EFFAS THE EUROPEAN FEDERATION OF FINANCIAL ANALYSTS SOCIETIES

Mr. Gauzès, EFRAG Chairman

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EFFAS comments on EFRAG's *assessments on IFRS-17 Insurance Contracts as amended in June 2020*.

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Dear Jean-Paul,

EFFAS Commission on Financial Reporting ("CFR", "Commission", "we") is pleased to share with you the views of European users of financial statements regarding EFRAG's Draft Comment Letter "*invitation to comment on EFRAG's assessments on IFRS-17 Insurance Contracts as amended in June 2020*" which was published in 2020 and on which EFRAG is seeking comments from its constituents until 29th January 2021.

While we believe that the annual cohorts' approach does not improve the visibility for users, we think that there is a solution not to harm it either. Please see our response in section 2b.

At this point, we think that it is important that there is no more delay in applying IFRS 17. Actually, we would only consider temporary exceptions from the implementation of the standard within the EU but not with any further delay of January 1-2023. Otherwise, this would harm comparability between entities in the long run.

We would like to point out that a few questions have not been directly addressed as we consider those questions to have a low effect on users' analysis.
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Commission's comments on ED's specific questions, are as follows:

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:

EFFAS Commission on Financial Reporting (CFR)

(b) Are you a:

☐ Preparer ☒ User ☐ Other (please specify)

European users of financial statements

(c) Please provide a short description of your activity: See letter footer.

EFFAS was established in 1962 as an association for nationally based investment professionals in Europe. Headquartered in Frankfurt am Main, EFFAS comprises 15-member organizations representing more than 16,000 investment professionals

(d) Country where you are located:.

Germany

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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 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 agree that financial information provided through the application of IFRS17 should be separated from the requirement to apply annual cohorts to intergenerationally mutualized and cash-flow matched contracts. If this information

is to be provided as an integrated disclosure together with the information on annual cohorts it may be difficult for the financial analysts to understand the insurance reports due to the volatility and pro-cyclical effects introduced by the annual cohorts' products. Financial reporting figures that integrate annual cohort data with other insurance contracts data reduce the usefulness of the global reporting information and increase the complexity of developing a robust and coherent financial analysis evaluation.

(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 agree with the view of some Board members. In Europe in many instances 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. In addition, we observe that paragraphs B67-B71 of IFRS 17 are creating a problem for financial analysts for comparing past results with present ones due to this deep change in methodology. The International accounting principle should reflect the contracts and the business model. International accounting principles are written to reflect in accounting the business impact of the contract obligation. If we put analyse the Insurance contracts that are classified in the group of the intergenerationally-mutualised contracts (within the context of paragraphs B67-B71 of IFRS 17), we noted that these accounting rules don't reflect the business model and the contract's legal requirements.

During 2018 EFRAG summarized the requests of improvement of IFRS 17 from the EU stakeholders in about 10 points, with a focus on the "mutualisation" problems for some groups of insurance contracts and with a specific focus on the Variable Fee Approach (VFA). In this group many of the European life insurance products classified are mostly used for the family and companies' savings, and pension funds.

As users we confirm the concerns already reported in the different working groups of insurance financial analysts. From a user's point of view, we stress that we would appreciate an exception on this point.

European financial analysts would like to strongly highlight the EFFAS Financial Accounting Commission position letter of 6th September 2019 answering EFRAG's public consultation on the draft letter to the "IASB/ED/2019/4 Amendments to IFRS 17" where, in reference to the Annual Cohorts issue, the EFFAS FAC asked for:

"The Commission understands EFRAG's concern on the annual cohorts' application on VFA. This might create accounting mismatches due to the contractual rules that in some major European countries are based on mutualisation between contracts in different annual cohorts. We consider the EFRAG position sensible to improve users' information and the potential impact on new accounting rules based on annual

cohorts on the European market of life products classified as VFA. From an users' standpoint annual cohorts are useful to analyse and evaluate non-life insurance products that are classified as a General Model or Premium Allocation Approach (PAA). However, we prefer a classification based on a group of contracts without the split by annual cohorts of the life insurance contracts under VFA. Due to this we support EFRAG's request to find a solution to define the accounting framework of VFA contracts in line with the business model. We agree with EFRAG that an exception should be introduced to enable meeting the information targets of IFRS 17".

As users we noted that in the European working groups there are some possible solutions to avoid the accounting mismatch and we noted as interesting the solution that proposed to separate the use of the annual cohort valuation in the "Initial recognition" and in the "subsequent measurement". This proposal starts from the observation that the annual cohort requirement must always be seen in connection with the fact that it must be possible to separate mutualization effects. While performing this separation the annual cohort split can be seen as one additional granularity requirement that has to be included in the measurement approach. Whereas this separation can be explicitly performed at initial recognition, an allocation logic needs to be established to meet the required split for subsequent measurement.

In this proposal, that we support as a possible solution, at initial recognition, the CSM is explicitly calculated for the annual new business cohort. At subsequent measurement, interactions between groups of contracts for mutualised business and thus also for different cohorts are reflected in the determination of the CSM-Unlocking. At initial recognition, mutualisation occurs between the existing portfolio and the new business written. The expected future cash flows before taking into account mutualisation will be determined for the new business (annual) cohort. In addition, the mutualisation effects at initial recognition between existing and new business can be quantified explicitly with the projection models and can be assigned to the new business as an additional cash inflow or outflow for the new business reporting. This is common practice already today for determination of the new business value in embedded value reporting. In total, the new business CSM will be determined individually for each group of contracts taking into account annual cohorts.

For subsequent measurement however, neither the effects of mutualisation nor the required cohort split can be directly determined but need to be derived by using reasonable and consistent allocation algorithms. This is also in line with the solution for similar granularity challenges as fulfilment cash flows under the VFA are usually determined at the level of mutualisation units and must then be assigned to the required more granular level. The following approach can be used to achieve the required annual cohort split and to separate mutualisation effects:

- Stochastic cash flows for subsequent measurement are determined at a higher granularity level than groups of contracts.
- The CSM unlocking is determined at the level at which mutualisation occurs.

- An amount of CSM is allocated to each group of contracts. The allocation reflects mutualisation effects between groups of contracts and also needs to take into consideration the required annual cohort split.

The CSM release is determined at group of contract level allowing for annual cohorts.

Thus, the task is to develop an appropriate allocation procedure that assigns the mutualization effect among the groups while also taking the cohort split into account.

The CSM release is determined at group of contract level allowing for annual cohorts.
Thus, the task is to develop an appropriate allocation procedure that assigns the mutualization effect among the groups while also taking the cohort split into account. We would like to stress that in that case additional disclosure of the CSM of these portfolios could be avoided. Otherwise, we would require a separate disclosure of the CSM to assure comparability.

(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 agree with the view of some Board members. In Europe the requirement to apply annual cohorts' cash-flow matched contracts in many instances will result in information that is neither relevant nor reliable.

The International accounting principle should reflect the contracts and the business model. All the International accounting principles are written to reflect in the accounting the business impact of the contract obligations and we expect that the accounting principles reflect the business model and the contract obligations.

To assess insurance life contracts, European financial analysts use contracts clauses effects and business model valuation models. We do not appraise the life business group of contracts in annual cohort because the business model is based on a mutualized group of contracts that cover all generations contracts in a single unit of account to reflect the real world. This unit of account is also used to simulate the effects of Solvency II capital requirement and the expected profitability of the future cash flow. If the IFRS 17 accounting rule creates a segregation of the business model in annual cohorts, it will result in an accounting mismatch without any benefit for the user and worse off financial information in comparison with Solvency II rules.
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Observing financial markets' volatility during financial crises such in 2000, 2008,

2011-12 or in 2020, we notice that the use of data disaggregated by annual cohort to a context, creates a volatility different from the one we usually find in the context of life insurance products like the mutualized product group of contracts.

The financial analyst would be faced with a difficult or impossible to solve problem: how to separate the market volatility effects related to the business from the artificial volatility induced by accounting rules such as the annual cohort in VFA. Accounting mismatches would therefore be generated so complex to solve that probably part of the financial analysts would prefer to use financial solvency data from the Solvency II rules instead of the accounting data of the new IFRS 17

(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?

☐ Yes ■ No

We agree with the view of some Board members. In Europe the requirement to apply annual cohorts for insurance contracts with intergenerational mutualisation and cash-flow matched contracts will, in many instances, result in information that is neither relevant nor reliable.

For information purposes we believe that the usefulness of annual cohorts for users is limited, since, instead of being able to identify a trend and have additional information on the trend in profitability over time, we would be faced with a real " results volatility" (up or down) from one year to the other (and clear pro-cyclical effects), which would not be useful for analysing the trend in the profitability of contracts and the whole company over time. The financial analyst would be faced with a difficult or impossible to solve problem: how to separate the market volatility effects related to the business from the artificial volatility induced by accounting rules such as the annual cohort, which may have a misleading effect on the exposure and consequent understanding of the actual results of individual contracts (or groups of contracts).

We confirm our concerns on the effects on the volatility of the annual results and on the usage of an information produced by applying the annual cohorts principle. Those concerns have been already raised in different working groups of insurance financial analysts and starting from the point of view of the users, we point out that a solution should be sought through an exception to be applied on this point.

As Insurance financial analysts, we use a selected group of KPIs to estimate the value of the life group of contracts and portfolio starting from the analysis of the life business model.

If we put attention to the users' requirement, starting from the standard settler of EFFAS (The European Federation of Financial Analysts Societies) definition guide,

two of the most used KPIs for analysing the life insurance contracts with the characteristic of intergenerationally mutualised and cash-flow matched contracts are:

Indicators of value of future cash flow like the Life Embedded Value (Life EbV)
Life EbV is the present value of shareholders' interests in the earnings distributable from assets allocated to the in-force life insurance business after sufficient allowance for the aggregate risks in the in-force life insurance business.
Life Running Insurance Yield (%). Is the ratio between the life running insurance investment and the year-end average investments using quarterly average investments?

The KPI used to evaluate the portfolio's future value is the EbV that is often calculated out of IFRS financial reporting. These data are based on the group of contracts that always start from insurance contract clauses and never calculate it starting from annual cohorts' groups of contracts due to the requirement to be able to reflect the business model and the contracts' legal requirement of intergenerationally mutualised and cash-flow matched contracts.

The Life Running Insurance Yield (%) is a very interesting indicator. There are different compositions of it: for running insurance investments Income life from only bond yield to all ordinary yield from all assets: bond, equity, real estate… This KPI is the value of the life running investments income before mark to market and harvesting (own accounts) with components by all ordinary yield from all assets: bond, equity, real estate… The interesting point on this KPI is that the unit of account taken as the granular starting point is the portfolio of assets that match the portfolio liabilities where the liabilities are the unit of account that reflect the business model and the contract's legal requirement of intergenerationally mutualised and cash-flow matched contracts.

In conclusion, for analysing the insurance life business with the characteristic of intergenerationally mutualised and cash-flow matched contracts, we never use as unit of account the annual cohorts because we know that both the business model and the contract's legal requirements are at the level of lifetime product and not at the level of annual cohorts! For this reason, we agree with the view of the group of Board members who consider that in many cases in Europe the requirement to apply annual cohorts' cash-flow matched contracts will result in an information neither relevant nor reliable. As users we confirm the concerns already reported in the various working groups as insurance financial analysts and, starting from the users' point of view, we point out that we should look for a solution through an exception to be applied on this point.

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.

- 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

As we already said, the application of annual cohorts does not reflect the strategical choices and business models of insurance companies. It could reduce the positive effect of mutualisation affecting the way the insurance coverage system is organized.

In particular this decision could affect the current system of mutualisation in place in some European countries which represent "a highly sensitive feature on insurance markets since it reflects and also shapes up a level of social/societal

understanding of what is covered by insurance and what is left to the direct responsibility of the individual (natural or moral person)" as EFRAG pointed out.

We are talking about savings and long-term products whose role of protection of families is based on intergenerational mutualisation which provides a transfer of wealth across generations ensuring them a stable flow of revenues over a number of years. By reporting annual results coming in each current year, according to the annual cohorts' approach, insurance companies could be affected by volatility in their results.

The impact on volatility of results and on annual profitability of insurance companies could influence their decisions in two different ways: by reducing the supply of these products with high protection for policyholders or by increasing their price levels. One case could involve pension funds whose role of saving protection is essential in all countries which often adopt life insurance products with a guaranteed minimum return.

Pension fund managers usually operate in these sectors by making tenders every 5-10 years and assigning the management of the sector to one or more insurance companies through the signing of collective agreements linked to pension fund members. In this way, the members of the fund can decide to use the "guaranteed" sector which, being directly linked to one or more asset managements of insurance companies, will allow the payment of what is subscribed by the member of the pension fund.

If the IFRS 17 accounting standard is approved in its current version, which provides for the application of annual cohorts to VFA contracts, pension funds will most likely have difficulty renewing collective agreements with pension funds for sectors with guaranteed minimums that use life insurance of this type at the end of 5 or 10 years.

At best, the manager would be in the position of having to increase the cost of management for pensioners in order to find insurance companies willing to sign contracts that will certainly be onerous in the first year and will allow the pension fund to continue to supply the sectors with a guaranteed minimum.
Alternatively, the pension fund could hardly find insurance companies willing to manage these funds due to new accounting constraints exposing pension fund members to the risk of not obtaining the minimum return yield provided by the contracts.

In this scenario, accounting principle can affect not only of the technical and contractual features and guarantees offered by current pension funds, but also the public good of the European policyholders who have subscribed a "guaranteed minimum" contract.

Further damage for the European policyholder would be caused by the fact that, since it will no longer be possible to find pension contracts, he could be inevitably

directed towards pension funds with greater risk for himself. We think that an accounting solution must be found which will enable European citizens to maintain those contracts signed with the pension fund and thus having preserved the safety of their investments.

By extending this consideration to the whole range of products for which annual cohorts' approach should be provided, we would point out that, for many European countries, as highlighted by the ANC French and EFRAG itself, this is the most offered coverage due to the embedded characteristic of protecting policy-holders' savings and pensions. In this sense, their penalization in terms of accounting could create distortions at a higher level of protection provided by insurance companies that adopt these coverages to a significant extent because, as has been pointed out, they could be pushed to reduce guarantees for policyholders or, at least, to increase their costs.

The commitments to policyholders for these types of contracts are directly guaranteed by the assets of insurance companies, so that investment returns must remunerate guarantees to policyholders. Without the application of intergenerational mutuality this guarantee may not work year by year.

The balance sheet representation of the annual cohort and the annual service margin does not reflect the characteristics of the contract by eliminating or reducing the positive effects, especially for the policyholders, of these types of contracts that are among the most widespread and protective in many European countries. So, it leads to distorting effects both in product choices and in insurance coverage.

Another relevant impact is on competition because the annual cohorts' approach penalises specific types of coverages, that undoubtedly offer high customer protection compared to others, distorting competition between companies in the same country and, above all, among companies in different countries. In this sense companies in some European countries, for which these coverages are the most widespread, would be penalized affecting the competitiveness of some European undertakings.

From the point of view of EU economic development, we underline two aspects.

First, the penalization of outlined insurance covers, aimed at protecting the savings and income of the population, would then reduce the role played in the various countries by the insurance sector in contributing to the economic growth of nations. In some European countries these types of products could be an opportunity to enhance investments in infrastructure and other long-term works with relevant impacts on economic development.

Second, the application of annual cohorts, being exposed to the risk of increased volatility and annual losses of long-term investments, damages and limits the coverage that can be offered by insurance companies and adversely affects the role that insurance and other financial institutions could play in the process of

adaptation and mitigation of climate change risk.

(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

For cash flow matched contracts, we see risks related to the potential mismatch between duration and value of assets compared with that of liabilities. The matching between liabilities and investments placed to their coverage is an essential issue to ensure the soundness and profitability of undertakings in the short term and, consequently, the protection of policyholders by the returns of the undertakings themselves. The mismatch will be created by the difference between "unit of account" and classification of "group of contracts" under European local contractual rules.

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 agree that financial information provided through the application of IFRS17 is better

than in the past especially with reference to:

1) the comparability within the sector across Europe.
2) the recognition of emerging profitability from some kinds of contracts not reflected through the current accounting principles and local GAAP.
3) the elimination of valuation mismatch between assets and liabilities thanks to the adoption of IFRS 9 and IFRS 17 at the same time.

However, our answer cannot avoid considering the impact of the application of annual cohorts to intergenerationally mutualized and cash-flow matched contracts, which could translate into a consolidated/ aggregated net profit impacted by an accounting policy not reflecting the real contribution of the business underlying traditional life policies in Europe (in particular, its drivers and its revenue and cost patterns). This could lead to a lack of true and fair view of the financial statements, negatively impacting the relevance requirements. In addition, the abovementioned better comparability implied by the application of IFRS 17 could be put at risk as the "artificial" division in annual cohorts might depend on different accounting policies adopted company by company. Beyond the annual cohorts, other critical points are represented by the use of margins instead of volumes (premiums) and the non-required classification in life and non-life contracts, which prevents identifying the businesses' different levels of risk and introduces a divergence from the Solvency rules.

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 do not agree with the statement. Overall costs for the application of the new IFRS 17 include the costs related to the implementation of the annual cohorts, therefore significant IT investments are to be made to modify the accounting system of the related insurance contracts (and to maintain it updated) and higher annual expenses related to more complex calculation and disclosure procedures. We agree that the benefits of the other IFRS 17 requirements exceed the related costs

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.

We agree that IFRS 17 does not overall negatively affect financial stability. However, a critical aspect could be represented by the fact that, through the application of the annual cohorts, financial statements are exposed to the risk of not providing an accurate representation of the financial condition of the entity, due to the fact that the artificial division in life annual cohorts does not reflect the real profitability of the contracts (intergenerationally mutualized). In this respect, it is also important to keep in mind that financial statements should reflect sound management practices, thereby producing financial information that is economically meaningful and recognizing the risks incurred by the insurance company. Moreover, a key criterion for financial stability is avoidance of negative and promotion of positive externalities: however, the application of the annual cohorts to long-term minimum guaranteed life contracts could lead to higher costs for those kinds of products or introduce a distortion in favour of riskier long-term life products.

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.

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

We overall agree that the underlying economics and profitability of the insurance business will be more decisive in being active in a particular region or through a particular insurance product than changes to accounting practices introduced by IFRS 17. The exception remains the application of the annual cohorts in VFA life products, which, in our view, could affect the competitiveness of those companies most active in the minimum-guaranteed life insurance business (see above answer to question 6.).

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.

We overall agree that the IFRS 17 effect will be on both pricing (on which, anyhow, the most significant impact comes from capital requirements), as the use of current make values will bring pricing and underwriting closer, and on product offering, like for the application of annual cohorts (in this case, an effect on product offering could also occur, see our answer to question 7.). In addition, we believe that interest-rate sensitive products are expected to be more affected by the introduction of IFRS 17 due to the onerous contract test and the impact of measuring those portfolios with risk-free rates: this might affect insurance companies’ ability to offer certain life insurance products.

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

■ 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 think that the application of both IFRS 17 (liability side) and IFRS9 (asset side), both based on current market values, thus on different metrics compared to the past, should impact insurance companies’ asset allocation.

(c) 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.

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 consider this point not to be particularly relevant for users.

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.

We agree that IFRS 17 accountability and Solvency II should adequately talk to each other. However, we believe that it is not only the actuarial systems developed for Solvency II that have to adapt to reporting requirements envisaged by IFRS 17. It is also IFRS 17 that has to take into account the differences between non-life and life businesses envisaged by Solvency II

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 hasthe benefit for investors to be able to react timely to any changes at hand, thereby avoiding cliff-effects. (Appendix III paragraphs 483 to 507).

a. 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.

We agree that except for life portfolio affected by issues of annual cohorts in VFA contracts, IFRS 17 does not overall materially affect the insurance companies' decisions on asset allocation or holding periods, although its application alongside with the IFRS 9 raised some doubts. However, the application of the annual cohorts, may not correctly reflect the contracts real profitability, therefore could lead to some extent to short-term asset allocation decisions or active trading policies, as well as hedging policies in order to mitigate any negative performance, which could arise on annual base.

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 agree that the IFRS 17 has mixed effect on procyclicality and it may result in a more volatile annual financial performance measure as effect of the use of the short-term market price to estimate a long-term business model like some life insurance products. In particular, the application of the annual cohorts could introduce some further volatility effects in the annual reports, a sort of accounting mismatch, which could also affect the fair comparison with countries where the traditional life products are not so common.

IFRS 17 and IFRS 9

12 We consider this point not to be particularly relevant for users.

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

We believe that applying the same principles for all the contracts with customers could reduce the complexity for the company, providing a good set of information for the users of the financial statements without any additional costs.

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.

We partially agree. Although the existence of three transition approaches could reduce the cost and efforts, we point out that it may affect the comparability within companies over time, particularly as regards long-term contracts, conflicting with one of the main purposes of the IFRS 17. These effects could also be intensified by the application of the annual cohorts

Impact on reinsurance

15 We consider this point not to be particularly relevant for users.

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.
We agree. The implementation date is realistic and could allow to prepare the first adoption in a timely way. Any delay from the implementation date (1 January 2023) is likely to add further costs for the insurance companies. Furthermore, the still uncertain current situation due to the pandemic and the application of the annual cohorts need time.

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.

We partially disagree. We believe that the new standard could be conducive to the European public good, mainly thanks to the better financial information provided, for example regarding the comparability within sectors across Europe. That said, it must be considered that the new standard could underestimate the impact of the application of the annual cohorts on some kind of life contracts (e.g., intergenerationally mutualized contracts), interfering with the correct representation of the underlined profitability and preventing analysing and interpreting the financial statements fairly. In addition to the annual cohorts, we remind you about other sizable points such as the adoption of margins instead of premiums and the non-required classification of non-life and life contracts that is not in line with the SII rules and could give a misleading representation of the groups' risk

We consider that Parts IV-V-VI not to be particularly relevant for users.

If you would like to further discuss the views expressed in this letter, please do not hesitate to contact us.

Dr. Carsten Zielke
Dr. Luca D'Onofrio

On behalf of EFFAS Commission on Financial Reporting

EFFAS was established in 1962 as an association for nationally based investment professionals in Europe. Headquartered in Frankfurt am Main, EFFAS comprises 16-member organizations representing more than 16,000 investment professionals. The Commission on Financial Reporting is a standing commission of EFFAS aiming at proposing and commenting on financial issues from an analyst standpoint. CFR members are Javier de Frutos (Chairman, IEAF-Spain), Jacques de Greling (Vice-Chairman- SFAF, France), Friedrich Spandl (ÖVFA, Austria), Henning Strom (NFF, Norway), Serge Pattyn (BVFA/ABAF, Belgium) Luca D'Onofrio (AIAF, Italy) and Dr. *Carsten Zielke (DVFA, Germany)*