EFRAG
European Financial Reporting Advisory Group

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS ON IFRS 9 *Financial Instruments*

Comments should be sent to commentletters@efrag.org by 30 June 2015

EFRAG has been asked by the European Commission to provide it with advice and supporting material on IFRS 9 *Financial Instruments* ('IFRS 9' or 'the Standard'). In order to do that, EFRAG has been carrying out an assessment of IFRS 9 against the technical criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing impact of IFRS 9 on the European public good.

A summary of IFRS 9 is set out in Appendix 1 to the draft endorsement advice letter.

Before finalising its assessments, EFRAG would welcome your views on the issues set out below and any other matters that you wish to raise. Please note that all responses received will be placed on the public record, unless the respondent requests confidentiality. In the interest of transparency EFRAG will wish to discuss the responses it receives in a public meeting, so we would prefer to be able to publish all the responses received.

EFRAG initial assessments summarised in this questionnaire will be amended to reflect EFRAG's decisions in Appendices 2 and 3 of the draft endorsement advice.

Your details

1 Please provide the following details about yourself:

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

Talanx AG

Riethorst 2, 30659 Hannover

Hannover Rück SE

Karl-Wiechert-Allee 50, 30625 Hannover

(b) Are you a:

☒ Preparer ☐ User ☐ Other (please specify)

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

Talanx Group offers high-quality insurance services in non-life and life insurance as well as reinsurance and also conducts business in the asset management sector. With premium income of EUR 29.0 billion (2014) and more than 21,300 employees, Talanx is one of the major European insurance groups. The Hannover-based Group is active in some 150 countries. Talanx operates as a multi-brand provider with a focus on B2B insurance.

Hannover Re Group, being part of the Talanx Group, transacts all lines of property & casualty and life & health reinsurance. It is the third-largest

reinsurer in the world based on gross written premium.

(d) Country where you are located:

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(e) Contact details including e-mail address:

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

2 EFRAG's initial assessment of IFRS 9 is that it meets the technical criteria for endorsement. In other words, it is not contrary to the principle of true and fair view and it meets meet the criteria of understandability, relevance, reliability and comparability and leads to prudent accounting. EFRAG's reasoning is set out in Appendix 2, paragraphs 2 to 197 of the draft endorsement advice.

(a) Do you agree with this assessment?

☐ Yes ☒ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

Although we agree in general with EFRAG's initial assessment, in our opinion, there are two material deficiencies which do not fully comply with the criteria understandability and relevance of IFRS 9:

- Prohibition of recycling on equity securities measured at fair value through OCI (see our comments in paragraph 7a)
- Missing FVOCI option for instruments measured otherwise at amortised costs (see our views in paragraph 7b).

Regarding these two issues IFRS 9 generally supports a preference for full fair value accounting, which, in our view, is not in line with the IASB's proposal to allow an accounting policy choice for the use of OCI presentation in insurance contracts (IFRS 4 Phase II), which we strongly support. We therefore respectfully ask EFRAG to recommend to the European Commission that it should request the IASB to remove these two deficiencies in IFRS 9. In our view, this will help to avoid significant disadvantages in investment strategies for long-term equity and debt financing in the future.

Furthermore, we agree with the view regarding the need for a European deferral of mandatory effective date of IFRS 9 for insurers if the IASB would not defer the mandatory effective date of IFRS 9 on a global basis. However, the best solution will be an alignment of the adoption of IFRS 9 and IFRS 4 Phase II for insurance companies (we refer to our comments in paragraph 13). For us as a global insurance and reinsurance group it is essential to consider the interaction of IFRS 9 with IFRS 4 Phase II regarding the mandatory effective date (see detailed information in paragraph 12, 13 and 16).

Being fully aware of the requests for swiftly implementing IFRS 9, especially due to the new impairment model, **we do not intend to oppose the endorsement procedure as such as long as insurers are not obliged to apply IFRS 9 separately ahead of the final insurance standard (IFRS 4 Phase II).**

3 EFRAG's initial assessment of IFRS 9 is that it leads to prudent accounting. EFRAG's reasoning is set out in Appendix 2 paragraphs 185 to 191 of the draft endorsement advice.

(a) Do you agree with this assessment?

☐ Yes ☒ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

We are concerned that short-term fair value movement could dominate the performance reporting because of the strong preference for full fair value accounting of financial instruments in IFRS 9. This is particularly true, in our view, with regard to the limitation of the amortised cost category as well as the limitation of FVOCI category.

(b) Are there any issues relating to prudence that are not mentioned in Appendix 2 that you believe EFRAG should take into account in its technical evaluation of IFRS 9? If there are, what are those issues and why do you believe they are relevant to the evaluation?

(c) Are there any other issues that are not mentioned in Appendix 2 of the draft endorsement advice that you believe EFRAG should take into account in its technical evaluation of IFRS 9? If there are, what are those issues and why do you believe they are relevant to the evaluation?

The European public good

4 In its assessment of the impact of IFRS 9 on the European public good, EFRAG has considered a number of issues that are addressed in Appendix 3 of the draft endorsement advice.

IFRS 9 compared to IAS 39

5 EFRAG's initial assessment of IFRS 9, and particularly with respect to the impairment and hedging requirements, is that it is an improvement over IAS 39 and will lead to higher quality financial reporting. The assessment is reflected in paragraphs 3 to 52 of Appendix 3 of the draft endorsement advice.

(a) Do you agree with this assessment?

☒Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues relating to IFRS 9 compared to IAS 39 that are not mentioned in Appendix 3 of the draft endorsement advice that you believe EFRAG should take into account in its technical evaluation of IFRS 9 when comparing to IAS 39? If there are, what are those issues and why do you believe they are relevant to the evaluation?

The lack of convergence with US GAAP

6 EFRAG's initial assessment is that IFRS 9 will lead to higher quality financial reporting when compared to current US GAAP and proposed changes to impairment requirements. The assessment is reflected in paragraphs 53 to 74 of Appendix 3 of the draft endorsement advice.

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues related to the impact of the lack of convergence that are not mentioned in Appendix 3 of the draft endorsement advice that you believe EFRAG should take into account in its technical evaluation of IFRS 9 when comparing with US GAAP? If there are, what are those issues and why do you believe they are relevant to the evaluation?

Impact on investor and issuer behaviour

7 EFRAG's analysis in this area is based on our understanding of both changes in IFRS 9 and current practices of financial institutions and is not a full impact assessment. In its analysis EFRAG has tried to identify potential negative effects only, to contribute to identifying whether there would be any impediment to IFRS 9 being conducive to the European public good. The assessment is reflected in paragraphs 75 to 99 of Appendix 3 of the draft endorsement advice.

(a) Do you agree with this assessment?

☐ Yes ☒ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

Recycling of accumulated gains or losses on equity investments (measured at FVOCI)

We strongly believe that the prohibition of recycling of accumulated gains or losses on equity investments (measured at FVOCI) from other comprehensive income to profit or loss at the moment of realisation (sale or derecognition) would lead to a distorted picture on the performance of these instruments and consequently the performance of the entity holding such assets. Especially, in case of participating contracts in the insurance business, the benefits to policyholders are required to be recognized in profit or loss. To ensure a linked and consistent presentation of performance in the affected reporting period a related recycling of realised fair value changes in profit or loss is indispensable.

The need to obtain a long term yield on the asset portfolio sufficient to meet the obligations to policyholders might prevent insurance companies from changing their investment strategy with regard to equity investments. However, the need to explain this distorting effect and to provide relevant information to the users of financial statements, in particular to investors, may lead to non-GAAP measures being developed by issuers to remove such fluctuations caused by unrealised gains or losses from profit or loss, thus providing relevant information about their performance.

Insurance companies may also incur further costs to provide additional information about their economic performance in the financial statements or accompanying documents making the cost-benefit relationship of the implementation of IFRS 9 less favourable and information in the financial statements less comparable to other industries and also within the industry itself. This effect would be even reinforced by the adoption of IFRS 9 ahead of the future insurance contracts standard (please also refer to our answer to the question 12/13).

Therefore, we recommend to EFRAG that it should include in the final endorsement advice on IFRS 9 an appeal to the European Commission to urge the IASB to include in IFRS 9 a requirement for the recycling of accumulated gains or losses on equity instruments from other comprehensive income to profit or loss.

(b) Are there any issues related to the impact of IFRS 9 on investor and issuer behaviour that are not mentioned in Appendix 3 of the draft endorsement advice that you believe EFRAG should take into account in its technical evaluation of IFRS 9? If there are, what are those issues and why do you believe they are relevant to the evaluation?

> <u>FVOCI option for financial assets otherwise classified at amortised cost</u>
>
> Taking into account the interrelation of IFRS 9 with the future insurance contracts standard, the absence of a FVOCI option may have an impact similar to the one described above on the issuers in the insurance business.
>
> Especially in the case of insurers holding certain portfolios of investments (e.g. infrastructural debts) that are managed in order to collect contractual cash flows only, the business model assessment might lead unavoidably to amortised cost measurement under IFRS 9. On the other hand, the IASB's decision on insurance contracts requires insurance contracts to be measured at current fulfilment value basis. Considering the related decision on the other comprehensive income presentation for insurance contracts (revised ED/2013/7 on IFRS 4 Phase II), there is a need to avoid the created accounting mismatch through a supplementary FVOCI option for the related financial items in the amortised cost category on the asset side to the extent possible.
>
> We strongly believe that current measurement and the use of FVPL under IFRS 9 would, in many cases, lead to significant and inappropriate volatility in earnings thus not providing useful information about the underlying economic performance of the entity and resulting in too much focus on short-term and/or market-driven volatile results. Consequently, we do not view the existing FVPL option as a viable or sufficient alternative.
>
> Therefore, we recommend including a request for a FVOCI option for the financial assets otherwise categorised at amortised cost in the final endorsement advice on IFRS 9.

Inter-relationship of IFRS 9 with the future insurance contracts standard

8 EFRAG has initially concluded that the mismatch in timing of the future insurance contracts standard and IFRS 9 will create disruptions in the financial reporting of insurance activities which may not be beneficial to investors and other primary users (see Appendix 3, paragraphs 100 to 110 of the draft endorsement advice). Hence EFRAG proposes to advise the European Commission to ask the IASB to defer the effective date of IFRS 9 for insurers and align it with the effective date of the future insurance contracts standard.

9 In reaching this preliminary position, EFRAG has relied on quantitative assessments prepared by the European insurance industry and released shortly before EFRAG concluded on its tentative advice to the European Commission. EFRAG intends to deepen its understanding of the effect on the reporting by insurance businesses by implementing IFRS 9 in advance of the forthcoming IFRS 4. EFRAG invites all quantitative evidence that can supplement the impact assessment received from the European insurance industry, including evidence gathered by those who oppose the deferral.

(a) Do you agree with this assessment and the subsequent advice to the European Commission?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

We agree with EFRAG's tentative assessment (analysis of interaction of IFRS 9 and IFRS 4) and fully support the suggested advice to the European Commission. We strongly recommend that the final endorsement advice should contain this assessment.

(b) Do you think that EFRAG should recommend the EC to grant to insurance businesses a deferred mandatory date of application for the endorsed IFRS 9 if the IASB were not to defer the effective date of IFRS 9?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

We have the strong view that the deferral of the mandatory effective date of IFRS 9 for insurers and reinsurers should be provided by the IASB as a global solution in the form of granting them a deferral option. In this connection, we think that the interrelation of IFRS 9 with the future insurance standard will even be so essential for insurers and reinsurers that this also justifies a European solution in the event that the IASB will not defer the mandatory effective date of IFRS 9 for both insurers and reinsurers. Therefore, we recommend that EFRAG's final endorsement advice should contain this issue and clearly specify that an EU-only approach (aligned adoption of IFRS 9 and IFRS 4 Phase II for insurers) would only be the second best solution.

(c) Are there any issues related to the inter-relationship of IFRS 9 with the future insurance contracts standard that are not mentioned in Appendix 3 of the draft endorsement advice that you believe EFRAG should take into account in its technical evaluation of IFRS 9 when assessing the inter-relationship between IFRS 9 and the future insurance contracts standard? If there are, what are those issues and why do you believe they are relevant to the evaluation?

In addition to our comments in respect of question 2(a) and specifically regarding the proposed temporary deferral of IFRS 9 for insurers and reinsurers (e.g. see also 9 (b)): We disagree that addressing accounting mismatches and undue volatility through features in the current IFRS 4 Phase I (e.g. shadow accounting, option to apply current market interest rates or potential extensions to these features) should be an appropriate alternative to (optionally) deferring IFRS 9. This is primarily due to the lack of understandability of such alternative for the users of our financial statements as well as due to the extremely complex handling of those accounting changes for insurers in a short time series.

European carve-out

10 EFRAG has initially concluded that the endorsement of IFRS 9 would not affect the ability of entities to rely on the European carve-out (see Appendix 3, paragraphs 111 to 117 of the draft endorsement advice).

(a) Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

(b) Are there any issues related to the European carve-out that are not mentioned in Appendix 3 of the draft endorsement advice that you believe EFRAG should take into account in its technical evaluation of IFRS 9 when assessing the EU carve out? If there are, what are those issues and why do you believe they are relevant to the evaluation?

Costs and benefits of IFRS 9

11 EFRAG is assessing the costs that are likely to arise for preparers and for users on implementation of IFRS 9 in the EU, both in year one and in subsequent years. Some initial work has been carried out, and the responses to this Invitation to Comment will be used to complete the assessment.

12 The results of the initial assessment of costs are set out in paragraphs 120 to 155 of Appendix 3 of the draft endorsement advice. To summarise, EFRAG's initial assessment is that overall, IFRS 9 is likely to result in significant costs for preparers related to implementation of and ongoing costs of complying with the standard. However, IFRS 9 is not likely to result in significant costs for users after the transition. At transition costs will be incurred in understanding the new financial reporting.

(a) Do you agree with this assessment?

☐ Yes ☒ No

If you do not, please explain why you do not and (if possible) explain broadly what you believe the costs involved will be.

As far as insurance and reinsurance companies are concerned, adoption of IFRS 9 ahead of the future insurance contracts standard would lead to significant ongoing costs during the period in between as well as to additional costs at the adoption of the future insurance contracts standard. Please refer to our answer to the question 13 below.

Nevertheless, we generally agree with this assessment when the misalignment period is overcome.

(b) In addition, EFRAG is assessing the benefits that are likely to be derived from the application of IFRS 9. The results of the initial assessment of benefits are set out in paragraphs 156 to 170 of Appendix 3. To summarise, EFRAG's initial assessment is that overall, users and preparers are both likely to benefit from IFRS 9, as the information resulting from it will be relevant and transparent and therefore will enhance the analysis of users.

Do you agree with this assessment?

☐ Yes ☒ No

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

In our view, a full analysis with respect to the benefits of IFRS 9 can only be done once the future insurance contract standard is available. In addition, we refer to the deficiencies of IFRS 9 mentioned above (i.e. comments in paragraph 7), which should be addressed to reflect an appropriate performance reporting in line with the economics of an insurer's business.

13 EFRAG's initial assessment is that the benefits to be derived from implementing IFRS 9 in the EU as described in paragraph 12 (b) above are likely to outweigh the costs involved as described in paragraph 12 (a) above.

Do you agree with this assessment?

☐ Yes ☒ No

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

This assessment cannot be shared for insurers and reinsurers if the effective dates of both IFRS 9 and the future insurance contracts standard are not aligned. Compared to other preparers, the following additional costs that are not balanced by any additional benefits arise for insurers:

- Cost of reassessing the business model again and possible reclassification between financial asset categories when the future insurance contracts standard becomes effective;
- Negative effects of possible accounting mismatches arising between the accounting for liabilities from insurance obligations (existing accounting regime under IFRS 4 Phase I) and the assets used to cover these obligations (under IFRS 9) on the performance indicators and consequently on the cost of (re-)financing;

Cost of increased efforts required to explain the above effects to the users of financial statements.Additional costs will also arise for the users of financial statements in the insurance industry in order to understand the effects of the accounting mismatch arising in the period between the effective date of IFRS 9 and the future insurance contracts standard as well as the possible further effects by the time the future insurance contracts standard becomes effective.

We therefore strongly argue in favour of including in the endorsement advice a recommendation to ask the IASB to align the adoption dates of IFRS 9 and the future insurance contracts standards for insurance and reinsurance companies by granting them a deferral option on IFRS 9 adoption.

A second but less attractive alternative would be an EU-only approach (but that might be a problem for global insurers or entities which are listed on a stock exchange outside Europe). That is why we recommend including in the endorsement advice a deferral option for insurers and reinsurers at an EU-only level as a second-best solution. In summary, we believe that the IASB should develop a suitable solution that could also be supported by the EU and the global stakeholders.

In addition, for a positive cost/benefit assessment, from our perspective the following deficiencies should be remedied:

- A requirement for recycling for FVOCI equity securities must be introduced
- A FVOCI option for debt instruments must be introduced

Overall assessment with respect to the European public good

14 EFRAG has initially concluded that endorsement of IFRS 9 would be conducive to the European public good (see Appendix 3, paragraphs 174 to 176 of the draft endorsement advice).

Do you agree with the assessment of these factors?

☐ Yes ☒ No

If you do not agree, please explain your reasons.

Referencing our comments in paragraph 13, we are not in a position to fully confirm the tentative assessment that IFRS 9 would be conductive to the European public good from the perspective of insurance and reinsurance companies. That is why we recommend that EFRAG should advise the European Commission to urge the IASB to address our identified concerns. This applies especially to the misaligned mandatory effective dates of IFRS 9 and IFRS 4 Phase II.

Other issues for consideration

Request to provide quantitative data on a confidential basis

15 EFRAG continues its search for quantitative data in the fields of impairment and the inter-relationship between IFRS 9 and the future insurance contracts standard. EFRAG calls upon constituents who have quantitative data available in these fields, to provide it to EFRAG on a confidential basis during the consultation period of the draft endorsement advice. Data provided will be used in finalising the endorsement advice but will not be made public.

The collection of these data is subject to EFRAG's field-work policy which is available on the EFRAG website.

(All effects described below are presented on an ultimate group level (i. e. including both Talanx Group´s and Hannover Re Group´s high-level assessments).

1) Impairment
   Although no quantitative data is available to us yet, we expect the impact regarding impairment to be very limited or insignificant based on the current market environment due to the high proportion of investment grade assets in our portfolio (approximately 95 % investment grade).

2) Quantification of financial impact
   Referred to a high-level quantification more than 5% of our assets currently at AC or AFS will be reclassified into the FVPL category.
   The high-level quantification of the P&L impact from reclassified assets to FVPL at the ratio of group profit is higher than 12 % (on a gross basis)

   In consequence for us, if IFRS 9 has to be applied ahead of the final insurance standard (IFRS 4 Phase II), the increased use of FVPL will create a significant accounting mismatch. This issue cannot be solved under the existing accounting for insurance contracts (IFRS 4 Phase I) because of the existing cost-type measurement approach for insurance liabilities.

Should endorsement be halted until quantitative data are available?

16 Based on the results of our questionnaire follow up to the field-tests, it can take up to 2017 to have quantitative impacts of the implementation of IFRS 9 available. It has been argued by some that the quantitative impacts of IFRS 9 should be known before endorsement of the standard is decided upon. EFRAG does not agree with this view and believes that the improvements brought to financial reporting by IFRS 9 should not be withheld from European companies for a period that long.

Do you agree with this assessment?

☐ Yes ☒ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.

Due to the distorting effect that adoption of IFRS 9 ahead of the future insurance contracts standard would have on the presentation of economic performance of insurance and reinsurance companies (as well as costs for dual implementation of IFRS 9), we strongly recommend a global solution to align the effective dates for IFRS 4 Phase II and IFRS 9 for insurers and reinsurers. This can be achieved through an optional temporary deferral of IFRS 9 until IFRS 4 Phase II is implemented. A second but less attractive solution would be an EU-only approach for insurers.

Nevertheless, we generally agree with EFRAG´s assessment in the DEA that further quantification exercises would presumably not provide new insights regarding the effects of IFRS 9 in isolation. However, we do not support a swift endorsement decision if insurers and reinsurers would be obliged to apply IFRS 9 in isolation ahead of the final insurance contracts standard as both standards are highly interrelated.

Should early application of IFRS 9 be prohibited?

17 It has been argued by some that early application of IFRS 9 should not be allowed for specific regulated industries. EFRAG does not agree with this and is of the opinion that entities should be able to apply IFRS 9 early (see Appendix 2, paragraphs 192 to 195 of the draft endorsement advice).

Do you agree with this assessment?

☒ Yes ☐ No

If you do not, please explain why you do not agree and what you believe the implications of this should be for EFRAG's endorsement advice.