

NON PAPER

Disclaimer: This non-paper has been drafted for the sole purpose of facilitating the discussion within the ARC on the endorsement process of the amendments to IFRS 4.

This non-paper does not bind the Commission services under any circumstances to continue the analysis or to initiate any other different type of action on this matter.

1 Background

The IASB published the Amendments to IFRS 4 on 12 September 2016. The Amendments address concerns arising from the different effective dates of IFRS 9, Financial Instruments, and the forthcoming insurance contracts Standard by providing for two alternative, optional solutions: the temporary exemption and the overlay approach.

The problem of the non-alignment of effective dates of the two standards stems from the way in which insurance companies manage their business. They generally operate a business model in which they invest in financial assets in order to generate income and capital appreciation to cover liabilities arising from the insurance contracts they have written. The accounting for their financial assets will be determined by IFRS 9 whereas the accounting for insurance liabilities is covered by IFRS 4, 'Insurance Contracts'. The latter standard is currently being substantively changed. If IFRS 9 and the forthcoming insurance contracts Standard IFRS 17 had been finalised by the IASB at about the same time, their effective dates could have been aligned which would have meant that, in implementing them, the insurance industry could appropriately reflect their business model of managing financial assets and insurance contract liabilities together. However the IASB has not yet finalised the new standard so such an alignment of effective dates is not possible. The IASB is expected to finalise the standard in the first half of 2017 with an effective date of 1 January 2021.

2 EFRAG's assessment of the IASB's proposal and its economic impact

In its endorsement advice on IFRS 9, EFRAG assessed the effects on the insurance industry of the non-alignment of the effective dates between IFRS 9 and the future Standard on accounting for insurance contracts. EFRAG noted that this non-alignment would create disruptions in the financial reporting of many entities undertaking insurance activities during the period until the future insurance contracts Standard is applied.

EFRAG noted that the extent of the difficulties created by the non-alignment of the effective dates of the two standards varies between companies. This is due to the diversity that currently exists across Europe in accounting policies for insurance liabilities as the existing standard, IFRS 4, effectively permits insurance companies to continue using their national Generally Accepted Accounting Principles (GAAP).

The IASB Board decided that the temporary exemption from IFRS 9 should be available only if the entity as a whole has activities predominantly related to insurance. The Board also considered that the second element of its solution, the overlay approach, could be used by groups that do not meet this predominance test. Nevertheless, this decision means that some sizeable insurance companies in

Europe that are within bank-led financial conglomerates would not be able to take advantage of the temporary exemption from applying IFRS 9 and would have to use it from 1 January 2018.

In its endorsement advice to the European Commission, EFRAG found that the IASB amendments to IFRS 4 meet the criteria for endorsement. However, EFRAG concluded that the scope of the IASB deferral solution do not address the cost concerns of bank led groups (i.e. not predominant insurers) and **as a result could not exclude that it could create a competition issue in the EU**. But it was not in a position to conclude on whether this is material from an economic perspective. The impact of the temporary exemption under the IASB proposal would affect the same business activity (insurance) differently depending on how the insurance activity is structured. EFRAG mentioned in its endorsement advice some specific competition issues for the insurance part of the bank-led conglomerate compared to a predominant insurer allowed to use the IASB temporary exemption: 1) the possible adverse impact on investment strategies, 2) no practical choice but to report less relevant information about their performance, 3) certain cost mitigations available to predominant insurers are not available to bank led groups (e.g.: additional implementation costs due to the need to revisit accounting choices made on the initial application of IFRS 9 once IFRS 17 will be implemented; the overlay approach is costly to apply) and 4) the overlay approach does not eliminate the effects of the IFRS 9's expected credit loss model.

The table below is based on an EFRAG assessment of the 50 largest entities undertaking insurance activities in the EU and Switzerland which represent EUR 7.5 trillion insurance liabilities (and EUR 22 trillion total liabilities). The table provides a breakdown of the relative importance of the insurance liabilities per Member State (and Switzerland). Overall 23% of the insurance activities measured by size of the insurance liabilities would not be covered by the scope of the temporary deferral proposed by the IASB amounting to EUR 1.7 trillion. For individual Member States this share ranges between 8% and 100% but the absolute size of the insurance liabilities that would not benefit from the temporary deferral varies significantly between Member States from EUR 672 million for Malta to almost a trillion EUR for France.

by MS (and CH)	Fail predominance test (amounts in million EUR)	Pass predominance test	total insurance liabilities	Fail insurance liabilities to total
BE	35,104	92,510	127,614	28%
FR	979,160	1,300,491	2,279,651	43%
DE	92,372	1,071,511	1,163,883	8%
IE	21,024	0	21,024	100%
IT	131,638	459,522	591,160	22%
MT	672	0	672	100%
NL	181,480	587,444	768,924	24%
PT	11,324	0	11,324	100%
ES	61,763	0	61,763	100%
CH	50,399	572,638	623,037	8%
UK	172,983	1,720,658	1,893,641	9%
total sample	1,737,919	5,804,774	7,542,693	23%

This table indicates that the potential competitive distortions arising from the IASB's proposed amendments to IFRS 4 may be significant and could affect several Member States. The impact – in absolute terms – may be particularly important in one Member State.

3 Can the Competition Issue be addressed?

In order to remedy the potential competition issue created by the IASB's proposed amendments to IFRS 4, the Regulation endorsing these Amendments could permit, subject to meeting strict criteria, insurance entities within bank-led financial conglomerates to defer the application of IFRS 9 until 2021, thus putting these entities on a level playing-field with insurance undertakings that meet the predominance test.

The effect of introducing such an option would mean that the insurance entities within bank-led financial conglomerates would continue reporting under IAS 39 and the rest of the group, including the banking entities, would report under IFRS 9. Insurance entities within bank-led financial conglomerates wanting to defer the application of IFRS 9 until 2021 would have to satisfy strict criteria designed to address potential concerns arising from the application of non-uniform accounting policies across the group.

A potential approach would be that a financial conglomerate as defined in Article 2(14) of Directive 2002/87/EC may elect for its entities within the insurance sector within the meaning of Article 2(8)(b) of that Directive to apply IFRS 9 in the consolidated financial statements for financial years starting on or after 1 January 2021 at the latest where all of the following conditions are met:

- (a) no financial instruments are transferred¹ between the insurance sector and any other sector of the financial conglomerate after the financial years ending on or before 31 December 2016² unless such transfer takes place and is accounted for as if it was an arm's length transaction concluded at market price under prevailing market conditions between two independent market participants.*
- (b) the financial conglomerate states in the financial statements which insurance entities are applying IAS 39 and which other entities are applying IFRS 9;*
- (c) disclosures requested by IFRS 7 should be provided separately for entities in the group applying IAS 39 and entities applying IFRS 9 and disclosures requested by the Amendments to IFRS 4 are provided.*

In practice, this would allow the insurance activities within a bank-led conglomerate, to defer the application of IFRS 9 until 2021 just as their competitors that meet the predominance test, thus ensuring a competitive level playing field within the insurance industry.

¹ The scope of this ban on "transfers" would be transactions that would result in the de-recognition of the financial assets from the accounts of the company disposing of them based on the IFRS accounting framework. In other words, transfers that do not require de-recognition, such as repurchase agreements, would not be subject to this ban.

² The ban on transfer of assets would apply retrospectively as from financial years ending on or before 31 December 2016 to avoid any earning management prior to the entry into force of the endorsing regulation.

4 Questions for ARC members

- I Do you consider that a provision drafted as suggested in section 3 (using the definitions set-out in the financial conglomerates directive) to include the insurance sector of a bank-led financial conglomerate could adequately capture the sizeable insurance entities within bancassurers?
- II Do you consider that the criteria that must be met in order to qualify for the use of the temporary deferral provide adequate safeguards to address the potential issues arising from the application of different accounting policies within one set of consolidated financial statements for a group?
- III Do you have any other comments about the merits of the approach set-out in this non-paper?