

This paper has been prepared by the EFRAG Secretariat for discussion at a public meeting of EFRAG TEG. The paper forms part of an early stage of the development of a potential EFRAG position. Consequently, the paper does not represent the official views of EFRAG or any individual member of the EFRAG Board or EFRAG TEG. The paper is made available to enable the public to follow the discussions in the meeting. Tentative decisions are made in public and reported in the EFRAG Update. EFRAG positions, as approved by the EFRAG Board, are published as comment letters, discussion or position papers, or in any other form considered appropriate in the circumstances.

## **IFRS 17 *Insurance Contracts***

### **User Outreach - Preliminary results**

#### **Objective**

- 1 The objective of this session is to provide EFRAG TEG members with preliminary feedback received during EFRAG's User Outreach regarding current accounting of insurance contracts and regarding IFRS 17 *Insurance Contracts*.

#### **Introduction**

- 2 To prepare its input to the IFRS 17 draft endorsement advice, the EFRAG Secretariat conducted interviews with users between April and May 2018.
- 3 This User Outreach Report summarises the feedback received during the user outreach activities of 19 users. A later version of the report will include all the interviews.

#### **Question for EFRAG TEG**

- 4 Does EFRAG TEG have any comments on the preliminary results?

#### **User outreach activities**

##### *What we did*

- 5 EFRAG consulted a number of European investor and analyst users of financial statements through telephone/webcast meetings and some in person. The outreach aimed at obtaining user views on:
  - (a) how they analyse and value insurance companies currently;
  - (b) how current financial reporting under IFRS 4 *Insurance Contracts* affects their analysis; and
  - (c) expected benefits, costs and issues regarding IFRS 17.
- 6 Three users presented their views on IFRS 17 at the EFRAG Board meetings of 20 March 2018 and 30 May 2018.
- 7 In addition, the EFRAG Secretariat consulted the EFRAG User Panel on 15 May 2018.
- 8 The feedback received at these meetings is included in this report.
- 9 The EFRAG Secretariat acknowledges that the user views reflected below are based on a best effort basis, given the short time to partially compile the results. Users were clear that their views could change as they better understand the effect of IFRS 17.

*Interviews conducted*

- 10 EFRAG sent out a public call for users to be interviewed and also emails were sent out to investors and analysts drawing their attention to the public call. This preliminary analysis summarises the interviews with 19 users.
- 11 The types of users interviewed were mostly buy side and sell side analysts who focus on equities. Other users interviewed were buy side analysts who focus on fixed-rate bonds, credit analysts, a researcher and private/retail investors.
- 12 The users focus on a range of different insurance businesses, e.g. life, non-life, reinsurance, multi-line and also asset management.

**Executive summary**

- 13 The main feedback made by users are summarised as follows.

*Current accounting*

- 14 Regarding the analysis and valuation of insurance companies currently, there are a wide range of sources of information and metrics being used by both specialist and generalist users. The generalist users make their valuations more frequently than the specialist users.
- 15 Generalist and specialist users indicated the current application of IFRS 4 *Insurance Contracts* prevents comparability between insurance companies. As a result, users need to rely on alternative measures and/or to adapt the figures in the financial statements.

*Information under IFRS 17*

*Comparability*

- 16 Most generalist and specialist users are expecting an improvement in comparability between insurance entities for various reasons. Users appreciated that there would only one framework applicable across countries and that they would benefit from the enhanced disclosures. A minority of users was not convinced that IFRS 17 would improve comparability.
- 17 Users that expected an improvement in comparability also thought IFRS 17 did not go far enough in building a uniform reporting framework. The need to apply judgement and the use of options were noted as examples where financial reporting would not achieve full comparability.

*Presentation and disclosure*

- 18 No general trend has emerged so far about presentation. Individual views are available only, for example:
  - (a) Separate presentation of groups of contracts in an asset and a liability position could be useful, but is not perceived as a game changer; a
  - (b) A request for disclosure of the net result after reinsurance; and
  - (c) A request to have more segment information available.

*Volatility*

- 19 Both generalist and specialist users did not see volatility as a problem as long as it reflects real economic substance. Volatility is seen by users as an opportunity to learn more about the capabilities of the management in steering their company. Also, specialist users indicated that they can adjust their figures for volatility.

*Transition*

- 20 Both generalist and specialist users were uncomfortable with the range of transition approaches offered by IFRS 17. It is feared that these will create confusion, but specialist users also warn for window dressing at the moment of transition.

*Expected impact on cost of capital/investability of insurance sector*

- 21 The majority of users expects the cost of capital to decrease, a minority expects an increase. A significant part of the specialist users provided a view that an initial raise in the cost of capital is expected due to the need for all market participants to adapt to the new approach. Subsequently, a decrease in the cost of capital was expected. Also it was noted that the decrease in cost of capital would not be for all insurance companies, with the benefit of more detailed information about the insurance business, the cost of capital for some insurance companies might raise. Finally, the investability of the insurance sector was expected to increase.

*Expected costs*

- 22 Both generalist and specialist users expected their costs to be minor, and the costs to be made were rather seen as an investment. One specialist user expected significant costs will be incurred.

*Benefits*

- 23 Both generalist and specialist users saw benefits to IFRS 17. For example, the identification of onerous contracts, profit earned as services are provided, disclosure of the assumptions used and measurement closer to Solvency II.

*Concerns with IFRS 17*

- 24 Some specialist users raised concerns about the treatment of reinsurance. Generalist users were concerned about the impact of IFRS 17 on the business models and the information they would (or would not) get from insurance companies. Also, the existence of an additional framework in addition to Solvency II was seen as a challenge.

- 25 The table below presents the number of respondents interviewed by location based on expected investing activities and respective type of user.

**Table 1: Number of respondents by location based on expected investing activities and type of user**

<i>Respondent by location based on expected investing activities:</i>		<i>Respondent by type of user:</i>	
<b>Specialist users:</b>			
Global	4	Buy side analyst:	
France	4	• Equities	5
Germany	3	• Fixed rate bonds	1
UK	1	Sell side analyst:	
Norway	1	• Equities	5
		Credit analysts/Rating agency	1
		Private/Retail investors	
		Researcher	1
	<b>13</b>		<b>13</b>
<b>Generalist users:</b>			
Global	2	Buy side analyst:	
Europe	1	• Equities	2
Hungary	1	• Fixed rate bonds	
Belgium	1	Sell side analyst:	
Italy	1	• Equities	2
		Credit analysts/Rating agency	
		Private/Retail investors	1
		EFRAG User Panel	1
	<b>6</b>		<b>6</b>

- 26 The names of the individual users and their respective organisations have been treated on a confidential basis.

## Detailed feedback

### Analysis and valuation of insurance companies currently

#### Information used currently

- 27 Fourteen generalist and specialist users use the financial statements as one of the sources of information. While one specialist user stated that he does not often use most of the details in the financial statements.
- 28 Eight specialist users provided other additional sources of information that they use to value insurance companies. The sources of information mentioned were company specific releases, official statistics of the regulator, Solvency II reports, sell-side reports, macro-economic and market information (such as interest rates, etc.), direct contact with decision makers (CFO's, CEO's) /investor relation departments/brokers, data from data aggregators, own valuation, non-GAAP credit measures and consultant reports on the industry.
- 29 These specialists focus on predicting earnings, financial return, governance, stewardship, focus on cash, dividends and sustainable profitability.
- 30 Three generalist users indicated that they use all information that they are able to obtain to value insurance companies. Examples provided, besides the financial statements, were press releases, information directly from companies, liaise with management, Solvency II reports, embedded value information, ratio analysis, governance, news from the press.

#### Metrics used currently

- 31 Different metrics are used by different *specialist* users:
  - (a) For sell-side specialist users, the metrics used are price/earnings ratio; Solvency II including capital generation/ embedded value information; cash flow generation, e.g., to determine how dividends are funded; profit recognition pattern in some markets using present book or for life business, embedded value; operating profit (as defined) and they look at profit sources to exclude volatility in order to identify underlying earnings potential; sustainable earnings and economic value.
  - (b) The specialist researcher mentioned that the combined ratio is used.
  - (c) For specialist buy-side users, the metrics used are matrix for key performance indicators; price/earnings ratio; combined ratio; use of population growth and book value growth for life business and looking at sustainable cash flows; metrics to assess dividend paying capacity; cash flow generation; top line (change in premiums); net in-flows in life insurance; expenses ratios; loss ratios; investment margin; annual premium equivalent; new business margin; investment return on assets; operating results; net income and shareholder equity; capital generation; business value that has been generated; earnings per share; embedded value information; return on equities; and Solvency II measures life business, metric used in the value earned return on equities. For life business, focus is on Solvency II/embedded value type measures.
- 32 There were also different metrics used by different *generalist* users. The metrics stated were valuation multiples; comparisons made to peer groups as well as over time; price/earnings ratio; information on volume and profitability; capital adequacy; ratios comparing capitalisation in the market versus net worth of a company; fixed assets/sales; added value per personnel; working capital management and capex/sales.

*Valuing an insurance company currently*

- 33 There were different views on the frequency of updating the users' valuation models. However, the generalist users made their valuations more frequently than the specialist users.
- 34 For two specialist users, update/relooking of their models ranged from quarterly to bi-annually (although it may happen more often if necessary). For three generalist users, update/relooking of their models ranged from every week to a quarterly basis.

*Number of years users forecast returns/profits or typical holding period*

- 35 Regarding the specialist users:
- (a) Five buy-side specialists provided a range of holding periods between 2 to 5 years. The forecast period for most of these specialist users ranged from 3 to 8 years. One of these users mentioned that for some companies, they look at 10 to 20 years while for others between 1 year and 20 years depending on mismatches arising between the financial statements and the user's valuations.
  - (b) One sell-side specialist user looks at earnings five years out.
- 36 Regarding the generalist users, one sell-side generalist user stated that he invests for the long-term, i.e. seven to eight years. while the buy-side generalist user has a holding horizon for three to six months and for strategic investments, one to two years.

*Current financial reporting*

*Generalist*

- 37 Four generalist users indicated that the current application of IFRS 4 makes it very difficult to compare insurance companies. One user specifically indicated that the mere aggregation of data prepared under various financial reporting frameworks for consolidation purposes makes the data provided meaningless. Therefore they are unable to analyse and assess the results from one company to the other. In the absence of comparable financial reporting, these users indicated that they rely on other measures to make a comparison.
- 38 In contrast, one generalist user indicated that the flexibility of IFRS 4 did not have a significant impact on life insurance market and on financial statement presentation. The user believed that the accounting principle of the insurance companies are uniform for the sector.

*Specialist*

- 39 Nine specialist users indicated that current accounting under IFRS 4 does not allow for the comparison of financial information. These users also have the following comments:
- (a) Five users noted that as a result of the comparability issue they are making use of alternatives measures;
  - (b) Three users stated that they are making adjustments to the information reported in order to make it comparable between companies;
  - (c) Two of the users indicated that they were not in favour of shadow accounting under IFRS 4;
  - (d) One user indicated that: (i) inconsistent accounting policies and profit recognition patterns makes comparative use of information overly complex and difficult to assess the dividend capacity; (ii) the wide use of discount rates for liability measurement leads to complications in assessing risk in models; (iii) allowed inconsistent consolidation policies are misleading (iv) capital

allocations are based on policies relating to profit recognition and liability measurement that are differently applied and is not consistent across geographies; (iv) it is difficult to make sense of some accounting policies adopted in light of the fundamental economics of industry.

- 40 In contrast to the above, one specialist user indicated that they use operating profit as defined and look at profit sources to exclude volatility to look at underlying earnings potential. This user was also in favour of using cash rather than accrual accounting.

*Information under IFRS 17*

*Comparability*

Generalist

- 41 Four generalist users stated that IFRS 17 is expected to result in better comparability because:
- (a) there will be one framework applicable to all and not a mixture of national standards; and
  - (b) there will be more useful information in terms of relevant and transparent information.
- 42 One generalist private investor was not clear what the figures would be in the financial statements under IFRS 17 in terms of premiums and losses by line of business.

Specialist

- 43 Seven specialist users stated that IFRS 17 is expected resulting in better comparability compared to IFRS 4 because:
- (a) it would increase predictability of the future;
  - (b) it will bring more stability to earnings and disclosures on the source of earnings will enhance this more;
  - (c) it will meet the user's requirements in respect of measuring the liabilities but more guidance was preferred on discount rate;
  - (d) there will be consistent accounting along with disclosures about the assumptions and better comparisons can be made on performance among other company types; and
  - (e) it introduces comparability across countries and increases the understanding of the accounting for different companies.
- 44 One specialist user was not sure at this stage whether IFRS 17 would result in better comparability but stated that IFRS 17 is a step in the right direction.
- 45 Four specialist users had comparability concerns:
- (a) due to the discretion allowed in the standard;
  - (b) between companies due to the options under IFRS 17 therefore the impact would depend from company to company. However, disclosures would help to reduce the comparability issue;
  - (c) due to judgement used by entities on variables for their valuation of the insurance liabilities. However, it was indicated that uniform application of these variables would arguably increase comparability; and
  - (d) due to scope and local differences.

*Presentation and Disclosure*

Generalist:

- 46 One generalist user noted that it is useful to limit the netting of groups of contracts that are in an asset position and groups of contracts that are in a liability position as netting can obscure important information.

Specialist:

- 47 Four specialist users had the following individual views:
- (a) Separate presentation of groups of contracts in asset and liability positions could be useful but it is not game changing in terms of how they look at things.
  - (b) The net result after reinsurance should be disclosed.
  - (c) More segment disclosure is needed as well as disclosure on sources of earnings.
  - (d) Requested disclosures on the CSM run-off in aggregate and per product line.

*Volatility*

Generalist:

- 48 Three generalist users indicated that volatility is not an issue as long as it reflects the real economic substance. These users indicated that:
- (a) volatility provides insight in how management is dealing with economic setbacks;
  - (b) hiding volatility by showing stable results does not bring clarity which does not allow for the assessment and management of risks;
  - (c) volatility might increase the cost of capital in some cases but that is what is needed to accurately reflect the nature of the business; and
  - (d) the current results lack credibility as they do not portray economic volatility.

Specialist:

- 49 Six users provided the following reasons as to why they do not regard volatility as a problem:
- (a) Two users stated that as long as transparent information enables them to understand the volatility;
  - (b) Two users acknowledged that adjustments could be made to eliminate the effect of volatility;
  - (c) One user had an expectation that under IFRS 17 they will see much more stable numbers; and
  - (d) One user noted that any volatility should represent economic volatility.

*Transition approaches*

Generalist

- 50 Generalist users had the following comments:
- (a) Transition period will be long and will create confusion for analysts but investor days should take care of that;
  - (b) There is a need for additional disclosures in order to cope with the options on transition;
  - (c) There is no perfect solution to the problem. It will be an uncomfortable journey but they can live with the transition options;

- (d) The transition measures are seen as a practical expedient. Ideally only one transition method would be permitted.

Specialist

51 Specialist users had the following comments:

- (a) Five users noted that the different transition methods would cause comparability concerns. Ideally only one transition method should be applied. Some users noted that disclosures could help users in understanding and making adjustments to the figures, but not everyone was convinced that the disclosures of IFRS 17 were sufficient;
- (b) Three users were concerned that people will choose the option they want in terms of opening balances and applying window dressing and not necessarily what is most appropriate (transition to Solvency II was used as an example). One of these users also expressed the potential for double counting;
- (c) One user expected that insurers will agree on a common approach.

*Expected impact on cost of capital / Investability of insurance sector*

Generalist

52 Generalist users had the following comments:

- (a) Three users thought the cost of capital would decrease because of more disclosures and increased comparability. This may attract new investors that currently avoid the insurance sector because of the complexity. Also the investability of the sector was expected to increase. One of these users noted that if volatility were to increase, this would also increase the cost of capital but that would be reflection of the underlying business.
- (b) One user noted that the cost of capital may increase because investors that currently invest in the insurance industry for the dividends as a proxy for bond returns may find out that they are actually buying shares with the risks that are attached to it.

Specialist

53 Specialist users had the following comments:

54 Six users provided a balanced view:

- (a) Five users noted a transition period would be necessary for the market to absorb the new accounting and its effects (getting acquainted with the new metrics). The cost of capital is initially expected to rise but after some time it should overall be lower or stay at the same level. This is valid for the insurance industry as a whole, but individual companies may see different results;
- (i) This is because all market participants (issuers, investors, auditing firms, supervisors) will need time to adapt to this new approach and find a new equilibrium in terms of information provision:
- Issuers will need to define common disclosure templates;
  - Investors will need to understand the variables and transitional arrangements chosen by each issuer, the impact of the first time application, the volatility induced by the new accounting rule, the impact on pricing;
  - auditing firms will need to set benchmarks to challenge assumptions set forth by issuers;
  - supervisors will need to provide supplementary guidelines to issuers, if the new equilibrium on disclosure poses risk to financial

stability (access to financial markets, aversion on the insurance sector).

- (b) One user thought that the cost of capital would be lower but not for everyone.
- (c) Three users thought the cost of capital would be lower or would not change at all; and
- (d) Three users thought the cost of capital would increase.

*Benefits and costs of IFRS 17*

55 The users interviewed ranged from those still developing their knowledge on IFRS 17 to being reasonably knowledgeable:

- (a) Most of the generalists ranged from starting to look at IFRS 17 to having general knowledge of IFRS 17. One generalist was reasonably knowledgeable about IFRS 17.
- (b) Five specialists were knowledgeable of IFRS 17 but the other specialists were developing their IFRS 17 knowledge.

Expected costs

*Generalist*

56 Two generalist users expected their costs to be reasonable and to create value. They mentioned that there will be costs for them to understand IFRS 17.

*Specialist*

57 Five specialist users expected their costs to be minor/not significant. Costs expected to be incurred by these users are the following:

- (a) Time needed for the learning curve and to understand the numbers
- (b) Adjustments to the users' models as companies change accounting or the way they disclose things; and
- (c) Bridging different regulations, Solvency II, embedded accounting.

58 One specialist user expected that significant costs will be incurred by them due to training and remodelling.

*Would users update their valuation models more often than today and are any adjustments expected to IFRS 17 numbers?*

Generalist

59 One generalist user indicated that even under IFRS 17, analysts would always make adjustments to numbers for various reasons, this user also indicated that non-GAAP measures would continue to be used.

Specialist

60 Six specialist users did not expect a huge/fundamental change in their models nor did they have issues with updating their models. One specialist user stated that changes are expected in modelling with IFRS 17 (which could be costly) in order to try and understand the information. Another specialist user stated that it was too early to assess the extent to which the valuation models will be changed.

61 Three specialist users considered that adjustments would be made to the IFRS 17 numbers and/or non-GAAP measures would continue to be used.

*Benefits of IFRS 17*

Generalist

62 Users made the following comments:

- (a) IFRS 17 will “fair value” insurance liabilities, which will reduce the “mismatch” between marked-to-market assets and liabilities. In this respect, IFRS 17 will move closer to the Solvency II approach, which is positive for the assessment from credit investors.
- (b) There is an expectation that IFRS 17 may reduce the need to rely on non-GAAP measures;
- (c) The identification of onerous contracts is not only useful information, it is also important in bringing discipline to the management of insurance companies to see the errors made in the past.
- (d) The split between underwriting and investing results is seen as very useful. In one user’s view, some insurers compensate poor underwriting with successful investing activities, thus overstating the success of their core business.

Specialist

63 Users made the following comments:

- (a) Four users noted that profit earned based on services provided and the split between underwriting and investing result was useful information to them. One user thought it was too early to tell. Of the ones that thought it was useful, the profit recognition pattern was considered more intuitive and makes more sense [than today]. One of these users added that it was a good indication of how companies cope with the low interest rate environment.
- (b) One user stressed the importance of disclosing the assumptions used in measuring insurance liabilities.
- (c) One user noted that discount rates should reflect what is happening in the real world, currently Solvency II was not helpful in this regard.
- (d) One user saw a potential for significant improvements in corporate governance which will lead to benefit for regulators through better understanding of pricing policies, onerous contracts and risks.

*Concerns with IFRS 17*

64 Eight specialist users provided different the following concerns:

- (a) IFRS 17 would be a very different approach and view of the insurance world. It would be another big change after Solvency II and the time and effort spent understanding that Solvency II change;
- (b) IFRS 17 would affect/change the business models of insurers (e.g. duration of liabilities which would alter the balance with assets, from an asset and liability perspective);
- (c) any possibility of accounting arbitrage that may arise;
- (d) the additional complexity under IFRS 17;
- (e) a reduction in comparability between IFRS 17 and Solvency II as Solvency II does not require profit or loss and also due to the difference in discount rates;
- (f) accounting will still be a ‘black box’ and disclosures are needed to address this concern; and
- (g) the granularity of information and disclosures that will be obtained from companies. For example, how companies will separate product lines, what will happen with discount rates and any tax implications where tax is based on IFRS 17.

65 In addition, five specialist users raised various concerns/points to note regarding reinsurance accounting under IFRS 17:

- (a) Concerns were raised regarding the mismatch in accounting of a primary insurer who obtains reinsurance, how that will work and whether users would be able to understand. For example, difficulties in understanding the asymmetry on reinsurance, relating to recognition of onerous contracts immediately for the underlying contract but including the reinsurance contract held on the balance sheet;
  - (b) The mismatch between reinsurance and insurance was not considered helpful and the net of the two would be preferred. Reinsurance and insurance are not considered separate businesses, and the net effect is considered;
  - (c) The future of reinsurance business could be under threat with the introduction of Solvency II and pricing for reinsurance could be changed in the future; and
  - (d) One user stated that he had witnessed an increase in accounting arbitrage contracts for reinsurance. He considered the new requirements to be helpful.
- 66 The concerns on IFRS 17 from three generalist users are:
- (a) IFRS 17 is not that easy to understand;
  - (b) There were concerns regarding the consistency of the assumptions used by insurers, especially the discount rate used; and
  - (c) IFRS 17 should be changed to require line of business reporting similar to that in Solvency II.