12 February 2016

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Mr Hoogervorst,

Re: IASB ED/2015/11 Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft, ED/2015/11 *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts*, issued by the IASB on 9 December 2015 ('the ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG appreciates the efforts of the IASB to address the concerns that the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard have brought. In its final endorsement advice on IFRS 9, EFRAG noted that the misalignment of the effective dates of the two Standards would cause additional accounting mismatches in profit or loss, be difficult for users to understand and lead to additional costs of implementation. EFRAG notes that the IASB is proposing an overlay approach and a temporary exemption from applying IFRS 9 to mitigate these concerns, both approaches on an optional basis.

While the temporary exemption from applying IFRS 9 helps mitigate all the concerns of the misalignment of the effective dates of the two Standards, the overlay approach helps neutralise in profit or loss the additional accounting mismatches that arise from the implementation of IFRS 9, without addressing the other concerns arising from the misalignment of the effective dates of the two Standards. Furthermore, the overlay approach generates supplementary costs of its own.

EFRAG has nevertheless been made aware that, given the diversity of circumstances among entities which issue insurance contracts within the scope of IFRS 4, the overlay approach is found to be a suitable approach for some banks which carry insurance activities and are hence affected by the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard. Indeed, for such entities, addressing the accounting mismatches without delaying the implementation of IFRS 9 may be the best option, despite the supplementary costs involved. Consequently, EFRAG agrees that both solutions should be pursued and should remain optional.

EFRAG considers that an optional temporary exemption from applying IFRS 9 should be made available to as many entities as possible that are significantly impacted by the interaction between IFRS 9 and IFRS 4. Also, EFRAG considers that applying the temporary exemption from applying IFRS 9 should not run the risk of being extended to banking activities that are material at the reporting entity level. Further, EFRAG considers that having significant amounts of insurance contracts within the scope of IFRS 4 should apply as a requirement regardless of whether the temporary exemption from applying IFRS 9 is based on a widened predominance criterion or a regulated entity criterion. For these reasons, EFRAG has concluded that the temporary exemption from applying

IFRS 9 should be available both at and below the reporting entity level. Our proposals, which are summarised below, are made with these objectives in mind.

Temporary exemption from applying IFRS 9

To meet the above-stated objectives, EFRAG considers that the scope of application of the temporary exemption from applying IFRS 9 should be guided by the identification of "insurers" or "insurance activities" that are generally recognised, as such, in practice and that would be significantly affected by the misalignment of IFRS 9 and the new insurance contracts Standard. EFRAG notes that the IASB has made an attempt at identifying "pure insurers", acknowledging that their proposals would only capture a narrow population of "insurers". EFRAG considers that a playing field within the insurance sector should be maintained as much level as possible, whilst acknowledging that a perfect level playing field will not and cannot be obtained, even with our proposals. Therefore, EFRAG recommends that the IFRS 4 amendments should be finalised by giving entities the possibility of applying one of the following approaches, which we have called:

1- A widened "predominant activity" criterion however set at a higher threshold than proposed by the IASB; and

2- The "regulated entity" criterion.

EFRAG considers that the predominance criterion as developed by the IASB does not appropriately identify insurers because of its narrow focus on insurance contracts within the scope of IFRS 4. EFRAG therefore proposes to widen the predominance criterion. In order to avoid it being applied to banking activities that would be material at the reporting entity level, EFRAG also proposes to increase the predominance criterion to a threshold that is substantially higher than the one proposed by the IASB.

We have detailed and justified our alternative proposals in the Appendix to this letter.

<u>Level at which to apply the temporary exemption from IFRS 9</u>

EFRAG understands the IASB's arguments for applying the temporary exemption from IFRS 9 only at reporting entity level. However, EFRAG recommends that the temporary exemption from applying IFRS 9 should also be available at levels below a mixed group reporting entity regardless of how the application of the basis for applying the temporary exemption from applying IFRS 9, i.e. both when applying the widened predominance test and when using the regulated entity criterion.

EFRAG considers that having a level playing field in the insurance sector wherever it is relevant is important. In the Appendix we recommend how internal transfers should be accounted for in order to best avoid earnings management and why, in our view, the temporary breach in the uniformity of accounting policies is acceptable in the circumstances when the temporary exemption from applying IFRS 9 is applied below a mixed group reporting entity level. Whilst we acknowledge it is not ideal, in our view it is the price to pay in order to allow a playing field as level as possible in the insurance sector, whilst acknowledging that a perfect level playing field will not and cannot be obtained, even with our proposals. It is also to avoid capturing banking activities that are material at the reporting entity level in the temporary exemption from applying IFRS 9.

<u>Reassessment of the use of the temporary exemption from applying IFRS 9</u>

EFRAG considers that regular periodic reassessment of eligibility for the temporary exemption from applying IFRS 9 is impracticable. Applying the temporary exemption from IFRS 9 below reporting entity level, in EFRAG's view, caters for changes in the composition of a reporting entity leading to the predominance test ceasing to be met at reporting entity level.

Sunset clause

EFRAG supports setting an expiry date to the use of the temporary exemption from applying IFRS 9 and supports that expiry date being set at 1 January 2021 because EFRAG considers that the new insurance contracts Standard has to be finalised as soon as possible and, in any event, no later than this date. The very significant improvements in financial reporting that are expected from the new insurance contracts Standard should not be delayed. Furthermore, given the limitations of the overlay approach, EFRAG disagrees that the overlay approach is identified as a backstop in case of a possible delay in the finalisation of the new insurance contracts Standard.

If you would like to discuss our comments further, please do not hesitate to contact Didier Andries, Sapna Heeralall, Joseba Estomba or me.

Yours sincerely,

Roger Marshall
Acting President of EFRAG Board

APPENDIX – EFRAG's responses to the questions raised in the ED

Question 1 – Addressing the concerns raised

Paragraphs BC9–BC21 describe the following concerns raised by some interested parties about the different effective dates of IFRS 9 and the new insurance contracts Standard:

(a) Users of financial statements may find it difficult to understand the additional accounting mismatches and temporary volatility that could arise in profit or loss if IFRS 9 is applied before the new insurance contracts Standard (paragraphs BC10–BC16).

(b) Some entities that issue contracts within the scope of IFRS 4 have expressed concerns about having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated (paragraphs BC17–BC18).

(c) Two sets of major accounting changes in a short period of time could result in significant costs and effort for both preparers and users of financial statements (BC19–BC21).

The proposals made by the IASB are designed to address these concerns.

Do you agree that the IASB should seek to address these concerns? Why or why not?

EFRAG's response

EFRAG is appreciative that the IASB has considered the difficulties caused by the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard. In its endorsement advice on IFRS 9, EFRAG noted that the misalignment of the effective dates of the two Standards would potentially cause additional accounting mismatches in profit or loss, be difficult for users to understand and lead to additional costs of implementation. EFRAG continues to have these concerns. Also, based on its outreach with individual analysts of insurance companies, EFRAG notes that a majority of them supported the application of the new insurance contracts Standard and IFRS 9 at the same time.

Question 1 (a)

1 During its outreach with individual users of the financial statements of insurance entities and in its participation in the outreach led by the IASB, EFRAG heard that a majority preferred that both IFRS 9 and the new insurance contracts Standard should be implemented by the insurance industry at the same time.

2 EFRAG agrees that the IASB should address the concerns identified in paragraphs BC9 – BC21 of the ED, due to the following reasons:

(a) Avoidance of temporary accounting mismatches causing volatility in profit or loss without economic substance;

(b) The difficulties of explaining this volatility to investors; and

(c) Avoiding the need for analysts' forecasting models to be changed more than once.

3 EFRAG notes that some analysts made their support for a temporary exemption from applying IFRS 9 conditional upon an interim period during which this temporary

exemption from applying IFRS 9 being applied would not be too long (approximately 3 or 4 years). EFRAG is of the view that the risk of continuous application of the temporary exemption from applying IFRS 9 is adequately addressed through the introduction of a sunset clause as discussed in our answer to Question 6 below.

Questions 1 (b) and 1 (c)

4 EFRAG's endorsement advice on IFRS 9 reflects its analysis of the effects of the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard. It is available on the EFRAG website at http://www.efrag.org/files/IFRS%209%20endorsement/IFRS_9_Final_endorsement_advice.pdf.

5 EFRAG is therefore appreciative that the IASB has acknowledged the difficulties arising from the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard and is proposing two options that are designed to address the concerns.

Question 2 – Proposing both an overlay approach and a temporary exemption from applying IFRS 9

The IASB proposes to address the concerns described in paragraphs BC9–BC21 by amending IFRS 4:

(a) to permit entities that issue contracts within the scope of IFRS 4 to reclassify from profit or loss to other comprehensive income, some of the income or expenses arising from designated financial assets that:

(i) are measured at fair value through profit or loss in their entirety applying IFRS 9 but

(ii) would not have been so measured applying IAS 39 (the 'overlay approach') (see paragraphs BC24–BC25);

(b) to provide an optional temporary exemption from applying IFRS 9 for entities whose predominant activity is issuing contracts within the scope of IFRS 4 (the 'temporary exemption from applying IFRS 9') (see paragraphs BC26–BC31).

Do you agree that there should be both an overlay approach and a temporary exemption from applying IFRS 9? Why or why not?

If you consider that only one of the proposed amendments is required, please explain which and why.

EFRAG's response

EFRAG supports both the overlay approach and the temporary exemption from applying IFRS 9 as complementary approaches in addressing the misalignment between the effective dates of IFRS 9 and the new insurance contracts Standard. This is because we are aware that both approaches would apply to different entities, depending on their circumstances.

Questions 2 (a) and 2 (b)

6 EFRAG assesses that the temporary exemption from applying IFRS 9 resolves all the issues related to the misalignment between the effective dates of IFRS 9 and the new insurance contracts Standard as described in EFRAG's endorsement advice on IFRS 9. This is because the relevant entities would still be able to apply IAS 39 and IFRS 4 and as a result there would not be additional accounting mismatches in profit or loss, users would not suffer from an unnecessary breach of

consistency in financial reporting and any additional cost due to a successive implementation of the two Standards would be avoided.

7 In contrast, the overlay approach only provides a solution for the accounting mismatches. The overlay approach does not address the successive implementation (and the related costs) of two accounting Standards which for the insurance business are closely related to each other. Furthermore, it generates supplementary costs of its own, due to the necessary dual bookkeeping for the eligible assets under IAS 39 and IFRS 9 that is required at financial asset level and the related supplementary internal controls.

8 EFRAG has nevertheless been made aware that, given the diversity of circumstances among reporting entities which issue insurance contracts within the scope of IFRS 4, the overlay approach is a suitable approach for some banks which carry out insurance activities, despite the supplementary costs that it triggers. More particularly, the overlay approach would be considered appropriate by entities where bank and insurance activities are supported by a single information system; are to be applied to an easily circumscribed category of financial assets such that all necessary information is already processed in and available from existing systems; sub-consolidations for regulatory purposes are derived from the integrated information system and financial analysts consider the group as a whole as belonging to the banking sector. Consequently, based on the above, EFRAG agrees that both solutions should be pursued and should remain optional.

Question 3 – The overlay approach

Paragraphs 35A–35F and BC32–BC53 describe the proposed overlay approach.

(a) Paragraphs 35B and BC35–BC40 describe the assets to which the overlay approach can be applied. Do you agree that the assets described (and only those assets) should be eligible for the overlay approach? Why or why not? If not, what do you propose instead and why?

(b) Paragraphs 35C and BC48–BC50 discuss presentation of amounts reclassified from profit or loss to other comprehensive income in applying the overlay approach. Do you agree with the proposed approach to presentation? Why or why not? If not, what do you propose instead and why?

(c) Do you have any further comments on the overlay approach?

EFRAG's response

EFRAG considers that the ED has correctly identified the financial assets that should be eligible for the overlay approach. We do however consider that:

(a) The eligibility criteria for the overlay approach should be enhanced including detailed examples that would assist entities in interpreting the criteria; and

(b) Flexibility in presentation should be reduced and presentation requirements should be clearer.

EFRAG also has concerns about the practical applicability of the overlay approach due to the expected supplementary costs that its implementation could imply for institutions.

Question 3 (a)

9 As indicated in paragraph BC32 of the Basis for Conclusions of the ED, the overlay approach has been developed to address the concern raised by the additional accounting mismatches that would arise in profit or loss as a result of applying IFRS 9 before the new insurance contracts Standard.

10 The ED proposes that a financial asset qualifies for the overlay approach if and only if the following criteria are met:

(a) It is designated as relating to contracts that are within the scope of IFRS 4; and

(b) It is measured at fair value through profit or loss applying IFRS 9 but would not have been measured at fair value through profit or loss, in its entirety, applying IAS 39.

11 EFRAG agrees with the eligibility criteria established by the IASB in paragraph 35B of the ED for the overlay approach because it addresses the concern about the additional accounting mismatches in profit or loss that would, potentially, arise from the implementation of IFRS 9 in advance of the new insurance contracts Standard.

12 EFRAG also agrees with the proposal to limit the eligibility criteria of the overlay approach to those financial assets relating to contracts that are within the scope of IFRS 4 because these are the only financial assets likely to create additional accounting mismatches in profit or loss as a result of the application of IFRS 9 and IFRS 4. Those financial assets that are not within the scope of the overlay approach must be classified and measured under IFRS 9 and consequently any accounting mismatch in profit or loss would have been resolved on transition to IFRS 9.

13 EFRAG is concerned about the clarity of the wording "*as relating to contracts that are within the scope of IFRS 4*". EFRAG understands the reasons, stated in paragraph BC36 of the Basis for Conclusions of the ED, for not restricting the application of the overlay approach to financial assets that are contractually linked to contracts within the scope of IFRS 4. However, the actual wording in the ED could be interpreted as meaning a strict test of relationship of a financial asset to an insurance contract within the scope of IFRS 4 or, alternatively, as relating to all financial assets other than those that are related to liabilities outside the scope of IFRS 4 as, for example, those surplus assets that an insurance entity holds in the normal course of carrying out insurance activities, either to meet regulatory requirements or their internal capital requirements. The two interpretations lead to significantly different outcomes.

14 In addition, entities applying the overlay approach determine which financial assets relate to contracts within the scope of IFRS 4. In some cases, it could be easy to identify financial assets relating to particular contracts within the scope of IFRS 4, e.g. where those contracts reference specific financial assets, or where the entity allocates financial assets to particular portfolios of contracts that are within the scope of IFRS 4. However, there may also be situations in which the relationship between financial assets and contracts within the scope of IFRS 4 is unclear.

15 Therefore, EFRAG recommends the inclusion of detailed examples that could allow entities to have a better understanding of the applicability of the overlay approach.

Question 3 (b)

16 As indicated in paragraph 35C of the ED, EFRAG notes that the overlay approach requires the presentation of the amount reclassified from profit or loss to OCI as a separate line item in the statement of profit or loss, OCI or both net of related tax effects. The effect on line items in profit or loss of the amount reclassified from profit or loss to OCI is disclosed either on the face of the statement of profit or loss or in the notes to the financial statements.

17 Based on the previous paragraph, EFRAG understands that an entity that elects to apply the overlay approach will have a number of presentation alternatives including:

(a) Alternative A where the revenues and expenses related to the eligible financial assets would first be determined in accordance with the measurement criteria of IFRS 9 before an adjustment is made, both in profit or loss and in OCI, to add or eliminate the difference between the fair value of the eligible financial assets under IFRS 9 and the amortised cost of the same eligible financial assets in accordance with IAS 39 (the 'overlay adjustment'); and

(b) Alternative B where the revenues and expenses related to the eligible financial assets would first be determined in accordance with the measurement criteria of IAS 39 before the overlay adjustment is made, in profit or loss or in OCI (subject to further clarification as requested below), to align the measurement of the eligible financial assets with its values under IFRS 9.

18 Further, EFRAG notes that there appears to be a contradiction between paragraph 35A and 35C of the ED. Paragraph 35C states that the overlay adjustment should be presented in profit or loss, other comprehensive income *or both* while paragraph 35A states that there should be a reclassification of the overlay adjustment from profit or loss to other comprehensive income. Therefore, EFRAG considers that clarification of these paragraphs is needed.

19 EFRAG is concerned about the flexibility provided by the possible ways of presenting the overlay adjustment. In general terms, EFRAG does not support unrestricted options in presentation because they create a lack of comparability. Even in a context where different optional approaches already exist, EFRAG considers that additional limitations to comparability are best avoided. EFRAG is therefore concerned that entities would have different options to present the overlay adjustment in the statement of comprehensive income. This leads EFRAG to identify its preferred option as follows.

20 EFRAG considers that Alternative A has the advantage of aligning the recognition basis of the eligible financial assets in profit or loss with the statement of financial position, i.e. based on IFRS 9. In addition, the overlay adjustment could be understood more easily by users of financial statements as no translation from IAS 39 to IFRS 9 is required in individual line items because profit or loss before the overlay adjustment is based on IFRS 9. However, Alternative A would have the following disadvantages:

(a) Not achieving comparability of financial statements within the insurance sector with those entities applying the temporary exemption from IFRS 9; and

(b) Misalignment between the accounting (external reporting) and the way these assets currently are being reported internally, i.e. based on IAS 39.

21 Alternative B would have the advantage that the financial assets within the scope of the overlay are being presented in profit or loss in the same way that these assets are currently being reported internally, i.e. based on IAS 39. This approach may also reduce the breach in consistency arising from successive changes that reduces complexity for users of financial statements. In addition, it would ensure comparability within the insurance industry with insurers applying the temporary exemption from IFRS 9. Alternative B would have the following disadvantages:

(a) Including revenues and expenses based on IFRS 9 where the overlay approach is not applied (either voluntarily or mandatorily) and revenues and expenses based on IAS 39 where the overlay approach is applied;

(b) Requiring an extra disclosure explaining the overlay adjustment to users of financial statements; and

(c) Misalignment between the recognition bases of the eligible financial assets in in the statement of comprehensive income with the statement of financial position, i.e. based on IFRS 9.

22 EFRAG has identified that entities may be attracted to the overlay approach because they have identified that not delaying the implementation of IFRS 9 is the best option for them. A presentation that is as consistent as feasible with IFRS 9 is preferable. Consequently, EFRAG prefers Alternative A because it does not bring additional complexity and also because the overlay approach requires the application of IFRS 9 in full.

23 Furthermore, additional disclosures would be required in order to comply with the requirements in IAS 1 *Presentation of Financial Statements*. EFRAG notes that the wording of the ED: *"…as a separate line item…"* is not aligned with the IAS 1 paragraphs 92 to 96 that indicate that: *"An entity shall disclose reclassification adjustments [to profit or loss] relating to components of OCI."* This encompasses the following:

(a) Allocation of tax between items that might be reclassified to profit or loss and those that will not be reclassified to profit or loss; and

(b) Specification of reclassification adjustments (for example on disposal of a foreign operation or in case of cash flow hedges of forecasted cash flows).

Question 3 (c)

24 EFRAG agrees with paragraph BC53 of the Basis for Conclusions of the ED which states that applying the overlay approach would be more costly than applying only IFRS 9. For some banking conglomerates, the costs of the overlay approach could be relatively minor compared to the costs of implementing IFRS 9 and the costs are outweighed by the improved information for users. However, EFRAG understands that for many insurers these costs could be greater than acknowledged by the IASB in paragraph BC53, e.g., keeping track of impairment performed under both IAS 39 for some financial assets and IFRS 9 for other financial assets.

25 The overlay approach does not avoid the supplementary cost of implementing IFRS 9 and then reviewing the implementation. Furthermore, in applying the overlay approach, both IFRS 9 and IAS 39 would need to be run in parallel for the assets to which the overlay approach is applied. EFRAG understands that entities may need to develop new data-processing systems, (to support two systems) and set up new internal controls and performance assessment processes. This could imply costs on top of the costs incurred in implementing IFRS 9 in full just for a short period of time. These extra costs can be grouped as follows:

(a) *Reassessment of the use of the fair value option and of the business models on transition to the new insurance contracts Standard*: Entities that issue contracts that are within the scope of IFRS 4 will need to consider the possibility of accounting mismatches between IFRS 9 and their current accounting for insurance contracts when implementing the overlay approach and this is the supplementary cost for preparers. They will then need to reassess the application of IFRS 9 when the new insurance contracts Standard becomes effective in order to reflect their asset-liability management appropriately. The new insurance contracts Standard cannot be fully analysed in advance, and when combined with IFRS 9 will require an entity to reassess the classifications of the assets and the underlying investment strategy.

(b) *Implication of running two accounting systems in parallel for the eligible financial assets:* The overlay adjustment would imply maintaining IAS 39 information to determine the overlay adjustment for those very specific assets within the scope of the overlay approach as described above.

(c) *Other costs*: The overlay adjustment will imply maintaining IAS 39 internal processes and systems for audit and internal control purposes.

26 EFRAG understands that the concerns raised above could discourage some from applying the overlay approach. However, EFRAG has also been made aware that others wish to apply the overlay approach to specific categories of financial assets such as equity investments presently classified as available for sale which would not create material costs above the costs of implementing IFRS 9.

Question 4 – The temporary exemption from applying IFRS 9

As described in paragraphs 20A and BC58–BC60 the ED proposes that only entities whose predominant activity is issuing contracts within the scope of IFRS 4 can qualify for the temporary exemption from applying IFRS 9.

(a) Do you agree that eligibility for the temporary exemption from applying IFRS 9 should be based on whether the entity's predominant activity is issuing contracts within the scope of IFRS 4? Why or why not? If not, what do you propose instead and why?

As described in paragraphs 20C and BC62–BC66, the ED proposes that an entity would determine whether its predominant activity is issuing contracts within the scope of IFRS 4 by comparing the carrying amount of its liabilities arising from contracts within the scope of IFRS 4 with the total carrying amount of its liabilities (including liabilities arising from contracts within the scope of IFRS 4).

(b) Do you agree that an entity should assess its predominant activity in this way? Why or why not? If you believe predominance should be assessed differently, please describe the approach you would propose and why.

Paragraphs BC55–BC57 explain the IASB's proposal that an entity would assess the predominant activity of the reporting entity as a whole (i.e. assessment at the reporting entity level).

(c) Do you agree with the proposal that an entity would assess its predominant activity at the reporting entity level? Why or why not? If not, what do you propose instead and why?

EFRAG's response

As the temporary exemption from applying IFRS 9 helps mitigate all negative effects of the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard, EFRAG considers that it should be available to as many insurance entities that are significantly affected by the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard, so as to have as level a playing field in the insurance sector as possible, whilst acknowledging that a perfect level playing field will not and cannot be obtained, even with our proposals. EFRAG therefore considers that the temporary exemption from applying IFRS 9 should only be available to entities that have significant amounts of insurance contracts within the scope of IFRS 4.

EFRAG further considers that the temporary exemption from applying IFRS 9 should not capture material banking activities that are material at the reporting entity level. In this area, EFRAG is more demanding than the IASB. EFRAG therefore disagrees with the IASB's decision to "only capture a relatively narrow population of entities" (paragraph BC60) or to limit the temporary exemption from applying IFRS 9 "at reporting entity level" (paragraph BC57).

To achieve these objectives, EFRAG considers that the scope of the temporary exemption from applying IFRS 9 should be guided by the identification of "insurers", focusing on how they can be identified in practice and whether they are significantly impacted by the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard. This leads EFRAG to consider approaches that are both broader and more restrictive than proposed by the IASB (as an attempt at enabling those entities that are significantly affected by the interaction of IFRS 9 and IFRS 4 to qualify for the temporary exemption and excluding banking activities that are material at the reporting entity level) and could be applied both at a reporting entity level and below a mixed group reporting entity level. EFRAG therefore considers that the IFRS 4 amendments should include both of the following approaches whereby an entity can select either:

(i) A widened "predominant activity" criterion however set at a higher threshold than proposed by the IASB; or

(ii) The "regulated entity" criterion.

General comments

27 In EFRAG's view, the objective of the IFRS 4 amendments are to address the concerns identified by EFRAG in its endorsement advice to the European Commission on IFRS 9 and mentioned in response to Question 1 above. That is, the objective is to avoid the additional accounting mismatches that the implementation of IFRS 9 would trigger, avoid successive breaches in consistency of financial reporting that create complexity for users and avoid the supplementary costs due to an implementation of IFRS 9 in stages, on the basis of both the current and the new insurance contracts Standards.

28 EFRAG observes that the temporary exemption from applying IFRS 9 is the only approach that eliminates all these difficulties. Consequently, and in order to have as level a playing field in the insurance sector as possible, EFRAG considers that this temporary exemption from applying IFRS 9 should be available to those entities that are significantly affected by the misalignment of the effectives dates of the new insurance contracts Standard and IFRS 9. In our endorsement advice on IFRS 9, EFRAG had identified that those entities implementing IFRS 9, in advance of the new insurance contracts Standard, would lead to an unfavourable cost-benefit

trade-off, for example, users being impacted by successive changes and preparers incurring costs which could be avoided in the preparation of financial statements. In those circumstances ensuring as level a playing field as possible means that, most if not all significantly affected entities have the possibility of applying the temporary exemption as that is the only option, as highlighted above, that eliminates the negative effects of the misalignment of effective dates of IFRS 9 and the new insurance contracts Standard.

29 As a result, EFRAG does not support the IASB's proposals which would deliberately "only capture a relatively narrow population of entities" (paragraph BC60). However, in EFRAG's view, all banking activities that are material at the reporting entity level should be subject to IFRS 9, as IFRS 9 brings significant improvements in financial reporting, in particular in the banking sector. Consequently, EFRAG does not support a delay in the implementation of IFRS 9 for these banking activities that are material at the reporting entity level. We note that whilst the IASB has paid attention to this constraint, it has not made proposals that totally avoid banking activities that are material at the reporting entity level being captured within the scope of the temporary exemption from applying IFRS 9.

30 EFRAG firmly considers that any approach that will succeed in meeting the objective of (1) making the temporary exemption from applying IFRS 9 available to those entities that are significantly impacted by the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard; (2) avoiding applying the temporary exemption from IFRS 9 to banking activities that are material at the reporting entity level, is one that will focus on identifying entities that would qualify as "insurers" in practice and be significantly impacted by the interaction between IFRS 9 and IFRS 4. Identifying entities that qualify as "insurers" in practice requires a broader perspective than focussing on contracts within the scope of IFRS 4 alone and being limited to an assessment only at reporting entity level.

31 As IFRS generally are based on transactions rather than industries, we can find no IFRS definition that would assist in scoping the temporary exemption from applying IFRS 9. Similarly to the IASB, however in a manner consistent with the objectives that EFRAG has identified, EFRAG proposes two approaches, as is explained below, that characterise "insurers" that are affected by the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard in a manner as close as possible to how they can or are identified in practice. As circumstances vary greatly in practice, one or the other criterion may in different circumstances constitute the most straightforward manner to identify the scope of the temporary exemption, in particular when the assessment is carried at below reporting entity level.

32 The following two approaches are proposed by EFRAG:

(a) Approach 1: a widened "predominant activity" criterion however set at a higher threshold than proposed by the IASB; and

(b) Approach 2: the "regulated entity" criterion.

33 We consider that, given the diversity in the insurance sector, both of the above approaches should be included in the final amendments, with an entity selecting one or the other as the basis for determining eligibility for the temporary exemption from applying IFRS 9 and explaining why it has selected that option. Indeed, EFRAG is of the view that both approaches would effectively capture those relevant entities that are significantly impacted by the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard and therefore should be eligible for the temporary exemption from applying IFRS 9.

34 Based on these two approaches, EFRAG's answers to Questions 4(a), 4(b) and 4(c) are as follows.

Question 4 (a) - Temporary exemption from applying IFRS 9 based on an entity's predominant activity of issuing contracts within the scope of IFRS 4

35 In EFRAG's view, entities which do not issue insurance contracts within the scope of IFRS 4 do not encounter any additional implementation difficulty that would justify a temporary exemption from applying IFRS 9. Therefore, EFRAG agrees with the IASB that having a significant amount of insurance contracts within the scope of IFRS 4 is a necessary condition for the application of the temporary exemption from applying IFRS 9 for both the widened "predominant activity" criterion and the "regulated entity" criterion.

36 Please note that the comments we provide in response to the next question on the temporary exemption from applying IFRS 9 are to be read as applying only to entities that have a significant amount of insurance contracts within the scope of IFRS 4.

Question 4 (b) – How to apply the temporary exemption from applying IFRS 9

37 As explained above, a successful approach in scoping the temporary exemption from applying IFRS 9 is one that will capture those entities that are significantly impacted by the interaction between IFRS 9 and IFRS 4. Therefore, EFRAG proposes the following two approaches.

<u>Approach 1: a widened "predominant activity" criterion</u>

38 EFRAG considers that the "predominance criterion" based on a ratio of total liabilities may be a way of identifying "insurers", however the definition of the ratio would need to be revisited so as to encompass all liabilities that an entity that is identified in practice as an "insurer" would bear, in addition to liabilities arising from insurance contracts in the scope of IFRS 4. Doing so would allow the setting of a threshold at a higher level than proposed by the IASB, and help meet the objective of excluding any banking activities that are material at the reporting entity level.

39 EFRAG observes that the activities of insurers are not limited to issuing insurance contracts within the scope of IFRS 4. Insurers also routinely provide asset management services. EFRAG has considered that for those asset management activities which are accounted for at fair value through profit or loss, the change from IAS 39 to IFRS 9 would bring no change. In addition, insurers bear a variety of liabilities that are related to these two core activities, such as, provision for premium rebates (amounts to be paid back to the policyholder), hedging instruments (which, when accounted for at fair value through profit or loss, would bring no change when transitioning from IAS 39 to IFRS 9), debt to finance insurance activities, written put options over non-controlling interest and operating liabilities such as deferred tax and employee benefit liabilities (all these not being impacted by the change in accounting standard either).

40 As a result, EFRAG recommends changing the proposals in the ED as follows:

(a) The numerator would be the same as in the ED, i.e., liabilities arising from insurance contracts within the scope of IFRS 4 (whether bundled or unbundled); and

(b) Instead of keeping 100% of the entity's liabilities as the denominator, EFRAG recommends subtracting from the total liabilities, (i) those asset management activities liabilities and hedging instruments liabilities which are accounted for at fair value through profit or loss under both IAS 39 and IFRS 9 because these would not be affected by the change in accounting standards and (ii) those liabilities listed in paragraph 39 above insofar as they are related to the management of insurance and investment contracts. This limitation to insurance and investment contracts is designed to avoid eliminating, from the total liabilities, liabilities that could relate to banking activities that are material at the reporting entity level.

41 EFRAG considers that, when comparing the widened predominant activity criterion to the proposal in the ED, this widened criterion better reflects the set of activities that are relevant to insurers because they are insurance and asset management-related, rather than the proposal in the ED that bases the predominance criteria on a relevant, but restrictive, subset of insurance activities.

42 When the predominant activities of an insurer are widened as described above, EFRAG would expect that the predominance ratio should be increased to a threshold that is substantially higher than the one identified by the IASB in its Basis for Conclusions. This should avoid the temporary exemption from applying IFRS 9 being applied to banking activities that are material at the reporting entity level.

Approach 2: the "regulated entity" criterion

43 In defining insurers, EFRAG proposes to rely on the following definitions:

(a) An 'insurance undertaking' is defined as 'a direct life or non-life insurance undertaking which has received authorisation from the supervisory authorities' and is supervised by them; and

(b) A 'reinsurance undertaking' is defined as 'an undertaking which has received authorisation from the supervisory authorities to pursue reinsurance activities' and is supervised by them.

44 The basis of the regulated entity criterion is that an insurance undertaking or a reinsurance undertaking that is supervised by an insurance regulator and that have significant amounts of insurance contracts within the scope of IFRS 4 should be eligible to apply the temporary exemption from IFRS 9. This latter condition eliminates the criticism that EFRAG has heard against the regulated entity criterion, i.e. it would help qualify entities that are not affected significantly by the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard. EFRAG notes that in all material jurisdictions, insurance activities fall within the remit of relevant supervisory authorities[1].

45 Relying solely on the regulated entity criterion would not adequately capture all possible corporate structures of insurers. Relevant components to be captured include, for example, the holding company of an insurance entity, the existence of insurance sub-groups and situations when assets backing the insurance activities are held in separate special purpose vehicles which themselves are not regulated. As the corporate structure in itself does not change the nature of the insurance activities, EFRAG proposes that the regulatory entity criterion should capture all of the above situations building on the concept of reporting entity.

46 Under this approach, credit institutions and financial institutions within a reporting entity, which are material at the reporting entity level, in particular, would not benefit from the temporary exemption from applying IFRS 9. EFRAG considers that this

[1] This observation has been based on the membership and core principles of the International Association of Insurance Supervisors (IAIS): http://iaisweb.org/index.cfm?event=getPage&nodeId=25189.

creates a playing field as level as possible (albeit not perfect) for the activities undertaken by these entities.

47 In forming this proposal, EFRAG has considered the following definitions[2] of a credit institution and a financial institution.

(a) A credit institution means an undertaking the business of which is to take deposits or other repayable funds from the public and to grant credits for its own account.

(b) A financial institution means an undertaking other than a credit institution, the principal activity of which is to acquire holdings or to carry one or more activities such as lending, financial leasing, payment services and trading for own account or for account of customers (e.g. in transferable securities). The definition of financial institutions includes financial holding companies, mixed financial holding companies, payment institutions and asset management companies, but excludes insurance holding companies and mixed-activity insurance holding companies.

<u>Other comments</u>

48 The ED proposes that initial application of the temporary exemption from applying IFRS 9 should be the beginning of the first annual reporting period beginning on or after 1 January 2018.

49 With respect to reassessment, the ED proposes that after initial application of the temporary exemption from applying IFRS 9, an entity should be required to reassess whether insurance activities are predominant if there is a demonstrable change to the entity's corporate structure. If after the reassessment, the entity has insurance activities which are no longer predominant, the ED proposes that the entity should apply IFRS 9 in the next reporting period. Subsequently, such an entity would be permitted but not required to apply the overlay approach to its eligible financial assets.

50 EFRAG is concerned about the reassessment proposal in the ED for the following reasons:

(a) Implementing IFRS 9 cannot be done without planning and requires more than one year for implementation;

(b) In the event it could be done in practice, a rushed implementation of IFRS 9 after reassessing and failing the predominance test would affect the quality of the resulting accounting data;

(c) The temporary exemption from applying IFRS 9 is a short term practical expedient, and assessing eligibility for it should remain practical; and

(d) EFRAG understands the concern that a group that is initially predominantly an insurer could acquire significant banking activities. However, EFRAG notes that banking and insurance activities are more likely to be separated into different reporting entities than to be merged. In such cases, EFRAG does not agree that the banking activities that are material at the reporting entity level would apply IAS 39 because of the non-alignment with EFRAG's objectives as stated in paragraph 30 above. Consequently, EFRAG notes that any

[2] EFRAG considers the definitions proposed as operable as they have been derived from European regulatory sources. However, as the derived definitions do not contain any specific European characteristics, EFRAG considers that these could be used in a global setting.

merger would be best addressed by applying the temporary exemption from IFRS 9 below the reporting entity level.

51 EFRAG does not express a preference at which date the assessment of eligibility for the temporary exemption from applying IFRS 9 is done. It may be in 2018 or earlier to enable an insurer to determine eligibility before 2018 because EFRAG is of the view that the temporary exemption from applying IFRS 9 is short-term and therefore it should remain practical to apply.

52 Therefore, for the reasons and in the conditions described above, EFRAG does not support reassessing the eligibility for the temporary exemption from applying IFRS 9, even when there is a demonstrable change to the entity's corporate structure.

Question 4 (c) - Whether to assess predominance at the reporting entity level

53 Both approaches considered by EFRAG (i.e. the widened "predominant activity" criterion and the "regulated entity" criterion) result in application either at or below reporting entity level for the reasons explained in the paragraphs above. The discussion below relates to both criteria.

54 In EFRAG's view, in the case of mixed groups, when neither the widened predominance criterion nor the regulated entity criterion are met at the mixed group reporting entity level, the test should be performed below the mixed group reporting entity level. This is done by analysing entities within the mixed group reporting entity starting from the top and moving down to the point when the criterion that has been selected is met by an entity that meets the reporting entity definition in accordance with the *Conceptual Framework for Financial Reporting* ED, in a waterfall approach. As a consequence, the objective of applying IFRS 9 to all banking activities that are material at the reporting entity level and exempting entities that have significant amounts of insurance contracts within the scope of IFRS 4 would be met: the temporary exemption from applying IFRS 9 would only apply in a way that meets the objectives set by EFRAG.

55 In applying the regulated entity criterion, a reporting entity would need to ensure that it has significant amounts of insurance contracts within the scope of IFRS 4, it does not have banking activities that are material for any reporting entity within the consolidated group and is regulated in order to apply the temporary exemption from IFRS 9. If these three criteria are not met, the reporting entity would go below the reporting entity level until all three elements are met, taking into consideration an entity's corporate structure which does in itself not change the nature of the insurance activities as stated in paragraph 45 above.

56 EFRAG considers that, as a minimum, the temporary exemption should be available below the mixed group reporting entity level to an entity that meets the reporting entity definition in accordance with the *Conceptual Framework for Financial Reporting* ED. That is, where such an entity has subsidiaries, associates or joint arrangements, the temporary exemption from applying IFRS 9 should be available to them as part of that "entity" which chooses or is required to prepare financial statements. Sub-groups that are reporting entities themselves should be able to apply the temporary exemption from IFRS 9 in (a) their individual financial statements, if any, (b) their sub-group consolidated financial statements, if any and (c) their input into the consolidated financial statements of a parent company that controls them or an investor that has significant influence or joint control over them. However as evidenced by the letter EFRAG has received from a pan-European user organisation financial analysts support allowing applying the temporary exemption below reporting entity level also when an insurance sub-group of a reporting entity is not publishing distinct financial statements.

57 One effect of permitting the temporary exemption from IFRS 9 to be applied at below reporting entity level is that it might be possible for a reporting entity to apply the overlay approach within one component of the entity and the temporary exemption from applying IFRS 9 elsewhere within the same reporting entity. EFRAG considers that such dual application should not be permitted as it would lead to extreme complexity for users in understanding the financial statements.

58 In developing its views, EFRAG has considered the arguments of the IASB which led to the rejection of the application of the temporary exemption from IFRS 9 below the reporting entity level. These arguments are that applying the temporary exemption from IFRS 9 only at reporting entity level:

(a) Avoids a breach in uniformity of accounting policies; and

(b) Avoids the need to account for transfers and avoids potential earnings management.

Avoiding a breach in uniformity of accounting policies

59 EFRAG agrees with the IASB that a breach in uniformity of accounting policies is best avoided. However, the temporary exemption from applying IFRS 9 is a response to exceptional circumstances that call for pragmatic solutions that can be supported as short-term interim measures.

60 In the present circumstances, EFRAG notes that both IFRS 9 and IAS 39 make use of the same measurement bases: amortised cost[3] and fair value, with fair value changes being presented in profit or loss or other comprehensive income. IFRS 9 has the merit of bringing an improved discipline in how the different measurement bases apply, notably with the reference to the business model. A below reporting entity level temporary exemption from applying IFRS 9 can result in users being presented, in consolidated financial statements, with financial assets accounted for in accordance with IAS 39 and which participate in the asset management activity of the insurance activities of the group, while all others are reported in accordance with IFRS 9. It is not ideal, however proper presentation and disclosure to enable users to understand the financial position and performance can help meet the objective assigned to the interim solution.

Transfers

61 EFRAG agrees with the statement in paragraph BC 57(b) of the ED that application of the temporary exemption from IFRS 9 below the reporting entity level has raised concerns of earnings management. For this reason, EFRAG has paid special attention to the accounting for transfers of financial assets between an IAS 39 environment and an IFRS 9 environment and vice versa within a reporting entity and has considered the following alternatives.

(a) Retaining the original gross carrying amount;

(b) Transfers at fair value;

(c) Application of a tainting rule; and

(d) An asymmetrical tainting rule.

62 The above alternatives were rejected on the basis of the creation of an impact on profit or loss by internal transactions, complexity or cost.

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[3] EFRAG notes that amortised cost measurement under IAS 39 is not identical to that under IFRS 9 because the applicable impairment models differ.

63 EFRAG considers that when transfers of financial assets occur, the transferred assets should follow the origination accounting in order to avoid earnings management. For example, when a transfer is from IFRS 9 to IAS 39, the original accounting (IFRS 9) would follow the financial instrument being transferred. While complex, EFRAG assesses that the benefit of avoiding any potential earnings management outweighs the concerns about complexity.

64 This would avoid an entity having any gains or losses arising from an internal transfer. The entity would also not need to change its accounting for the financial assets involved when such a transfer takes place. This approach would, however, create complexity in that identical assets used for identical purposes could be measured in different ways.

65 EFRAG additionally proposes that transferred financial assets should be presented separately in the statements of financial position and comprehensive income, and separate disclosures should provide a reconciliation between the two accounting environments. These measures should discourage earnings management.

Question 5 – Should the overlay approach and the temporary exemption from applying IFRS 9 be optional?

As explained in paragraphs BC78–BC81, the ED proposes that both the overlay approach and the temporary exemption from applying IFRS 9 should be optional for entities that qualify. Consistently with this approach, paragraphs BC45 and BC76 explain that an entity would be permitted to stop applying those approaches before the new insurance contracts Standard is applied.

(a) Do you agree with the proposal that the overlay approach and the temporary exemption from applying IFRS 9 should be optional? Why or why not?

(b) Do you agree with the proposal to allow entities to stop applying the overlay approach or the temporary exemption from applying IFRS 9 from the beginning of any annual reporting period before the new insurance contracts Standards is applied? Why or why not?

EFRAG's response

EFRAG agrees that both the overlay approach and the temporary exemption from applying IFRS 9 should be optional due to the diversity of circumstances encountered in reporting entities that issue insurance contracts. EFRAG also agrees to permit entities to stop applying the overlay approach or the temporary exemption from applying IFRS 9 before the effective date of the new insurance contracts Standard because no entity should be prevented from benefiting from the improvements brought by IFRS 9 when its circumstances permit them to do so.

Question 5 (a)

66 Due to the diversity of insurance contracts across the insurance industry, some entities issuing insurance contracts may find it more beneficial to apply IFRS 9, whereas others may consider that applying either the overlay approach or the temporary exemption from applying IFRS 9 provides more relevant information in their circumstances.

67 EFRAG acknowledges that there would be a lack of comparability between financial statements of entities that issue insurance contracts as a result of permitting several options rather than requiring one or the other. There would also be a lack of comparability with entities that do not carry insurance contracts within the scope of

IFRS 4. Furthermore, in the context of a temporary remedy and given the difficulties created by the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard and the diversity of circumstances that various reporting entities may encounter, EFRAG considers that the proposed approaches are best offered on an optional basis.

68 Therefore, EFRAG agrees with the proposals that the temporary exemption from applying IFRS 9 and overlay approach should be permitted rather than required. However, EFRAG recommends that the disclosure requirements for the overlay approach are enhanced by requiring disclosures relating to the fact that an entity has ceased to apply the overlay approach and the reasoning for ceasing the approach. This is because, EFRAG considers that these disclosures would facilitate the understanding by users of the entity's financial statements.

Question 5 (b)

69 EFRAG agrees that entities should be permitted to stop applying the overlay approach or the temporary exemption from applying IFRS 9 before the effective date of the new insurance contracts Standard from the beginning of any annual reporting period before the new insurance contracts Standards is applied. EFRAG considers that all entities should be permitted to provide the improvements brought by IFRS 9 when its circumstances permit them to do so. Earlier application of IFRS 9 is appropriate if a reporting entity's circumstances change.

70 In relation to the overlay approach:

(a) When an entity ceases to apply the overlay approach, it ceases it on a reporting entity level and any accumulated OCI is transferred into retained earnings as if the overlay approach had never been applied.

(b) When an entity voluntarily designates or mandatorily de-designates individual financial assets from the overlay approach, it does so on an asset by asset basis and any accumulated OCI is transferred into profit or loss.

71 EFRAG is concerned that these different treatments may allow some degree of earnings management. However, EFRAG accepts that this cannot be easily resolved for a situation that is expected to be very short-term. Therefore, EFRAG agrees to permit entities to stop applying the overlay approach before the new insurance contracts Standard is applied for the reasons provided in paragraph 69 above.

Question 6 – Expiry date

Paragraphs 20A and BC77 propose that the temporary exemption from applying IFRS 9 should expire at the start of annual reporting periods beginning on or after 1 January 2021.

Do you agree that the temporary exemption from applying IFRS 9 should have an expiry date? Why or why not?

Do you agree with the proposed expiry date of annual reporting periods beginning on or after 1 January 2021? If not, what expiry date would you propose and why?

EFRAG's response

EFRAG supports that the temporary exemption from applying IFRS 9 should have an expiry date as this constitutes a strong incentive for all parties involved in as quick a finalisation of the insurance contracts Standard as feasible. EFRAG also supports that the expiry date should be reporting periods beginning on or after 1 January 2021 or earlier because EFRAG considers that the new insurance contracts Standard should be finalised as soon as possible and EFRAG expects that the effective date will in any event be no later than 1 January 2021.

Question 6 (a)

72 EFRAG is in the view that the temporary exemption from applying IFRS 9 should have an expiry date to ensure that those entities that apply the approach to move to IFRS 9 at some point in time. In addition, EFRAG agrees with the IASB that IFRS 9 brings a distinct improvement over the existing requirements in IAS 39, as stated in its endorsement advice on IFRS 9.

Question 6 (b)

73 EFRAG supports the proposed expiry date for the temporary exemption from applying IFRS 9 of reporting periods beginning on or after 1 January 2021. This is because EFRAG considers that the new insurance contracts Standard has to be finalised as soon as possible. The very significant improvements in financial reporting that are expected from the new insurance contracts Standard should not be delayed. EFRAG also considers that setting an expiry date constitutes a strong incentive for all parties involved to contribute to a quick finalisation of the long awaited new insurance contracts Standard. EFRAG would recommend that the expiry date is assessed when the insurance contracts Standard is finalised, and reset at an earlier date if feasible.

74 EFRAG considers that the existence of the overlay approach should not be regarded as a backstop in case of a possible delay in the finalisation of the new insurance contracts Standard because of the supplementary costs that the overlay approach generates and because, if and where applied, it responds to quite specific circumstances.

Other issues

Applicability for first time adopters

75 Although not explicitly addressed in the Invitation to Comment by the IASB in the ED, EFRAG does not support the consequential amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards* that would prohibit first-time adopters of IFRS from applying the temporary exemption from applying IFRS 9 or the overlay approach. EFRAG does not support this proposal because it would exclude entities that:

(a) Join a group that is applying the temporary exemption from applying IFRS 9 or the overlay approach and where the entity is required to provide a reporting package based on IFRS to the group level; or

(b) Is part of a group that adopts the temporary exemption from applying IFRS 9 or the overlay approach but, at the time of adopting the temporary exemption from applying IFRS 9, is a first-time adopter in its own right.

76 EFRAG assesses that such an exemption would lead to subsidiaries within a group being required to apply both IFRS 9 and IAS 39, leading to excessive costs.

77 Therefore, EFRAG recommends that IFRS 1 permit a first-time adopter to adopt the temporary exemption from applying IFRS 9 or the overlay approach if they are described in paragraph 3(c) of IFRS 1 and prepared a reporting package in accordance with IFRSs for consolidation purposes without preparing a complete set of financial statements as defined in IFRS 1. EFRAG agrees that the temporary exemption from applying IFRS 9 or the overlay approach should not be available to other first-time adopters of IFRS.