EFRAG
European Financial Reporting Advisory Group

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS ON IFRS 17 INSURANCE CONTRACTS AS AMENDED IN JUNE 2020

Once filled in, this form should be submitted by 29 January 2021 using the 'Comment publication link' available at the bottom of the respective news item. All open consultations can be found on EFRAG's web site: Open consultations: express your views.

EFRAG has been asked by the European Commission to provide it with advice and supporting material on IFRS 17 *Insurance Contracts* as amended in June 2020 ('IFRS 17' or 'the Standard'). In order to do so, EFRAG has been carrying out an assessment of IFRS 17 against the technical criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the European Union (the EU) and European Economic Area.

A summary of IFRS 17 is set out in Appendix I.

Before finalising its assessment, EFRAG would welcome your views on the issues set out below. Please note that all responses received will be placed on the public record, unless the respondent requests confidentiality. In the interests of transparency, EFRAG will wish to discuss the responses it receives in a public meeting, so it is preferable that all responses can be published.

In order to facilitate the EFRAG process, it is strongly recommended to use the structure below in your responses.

EFRAG's initial assessments, summarised in this questionnaire, will be updated for comments received from constituents when EFRAG is in the process of finalising its *Letter to the European Commission* regarding endorsement IFRS 17.

Your details

1 Please provide the following details:

(a) Your name or, if you are responding on behalf of an organisation or company, its name:

Prudential PLC

(b) Are you a:

☒ Preparer ☐ User ☐ Other (please specify)

(c) Please provide a short description of your activity:

Prudential PLC is an Asia-led portfolio of businesses focused on structural growth markets. The business helps individuals to de-risk their lives and deal with their biggest financial concerns through life and health insurance, and retirement and asset management solutions.

Prudential offers a wide range of retail financial products and services and asset management services. The retail financial products and services primarily include life insurance, pensions and annuities as well as collective investment schemes.

Our business is focused on Asia and the US where we see structural demand for our products. In recent years we have expanded into Africa, taking advantage of the emerging demand for our products in the region.

We have recently announced our intention to divest our US business.

(d) Country where you are located:

Our primary listing is in the UK. We are also listed in Hong Kong, US and Singapore. As described in our response to question 1(c) above, our business is currently focused on Asia and the US.

(e) Contact details, including e-mail address:

Richard Olswang (richard.olswang@prudentialplc.com)

Part I: EFRAG's initial assessment with respect to the technical criteria for endorsement

Note to the respondents: *Appendix II presents EFRAG's reasoning with reference to all requirements in IFRS 17 apart from the application of the annual cohorts requirement to some contracts specified in paragraph 6 of Annex A within Annex 1 (those contracts are conventionally referred to in this questionnaire, in the Cover Letter, in its Appendices and Annex as 'contracts with intergenerationally mutualisation and cash-flow matched contracts'[1], or 'intergenerationally mutualised and cash flow matched contracts'. Annex 1 presents content of this requirement that contribute positively or negatively to the technical criteria on this matter.*

2 EFRAG's initial assessment of IFRS 17 is that:

- The EFRAG Board has concluded on a consensus basis that, apart from the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts, as explained in the attached Cover Letter, on balance, all the other requirements of IFRS 17 meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support 'economic decisions and the assessment of stewardship and raise no issues regarding prudent accounting. EFRAG has concluded that all the other requirements of IFRS 17 are not contrary to the true and fair view principle.
- EFRAG Board members were split into two groups about whether the requirement to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts meet the qualitative characteristics described above.
  - (i) Nine EFRAG Board members consider that overcoming in a timely manner the issues of IFRS 4 brings sufficient benefits despite the concerns on annual cohorts. They believe that, in the absence of an alternative principles-based approach to grouping of contracts, on

[1] For a description of the affected contracts please refer to paragraphs 8 to 28 of Annex A to Annex 1 of the endorsement package relating to IFRS 17.

balance the annual cohorts requirement provides an acceptable conventional approach that enables to meet the reporting objectives of the level of aggregation of IFRS 17.

(ii) Seven EFRAG Board members consider that in many cases in Europe the requirement to apply annual cohorts for insurance contracts with intergenerational mutualisation and cash-flow matched contracts will result in information that is neither relevant nor reliable. This is because the requirement does not depict an entity's rights and obligations and results in information that represents neither the economic characteristics of these contracts nor the entity's underlying business model. These EFRAG Board members also consider that this requirement is not conducive to the European public good because it (i) adds complexity and cost and does not bring benefits in terms of the resulting information, (ii) may lead to unintended incentives to change the way insurers cover insurance risks and (iii) may produce pro-cyclical reporting effects.

EFRAG's reasoning and observations are set out in Appendix II, Annex 1 and the Cover Letter regarding endorsement of IFRS 17.

(a) Do you agree with this assessment for all the other requirements of IFRS 17 apart from the requirement to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts?

☒ Yes ☒ No

If you do not agree, please provide your arguments and what you believe the implications of this could be for EFRAG's endorsement advice.

We have answered both 'Yes' and 'No' to this question because, while we do not believe that the standard meets the technical endorsement criteria in respect of a number of key issues (described below), we do not believe these are significant enough to impede endorsement of IFRS 17 so as to achieve a 1 January 2023 effective date.

We believe that the following issues result in IFRS 17 failing to meet one or more of the characteristics of relevance, reliability, comparability, understandability and prudent accounting.

<u>Scope of Variable Fee Approach (VFA)</u>

The IASB amended paragraph B107 of IFRS17 in 2017 to require eligibility for the VFA to be assessed at individual contract level rather than for groups of contracts.

- We believe that this is inconsistent with the Level of Aggregation requirements of the standard that require the recognition and measurement requirements of IFRS 17 to be applied to groups of contracts. This inconsistency in IFRS 17 impedes the reliability of the standard.
- It will be extremely challenging to explain performance to users where portfolios of business (which are comprised of contracts with similar risks) are accounted for under more than one measurement model, thereby impacting the understandability of the financial statements.

<u>Retrospective application of the risk mitigation option</u>

The inability to apply the risk mitigation option prior to the date of transition results in a significant accounting mismatch for business accounted for under the VFA where risks have been mitigated through the use of a hedging programme. The accounting mismatch arises because the impact of historic market movements on the cost of guarantees is taken to the CSM under the VFA while the movement in the fair value of hedging instruments is taken to P&L. This will result in a misstatement of shareholder equity at the transition date with a consequential inappropriate level of profit thereafter, thereby impacting the relevance and understandability of the financial statements.

<u>Locked-in discount rate under the General Model</u>

The use of a locked-in discount rate for accreting interest and adjusting the CSM under the General Model will lead to an accounting mismatch with other components of the balance sheet (invested assets and fulfilment cash flows) that are calculated using a current rate. This mismatch will lead to information that is neither relevant nor understandable.

<u>Reinsurance</u>

The requirements of IFRS 17 results in a number of accounting mismatches in respect of reinsurance that will impede the relevance and understandability of the financial statements, in particular:

- Reinsurance contracts often meet the eligibility criteria for the VFA, yet these are required to be measured under the GMM. This does not reflect the economics of such contracts and results in an accounting mismatch between the treatment of the direct contracts and the reinsurance contracts held.
- Even when reinsurance contracts do not qualify for the VFA, accounting mismatches can arise. For example, reinsurance of risk elements of direct contracts accounted for under the VFA will be required to be accounted for under the GMM. The differences in the measurement methods under each model will give rise to mismatches.
- Contract boundary requirements will in many cases result in reinsurance assets including direct contracts not yet written giving rise to accounting mismatches between the liability in respect of direct contracts and the related reinsurance contract asset.

(b) Having considered the technical arguments for those that support and those that oppose the application of annual cohorts to intergenerationally-mutualised contracts, as described in Annex 1, and having considered the two views from the EFRAG Board above does the requirement to apply annual cohorts to intergenerationally-mutualised contracts (within the context of paragraphs B67-B71 of IFRS 17) meet the qualitative characteristics described above? Please explain your technical reasons for supporting your view.

☐ Yes ☐ No

We have not responded to this question as this is not a significant issue for Prudential.

(c) Having considered the technical arguments for those that support and those that oppose the application of annual cohorts to cash-flow matched contracts, as described in Annex 1, and having considered the two views from the EFRAG Board above does the requirement to apply annual cohorts to cash-flow matched contracts meet the qualitative characteristics described above? Please explain your technical reasons for supporting your view.

☐ Yes ☐ No

We have not responded to this question as this is not a significant issue for Prudential.

(d) Are there any issues that are not mentioned in Appendix II, Annex 1 and the Cover Letter regarding the endorsement of IFRS 17 that you believe EFRAG should take into account in its technical evaluation of IFRS 17? If there are, what are those issues and why do you believe they are relevant to the evaluation?

The requirement to assess eligibility for the VFA at the individual contract level is not mentioned in Appendix II, Annex 1 or the cover letter of EFRAG's Draft Endorsement Advice on IFRS 17. As discussed in our response to question 2(a) above:

- We strongly believe that this is inconsistent with the Level of Aggregation requirements of the standard that require the recognition and measurement requirements of IFRS 17 to be applied to groups of contracts. This inconsistency in IFRS 17 impedes the reliability of the standard.
- It will be extremely challenging to explain performance to users where portfolios of business are accounted for under more than one measurement model, thereby impacting the understandability of the financial statements.

Part II: The European public good

Note to the respondents: *EFRAG's reasoning and conclusions with reference to all the other requirements of IFRS 17 is presented in Appendix III, apart from the observations on the requirement to apply annual cohorts to intergenerationally mutualised and cash flow matched contracts, which are presented in Annex 1 (refer to the section titled Appendix III in Annex 1).*

3 In its assessment of the impact of IFRS 17 on the European public good, EFRAG has considered a number of issues that are addressed in Appendix III and Annex 1 regarding the endorsement of IFRS 17.

- The EFRAG Board has on a consensus basis assessed that, apart from the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts, all the other requirements of IFRS 17 would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified any other requirements of IFRS 17 that could have major adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that all the other requirements in IFRS 17 are, on balance, conducive to the European public good.

(a) Do you agree with this assessment for all the other requirements apart from the requirement to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts?

☒ Yes ☐ No

If you do not agree, please provide your arguments and what you believe the implications of this could be for EFRAG's endorsement advice.

We have answered 'Yes' to this question because, while we do not believe that the standard would reach an acceptable cost-benefit trade-off in respect of a number of key issues (described below), a significant proportion of the cost in respect of these issues has already been incurred and we do recognise that there are benefits to the insurance industry as a whole of a current, consistent and transparent approach to financial reporting.

However, we have significant concerns over the following key issues in relation to the cost-benefit trade-off.

<u>Scope of the Variable Fee Approach</u>

The amendment to paragraph B107 of IFRS17 to require eligibility for the VFA to be assessed at individual contract level rather than for groups of contracts has been disruptive to our implementation as the drafting in the IFRS 17 standard published in May 2019 had led us to assume a group level assessment in the design and build of changes to our actuarial and finance systems. Moreover, we believe it will be extremely challenging to explain performance to users where portfolios of business are accounted for under more than one measurement model. Consequently, we believe that the costs from the complexity that this amendment adds are not justifiable and this change should not have been made.

<u>Transition</u>

The Modified Retrospective Approach (MRA) to transition remains complex and the cost of implementing the MRA will be far higher than need be the case. Although the fair value approach can be used as an alternative to the MRA, this will lead to results that are less comparable between and within entities using different approaches (given the highly subjective and judgemental nature of determining a fair value for insurance contracts) and less comparability between business written before and after the date of transition. A more practical and simpler MRA approach would increase comparability.

<u>Locked in discount rates under the General Model</u>

The requirement to use locked-in discount rates to determine the CSM for contracts accounted for under the General Model results in significant operational complexity. This impacts systems, processes and data storage as a result of having to perform calculations using multiple different discount rates and maintain the relevant input and output data for these calculations for multiple historic and future cohorts. This increases very significantly for participating business where stochastic modelling is required to measure the cost of the guarantees.

Whilst we understand the IASB's arguments for the locked-in discount rate approach, we do not believe that any perceived benefit of such an approach is justified considering this operational burden. Furthermore, as we mentioned in our response to question 2(a) above, the use of a locked-in discount rate will lead to an accounting mismatch between the CSM that is determined based on this locked-in rate and other components of the balance sheet that are calculated using a current rate. The complexity of explaining this is equally important as the systems challenges and will also result in ongoing costs. The CSM for General Model business should be measured under a current basis.

<u>Excluding the investment component from revenue</u>

IFRS 17 requires the non-distinct investment component to be excluded from insurance contract revenue and incurred claims. The investment component paid in the event of certain claims, in particular death, is not currently available and, consequently, new systems and processes need to be developed. We believe that revenue excluding the investment component has no practical usage and, to our knowledge, users of our financial statements have not regarded the basis currently applied (which implicitly includes an investment component) as being problematic. We therefore believe that the costs associated with this requirement are not justified and this requirement should be removed.

Disclosure of portfolios that are in an asset and a liability position

It is normal and to be expected that some groups of contracts will be in an asset position and others will be in a liability position. This is not an indication of whether groups are onerous or not, it merely reflects differences in the way the fulfilment cash flows and CSM run off over time. Indeed, it is not unexpected for contracts to move between an asset and a liability position.

IFRS 17 requires extensive disclosures to be disaggregated between portfolios of contracts that are assets and liabilities at each reporting date. No process exists under current accounting that is capable of providing such disclosures and, consequently, complex new processes will need to be developed. We believe that such disclosure will not provide useful information to users and that, consequently, the cost of these disclosures exceeds the benefits. Separate disclosure of portfolios that are in an asset and a liability position should be removed.

The equivalent confidence level disclosure for the risk adjustment

Where an approach other than confidence level is used to determine the risk adjustment, IFRS 17 requires an equivalent confidence level to be disclosed. Such a confidence level is not available from existing systems and processes and, consequently, these will need to be reconfigured to facilitate its determination.

We also believe that, while the confidence level disclosure will create a perception of comparability between insurers, the reality is likely to be very different. For example, two insurers applying an identical cost of capital approach may have different confidence levels if the profiles of their business are different.

Furthermore, a confidence level is a percentile on a distribution of potential outcomes with regard to non-financial risk. Two insurers disclosing identical confidence levels will only have comparable levels of risk adjustment if they use consistent risk distributions.

We therefore believe that the cost of the equivalent confidence level disclosure is not justified by its perceived benefits and this disclosure requirement should be removed.

- EFRAG Board members were split between two groups, as described in the Cover Letter and above, with reference to the requirement to apply annual cohorts for contracts with intergenerational mutualisation and cash-flow matched contracts.

(b) Having considered the technical arguments for those that support and those that oppose the application of annual cohorts to intergenerationally-mutualised contracts, as described in Annex 1, and having considered the two views from the EFRAG Board above, is the requirement to apply annual cohorts to intergenerationally-mutualised contracts (within the context of paragraphs B67-B71 of IFRS 17) conducive to the European public good? Please explain your technical reasons for supporting your view.

☐ Yes ☐ No

We have not responded to this question as this is not a significant issue for Prudential.

(c) Having considered the technical arguments for those that support and those that oppose the application of annual cohorts to cash-flow matched contracts, as described in Annex 1, and having considered the two views from the EFRAG Board above, is the requirement to apply annual cohorts to cash-flow matched contracts conducive to the European public good? Please explain your technical reasons for supporting your view.

☐ Yes ☐ No

We have not responded to this question as this is not a significant issue for Prudential.

Part III: The questions in Part III relate to all the other requirements in IFRS 17 apart from the requirement to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts

Notes to the respondents: *In this Part, "IFRS 17" or "requirements in IFRS 17" or "the Standard" is intended to be referred to all the other requirements in IFRS 17 apart from the requirement to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts (your views on the latter requirement are to be covered in Part IV).*

The European Commission and the European Parliament asked EFRAG to provide its views on a number of specific matters, that are presented below.

Improvement in financial reporting

4 EFRAG has identified that, in assessing whether the endorsement of IFRS 17 is conducive to the European public good, it should consider whether the Standard is an improvement over current requirements across the areas which have been subject to changes (see paragraphs 15 to 27 of Appendix III). To summarise, for all the other requirements in IFRS 17 apart from the requirement to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts, EFRAG considers that they provide better financial information than IFRS 4.

Do you agree with this assessment?

☐ Yes ☒ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

We recognise that there is benefit in the requirements of IFRS 17 for companies to measure insurance contracts using updated current estimates reflecting the time value of money and making explicit allowance for uncertainty. However, we note that these requirements were already features of our reporting under IFRS 4 in many territories in which we operate. We believe that such objectives could have been achieved without much of the cost and complexity of IFRS 17.

Costs and benefits

5 EFRAG's initial assessment is that taking into account the evidence obtained from the various categories of stakeholders, the benefits of all the other IFRS 17 requirements in IFRS 17 exceeds the related costs.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

We have 'Yes' to this question because, while we do not believe that the standard would reach an acceptable cost-benefit trade-off in respect of a number of key issues (described below), a significant proportion of the cost in respect of these issues has already been incurred and we do recognise that there are benefits to the insurance industry as a whole of a current, consistent and transparent approach to financial reporting.

We refer to our response to question 3(a) above were we describe concerns over the following key issues in relation to the cost-benefit trade-off.

- Scope of the Variable Fee Approach
- Transition – Modified Retrospective Approach
- Locked in discount rates under the General Model
- Excluding the investment component from revenue
- Disclosure of portfolios that are in an asset and a liability position
- The equivalent confidence level disclosure for the risk adjustment

Other factors

Potential effects on financial stability

6 EFRAG has assessed the potential effects on financial stability based on the ten criteria set out in the framework developed by the European Central Bank "*Assessment of accounting standards from a financial stability perspective*" in December 2006. Based on this assessment, EFRAG is of the view that, on balance, IFRS 17 does not negatively affect financial stability (Appendix III paragraphs 428 to 482).

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

Potential effects on competitiveness

(Appendix III paragraphs 227 to 286)

7 EFRAG has assessed how IFRS 17 could affect the competitiveness of European insurers taking into account the diversity in their business models vis-à-vis their major competitors outside Europe.

EFRAG concludes that the underlying economics and profitability will always be more decisive in taking up a business in a particular region or a particular insurance product than changes to the accounting that is used to report on it.

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

There are a number of countries where insurers are not required to adopt IFRS 17 (for example, the United States, Japan and Switzerland). It is also not yet clear how IFRS 17 will be adopted in China. Consequently, European companies operating in these territories may potentially be disadvantaged compared to domestic insurers. Such a disadvantages could arise from both the cost of implementation of IFRS 17 and differences in the financial reporting outcome between alternative frameworks. However, we believe that the underlying economics and the regulatory position in different countries are more likely drivers of competition than the accounting outcome.

Potential impact on the insurance market (including impact on social guarantees)

8 EFRAG has assessed the potential impact on the insurance market in Appendix III paragraphs 287 to 325.

EFRAG commissioned a study from an economic consultancy. This study ('Economic Study') stated that entities may re-consider both their pricing methodologies and product offers when applying IFRS 17 for the first time. The effect on pricing may be more significant than the effect on product offers. However, EFRAG does not have any quantification of the extent of changes in pricing or product design that would result from it.

As per the Economic Study, a majority of stakeholders interviewed (i.e. supervisory authorities, insurers and external investors) agreed that IFRS 17 alone would not impact the asset allocation of insurance undertakings, because this activity is more driven by risk management and/or asset/liability management.

Furthermore, EFRAG has considered how IFRS 17 could affect small and medium-sized entities (SMEs). EFRAG concludes that the number of small insurers that would be affected by IFRS 17 in producing their individual financial statements is very limited (between 27 and 35 depending on the option chosen based on the proposed[2] EIOPA quantitative thresholds).

(a) Do you agree with the assessment on pricing and product offerings?

☒ Yes ☐ No

(i) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(ii) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

(b) Do you agree with the assessment on asset allocation?

☒ Yes ☐ No

[2] Reference is made to EIOPA's publicly consulted Consultation Paper on the Opinion on the 2020 review of Solvency II to amend the thresholds for applying Solvency II.

(i) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(ii) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

(c) I Do you agree with the assessment on SMEs?

☐ Yes ☒ No

(i) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(ii) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

We believe that a proportionate approach should be adopted by the IASB for SMEs. Investors' information needs vary by market and by type and size of reporting entity, as do the resources available to reporting entities. Standards that are developed for complex, multinational, listed entities may be unsuitable for emerging markets and for smaller entities more generally.

Presentation of general insurance contracts

9 EFRAG is of the view the presentation requirements of IFRS 17 would provide relevant information. EFRAG also concludes that providing separate information for contracts that are in an asset, from those in a liability, position would provide useful information to users. (Appendix II paragraphs 118 to 125, 360 to 362).

Do you agree with this assessment?

☐ Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

We do not write significant volumes of general insurance business. Consequently, we have not commented on this issue.

Interaction between IFRS 17 and Solvency II

10 EFRAG concludes that in implementing IFRS 17, there are possible synergies with Solvency II, but the extent of such synergies varies between insurers. In addition, no synergies are expected for building blocks that are specific to IFRS 17 such as the contractual service margin which is not an element of the measurement approach for insurance liabilities under Solvency II. 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. It also depends on the amount of effort to adapt existing actuarial systems, that were developed for the Solvency II environment, to the IFRS 17 reporting requirements. (Appendix III paragraphs 401 to 412).

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

Whilst Prudential PLC no-longer reports under Solvency II, we have responded to this question in the light of how we have leveraged current regulatory reporting systems for use under IFRS 17.

Impact of the new Standard on financial stability, long-term investment in the EU, procyclicality and volatility

11 On financial stability, refer to the conclusions in paragraph 6 of this Invitation to Comment.

On long-term investment in the EU, EFRAG's view is that asset allocation decisions are driven by a variety of factors, among which external financial reporting requirements might play some part but do not appear to be a key driver. 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 (Appendix III paragraphs 96 to 123).

On procyclicality and volatility, EFRAG believes that IFRS 17 has mixed effects on procyclicality. IFRS 17 may result in more volatile financial performance measures because of the use of a current measurement. 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. 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 within the requirements at national level, independently from the IFRS accounting. Finally, EFRAG 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. (Appendix III paragraphs 483 to 507a) Do you agree with the assessment on long-term investment?

☒ Yes ☐ No

(i) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(ii) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

b) Do you agree with the assessment on procyclicality and volatility?

☐ Yes ☒ No

(i) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(ii) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

We have responded to this question in the context of the European Parliament request to EFRAG to consider the impact of IFRS 17 on 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.

Insurers typically manage exposure to market risk by matching asset and liability cash flows. For example, if asset and liability cash flows are matched by duration, an entity is protected from interest rate movements as assets and liability values move consistently when assessed from an economic or regulatory perspective. However, under IFRS 17 the CSM is measured on a locked-in basis for General Model business leading to artificial accounting volatility (as described above). Non-GAAP measures will be required to explain this volatility to users.

IFRS 17 and IFRS 9

12 EFRAG is of the view that mismatches reported by preparers that contributed to EFRAG's assessment do not arise solely from the application of IFRS 17 and IFRS 9 but are mostly economic in nature. EFRAG considers that reporting the extent of the economic mismatches in profit or loss provides useful information.

In EFRAG's view, asset allocation decisions are driven by a variety of factors and disentangling the impact of accounting requirements from other factors is difficult. 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. EFRAG notes that the interaction between each of an entity's 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.

EFRAG has assessed the different tools that both standards offer to mitigate accounting mismatches. EFRAG assesses that:

(a) 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 (Appendix III, Annex 5);

(b) the treatment of OCI balances and risk mitigation at transition will not, on balance, negatively impact the usefulness of the resulting information.

(a) Do you agree with the assessment on the application of hedge accounting?

☐ Yes ☒ No

(i) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(ii) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

We do not agree that lack of experience and systems are the main drivers preventing insurance companies from applying hedge accounting. There are a number of other issues that impede the ability of insurers to use hedge accounting, in particular:

- Hedge accounting requires the hedged item to be separately identifiable and reliably measurable which is not possible where investment and insurance components of an insurance contract are highly interrelated.

- Insurers generally hedge open portfolios and, even in case of closed portfolios, hedging is regularly carried out dynamically. Consequently, both hedged items and hedging instruments constantly change over the hedge term.
- Policyholder behaviour and other future expectations (e.g. lapses, surrenders, new business sales, and mortality) are intertwined with the impact of financial market variables. It is not evident how these items could be excluded from the hedging relationship.

(b) Do you agree with the assessment on the treatment of OCI-balances and risk mitigation?

☐ Yes ☒ No

(i) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(ii) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

As discussed in our response to question 2(a) above, the inability to apply the risk mitigation option prior to the date of transition results in a significant accounting mismatch for business accounted for under the VFA where risks have been mitigated through the use of a hedging programme. The accounting mismatch arises because the impact of historic market movements on the cost of guarantees is taken to the CSM under the VFA while the movement in the fair value of hedging instruments is taken to P&L. This will result in a misstatement of shareholder equity at the transition date with a consequential inappropriate level of profit thereafter, thereby impacting the relevance and understandability of the financial statements.

Application of IFRS 15

13 In some instances, an entity (including insurers) may choose to apply IFRS 15 instead of IFRS 17 to contracts that meet the definition of an insurance contract but that have as their primary purpose the provision of services for a fixed fee. EFRAG concludes that this option would probably be made by those entities that do not operate in the insurance business. EFRAG concludes that for these entities accounting for these contracts in the same way as for other contracts would provide useful information and that applying IFRS 17 to these contracts would impose costs for no significant benefit (Appendix III paragraphs 68 to 76).

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

Implications of transitional requirements

14 Considering the extent of the information available for each particular group of insurance contracts at transition, EFRAG assesses that the existence of three transition approaches does not result in a lack of relevant information. The alleviations granted under the modified retrospective approach are still leading to relevant information as they enable achieving the closest outcome to a full retrospective application without undue cost or effort. In addition, EFRAG acknowledges that the possible use of three different transition methods may affect

comparability among entities and, for long-term contracts, over time. However, the practical benefits of the modified retrospective and fair value approach, which were introduced by the IASB to respond to operational concerns of the preparers, may justify the reduced comparability (Appendix II paragraphs 129 to 155, 228 to 237, 300 to 303, 372 to 374, 398 to 400).

Do you agree with this assessment?

☐ Yes ☒ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

As described in our response to question 3(a) above, the Modified Retrospective Approach to transition remains complex and the cost of implementing the MRA will be far higher than need be the case. Although the fair value approach can be used as an alternative to the MRA, this will lead to results that are less comparable between and within entities using different approaches (given the highly subjective and judgemental nature of determining a fair value for insurance contracts) and less comparability between business written before and after the date of transition. A more practical and simpler MRA approach would increase comparability.

Impact on reinsurance

15 EFRAG concludes that the separate treatment under IFRS 17 of reinsurance contracts held and underlying direct contracts reflects the rights and obligations of different and separate contractual positions. Furthermore, EFRAG acknowledges that reinsurance contracts issued or held may meet the variable fee criteria even though IFRS 17 states that they cannot be insurance contracts with direct participation features. However, EFRAG assesses that the risk mitigation option would largely address the accounting mismatches, thereby balancing relevant information. In addition, for reinsurance contracts held that are used to recover losses from the underlying contracts, EFRAG considers that the Amendments provide relevant information as they aim at reducing accounting mismatches which is present under the original version of the Standard (Appendix II paragraphs 63 to 74, 210 to 216, 274 to 275, 349 to 352, 395 to 397).

Do you agree with this assessment?

☐ Yes ☒ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

We do not agree with EFRAG's assessment. As described in our response to question 2(a) above, the requirements of IFRS 17 results in a number of accounting mismatches in respect of reinsurance that will impede the relevance and understandability of the financial statements, in particular:

- Reinsurance contracts often meet the eligibility criteria for the VFA, yet these are required to be measured under the GMM. This does not reflect the economics of such contracts and results in an accounting mismatch between the treatment of the direct contracts and the reinsurance contracts held.
- Even when reinsurance contracts do not qualify for the VFA, accounting mismatches can arise. For example, reinsurance of risk elements of direct contracts accounted for under the VFA will be required to be accounted for under the GMM. The differences in the measurement methods under each model will give rise to mismatches.

- Contract boundary requirements will in many cases result in reinsurance assets including direct contracts not yet written giving rise to accounting mismatches between the liability in respect of direct contracts and the related reinsurance contract asset.

These accounting mismatches cannot be resolved by use of the risk mitigation option.

Implementation timeline

16 Feedback from the Limited Update to the Case Studies shows that the delay to the effective date of IFRS 17 to 1 January 2023 results in higher one-off implementation costs for preparers. However, the delay is also helping preparers to adjust their project approaches to the operational difficulties of the Covid-19 crisis. EFRAG understands from preparers that they may choose to avoid these costs by revisiting solution designs or may make more use of internal (cheaper) resources. Furthermore, according to the Limited Update to the Case Studies and other feedback from insurance associations, most of the participants did not intend to early apply IFRS 17, whereas a small minority wanted to have this possibility. EFRAG is not aware of any European insurer having taken a firm commitment to early apply the Standard. Finally, EFRAG notes that IFRS 17 requires a presentation of restated comparative information when applying the Standard for the first time. However, IFRS 9 does not have similar requirements for financial assets and liabilities (Appendix III paragraphs and 609 to 613).

(a) Do you agree with the assessment relating to delay of IFRS 17 implementation till 2023?

☒ Yes ☐ No

(i) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(ii) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

(b) Do you agree with the assessment relating to early application?

☒ Yes ☐ No

(i) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(ii) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

17 Do you agree that there are no other factors to consider in assessing whether the endorsement of the Standard is conducive to the European public good?

☒ Yes ☐ No

If you do not agree, please identify the factors, provide your views on these factors and indicate how this could affect EFRAG's endorsement advice.

Part IV: The questions in Part IV aim at collecting constituents' inputs (Questions to constituents in Annex 1) and views relating to the requirement in IFRS 17 to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts

Notes to the respondents: *Respondents are reminded that responses to this Invitation to Comment will be made public on EFRAG's website. EFRAG is also inviting respondents to share quantitative data and to allow confidentiality of this information, constituents are kindly invited to submit these data separately from the Invitation to Comment. Such quantitative data can be sent to ifrs17secretariat@efrag.org. Only aggregated resulting data will be made public in the subsequent steps of the due process and will be presented in an anonymous way.*

The intergenerationally-mutualised and cash-flow matched contracts are specified in paragraph 6 of Annex A within Annex 1.

18 As stated in paragraphs 5 to 9 of Annex 1:

(a) What is the portion of intergenerationally-mutualised contracts and cash-flow matched contracts of all life insurance liabilities and all insurance liabilities? Please report the results for these two types of contracts separately where relevant.

At 31 December 2019, approximately 18% of our total insurance contract liabilities were in respect of with-profits contracts that could potentially be subject to inter-generational mutualisation.

Cash-flow matching is a common risk mitigation technique that is routinely applied to all types of participating and non-participating insurance contracts. It is not possible to separately identify the portion of our business that is subject to such cash-flow matching.

(b) Please indicate the proportion of contracts with intergenerational mutualisation (within the context of paragraphs B67-B71 of IFRS 17) for which the requirement around annual cohorts is considered a significant issue. Please specify the share that would qualify for VFA.

We do not consider that the annual cohort requirement is a significant issue for our business.

(c) Please describe the approach you envisage to implement the annual cohorts requirement to contracts with intergenerationally-mutualised contracts (within the context of paragraphs B67-B71 of IFRS 17).

We plan to apply the annual cohort requirements as set out in IFRS 17.

(d) Please indicate the proportion of cash-flow matching contracts for which the requirement around annual cohorts is considered a significant issue. Please specify how the features of the contracts compare with the description provided in Annex A of Annex 1.

This is not a significant issue for Prudential.

(e) Please describe the approach you envisage to implement the annual cohorts requirement to cash-flow matched contracts.

This is not a significant issue for Prudential.

Part V: Questions to Constituents raised in Appendix III

19 As stated in paragraphs 532 to 534 of Appendix III:

(a) 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 518 to 527 in Appendix III) and indirectly, on the European economy as a whole?

The potential impacts of the Covid-19 pandemic on the insurance market are wide-ranging and could include:

- The impact of financial market variables (e.g. the level and volatility of equity markets, bond yields, credit spreads, credit defaults) on asset and liability values;
- Changes in policyholder behaviour and new business volumes (e.g. resulting from personal economic circumstances, financial markets, reduction in face-to-face contact with the distributors of insurance products);
- Changes in mortality and morbidity experience; and
- The impact that large proportions of the staff of insurance companies and third-party service providers working remotely might have on insurers' operations.

Such factors will impact all reporting frameworks, including both solvency reporting and accounting. While we recognise that, the current, consistent and transparent nature of IFRS 17 brings significant benefits to financial reporting in such volatile conditions, that volatility also exacerbates the accounting mismatches that we have described above. There will very likely be a need for insurers to use alternative measures to explain business performance to users.

(b) 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.

The vast majority of our programme team around the world have been working remotely (i.e. other than from their usual office location) during the Covid-19 pandemic. While most are able to continue to operate effectively, in some locations broadband capacity has made this less efficient. Moreover, Covid-19 has also delayed the delivery of IT solutions from certain third-party software providers.

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

There are no further aspects we wish to expand on.

Part VI: EFRAG's overall advice to the European Commission

20 Do you have any other comment on, or suggestion for, the advice that EFRAG is proposing to give to the European Commission?

We have no further comments.