POSITION PAPER

ESBG comments on EFRAG's Draft Endorsement Advice on applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts (Amendments to IFRS 4)*

ESBG (European Savings and Retail Banking Group)

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ESBG

European Savings and Retail Banking Group (ESBG) members are most appreciative of the opportunity afforded to them by the European Financial Reporting Advisory Group (EFRAG) to comment on their Draft Endorsement Advice regarding the application of IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (Amendments to IFRS 4).
We are confident that the below feedback will prove useful in this process.

ESBG Position

ESBG have a long established position on the interaction of IFRS 9 and IFRS 4. All new IFRS as well as Amendments to existing standards must be shown to support the European "Public Good" and a number of our members are of the opinion that the Amendments to IFRS 4 may fall short in this area due to the disruption of the level playing field for insurance entities within a bank-led group. Members have stated their position, as was previously advocated by EFRAG, that the temporary exemption provision should also be made available to entity level insurers that meet the criteria in order to align the effective date of IFRS 9 with the effective date of the new insurance contracts standard (IFRS 17). This would allow them to defer the application of IFRS 9 in consolidated financial statements even if the insurer is owned by a non-insurance company like a bank. The deferral, will only apply to the insurance entities within a conglomerate and not to the banking entities.

General Comments

The IASB issued an amendment to address the concerns related to the different effective dates of IFRS 9 and the forthcoming insurance contracts standard until the forthcoming insurance contracts Standard is effective.

The Amendments provide:
- an optional, temporary exemption from the application of IFRS 9 for entities whose activities are predominantly insurance at the reporting entity level ;
- an alternative approach (the overlay approach) that would be available to financial conglomerates and which substantially mitigates the financial reporting-related concerns.
Only the alternative (overlay) approach is available to the entire insurance industry and especially, for financial conglomerates. The temporary exemption criterion – as it is designed by the IASB, i.e. applied at the reporting level entity and for entities that have predominant insurance activities – excludes insurance activities carried out within banking conglomerates. Therefore, it generates distortions of competition within the insurance sector. Insurance entities will be treated differently depending on whether the entity is an insurance market player or insurance's entity within a conglomerate.

We appreciate the efforts of EFRAG in working with the International Accounting Standards Board (IASB) and totally support EFRAG's position which considers that the "Amendments do not achieve a completely level playing field within the insurance sector". We are convinced that ensuring a level playing field between all entities that have insurance activities is a key element when defining the deferral of IFRS 9.

As mentioned in our position ESBG supports the application of the deferral approach below reporting entity level. This position takes into account the competitive disadvantages that a different approach will generate.

The current situation (i.e. financial conglomerates whose activities are not predominantly connected with insurance in the way defined by the IASB are not eligible to apply the optional temporary exemption from applying IFRS 9 until 2021) could lead to a competitive disadvantage for insurance companies that are part of financial conglomerates as opposed to insurance groups. ESBG members have suggested that EFRAG's claim that there is no material evidence of competitive issues when the draft advice states that 20% - 25% of insurance companies will not be eligible for temporary exemption is a clear contradiction.

Furthermore, it is our opinion that the difference in the application dates will impact the understandability of the financial statements, users of financial statements will find it difficult to understand the additional accounting mismatches and resulting volatility in profit or loss that cannot be offset by using existing options under IFRS 4 Insurance Contracts to address temporary volatility (only the temporary exemption from applying IFRS 9 helps mitigate all the concerns of the misalignment). In addition to this it will be very challenging to determine the parts of the volatility and accounting mismatches caused by the different effective dates. Also, it will be difficult to inform users what business model assessment changes will result from the adoption of IFRS 9 in 2018 and then further from the adoption of IFRS 17 in 2021.

Having to apply the classification and measurement requirements of IFRS 9 before the new insurance contracts Standard may be difficult for companies. Even if there was the possibility to later reclassify financial assets backing insurance contracts, it would be very difficult to explain to users of financial statements.

Accordingly, the temporary exemption criterion should be defined below the reporting entity in order not to exclude entities that are exclusively or mainly related to insurance activities / entities undertaking insurance activities that are not predominant insurers. In Appendix 2, paragraph 12 of the advice, it is suggested that predominant insurers are those most affected by the misalignment of dates between IFRS 9 and IFRS 17, members would contend that insurers within bank-led groups would equally benefit from the temporary exemption. Due to restrictions within the amendments in a number of cases, predominant insurers that are insurance subsidiaries within bank-led groups, may not be able to avail of this option.

The reliability and comparability of the financial statements due to the availability of the Amendments to different users have also been called into question by some of our members. EFRAG, they point out, has not addressed the matter of completeness in the draft endorsement advice, this may be an issue as the Amendments do not require the entities to apply the overlay approach to all eligible financial assets. Regarding comparability, preventing insurance entities within a bank-led group from availing of the temporary exemption will obviously lead to a gap in comparability of financial statements between similar entities. Members are of the opinion that EFRAG's suggestion that this will "slightly" reduce comparability is questionable at best.

When considering the possible impact on complexity, members are realistic that using two different reporting standards in a consolidated set of accounts could be challenging but also contend that it may not overly increase the complexity involved and may in fact give users a better picture of the insurance section of the group. It must also be noted that using the temporary exemption will likely lead to savings as opposed to the more costly overlay approach.

It is also worth mentioning that not allowing the temporary exemption could possibly lead to a scenario where the same assets have a different valuation at entity level compared to when they are recorded in the group accounts due to the use of two different standards. This could also result in understandability issues for users with different accounting policies applied to similar financial instruments within the same business model. Members accept EFRAG's assertion in paragraph 80 of Appendix 2 that investment grade assets make up a significant portion of insurance entities' holdings in debt-type assets but qualify this by pointing out that the remaining portfolio may represent a significant percentage of the loss on initial application of IFRS 9.

As previously mentioned EFRAG must determine whether a new IFRS or amendments to an existing IFRS are conducive to the European public good. This can be analysed from a number of standpoints. Members are of the opinion that by not allowing insurance entities within a bank-led group to avail of the temporary exemption these amendments are not necessarily improving financial reporting in Europe, they are, as previously mentioned, going to lead to less comparability and greater challenges for users to understand financial statements. As the Amendments are a short-term solution members have questioned whether it is justifiable to create this gap in insurance entites' reporting. The cost to bank-led groups of applying the overlay approach as well as having to explain the subsequent financial statements to users could also be prohibitive, further exacerbating the competitive gap between those entities who can and can't avail of the exemption. In fact, EFRAG go as far as to acknowledge the cost benefits to those who can use the temporary exemption. This is an indirect acceptance of the fact that those who are unable to apply the temporary exemption will be at a competitive disadvantage. There will also be an increased cost for users of financial statements as they will need to devise a model to allow them to adequately assess predominant insurance entities within and outside of bank-led groups.

EFRAG have informed us that more than half of the bank-led groups in their sample did not identify their insurance business as a separate reporting segment, in line with the stipulations of IFRS 8 Operating Segments and they have, therefore, questioned how many of these banks would actually avail of the temporary exemption method if it was to be made available to them. ESBG members have opined that due to the similarity of many banking and insurance products it may have made more sense for the entities not to separate them in their financial statements, as banking deposits and insurance technical liabilities are measured on a cost-basis across most jurisdictions. While the products may be similar it is also worth noting that this does not mean that the same systems will be used for managing financial assets in the bank-led group and the insurance entity. EFRAG's assertion, therefore, that the application of IFRS 9 across the entire group will lead to synergies is far from certain. It has also been suggested by members that the focus should be on addressing accounting mismatches that may arise from the application of different measurement models to insurance liabilities and the financial assets backing them and to distinguish short-term volatility from performance of the insurance activities instead of whether there are temporarily two different sets of accounting policies within the same group.

Finally, we do not agree with EFRAG's statement in Appendix 3 that "requiring bank-led entities that undertake insurance activities to apply IFRS 9 at the same time as other bank-led entities will avoid competition issues between bank-led groups and pure banks". As material non-insurance activities, i.e. banking activities, will not be included in the scope of the temporary exemption criterion, IFRS 9 will apply to all entities undertaking banking activities and, therefore, no competition issues would arise within the banking sector. As, indeed, different accounting policies will apply within the banking conglomerate, we will be pleased to work with EFRAG to find a solution that will mitigate the issue, and notably, we would suggest that all relevant information on that matter could be provided in the accounting statements.

<u>Conclusion</u>

Although members support a positive endorsement advice for predominant insurers, based on the comments provided in the previous sections, we would stress that, in the interest of the European public good, EFRAG must address the issue of the availability of the temporary exemption to predominant insurers within a bank-led group. This could possibly involve including a scope limitation in its endorsement advice opinion, therefore providing an endorsement advice exclusively on predominant insurers excluding other entities (such as bank-led groups) with significant insurance activities. Alternatively, EFRAG could consider clearly differentiating for each of the endorsement criteria its conclusions for predominant insurers from the conclusions for other entities (such as bank-led groups) with significant insurance activities.

European Savings and Retail Banking Group would, once again, like to thank EFRAG for this opportunity to contribute. We are confident that the above will prove useful to your organisation in the endorsement process and should you have any queries on the above please don't hesitate to contact us.

About ESBG (European Savings and Retail Banking Group)

ESBG – The Voice of Savings and Retail Banking in Europe

ESBG brings together nearly 1000 savings and retail banks in 20 European countries that believe in a common identity for European policies. ESBG members represent one of the largest European retail banking networks, comprising one-third of the retail banking market in Europe, with 190 million customers, more than 60,000 outlets, total assets of €7.1 trillion, non-bank deposits of €3.5 trillion, and non-bank loans of €3.7 trillion. ESBG members come together to agree on and promote common positions on relevant regulatory or supervisory matters.

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