required	Prohibited	69	3	66	20
Bulgaria	Permitted	Permitted[49]	37	5	32	37
Croatia	Required	Required	18	0	18	20
Cyprus	Required	Required	32	1	31	33
Czech Republic	Permitted	Permitted[50]	27	0	27	2
Denmark	Permitted	Prohibited	82	11	72	6
Estonia	Required	Required	10	0	10	11
Finland	Permitted	Permitted[51]	50	6	46	5
France	Permitted	Prohibited	713	237	462	13
Germany	Permitted[52]	Permitted[53]	402	27	338	7
Greece	Required	Required	38	2	36	42

[47] This column presents the number of insurers applying IFRS in their consolidated or individual financial statements; the split between these two statements is not available. The numbers do not include subsidiary insurers that apply IFRS only to report to their parent companies for consolidation purposes.

[48] Next to the thresholds in Article 4, the Solvency II Directive 2009-138/EC includes other criteria to scope-in or scope-out insurers from its application.

[49] The Insurance Code and Instructions by the Ministry of Finance require all insurers to apply IFRS. Since 2019, this requirement is included in the Accountancy Act.

[50] If the consolidated financial statements are prepared under IFRS.

[51] If audit is mandatory.

[52] Required for undertakings pending admission to trading on a regulated market.

[53] Only in addition to financial statements prepared under National GAAP.

Country	IFRS in non-listed consolidated financial statements of insurers	IFRS in individual financial statements of insurers	Number of EU insurers at the end of 2018			Number of EU insurers reporting under IFRS at the end of 2018[47]
Hungary	Permitted	Permitted	33	10	23	1
Ireland	Permitted	Permitted	201	1	187	1
Italy	Required	Prohibited[54]	100	1	96	27
Latvia	Required	Required	6	0	6	6
Lithuania	Required	Required	9	0	9	9
Luxembourg	Permitted	Permitted	278	0	268	0
Malta	Required	Required	68	0	65	11
Netherlands	Permitted	Permitted	134	22	132	6
Poland	Permitted[55]	Permitted[56]	60	1	60	3
Portugal	Required	Required	41	0	40	41
Romania	Permitted	Prohibited[57]	29	1	27	29
Slovak Republic	Required	Required	14	0	14	12
Slovenia	Required	Required	15	0	15	15
Spain	Permitted[58]	Prohibited	208[59]		152	8
Sweden	Required[60]	Prohibited	187	26	135	133
Total EU-27			2,945	403	2,402	500

[54] There were plans to require IFRS for all insurers. This decision has been postponed amid concerns with IFRS 17 (among other factors).

[55] For subsidiaries of a group in which the parent company prepares consolidated financial statements under IFRS, and for entities having filed or intending to file for admission to public trading.

[56] Same as for consolidated financial statements.

[57] IFRS is required for all listed companies, including insurers. IFRS is permitted in the individual financial statements of insurers, but only as a secondary reporting set.

[58] Required for groups in which there is a listed undertaking; otherwise permitted.

[59] Number of insurance companies provided by ICAC. The EIOPA Consultation Paper does not include the relevant numbers for Spain.

[60] Required by the national Financial Supervisory Authority, otherwise permitted. On 19 December 2019, the Authority communicated that it will propose changes in the group accounting regulation for unlisted insurance companies, removing the requirement for these companies and occupational pension funds to apply the IAS-regulation (full IFRS) in their consolidated financial statements. A decision will be made in Autumn 2020, effective 1 January 2021.

Annex 7: Glossary

Accounting mismatch: arises if changes in economic conditions affect assets and liabilities to the same extent, but the carrying amounts of those assets and liabilities do not respond equally to those economic changes. Specifically, accounting mismatch occurs if an entity uses different measurement bases for assets and liabilities. (IFRS 4)

Best Estimate Liability: The best estimate liability (BEL) is a Solvency II term and is the present value of expected future cashflows, discounted using a "risk-free" yield curve.

Conceptual Framework for Financial Reporting: The Conceptual Framework sets out the concepts that underlie the preparation and presentation of financial statements for external users. It is not an IFRS and hence does not define standards for any particular issue and do not override any specific IFRS

Contractual service margin: A component of the carrying amount of the asset or liability for a **group of insurance contracts** representing the unearned profit the entity will recognise as it provides services under the **insurance contracts** in the group. (IFRS 17, Appendix A)

Coverage period: The period during which the entity provides insurance contract services. This period includes the **insurance contract services** that relate to all premiums within the boundary of the **insurance contract**. (IFRS 17, Appendix A)

Current period book yield: The current period book yield is the change in the carrying amount of assets regarded as backing the insurance contracts, recognised in profit or loss for the period.

Dedicated fund: a particular group of assets that is supporting a particular group of insurance liabilities.

Economic mismatch: arises if the values of, or cash flows from, assets and liabilities respond differently to changes in economic conditions. It is worth noting that economic mismatch is not necessarily eliminated by an asset-liability management programme that involves investing in assets to provide the optimal risk-return trade-off for the package of assets and liabilities. (IFRS 4)

Excess of loss reinsurance: is a type of reinsurance in which the reinsurer indemnifies the ceding company for losses that exceed a specified limit.

Experience adjustment A difference between:

(a) for premium receipts (and any related cash flows such as **insurance acquisition cash flows** and insurance premium taxes)—the estimate at the beginning of the period of the amounts expected in the period and the actual cash flows in the period; or

(b) for insurance service expenses (excluding insurance acquisition expenses)—the estimate at the beginning of the period of the amounts expected to be incurred in the period and the actual amounts incurred in the period. (IFRS 17, Appendix A)

Financial risk: The risk of a possible future change in one or more of a specified interest rate, financial instrument price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract. (IFRS 17, Appendix A)

Fulfilment cash flows: An explicit, unbiased and probability-weighted estimate (ie expected value) of the present value of the future cash outflows minus the present value of the future cash inflows that will arise as the entity fulfils **insurance contracts**, including a **risk adjustment for non-financial risk**. (IFRS 17, Appendix A)

General fund: in this situation the assets of the insurer all together support all the insurance liabilities all together.

General model: Measurement approach under IFRS 17 for all types of insurance contracts except for certain and some short-term contracts and **contracts with direct participation features.**

Group of insurance contracts: A set of **insurance contracts** resulting from the division of a **portfolio of insurance contracts** into, at a minimum, contracts written within a period of no longer than one year and that, at initial recognition:

(a) are onerous, if any;
(b) have no significant possibility of becoming onerous subsequently, if any; or
(c) do not fall into either (a) or (b), if any. (IFRS 17, Appendix A)

Insurance acquisition cash flows: Cash flows arising from the costs of selling, underwriting, and starting a **group of insurance contracts** that are directly attributable to the **portfolio of insurance contracts** to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or **groups of insurance contracts** within the portfolio.

Insurance contract: A contract under which one party (the issuer) 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**. (IFRS 17, Appendix A)

Insurance contract services: The following services that an entity provides to a policyholder of an insurance contract:

(a) coverage for an **insured event** (insurance coverage);
(b) for **insurance contracts without direct participation features**, the generation of an investment return for the policyholder, if applicable (investment-return service); and
(c) for **insurance contracts with direct participation features**, the management of underlying items on behalf of the policyholder (investment-related service). (IFRS 17, Appendix A)

Insurance contract with direct participation features: An **insurance contract** for which, at inception:

(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 on 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**. (IFRS 17, Appendix A)

Insurance contract without direct participation features: An **insurance contract** that is not an **insurance contract with direct participation features**. (IFRS 17, Appendix A)

Insurance rider: A rider is an extra provision that can be added to an insurance policy.

Insurance risk: Risk, other than **financial risk**, transferred from the holder of a contract to the issuer. (IFRS 17, Appendix A)

Insured event: An uncertain future event covered by an **insurance contract** that creates **insurance risk**. (IFRS 17, Appendix A)

Investment component: The amounts that an **insurance contract** requires the entity to repay to a **policyholder** even if an **insured event** does not occur. (IFRS 17, Appendix A)

Investment contract with discretionary participation features: A financial instrument that provides a particular investor with the contractual right to receive, as a supplement to an amount not subject to the discretion of the issuer, additional amounts:

(a) that are expected to be a significant portion of the total contractual benefits;
(b) the timing or amount of which are contractually at the discretion of the issuer; and
(c) that are contractually based on:
(i) the returns on a specified pool of contracts or a specified type of contract;
(ii) realised and/or unrealised investment returns on a specified pool of assets held by the issuer; or
(iii) the profit or loss of the entity or fund that issues the contract. (IFRS 17, Appendix A)

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.

Liability for incurred claims: An entity's obligation to:

(a) investigate and pay valid claims for insured events that have already occurred, including events that have occurred but for which claims have not been reported, and other incurred insurance expenses; and
(b) pay amounts that are not included in (a) and that relate to:
(i) **insurance contract services** that have already been provided; or
(ii) any **investment components** or other amounts that are not related to the provision of **insurance contract services** and that are not in the **liability for remaining coverage**. (IFRS 17, Appendix A)

(This is sometimes referred to as the settlement period).

Liability for remaining coverage: An entity's obligation to:

(a) investigate and pay valid claims under existing **insurance contracts** for **insured events** that have not yet occurred (i.e. the obligation that relates to the unexpired portion of the insurance coverage); and
(b) pay amounts under existing **insurance contracts** that are not included in (a) and that relate to:
(i) **insurance contract services** not yet provided (ie the obligations that relate to future provision of **insurance contract services**); or
(ii) any **investment components** or other amounts that are not related to the provision of **insurance contract services** and that have not been transferred to the **liability for incurred claims**. (IFRS 17, Appendix A)

Liquidity premium: is the term for the additional yield of an investment that cannot be readily sold at its fair market value.

Matching adjustment: The matching adjustment adjusts the risk-free rate where insurers hold qualifying long-term assets that match the liability cash flows. It reflects that long-term investors are not exposed to spread movements in the same way as those with trading portfolios.

Policyholder: A party that has a right to compensation under an **insurance contract** if an **insured event** occurs. (IFRS 17, Appendix A)

Portfolio of insurance contracts: Insurance contracts subject to similar risks and managed together. (IFRS 17, Appendix A)

Premium allocation approach: measurement approach under IFRS 17 for short-term insurance contracts

Reinsurance contract: An **insurance contract** issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more **insurance contracts** issued by that other entity (underlying contracts). (IFRS 17, Appendix A) Reinsurance contracts can be either described from the perspective of the reinsurer (reinsurance contracts issued) or from the perspective of the insurer (reinsurance contracts held).

Risk adjustment for non-financial risk: The compensation an entity requires for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils **insurance contracts**. (IFRS 17, Appendix A)

Separation/Bifurcation: 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

Shadow accounting: is the approach to present effects resulting from an OCI-item to the liability in OCI (the shadow in the OCI) rather than in profit or loss (

SPPI-test: in accordance with IFRS 9 *Financial Instruments*, a financial asset can be measured at amortised cost (or at FVOCI) when – amongst others - the contractual terms of the financial assets give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

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)

Underlying items: Items that determine some of the amounts payable to a **policyholder**. **Underlying items** can comprise any items; for example, a reference portfolio of assets, the net assets of the entity, or a specified subset of the net assets of the entity. (IFRS 17, Appendix A)

Unit-linked business with protection riders: is a product offered by insurance companies that, unlike a pure insurance policy, gives investors both insurance and investment under a single integrated plan. A rider is an extra provision that can be added to an insurance policy.

Variable fee approach: Measurement approach in IFRS 17 for **insurance contracts with direct participation features**

Volatility adjustment: Under the volatility adjustment, insurers and reinsurers may adjust the risk-free rate to mitigate the effect of short-term volatility of bond spreads on their solvency position.

With profit business: A with-profits policy is an insurance contract that participates in the profits of a life insurance company.

Zillmerisation: A prospective measurement of the future cash outflows minus future premiums, where instead the expected full premiums (which would result in an initial gain, i.e. a CSM under IFRS 17) a premium amount is used, which excludes the profit margin but includes the margin needed for covering acquisition cost with the result, that, as in IFRS 17, the initial measurement before receiving the first premium but after paying the acquisition cost results in an asset in the amount of the acquisition cost. The calculation does not need to be done by an actuary to qualify as Zillmerisation.

Annex 8: EFRAG's work on IFRS 17

2017	EFRAG IAWG questionnaire on current accounting practices
2018	Extensive field test
	Background briefing document on level of aggregation
	Background briefing document on CSM amortisation
	Background briefing document on Transition
	Simplified field test
	Economic Study
	User Outreach
	Letter to IASB on improvements to IFRS 17 – September 2018
2019	Comment letter to the Amendments to IFRS 17
	Update on the User Outreach
2020	Analysis hedge accounting with audit firms
	Limited Update on the 2018 Case Studies
	Update on the Economic Study
	Letter to the IASB on annual cohorts – March 2020

Annex 9: Input on OCI-balances

1 In March 2020 EFRAG held an enquiry about the intention of IAWG members to set the OCI balance to nil. EFRAG received eight replies to this enquiry.

2 Three members did not report remaining concerns with the requirements resulting from IFRS 17 after the Amendments. Two of them do not have contracts in the scope of the suggested relief (i.e. FVA at transition and OCI option to disaggregate financial results) as one would not use: one because they were not planning to apply the fair value approach, another because they would not use were not planning on using the OCI option.

3 The third was not planning to set the asset OCI balances to nil at transition, should such an option be granted. This is due to different reasons:

(a) Result impact: Based on their impact assessments, no significant distortions occurred from the fact that in some cases the liability OCI is set to nil at transition under the fair value approach. In addition, setting the asset OCI balance to nil would distort the investment result, because by doing so any accumulated unrealised gain or losses from the assets would disappear.

(b) Operational complexity: It would be mechanically overly complex to set the asset OCI balances to nil and this would require manual adjustments of the affected investments in our investment subledgers.

(c) Conceptual issues: It is not at all clear how this should work when the FCF could be discounted at the rate the entity is expecting to be committed to against its policyholders (the “crediting rate”). Accordingly, accretion of the liability would reflect the returns transferred to policyholders. From an economic standpoint, the difference between that rate (estimated at transition date) and the current date on subsequent measurement would lead to volatility.

4 Out of the 5 entities that reported remaining concerns,

(a) two provided a quantitative impact of the assets for which they would have set OCI to nil, should the IASB consider the amendment in case the final Standard would have allowed it;

(b) two still referred to setting OCI to nil in the asset side but did not provide quantitative impacts. One provided counter arguments that were being considered, such as a future declining path of earnings of the fact that the VFA was not the best choice for them.

(c) Two preferred to set a discount rate for the liabilities similar to that for the assets.