

Dear Mr Deckers,

Following the publication by the International Accounting Standard Board (IASB) of the IFRS 17 "Financial Instruments" on 18 May 2017, we welcome the opportunity to share the list of areas we believe should be considered in the endorsement advice request letter to EFRAG.

We believe that the insurance industry's significant concerns regarding outstanding issues related to the implementation of IFRS 17 should be carefully assessed by EFRAG as part of the endorsement advice process. We set out here a summary of key concerns that our members believe can, if not resolved before the Standard is endorsed at European level, result in information that either does not meet the criteria of understandability and relevance because of unnecessary complexity or costs more to implement and operate than the benefit derived from it.

The key concerns are summarised as follows:

1. Initial onerous contract assessment

The Standard establishes a top down approach that result in measuring insurance contracts by dividing a portfolio into groups of insurance contracts based on profitability, including groups of insurance contracts that are onerous at inception. While we welcome this top-down approach, there is significant concern that the requirement to demonstrate that all contracts should be in the same group, by way of reasonable and supportable information, effectively leads to assessment of individual contracts.

Assessment of individual contracts would not be in line with the insurance business model, because when an insurer sells a policy, the cost of a claim at contract level is not known in advance. The cost of a claim, when the contract is written can meaningfully be estimated only if based on a pool (i.e. portfolio) of contracts.

The Standard provides a simplified assessment of onerous contracts for insurance contracts that fall within the scope of the premium allocation approach by assuming that no contracts in the portfolio are onerous at initial recognition, unless facts and circumstances indicate otherwise. Many insurers have argued that since the IASB has acknowledged that the premium allocation approach is a simplification of the general model, extending such approach to all contracts would essentially simplify an otherwise complex aspect of IFRS 17 requirements and reflect better the IASB's intention that onerousness test at initial recognition should generally not refer to individual contracts.

EFRAG should assess whether the requirements of the Standard for assessing groups of contracts that are onerous at inception lead to the assessment of individual contracts and if so, whether isolating such individual contracts is workable and/or justifies the consequential operational costs.

2. Annual cohort requirement

IFRS 17 states that entities shall not include contracts issued more than one year apart in the same group. This requirement has become known as annual cohort requirement. The IASB has justified this requirement by arguing that it ensures a key objective is met, namely that the profit recognised in each period faithfully depicts changes in profitability of contract over time and that unearned profit appropriately reflects coverage still to be provided. In other words, the annual cohort requirement ensures that the right amount of the contractual service margin can be amortised in the income statement at the relevant insurance service period and is fully amortised when related contracts expire or lapse.

However, while there is agreement that the key objective is appropriate, many insurers believe that there are other different ways, including the use of coverage units, which can achieve the same objective of ensuring that the right amount of the contractual service margin is amortised in the right service period and that the contractual service margin is fully amortised when the related contract ends. Those insurers believe that they should not be required to create annual cohorts unnecessarily. They also observe that the Standard does not provide any exception to annual cohort requirement even for contracts that fully share risks, often known as mutualised portfolio, notwithstanding that the IASB acknowledges that, for such contracts, a single combined risk-sharing portfolio would give the same results as annual cohorts.

Furthermore, some non-life insurers, such as car insurers, have noted that they generally group their claims based on accident year instead of underwriting year. The annual cohort requirement in IFRS 17 adds additional complexity to the grouping of contracts for those non-life insurers.

EFRAG should assess whether there are other approaches other than annual cohort requirement that can achieve the objective of making sure that the profit recognised in each period faithfully depicts changes in profitability of contract over time and that unearned profit appropriately reflects coverage still to be provided. If so, whether such approaches can be acceptable under IFRS 17.

3. Mandatory restatement of comparatives at initial application

Some insurers believe that the requirement in IFRS 17 to restate the comparative period as if the standard had always applied to existing business on the implementation date will lead to significant cost and effort. The IASB has argued that the restatement of comparative information is mandatory because investors cannot otherwise understand the impact of the new Standard without comparative information.

However, many insurers observe that such a restatement of comparative insurance liabilities cannot be meaningful without a corresponding restatement of comparative financial assets under IFRS 9 because of a possible misalignment of assets and liabilities in the comparative information. Since the IASB has made the restatement of comparative information under IFRS 9 optional, those insurers call for a similar optional restatement under IFRS 17. Some argue that to make comparative information meaningful, insurers would be compelled to also restate IFRS 9 even though all other industries had an option to restate IFRS 9, which would raise the issue of level playing field and fairness.

Many insurers have also raised concerns that requiring the restatement of the comparative information under IFRS 17 increases significantly the cost and difficulty of implementation because it effectively reduces the length of the implementation period by one year and requires an IFRS 9 restatement exercise.

EFRAG should assess the effects of the mandatory restatement of IFRS 17 comparative information without a corresponding restatement of IFRS 9 comparative information. Furthermore, EFRAG should assess whether the perceived compulsion of equally restating IFRS 9 comparative information in order to achieve a meaningful IFRS 17 comparative information leads to a lack of level playing field with other industries. EFRAG should also assess the effects of the mandatory restatement of comparative information on the cost and length of the implementation period.

4. Derivatives used to mitigate financial market risk

Derivative instruments are frequently used in the insurance industry to mitigate financial market risk of insurance contracts with participation features. When an entity applies the variable fee approach to contracts in which financial risks, such as options and guarantees, have been mitigated with a derivative, there is a volatility in profit or loss due to the fact that changes in the fair value of the derivative are recognised in profit or loss while

the related mitigated financial risks are recognised on the balance sheet in the CSM. IFRS 17 provides an option for contracts qualifying for the variable fee approach to recognise the changes in mitigated financial risks to profit or loss so as to offset the changes in fair value of the derivatives used to mitigate those risks, even though this option is available on a prospective basis.

Some insurers believe that this hedging solution should be extended to contracts with indirect participating features, at least for options and guarantees imbedded, primarily due to the following reasons:

- a) There is neither conceptual nor economic reason to limit this decision to direct participating contracts : indeed, the participation features (to be considered for the eligibility to the VFA) have no relationship with the value of guarantees granted to policyholders on interest rate; therefore when insurers use derivatives to hedge changes in the value of these guarantees, it should be relevant and consistent to record these changes through net income both for direct and indirect participating contracts.
- b) Without appropriate accounting insurers will have to use non-GAAP measures to address the accounting mismatches (volatility in net income) that will arise for indirect participating contracts.

The IASB has argued that insurers using derivatives to mitigate financial risks in the general model should apply the general hedge accounting guidance in IFRS 9. However, insurers note that most of the hedging strategies are dynamic hedges for which the IASB is yet to find a Standard.

EFRAG should assess whether the treatment of derivatives in IFRS 9 and IFRS 17 can lead to significant accounting volatility and reduce the meaningfulness of the financial statements.

5. Release of the Contractual Service Margin (“CSM”) to the income statement for insurance contracts with direct participation features

Under IFRS 17, an aggregation of CSM is performed for contracts that meet the conditions to be grouped together. With regards to insurance contracts with direct participation features, for each aggregation of CSM, IFRS 17 prescribes in substance a straight-line basis amortisation based on coverage units, reflecting the expected duration and the quantity of the benefits of the contracts in the group.

Some insurers observe that this mandatory linear amortisation method required by IFRS 17 is likely to improperly reflect the economic earnings pattern for some products and even may wrongly anticipate profits in some cases. They note that, for participating contracts, the CSM include asset management services and these services normally increase with the volume of the assets over the life of the contracts. Those insurers would favour an alternative method that amortises the contractual service margin in line with the way services are rendered. The IASB acknowledges that insurance contracts with direct participation features are insurance contracts that are substantially investment-related service contracts under which an entity promises an investment return based on underlying items.

EFRAG should assess whether an alternative method, other than linear amortisation, of the contractual service margin allocation that reflects the way services are rendered for insurance participating contracts is acceptable within the variable fee approach under IFRS 17..

6. Mandatory use of a locked-in discount rate for the unwind of the CSM in the general model

IFRS 17 requires the contractual service margin under the general model to be accreted using a rate that was current at initial recognition, i.e. a locked-in rate. The IASB has justified this requirement by the fact that the CSM was not a cash flow but rather a difference between cash inflows and cash outflows and therefore cannot be accreted using a current rate.

However, many doubt whether such a justification holds given that the contractual service margin under the variable fee approach is effectively accreted using current rate. Furthermore, insurers who recognise the full

discounting effect of their insurance liabilities in the profit or loss observe that they do not need the information related to locked-in rate. The mandatory accretion of the CSM using a locked-in rate would effectively create a burden of storing such information without an apparent benefit for readers of their financial information, and create an accounting mismatch since their financial assets are measured at fair value through profit or loss. Those insurers argue that it should be permissible to use current discount rate for the accretion of interest expense on the CSM and the calculation of the present value of cash flows that is offset against the CSM, i.e. amounts that unlock the CSM.

EFRAG should assess whether the mandatory use of a locked-in rate to accrete the CSM creates accounting mismatches and operational complexity that outweigh its benefits.

7. Contract boundaries

Some life insurance contracts have terms that allow the insurer to reset the guaranteed rate with each (future) premium payment. This allows the insurer to maintain profitability of the additional cover provided on these premiums. This is typical for contracts where the policyholder has the possibility to increase the amount of the premiums and where the insurer is not obliged to provide the initial guarantee to the part of the premium exceeding the initial premium.

There is doubt whether such future premiums fall within the boundary of insurance contracts under IFRS 17. Issuers of such insurance contracts observe that if such premiums are not included within the contract boundary, the entire portfolio would be reported as loss making which they believe would not reflect the substance of the economics of their business.

EFRAG should assess whether the contract boundary, as defined by IFRS 17 result in unfaithful presentation of the economics of such life contracts.

8. Balance sheet presentation

IFRS 17 requires that groups of insurance contracts that are in an asset position should be presented separately from groups that are in a liability position.

Some insurers question the relevance of such a requirement noting that:

- c) Investors are interested to know the liability for incurred claims which depicts the expected obligations from incurred claims and thus from past events and the liabilities for remaining coverage which depicts the expected future cash flows and thus also the unearned revenue potential from the in-force business. Some of that information would not be visible on the balance sheet if presented as part of groups of contracts that are in an asset position;
- d) While total information for the liability for remaining coverage and liability for incurred claims could still be obtained in the notes, this may be confusing to readers of the financial statements since it would be different from amounts presented on the balance sheet; and
- e) It is burdensome to some insurers to operate a system that distinguishes groups of contracts that are in an asset position from groups of contracts that are in a liability position. Most insurers believe such a distinction is practicable only at portfolio level.

Those insurers suggest that the balance sheet presentation should reflect the information disclosed in the notes, i.e. the distinction between the liability for incurred claims and the liability for remaining coverage, which they believe better reflects the insurer's financial position.

EFRAG should assess whether the costs of implementing systems that distinguish groups in asset position from groups in liability position outweigh the benefits derived from such information. Furthermore, EFRAG should assess the effects of aligning the balance sheet presentation to the disclosure note, i.e. liabilities for incurred claims and liabilities for remaining coverage.

9. Transition to IFRS 17

IFRS 17 transition requirements allow an entity to apply at transition either the modified retrospective approach or the fair value approach in case it is impracticable to apply the full retrospective approach. Almost all insurers believe that they have no available data to apply IFRS 17 fully retrospective, leaving the modified retrospective approach and the fair value approach as the only possible approaches.

However, some insurers question the relevance of the fair value approach. They observe that the fair value approach leads to the computation of the contractual service margin (CSM) by comparing the estimated price paid to transfer insurance contracts (fair value) with the fulfilment value. The fair value approach as specified in IFRS 17 would therefore result in a CSM on transition that reflects the market margin, which is in many cases smaller than the insurer's own expected profitability. Consequently, the fair value approach would exhaust a major portion of future profits if insurers write profitable business. Furthermore, those insurers argue that the fair value approach might result in similar future profits from in-force business after transition for all insurers, irrespective of their actual profitability. It is questionable if this will increase comparability of results between insurers.

This implies that insurers would have no realistic alternative to the modified retrospective approach. However, IFRS 17 sets out a list of permissible modifications in the absence of historical data. Some insurers are therefore concerned that they may not be able to avail of the modified approach on transition because some needed simplifications may not necessarily be included on the list of permissible modifications.

EFRAG should assess the effects of using the fair value approach on transition and whether insurers that use reasonable modifications not included on the list of permissible modifications can still use the modified approach.

We would also like to stress that in order for EFRAG to complete its effects analysis and provide endorsement advice, insurers will need until the end of 2018 to provide their necessary input to EFRAG.

Please do not hesitate to contact us if you would like to discuss any aspect of our comments in more detail.

Yours sincerely,

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