

**CONFERENCE CALL OF THE ACCOUNTING REGULATORY COMMITTEE
(ARC)**

15 APRIL 2021

ENDORSEMENT ADVICE ON IFRS 17 – INSURANCE CONTRACTS

This non-paper has been drafted for the sole purpose of initiating a discussion within the ARC about the endorsement of IFRS 17 *Insurance Contracts* issued by the IASB.

This non-paper does not bind the Commission services to initiate any type of action on this matter.

At the ARC conference call on 15 April 2021 the Commission services will seek the views from ARC Members and Observers on the endorsement of IFRS 17 *Insurance Contracts* (IFRS 17) as amended. This is opportune and needed considering that EFRAG submitted its final endorsement advice to the Commission on 31 March 2021¹ and the mandatory first application of IFRS 17 for reporting periods starting on or after 1 January 2023 (with early application allowed).

Background

In May 2017, the IASB issued IFRS 17 to replace IFRS 4 *Insurance Contracts*. IFRS 17 aims to harmonise the accounting treatment of insurance contracts issued by insurance undertakings or other companies.

The IASB issued amendments to IFRS 17 in June 2020 that, inter alia, addressed a number of concerns from European stakeholders. The amended standard retains the requirement to account for groups of insurance contracts issued no more than 12 months apart, the so called annual cohort requirement.² According to the IASB, the annual cohort requirement is, absent a principles based approach for the grouping of contracts, needed as a “practical simplification” to establish a unit of account that meets the IASB stated reporting objectives of: 1) depicting profit trends over time, 2) recognising profits from contracts over the duration of the contracts and 3) recognising losses from onerous contracts on a timely basis.

¹ <https://www.efrag.org/News/Project-482/EFRAG-has-finalised-its-due-process-around-IFRS-17-and-has-submitted-its-Final-Endorsement-Advice-on-IFRS-17-Insurance-Contracts-including-the-June-2020-Amendments-to-the-European-Commission>

² IFRS 17 paragraph 22.

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EFRAG's final endorsement advice

EFRAG's Board reached a consensus view that IFRS 17 meets the technical endorsement criteria and is conducive to the European public good, apart from the annual cohort requirement for inter-generationally mutualised life insurance savings contracts and cash flow matched life insurance savings contracts. EFRAG's Board is equally split on the merits of the annual cohort requirement. Seven out of 16 Board members considered that the annual cohort requirement neither meets the endorsement criteria nor is conducive to the EU public good. Seven members considered that the annual cohort requirement meets the endorsement criteria and is conducive to the EU public good. Two Board members abstained from voting in favour or against the annual cohort requirement.

Annex I of EFRAG's final endorsement advice helpfully summarises stakeholders' positive and negative views about the annual cohort requirement for inter-generationally mutualised life insurance savings contracts and cash flow matched contracts. Appendix II of that annex provides an overview of the qualitative characteristic of reporting, i.e. the technical endorsement criteria (relevance, reliability, comparability, understandability) and prudence. Appendix III provides an overview of stakeholders' views on the EU public good (business models, financial stability, social guarantees and cost and benefits).

Importance of life insurance (savings) contracts in the EU

Life insurance savings contracts for which the annual cohort requirement could be problematic are common and overall very significant in the EU, but not equally important in each Member State. The contracts in question have an estimated total liability value of more than € 5 trillion. This includes 98% of the life insurance business (€ 1.574 bn) in Germany, 76% of the life insurance market (€ 1.800 bn) in France, 72% of the total life technical provisions (€ 602 bn) in Italy, 70% of the technical reserves held by life insurer (€ 178 bn) in Spain and 95% of the life insurance business (€ 148 bn) in Denmark.

In order to allow an informed discussion on the annual cohort requirement by ARC members the Annex to this note provides a synthesis of the key features of various inter-generationally mutualised life savings contracts regimes that are common in several Member States (DE, DK, FR and IT) as well as of cash flow matched contracts that are prevalent in Spain.

Overall views on the annual cohort requirement and views by stakeholder group

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An important observation by stakeholders questioning the usefulness of annual cohort information for life insurance savings contracts with intergenerational mutualisation is that absent tracking of investments by individual contract for contracts that jointly share returns in a pool of assets, insurers need to make an arbitrary allocation of investment returns and discretionary benefits from the portfolio level to annual groups of contracts in order to determine the contractual service margin (CSM) by annual cohort. However, the arbitrary allocation into annual cohorts would neither reflect the legal or contractual mutualisation of contracts nor the economics of insurance policies. According to them, the cost of arbitrary allocations to annual cohorts would also not outweigh the benefit of increased usefulness of reported information.

Stakeholders in favour of the annual cohort requirement to any type of contract, argue that the annual cohort as a unit of account helps to identify trends in profitability associated with consecutive cohorts (as opposed to permanently re-averaging the CSM of the overall portfolio). They also argue that grouping of contracts by annual cohort would provide for timely loss recognition for contracts / annual cohorts that become onerous after initial recognition. They point out also that the management discretion exercised in the allocation and mutualisation of portfolio cash flows to annual cohorts is relevant information.

Overview of positions of some stakeholder groups on the annual cohort requirement as expressed in comment letters to EFRAG's draft endorsement advice:

- **The European insurance industry.** In addition to concerns about an unbalanced cost-benefit ratio, the European insurance industry expressed concerns about the mandatory application of the annual cohort requirement to life insurance savings contracts with intergenerational mutualisation as well as cash flow matched life insurance contracts. The European insurance industry calls for introducing an exemption possibility from the annual cohort requirement during the endorsement process for these specific life insurance contracts.
- **Investors** expressed mixed views on the benefits of the annual cohort requirement for these life insurance contracts. The international CRUF (Corporate Reporting Users' Forum) indicated that a majority of its members was in favour of the annual cohorts, but a minority against. CRUF concluded that overall, the endorsement with annual cohort exception is preferable to non-endorsement. EFFAS (The European Federation of Financial Analysts Societies) is against the annual cohort requirement, but expressed openness to possible solutions. An individual investor strongly supported the annual cohort requirement.
- **Actuaries.** Austrian, French and European associations of actuaries are all against the annual cohort requirement for inter-generationally mutualised life savings contracts. As to

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cash flow matched contracts they either indicated either that annual cohorts should be applied or did not express an opinion.

- **Accounting profession and audit firms** broadly support the annual cohort requirement with very few exceptions. The overall argument seems not to endanger global comparability by a possible European exemption from the annual cohorts.
- Several **National Standard Setters** did not support the annual cohort requirement for inter-generationally mutualised contracts, or cash flow matched contracts. One standard setter supported the annual cohort requirement. Another understands why the issue may be problematic, but warned for not delaying the endorsement of IFRS 17.
- **ESAs**. EIOPA and ESMA support the full endorsement of IFRS 17 as issued by the IASB. They warned against the potential adverse consequences of an exemption from the annual cohort requirement.
- The **Polish Ministry of Finance** does not support the annual cohort requirement for inter-generationally mutualised life insurance savings contracts. The comment letter suggested finding a solution at EU level, which could be an optional exemption possibility from the annual cohort requirement for certain types of contracts.

Several respondents stressed the overarching need for timely endorsement of IFRS 17, also to provide legal certainty for EU insurance companies preparing for the implementation of IFRS 17.

Questions to ARC members and observers

1. **Considering EFRAG's final endorsement advice, what are the views of ARC Members on IFRS 17 Insurance Contracts?**
 - a. **Do ARC Members see fundamental obstacles to the endorsement of IFRS 17 as issued by the IASB on issues other than the annual cohort requirement for specific life insurance contracts?**
 - b. **Do ARC Members see the annual cohort requirement to specific life insurance contracts as an impediment for EU endorsement? If so, for which contracts (e.g. for life insurance savings contracts with intergenerational mutualisation and/or with cash flow matched contracts)?**
2. **If ARC Members see an obstacle to the endorsement of IFRS 17 as issued by the IASB, what would be an appropriate proposal to solve this issue (to secure timely endorsement)? Would ARC Members support an optional carve-out from the annual cohort requirement for certain types of contracts?**

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ANNEX: Key features of inter-generationally mutualised life insurance savings contracts and Spanish cash flow matched contracts

This Annex provides a synthesis of the key features of various inter-generationally mutualised life insurance savings contracts regimes that are common in several Member States (DE, DK, FR and IT) as well as Spanish cash flow matched contracts. It aims to provide a background for informed discussions in ARC about the importance of the annual cohort requirement for these specific types of contracts. The synthesis is based on in-depth interviews and written material provided mainly by insurance companies.

Typical key features of life insurance saving products with **inter-generational sharing of cash flows and risks** (The focus is on risks other than insurance risks (longevity/mortality risk mainly)):

- Contracts have minimum guaranteed interest rates and share returns in an identified pool of assets and have direct participation features as defined in IFRS 17 Annex A.
- Contracts are subject to statutory or prudential rules on the (maximum) minimum guarantees at inception.
- Different generations of policyholders participate *jointly* in a common pool of assets.
- The annual investment income from the pool of assets is *realised* income as determined by (prudent) nGAAP. Absent fair value through profit or loss measurement, the insurer has discretion on determining the annual investment income.
- On a portfolio basis policyholders are typically entitled to a regulated minimum share between 85% or 90% of the annual investment income (and the insurer is therefore entitled to 15% or 10% of the annual investment income).
- The insurer allocates the minimum interest guaranteed amounts from the annual investment income attributable to policyholders (accretion of the insurance liability).
- After the allocation of the minimum guarantees, policyholders receive the remaining surplus as a discretionary “bonus”. The surplus does not need to be allocated in the reporting year, when it was realised, but has to be allocated within a certain timeframe (e.g. 8 years in FR). So, the insurer has discretion over when to allocate the surplus and therefore future policyholders could obtain a bonus that was realised in earlier years. There are no strict rules on the bonus allocation other than a prudential fair allocation principle. In some regimes there are (limited) disclosure requirements on the bonus allocation, but in others not.

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- The loss for the insurer would only arise, when the annual investment income is not sufficient to cover the guaranteed amounts on a portfolio basis.
- The insurer has discretion to allocate part of its investment income entitlement (15% or 10%) to policyholders taking into account the remuneration for shareholders.

Key features of (Spanish) **cash flow matched contracts**:

- Lifelong annuities based on a single premium at inception with minimum guaranteed interest rates and longevity guarantees. Generally taken out by employers to cover pension commitments. Also lifelong annuities with guaranteed interest rates and mortality guarantees for individual customers.
- No sharing of investment income (in addition to the fixed guaranteed interest rate) from an identified pool of assets between the insurer and the policyholders and amongst policyholders. Contracts do therefore not qualify under IFRS 17 as contracts with direct participation features, so the General Model Approach instead of the Variable Fee Approach applies.
- Sharing of longevity risks amongst policyholders in the cash flow matched group, but credit / default risk (mainly Spanish sovereign debt securities) is borne by the insurer.
- Multi-annual groups of contracts with homogenous insurance and financial risks are economically / cash flow matched, and are subject to monthly monitoring of outflows to policyholders with inflows from the financial assets (until extinction of the in force contracts) according to Spanish regulation.
- Contracts can use the “Matching Adjustment” under Solvency II.

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