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EFRAG TEG will still hold a discussion on mismatches during its meeting of 16 April 2020. The outcome of that discussion will be provided to the EFRAG Board orally.

IFRS 17 and IFRS 9 Issues Paper

Objective

- 1 This paper discusses the relationship between IFRS 17 *Insurance Contracts* and IFRS 9 *Financial Instruments* as part of Appendix III of the draft endorsement advice of IFRS 17.
- 2 The following key issues have to be covered in the DEA:
 - (a) Request by the EC: EFRAG has to consider potential impact of IFRS 17 taking into account its interaction with IFRS 9, on long-term investment including the investments held by insurance groups.
 - (b) Paragraph 9 of the Motion of the EP: In the wake of IFRS 17 and IFRS 9, two major changes in financial reporting standards are affecting accounting for insurance undertakings. Changes in valuation now occur on both the assets and the liabilities side of insurers' balance sheets, as investment assets are marked-to-market and the valuations of insurance contracts include forward-looking net cash flow estimates; calls on the EFRAG to **assess the potential interaction and any mismatches** between IFRS 9 and IFRS 17.
- 3 This paper focuses on the second issue, except for hedge accounting that is covered by a separate paper. The impact on long-term investment has been already incorporated in the current version of Appendix 3 starting from the deliberations of EFRAG Board in occasion of the recent advice to the EC on equity instruments. (see Appendix)

Interaction of IFRS 17 with IFRS 9

- 4 This part comprises:
 - (a) Overview;
 - (b) Measurement;
 - (c) Equity investment;
 - (d) IFRS 17 promotes fair value measurement of assets;
 - (e) Locked-in discount rate;
 - (f) Asset and liability management;
 - (g) Transition; and
 - (h) Hedge accounting.

Overview

- 5 **Assets**: As a result of applying IFRS 9, financial assets are measured on balance sheet at either amortised cost or fair value. When financial assets are measured at

fair value, gains and losses are recognised either in profit or loss (fair value through profit or loss, FVTPL), or in other comprehensive income (fair value through other comprehensive income (OCI)). Derivative financial instruments (when not used in hedge accounting) equity instruments and financial assets that do not meet the SPPI test are measured at FVTPL. Equity instruments not held for trading may be designated at FVOCI without recycling. Financial assets that meet the SPPI test when held to collect are measured at amortised cost and when held to collect and sale are measured at FVOCI with recycling. Irrespective of the business intent, financial assets may be designated at FVTPL when doing so reduces accounting mismatches.

- 6 **Liabilities:** IFRS 17 requires insurers to discount insurance contract liabilities using a current interest rate and the effect of changes in that interest rate can be reported in profit or loss. Thus, the income and expenses reported in profit or loss, as a result of changes in current interest rates, are expected to offset, to the extent the insurance liabilities are economically matched with the relating assets, the volatility in profit or loss that may arise from financial assets accounted for at fair value through profit or loss.
- 7 **FV option:** IFRS 9 allows all entities, including insurers to elect to measure financial assets at fair value through profit or loss where this addresses an accounting mismatch. This is important as the FV option for financial assets in IFRS 9 allows to minimise accounting mismatches¹.

Measurement

- 8 Measurement possibilities of financial assets and insurance liabilities could be illustrated as follows:

Financial assets (in accordance with IFRS 9)	Insurance liabilities (in accordance with IFRS 17)
Amortised cost (if it passes both the business model and the SPPI test)	
FVPL	Fulfilment value (a current value measurement)
FVOCI (with recycling – SPPI instruments, business model test)	OCI-option for insurance finance or expenses
FVOCI (without recycling – equity instruments)	

- 9 Both IFRS 9 and IFRS 17 include options to reduce accounting mismatches. Whereas IFRS 9 allows entities to elect to measure financial assets at fair value through profit or loss where this addresses an accounting mismatch, IFRS 17 allows entities to make an accounting policy choice between:
- (a) including insurance finance income or expense for the period in profit or loss; or
 - (b) disaggregating finance income or expense between profit or loss and OCI.

Evidence from case studies and economic study

- 10 Under the extensive case study, respondents were asked to identify the related assets of the portfolios included and how these are accounted for today and under IFRS 17/IFRS 9. Some respondents indicated the measurement bases they are using.

¹ Defined as differences arising if the values of assets and liabilities that are economically linked respond differently to changes in economic conditions.

- 11 Half of the respondents did not know whether IFRS 17 would result in a change in investment strategy. The remaining respondents had split views about the issue.
- 12 Respondents to the simplified case study were divided as to whether IFRS 17 would affect their current investment strategy. It was noted that economically risks are unchanged by the introduction of IFRS 17, but the accounting would make these risks visible. For those that expected an impact on their investment strategies, it was due to the intent to reduce capital requirements under Solvency II as well as volatility in profit or loss.
- 13 In the economic study commissioned by EFRAG it has also been noted that:
 - (a) Although there is considerable discussion about insurers moving away from debt securities towards new asset classes and/or equity, the aggregate data from EIOPA on the investments of EU insurers do not show a significant movement out of the debt securities at the EU wide level.
 - (b) The majority of stakeholders interviewed (i.e. supervisory authorities, insurers and external investors) agree that IFRS 17 alone will not impact the asset allocation of insurance undertakings, as this activity is more driven by risk management and/or asset/liability management.
 - (c) However, industry stakeholders expressed the view that the combined effect of applying IFRS 17 and IFRS 9 may have an impact on asset allocation.

EFRAG's analysis

- 14 Based on the assets identified in the case studies there will be few changes in the assets in the balance sheet structurally and from an accounting perspective² under IFRS 9 and indirectly under IFRS 17. However, for the income statement EFRAG assesses that, when measuring the insurance liability in a way that is consistent with observable market information:
 - (a) The income and expenses reported in profit or loss under IFRS 17 as a result of changes in current interest rates are expected to offset, at least to some extent, the volatility in profit or loss that may arise from financial assets accounted for at fair value through profit or loss under IFRS 9.
 - (b) The insurer can:
 - (i) elect the fair value option under IFRS 9 in order to reduce accounting mismatches; or
 - (ii) elect the option under IFRS 17 to disaggregate financial income or expense between profit or loss and OCI.
- 15 Given the few responses, EFRAG has little evidence of equity instruments that were carried at cost³ and the only available evidence points to bonds being classified as Available-for-Sale (AFS) under IAS 39 *Financial Instruments: Recognition and Measurement*. From the economic study commissioned by EFRAG, it is noted that although a significant shift in investments in bonds is not expected, the measurement category might change due to the SPPI test under IFRS 9. Some respondents to the extensive case study noted that they are currently classifying assets as AFS under IAS 39. For further discussion on equity instruments carried at FVOCI under IFRS 9, refer to paragraphs 58 - 60 and 88 - 96 below.

² However, some respondents indicated that complex bonds and equity-like instruments may be classified and measured differently under IFRS 9.

³ Although one respondent commented that illiquid investments may be measured at cost.

- 16 **In summary, EFRAG notes that although IFRS 17 in itself is not expected to change the investment strategy of insurers, the combined application of IFRS 17 and IFRS 9 might have some impact.**

Equity investment

- 17 Insurers invest in equity instruments with the aim of providing more attractive tariffs to policyholders. However, the non-recycling of gains or losses of equity instruments in accordance with IFRS 9 does not allow insurers to show the performance as realised.

- 18 The equity issue has been discussed in paragraphs 58 to 61 and in the chapter on the long-term business model [reference to be included]

IFRS 17 promotes fair value measurement of assets

- 19 IFRS 17 is using a fulfilment value to measure the insurance liabilities. The use of a current value creates a disincentive for insurers to choose another measurement of assets than fair value if they want to avoid accounting mismatches.

Locked-in discount rate;

- 20 Participating contracts not meeting the VFA criteria require to follow in the accounting IT-systems a “locked-in” discount rate in addition to the current rate for the purpose of CSM calculation. In addition, this accounting treatment might generate temporary OCI-volatility.

- 21 The IASB did not change this requirement for the following reasons. The IASB Board noted that accreting interest on the contractual service margin for an accounting period at a current rate differs from measuring cash flows at a current rate. The contractual service margin does not represent future cash flows; it represents the unearned profit in the contract, measured at the point of initial recognition and adjusted only for specified amounts. For insurance contracts without direct participation features, the contractual service margin is not adjusted (remeasured) for changes in interest rates. Accreting interest for a period at a current rate without also remeasuring the contractual service margin at the start of the period would create an internally inconsistent measurement of the contractual service margin.

Asset and liability management

Introduction

- 22 EFRAG expects insurers to define business models under IFRS 9 for financial assets that are consistent with their insurance business. Insurers invest the proceeds from premiums into different asset categories, such as bonds, equities or collective investment undertakings, with the aim of achieving a target investment return. The economic study Commissioned by EFRAG notes that the application of IFRS 17 alone will not impact the asset allocation of insurers as this is more driven by risk management and/or asset and liability management.

- 23 However, the combined application of IFRS 17 for the liability side in conjunction with IFRS 9 *Financial Instruments* for the asset side may have an impact on asset allocation. This is clarified as follows.

- 24 Typically, insurers seek to match the characteristics of their assets with those of their liabilities, in order to minimise economic mismatches between the two. The avoidance of economic mismatches has the effect of reducing volatility in the profit or loss statement. Avoidance of all economic mismatches is however not always possible or even desirable (as assets that minimise the economic mismatch may have insufficient asset returns to cover the expected insurance expenses). In selecting the assets, the asset liability management of the insurer will therefore consider not only the characteristics of the liabilities, but also the return of the assets and the solvency requirements related to it (different asset categories are more or

either less “expensive” in terms of regulatory capital depending on their nature, e.g. investments in equity require the insurer to hold more regulatory capital than investments in bonds).

- 25 The asset and liability management function will consider all of the above criteria in order to select the optimal asset portfolio(s). Nevertheless, it is noted by insurers that the application of IFRS 17 and IFRS 9 together will increase the volatility in profit or loss. Why is that?
- 26 The main reason for this is that IFRS 17 measures the insurance liability independently from the assets on the balance sheet (i.e. there is no accounting mirroring). That principle is upheld even for contracts with direct participation features, where the discount rate reflects the variability of the financial underlying items. Notwithstanding this variability adjustment economically linked to the assets, the discount rate still needs to reflect the other characteristics of the liabilities, as a main principle.
- 27 As a result, when economic mismatches exist between the asset and the liability side, the accounting will have to reflect this with resulting volatility in the profit or loss statement. In addition the application of IFRS 17 and IFRS 9 also creates some accounting mismatches. However, as mentioned in the chapter relating to the long-term business model, asset allocation decisions are driven by a plurality of factors and disentangling the impact of accounting requirements from other factors such as expectation of future returns or assets, regulations, taxes and prudential requirements is difficult.
- 28 Hence, it is stated by some insurers that the application of IFRS 17 and IFRS 9 together may lead to changes in asset allocation; however such re-allocations would have to consider other factors, such as the ones described in paragraph 24 above.
- 29 The economic study commissioned by EFRAG also notes that some insurers are of the view that investments in equity and structured funds will be become less attractive as these result in higher volatility in the profit or loss. Similarly as for potential re-allocations, such divestments would have to consider other factors, such as the ones described in paragraph 24 above. In addition, divestments in listed equities, in order to invest in non-listed equities, may raise other issues, such as an increase to risk factors including liquidity and credit risk with knock-on effects on the regulatory capital requirements.

The use of a dedicated fund or a general fund of assets

- 30 The degree to which matching insurance liabilities and assets backing those liabilities can be successfully matched depends on a number of factors:
- (a) The use of a dedicated fund of assets or a general fund of assets;
 - (b) The existence of economic mismatches between the assets and the liabilities; and
 - (c) The existence of accounting mismatches between the assets and the liabilities.
- 31 Some insurers invest in a dedicated fund, where a direct economic link exist between the assets and the liabilities, whilst others make use of a general fund where there is no direct link between the assets backing the liabilities.

Evidence from case studies

- 32 The case studies showed:

- (a) In the extensive case study that, of the nineteen portfolios⁴, eleven were funded through a general fund of assets, while eight were funded through a dedicated fund of assets.
- (b) in the simplified case study that half of the respondents held assets that back specific liabilities whilst the other half generally held assets in a general fund.

Economic mismatches

33 Insurance entities typically seek to match the characteristics of their assets with their liabilities to minimise economic mismatches⁵ between the two. Economic matching depends on several factors (for example, the unavailability of assets of sufficient duration, the deviation between expected and actual when pay-outs on insurance contracts, and the insurer’s intent to generate higher returns).

Evidence from the case studies

34 From the extensive case study respondents provided information on the following economic mismatches:

- (a) Currency mismatches;
- (b) Credit spread risk mismatches within the same currency (euro); and
- (c) Duration mismatches.

35 For three portfolios currency mismatches were quantified. For one portfolio, backed by a dedicated fund, the mismatch was small. The two other portfolios backed by a general fund showed much bigger differences, however no conclusions can be drawn as information on the size of the general fund compared to the tested portfolio was not received.

36 For 13 portfolios credit spread risk mismatches were reported, and for only three of these, quantitative information was provided.

37 As an illustration of the potential effect of credit spread risk mismatches, consider the following market interest rates:

Euro Member State	Interest on 30-year government bonds ⁶
France	1.63%
Germany	1.10%
Italy	3.52%
Spain	2.58%

38 Many of these credit spread risk mismatches were significant reflecting the credit spreads of each Eurozone Member State. In particular, respondents used qualifications such as “most”, “majority” or “mainly” to indicate whether their assets were held in the same jurisdiction as the corresponding liabilities.

39 The portfolios that were backed by a general fund of assets showed a significant average duration mismatch of 20%. In contrast, portfolios that were backed by a dedicated fund of assets showed a much smaller average duration mismatch of 4%.

⁴ For life insurance portfolios where sufficient information was received.

⁵ Defined as differences arising if the values of assets and liabilities respond differently to changes in economic conditions.

⁶ As at 11 September 2018.

- 40 Based on whether the portfolios were accounted for in accordance with the General Model or the VFA, no other particular trend information could be derived.

EFRAG's analysis

- 41 Economic mismatches are more prevalent in cases where portfolios are backed by a general fund as opposed to a dedicated fund. As a clear link between insurance liabilities and underlying assets is not needed under the General Model, it is more difficult to align the characteristics of the assets and the insurance liabilities in order to mitigate volatility. For the credit spread risk mismatches, EFRAG obtained evidence that there is significant variability.
- 42 Although the VFA could be applied in cases where entities do not hold the underlying assets, EFRAG is of the view that in such cases another economic mismatch arises, as changes in assumptions of the IFRS 17 liability will be recognised in profit or loss over time without the recognition of similar changes in assets.
- 43 Consequently, EFRAG is of the view that the mismatches identified above do not arise solely from the application of IFRS 17 and IFRS 9 but are economic in nature.
- 44 EFRAG considers that reporting in profit or loss the extent of the economic mismatches is a useful information, as it provides information about the possible future ability of the entity to generate sufficient cash flows from the assets to cover the liability obligations. It also provides information about the residual risks to which the entity is exposed.

Accounting mismatches

- 45 When applying IFRS 17 and IFRS 9 together, accounting mismatches could arise from insurance liabilities measured at a risk-adjusted present value while assets backing the liabilities are measured differently. An overview of these accounting mismatches is provided below:

	VFA			General model		
	w. OCI-option	without option	OCI-	w. OCI-option	without option	OCI-
Amortised cost	X	X		X	X	
FVOCI	V	X		V	X	
FVPL	X	V		X	V	

- 46 Other accounting mismatches are:
- (a) On transition, when applying the OCI option, OCI on liabilities has to be set to nil for non-VFA participating contracts;
 - (b) Risk mitigation cannot be applied retrospectively;
 - (c) IFRS 9 provisions on financial instruments derecognised in prior year deter from restating comparative financial statements.

OCI option for non VFA participating contracts under the MRA

- 47 For an entity that chooses to disaggregate insurance finance income or expenses between P&L and OCI in accordance with IFRS 17.88 (b), the MRA requirements indicate that the cumulative OCI relating to non-VFA contracts at the transition date should be assessed as nil under the assumption that the discount rate retained is the current rate on transition (IFRS 17.C19(b)(ii)).

- 48 From an economic standpoint, there is an issue in considering that changes in discount rate have not yet been recognised on the asset side (measured at amortised cost of FVOCI), whereas the insurance liability would be recognised on transition at a current value, e.g. implicitly considering that past changes in discount rate have been recorded in the retained earnings.
- 49 Not considering any impact of the OCI carried forward on the liabilities could significantly impact the result of future periods and then undermine the credibility of the transition which is a higher risk than the risk of hindsight created by accepting to retrospectively calculate former FCF.

Interaction with IFRS 9 – Risk mitigation

- 50 Risk mitigation provisions in IFRS 17.B115 allows for recording in the P&L instead of in the CSM the financial risk's component of changes in the CSM, in order to match the corresponding changes in the derivatives. Retrospectively apply such risk mitigation on transition would accordingly impact the CSM and the retained earnings.
- 51 However IFRS 17.C3(b) specifically prohibits a retrospective application of risk mitigation that may “give rise to the risk of hindsight” (IFRS 17.BC 393).
- 52 Conversely not reflecting it on transition could distort the historical CSM and significantly impact the insurance result for years.

Interaction with IFRS 9 – Comparative information in 2022

- 53 Applying IFRS 9 provisions, an entity deciding to restate the comparative year 2022 will have to apply both standards (i) IAS 39 on financial instrument derecognised before transition and (ii) IFRS 9 on financial instrument that have not been derecognised before transition.
- 54 Restating the comparative period provides more relevant information but applying both standards would be operationally burdensome and conceptually inconsistent so that it would deter preparers from choosing that option.
- 55 There is no conceptual reason for providing a relief on the retrospective application of IFRS 9 to financial instruments that have been derecognised before transition. It is a practical expedient that aimed at facilitating the transition on a standalone basis i.e. where no further collateral impact would arise. By contrast, when applied at the same time as IFRS 17, this provision leads to undue complexity when restating the comparative year.

Evidence from case studies

- 56 In its extensive case study, EFRAG noted the following product lines and how they were expected to be accounted for carried under the different approaches.

General Model	VFA	PAA
Annuities	Annuities	Motor
Non-life	Savings / Protection	Other
Protection	Unit linked	
Reinsurance ceded and held	Other	
Savings/Protection		
Unit linked		
Indirect participation		
Other		

EFRAG's analysis

- 57 In conclusion, entities that qualify and apply the VFA and manage their assets and liabilities together in order to reduce economic mismatches, can reduce economic and accounting mismatches significantly. However remaining economic and accounting mismatches are still present when the General Model are to be applied.

Equity instruments at fair value through OCI without recycling

- 58 IFRS 9 allows for equity instruments to be carried at fair value through OCI. However, the amount in OCI will never be recycled in profit or loss apart from dividends received which are recognised in profit or loss directly. If these instruments back insurance liabilities an accounting mismatch can arise as over time the changes in the insurance liabilities will be recognised in profit or loss whereas the changes to any equity instruments backing those liabilities will never be recycled through profit or loss.

Evidence from case studies

- 59 As part of evidence received, concerns have been raised by insurers that in the case of contracts with participation features, the share of profit of the policyholder is recognised in profit or loss over the total contract term, while for equity instruments at FVOCI the investment income will never be recognised in profit or loss. The lack of recycling is therefore perceived to create an accounting mismatch with the measurement of insurance liabilities.

EFRAG's analysis

- 60 EFRAG notes that the share of profit for the shareholders will be recognised in P&L over the period via the release of CSM to profit or loss.
- 61 Furthermore, the option to measure equity instruments at fair value through OCI is an option and not a requirement under IFRS 9 and excludes dividends which are accounted for through profit or loss. However, EFRAG notes that the reason for exercising this choice is to mitigate the volatility of the effect of strategic investments within the income statement. Nonetheless, EFRAG is generally of the view that if those assets are backing insurance liabilities, entities could choose to measure such instruments at fair value through profit or loss as opposed to OCI to reduce any perceived possibility for an accounting mismatch that could arise. There is one exception to this view. In case equity instruments are held within the context of a general fund that backs both participating insurance contracts and the insurer's own funds. In that case, the fair value changes arising from equity instruments are shared between the policyholders and the shareholders. Measuring equity instruments at FVPL would increase volatility because the shareholder's share in the fair value changes would also be recorded through profit and loss without any offset on the liability side.

Risk mitigation option in IFRS 17 and hedge accounting

- 62 The concerns relate to the risk mitigation option in IFRS 17 deals with contracts under the VFA and retrospective application of the risk mitigation option.
- 63 As with other industries, accounting mismatches may arise where a hedging instrument and hedged item are not measured consistently.

Evidence from case studies

- 64 Respondents indicated that derivatives are not the only method of hedging, other hedging instruments include mortality bonds or investments in special funds, but how these are accounted for were not discussed.
- 65 The IASB tentatively decided to retain the transition requirement in IFRS 17 that prohibits retrospective application of the risk mitigation option. In addition the IASB tentatively decided to amend IFRS 17 to expand the scope of the risk mitigation

exception for insurance contracts with direct participation features so that the exception applies when an entity uses a derivative, a non-derivative financial instrument measured at FVPL or a reinsurance contract held to mitigate financial risk, to the extent that the entity meets certain conditions.

Use of a locked-in discount rate for the contractual service margin – General model

- 66 The impact of assumption updates is absorbed in the CSM at the locked-in rate. The BEL⁷ is measured at the current rate. Some stakeholders have stated that the difference between the locked-in and the current rate is reflected in the P&L and will significantly distort the current period result. In addition, the use of the a locked-in discount rate (compared to all other components being based on current rates) would give rise to a material accounting mismatch.
- 67 In the situation where the BEL component of the insurance liability is an asset and the CSM component is a liability, some stakeholders have stated that inconsistencies arise due to the different discount rates for BEL (current rate) and CSM (locked-in rate) again giving rise to accounting mismatches.

EFRAG's analysis

- 68 EFRAG notes that insurers applying the VFA for contracts with direct participation features that use derivatives and financial instruments measured at FVPL to manage financial risks are permitted, but not required, to apply IFRS 17's 'risk mitigation solution'. Using this solution, the effects of changes in the effect of financial risks that would otherwise adjust the CSM under the VFA approach are instead recognised in profit or loss. One of the conditions for applying this option is to document the risk management objective and the strategy for mitigating the risk. This is in principle similar to IFRS 9's documentation requirement to be eligible for hedge accounting, however the conditions for hedge accounting, including testing every reporting period the hedge effectiveness, are more operationally complex to apply than the risk mitigation⁸.
- 69 Therefore, EFRAG notes that the recognition of changes in that financial risk in profit or loss partially offsets the effect of fair value changes in the relevant derivatives that are recognised in profit or loss and reduces potential accounting mismatches.
- 70 EFRAG notes that the issue of locked-in versus current rates for the CSM (both in the interest accretion and when updating for changes in estimates) impacts relevance and prudence. The CSM is a "cost-based" deferral that avoids a day 1 gain and provides a mechanism to allocate profit over the insurance coverage period.
- 71 In the extreme example where only interest rates change (with no other changes), the CSM and related amortisation would change if the CSM were to be accreted at current rates instead of locked-in rates. This would not appear to provide relevant information. This would also mean that the changes in discount rate that ought to be treated as investment result would be reported in the underwriting result through the release of the CSM.
- 72 Alternatively, when a change in non-financial assumptions occurs when the current interest rate is different to the locked-in interest rate the following would happen. The CSM would be impacted at the locked-in rate while the insurance finance income and expenses would be affected by the difference between the current and locked-in rate on the amount of those non-financial assumptions, creating volatility in the results.

⁷ Best Estimate of the Liability

⁸ However, hedge accounting under IFRS 9 is also subject to other more onerous eligibility criteria that do not apply to IFRS 17's risk mitigation solution.

- 73 In EFRAG's view, the following qualitative observations can be done:
- (a) Currently, under IFRS 4 important accounting mismatches exist: assets are measured at fair value whereas liabilities at cost (no discounting at all or at locked in rates), this mismatch is only partially solved by shadow accounting.
 - (b) When defining the accounting for financial assets under IFRS 9, an insurer would not apply business models determined in isolation, but rather business models that are supportive of or complementary to their insurance liability business;
 - (c) The choice of financial assets will continue to be driven by the ALM-function and will be defined considering more the degree of risk, liquidity, the expected return and cost in regulatory capital of these financial assets than their accounting measurement (i.e. with the aim of building of an economic neutral position);
 - (d) The ALM-function may opt to introduce an "optimisation window" or "Strategic Asset Liability Mismatch" in the balance sheet, i.e. ensuring that asset revenues not only cover expected insurance expenses but also provide a degree of extra return to the shareholders of the insurer;
 - (e) Financial assets – whether they are directly related to particular liabilities or not – can get reallocated over time. Reallocation is the situation whereby, as from a particular date, the return of an asset is no longer assigned to liability A, but to liability B instead. EFRAG's extensive case study showed that although reallocation of (financial) assets does not happen often, it does occur; and
 - (f) The accounting-function may rely on a number of accounting techniques in both IFRS 9 and IFRS 17 to reduce accounting mismatches.
- 74 The interaction between each of the above internal policy decisions will determine the importance of any accounting mismatches remaining in the balance sheet and this may differ largely from one insurer to another.

Option for the presentation of changes in financial assumptions

- 75 Changes in insurance contract liabilities may be the consequence of changes in financial assumptions (i.e. discount rates and other financial variables). When applying IFRS 17, an insurer will recognise the effect of some changes in financial assumptions in the period in which the changes occur. However, the insurer will choose whether to present this effect:
- (a) in profit or loss, or
 - (b) disaggregated between profit or loss and OCI.
- 76 The choice will be made individually for each portfolio of insurance contracts. Portfolios are determined based on risk characteristics of insurance contracts and how these are managed, rather than on any relationship with assets held. The flexibility in the presentation of the effects of changes in financial assumptions provided by IFRS 17 will allow an insurer to align the accounting treatment of each portfolio of insurance contracts with the accounting treatment of the assets that back that portfolio.

Evidence from case studies

- 77 In the extensive case study, some respondents accounted for their insurance finance income or expense through profit or loss under IFRS 17. The remaining 60% chose the disaggregation between OCI and profit or loss.
- 78 No general conclusions could be drawn from the extensive case study on the impact on volatility of combining IFRS 9 and IFRS 17. Respondents did not distinguish,

when measuring sensitivities, between the accounting and the economic mismatches impacting their balance sheets. The most common economic mismatch was the credit risk mismatch as described above. In addition, an overall high sensitivity to equity risk was reported, even while there was a low to very low level of investments in equity instruments.

EFRAG's analysis

- 79 EFRAG expects that insurers will choose the option that minimises accounting mismatches between investment income from financial assets and insurance finance expenses from insurance contract liabilities. For example, if an insurer mainly holds financial assets at fair value through profit or loss, it is expected that the insurer would present all changes in insurance contract liabilities from financial assumptions in profit or loss. The changes in financial assumptions might impact assets and will then be partially offset by a similar impact on the insurance liabilities with a reduced overall effect on profit or loss.

Credit risk

Expected credit losses in accordance with IFRS 9

- 80 IFRS 9 includes an expected credit loss model for financial assets. The question arises how the application of this expected credit loss model interacts with IFRS 17.
- 81 The insurance liabilities under IFRS 17 are measured independently from the underlying (financial) assets that support them. When applying discounting in determining the measurement of the insurance liabilities, the following applies:
- (a) When the cash flows from the insurance contracts vary based on the returns on any financial underlying item, the discount rate will reflect that variability;
 - (b) When the cash flows from the insurance contracts do not vary based on the returns of underlying items, the discount rate is determined starting either from a risk-free yield curve (bottom-up approach) or reference portfolio of assets (top-down approach) thereby eliminating any factors that are not relevant to the insurance contracts.
- 82 When financial assets are derecognised (or are held till maturity) and the credit risk did not realise (i.e. the financial asset is paid back in full), the initial provision is reversed at derecognition.
- 83 EFRAG assesses that for contracts under the Variable Fee approach (i.e. contracts with cash flows that mainly vary on the returns of underlying items), the expected credit loss provision would only affect the variability of the insurance cash flows if the expected return on the underlying items is affected. In other words, when the credit risk realises. In normal circumstances where the credit risk does not realise, the initial cost of the provision is reversed at the end of the investment.
- 84 EFRAG further assesses that for contracts under the General Model the expected credit-loss provision would not affect the measurement of these insurance contracts.

Credit risk in accordance with IFRS 17

- 85 In addition to the above, credit risk also arises from the insurance contract liabilities themselves, i.e. the risk of non-payment of premiums. The credit risk is included in the measurement of the insurance contract liabilities. It is not part of the risk adjustment as this focuses on non-financial risk only.
- 86 On the other hand, credit risk arising from the underlying assets is excluded from the measurement of the insurance liabilities. For example, when using a reference portfolio to build the discount rate, market risk premiums for credit risk are excluded as these are relevant only to the assets included in the reference portfolio.

- 87 IFRS 17 requires disclosing the maximum exposure to credit risk, separately for insurance contracts issued and reinsurance contracts held. In addition, IFRS 17 requires disclosure about the credit quality of reinsurance contracts held as assets.

Transition

OCI under the fair value approach

- 88 At transition, under the fair value approach, entities have the possibility of setting OCI on the insurance liabilities to nil as per paragraph C24(b) of IFRS 17. This option is not available to assets accounted for at fair value through OCI under IFRS 9. Therefore, EFRAG acknowledges that setting OCI on the liabilities to nil at transition, whilst maintaining the historical OCI on related assets has an asymmetric impact on equity at transition and the results going forward.
- 89 Alternatively, the mismatch in OCI at transition could be addressed by using the locked-in rate at the date of transition for the fair value methodology based on the rate of the underlying assets.

Evidence from case studies

- 90 In the extensive case study, it was noted that of the 14 portfolios under the fair value transition approach, respondents indicated the following with regards to the option of setting OCI to nil:
- (a) For 21% of the portfolios OCI will be equal to the cumulative amount recognised in OCI from the underlying items.
 - (b) For 14% portfolios the OCI will be set at nil as they are not restricted by IFRS 17 paragraph C24(c) from applying the option. Also, the selected portfolios were measured under the general model.
 - (c) For the remaining selected portfolios, no information was provided on the treatment of OCI at transition.
- 91 In March 2020 the EFRAG Secretariat held an enquiry about the intention of IAWG members to set the OCI balance to nil. The EFRAG Secretariat received eight replies to this enquiry.
- 92 Three members did not report remaining concerns. Two of them don't have contracts in the scope of the suggested relief (i.e. FVA at transition and OCI-option to disaggregate financial results). One because they were not planning to apply the fair value approach, another because they were not planning on using the OCI-option.
- 93 The third was not planning to set the asset OCI balances to nil at transition, should such an option be granted. This is due to different reasons:
- (a) Result impact: Based on their impact assessments, no significant distortions occurred from the fact that in some cases the liability OCI is set to nil at transition under the fair value approach. In addition, setting the asset OCI balance to nil would distort the investment result, because by doing so any accumulated unrealized gain or losses from the assets would disappear.
 - (b) Operational complexity: It would be mechanically overly complex if to set the asset OCI balances to nil. This would require manual adjustments of the affected investments in our investment subledgers.
 - (c) Conceptual issues: It is not at all clear how this should work in the subsequent measurement.
- 94 Out of the 5 entities that reported remaining concerns,
- (a) two provided a quantitative impact of the assets for which they would have set OCI to nil, should the IASB consider the amendment;

- (b) two still referred to setting OCI to nil in the asset side, but did not provide quantitative impacts. One provided counter-arguments that were being considered, such as a future declining path of earnings of the fact that the VFA was not the best choice for them;
- (c) two referred to the preference to set a discount rate for the liabilities similar to that for the assets.

EFRAG's analysis

95 EFRAG has considered the following elements:

(a) Asset side:

- (i) IFRS 9 is to be applied retrospectively, with few exceptions and considering IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. IFRS 9 is not applied to items that have already been derecognised at the date of initial application;
- (ii) The OCI-balance from the underlying assets refers to unrecognised fair value changes that occurred before transition date;
- (iii) The OCI-balance from the underlying assets may be partly the result of the use of an optimisation window in the balance sheet by the asset and liability management function as discussed in paragraph 73(d) above;
- (iv) The business model related to bond investments held at FVOCI is achieved by both collecting contractual cash flows and selling financial assets. In addition, the OCI-balance resulting from investments in bonds reverses to zero over time (when the bonds are held until maturity). In addition, upon derecognition there is recycling to profit or loss;
- (v) The OCI-balance from investments in equities does not recycle upon derecognition; and
- (vi) The OCI-balance from investments in bonds held at FVOCI partly relates to expected credit losses on these financial instruments.

(b) Liability side:

- (i) In accordance with IFRS 17, fair value at transition is one of the transition methods used when retrospective application is not possible;
- (ii) The OCI-balance at transition depends on the difference between interest rates when the insurance contracts were written and interest rates at transition:
 - When transition interest rates are lower than interest rates when the insurance contracts were written (the most likely scenario for insurance contracts written in Europe over the past years), the cumulative amount recognised in OCI, applying IFRS 17 retrospectively, would be a debit balance. This results in a higher insurance finance expense in reporting periods after transition compared to an approach that sets the cumulative amount recognised in OCI at nil;
 - When transition interest rates are higher than interest rates when insurance contracts were written, the cumulative amount recognised in OCI, applying IFRS 17 retrospectively, would be a credit balance, resulting in a lower insurance finance expense compared to an approach that sets the cumulative amount recognised in OCI at nil;
- (iii) IFRS 17 measures insurance liabilities as in their own right, there is no mirroring (even for contracts with direct participation features the

measurement reflects in the first place the characteristics of the liabilities); and

- (iv) When measuring the fair value of a liability (and an identical item is not held by another party as an asset), IFRS 13 notes that a valuation technique from the perspective of a market participant that owes the liability is to be used. Examples of such measurement techniques in measuring fair value in this situation are i) estimating future cash outflows a market participant would expect to incur in fulfilling the obligation, or ii) estimating the amount a market participant would receive to enter into an identical liability. Such measurements relate to future developments.

(c) Asset and liability sides combined

- (i) The effects on insurance finance expense are combined with the investment income from financial assets held by the insurer, resulting in an investment margin.

- 96 EFRAG acknowledges that for insurance contracts under the general model the OCI-balance will not always balance at transition between insurance liabilities and underlying assets. In an economic environment of declining interest rates Europe has witnessed over the past years, it is likely that the OCI-balances of bond investments are important.

Setting the OCI-balance on the assets side to nil

- 97 EFRAG identifies a number of issues in setting the OCI-balance to zero for underlying assets when applying the modified retrospective approach to transition:

- (a) Setting the asset-OCI balance to nil overrides the (long-term) business model of holding the related bonds which is based on collecting cash flows and selling; however, on transition there is no selling or derecognition of the bonds;
- (b) As there is a duration mismatch between (shorter term) assets and (longer term) liabilities the fair values of both have a different sensitivity to interest rate risk. Hence, even applying the same rate for both assets and liabilities at transition date results in different changes in the OCI balances for respectively assets and liabilities at transition date +1;
- (c) When the assets are held in an FVOCI business model, assets are occasionally sold. Given the shorter duration of the assets compared to the liabilities, recycling of the OCI-balance may be difficult as it has been moved to retained earnings at transition.
- (d) As the OCI-balance of a bond pulls to par over the life of the bond (over and beyond the date of transition), the (subsequent to transition) asset-OCI-balance may have a different sign than the one of the corresponding insurance liabilities. It leads to desynchronization between the asset-OCI balance and the liability-OCI-balance.
- (e) Permitting entities to deem the cumulative amount in OCI related to corresponding assets to nil at transition to IFRS 17 would involve an amendment to IFRS 9.

Aligning the OCI-balance of the assets to the OCI-balance of the liabilities by means of the locked-in (or alternatively a market yield) rate at transition

- 98 EFRAG has identified the following issue in applying this methodology:

- (a) As there is a duration mismatch between (shorter term) assets and (longer term) liabilities the fair values of both have a different sensitivity to interest rate risk. Hence, even applying the same rate for both assets and liabilities at

transition date results in different changes in the OCI balances for respectively assets and liabilities at transition date +1.

Overall conclusion on adjustment of the OCI-balance at transition

- 99 EFRAG understands the wish to match insurance finance income and expenses from assets and liabilities at transition and beyond and notes this may be helpful for a number of entities as they can match their asset-OCI balance with their liability-OCI balance. However, from a conceptual point of view, EFRAG notes there are a number of concerns as explained above that may affect the usefulness of the information that results from applying these methods.

Comparative information

- 100 In contrast to IFRS 17 which requires one year of comparative information, IFRS 9 permits, but does not require, an insurer to restate prior periods if it is possible without using hindsight. When an insurer does not restate prior periods (either as a matter of choice or because restatement without use of hindsight is not possible), the financial statements in which IFRS 17 is first applied will include restated comparative information for insurance contracts but the associated financial assets will be reported in accordance with IAS 39.

EFRAG analysis

- 101 EFRAG notes that IFRS 9 is applied retrospectively but it is not applied to items that have already been derecognised at the date of initial application, instead IAS 39 is applied to those financial instruments. This leads to a complex mixture of financial instrument accounting which EFRAG considers not very useful for users of financial statements

Hedge accounting

- 102 The possibilities of applying hedge accounting are discussed in a separate paper.

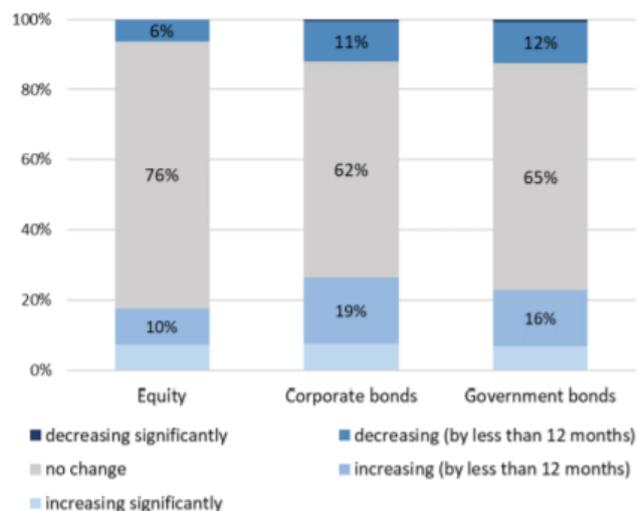
Question for EFRAG Board

- 103 Does EFRAG Board have comments on this paper? Please explain.

Appendix 1: Long-term business model

Potential effect on the long-term business model

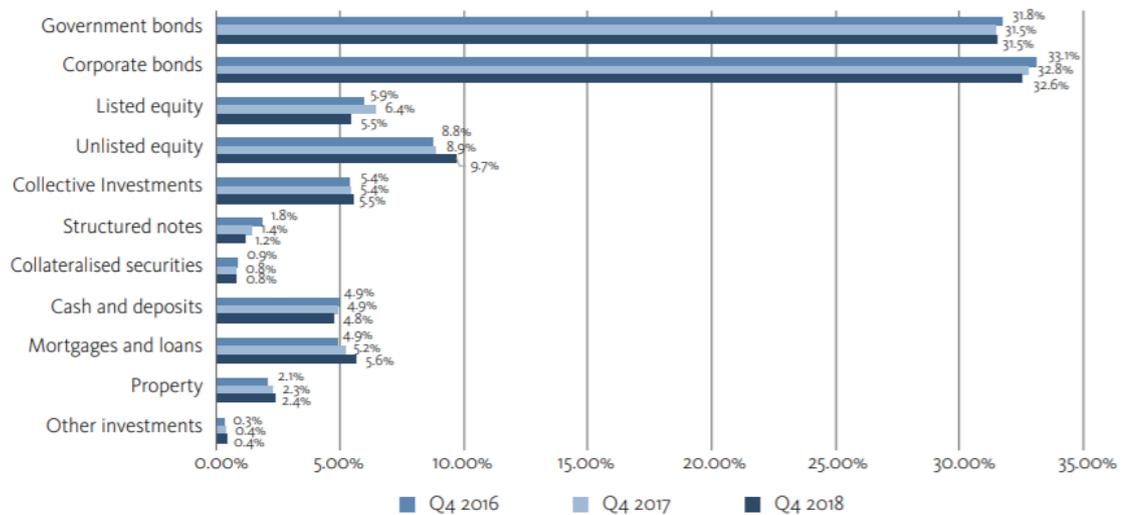
- 104 The request for Endorsement Advice by the European Commission to EFRAG asks “*EFRAG to analyse the potential impact of IFRS 17, taking into account its interaction with IFRS 9, on long-term investment including the investments held by insurance groups*”.
- 105 EFRAG notes the results of a recent investigation carried out by the European Supervisory Authorities, performed to collect evidence and stakeholders’ views on undue short-term pressure from financial markets on corporations. In its advice issued in December 2019, EIOPA observes that the financial literature often describes short-termism as the tendency to prioritise near-term shareholder interests and profitability at the expense of the long-term growth of the firm. EIOPA notes that short-term behaviour cannot be simply associated with a short investment horizon; instead, it is the tendency to focus on short-term profits without ensuring sufficient investment for long-term needs and development.
- 106 In its Advice to the European Commission issued in December 2019, EIOPA observes that the lack of an appropriate framework and a commonly accepted definition of excessive or undue short-termism prevents the authorities from pointing out and clearly analysing insurance institutions’ term behaviours and makes it harder to find clear evidence from which to draw conclusions. In addition, EIOPA concludes that the investigation has not found strong evidence for practices or trends that could be considered undue short-term behaviour. In addition, EIOPA in its Advice presents the results of a survey of a sample of entities:
- (a) the top 3 determinants for the time horizon underlying the business activity, are the profitability aspects, the shareholders’ interest and the prudential regulation. The top 5 include the monetary policies and macroeconomic factors and then the client demand. Reporting requirements, which are not included in the top 5 determinants, have high relevance according to 12% and medium relevance for the 31% of the sample, 34% attaching low relevance and the rest no relevance to reporting requirements;
 - (b) the top 3 determinants for the holding periods are the liability structure (which naturally reflects the business strategy and the client demand), the profitability aspects and the monetary policies and macroeconomic factors. The top 5 also include the prudential regulation and the shareholders’ interest. Reporting requirements, which are not included in the top 5 determinants, has high relevance according to 7% and medium relevance for the 22% of the sample, 32% attaching low relevance and the rest no relevance to reporting requirements;
 - (c) Several participants mentioned that they enforce ‘buy and hold’ strategies, but this does not imply a ‘buy and forget’ strategy: the necessary cash flows, policyholders’ behaviour and market developments determine adjustments to the portfolios. In more detail, the holding strategy aims to match the assets with the long-term liabilities, and only a small portion of the portfolio is usually subject to active trading and characterised by a shortened horizon to be able to react to sudden pay-outs. In the next 2 years, the participants expect to keep the holding periods of their portfolios rather stable (see Figure below). In more detail, investments in equity were revealed to be the most stable: more than three quarters of the participants are planning to keep the holding period constant in the near future.



Source: EIOPA, ad hoc survey 2019.

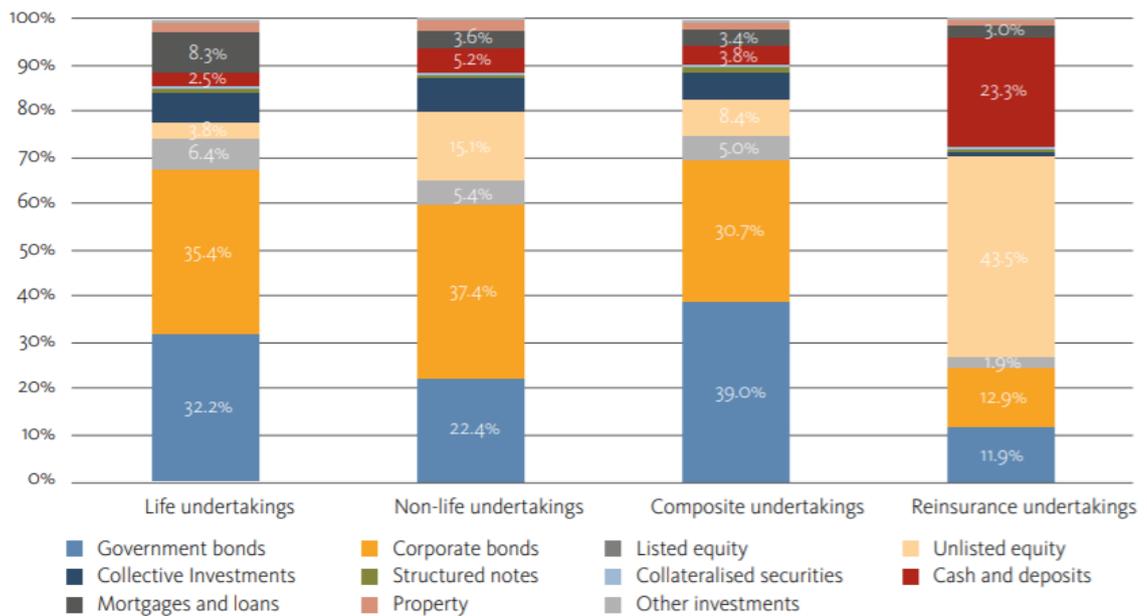
- 107 ESMA in its Advice to the European Commission issued in December 2019 summarises findings on how fair value may impact the capacity of financial reporting to provide relevant and reliable information on equity instruments held for long-term investment purposes. ESMA observes that neither the public survey, nor the collection of evidence from literature have highlighted that fair value measurement results in distortions of the investment process that trigger undue short-term pressures in financial markets. Fair value is deemed to be a relevant measurement basis for both managers and investors, and there is no evidence (or at least, no evidence yet) on the consequences of the implementation of IFRS 9 on long-term investment practices. This lack of evidence may also be due to the recent application of IFRS 9 by most issuers in Europe. Moreover, it was highlighted that the selection of investment horizons does not depend fundamentally on fair value measurement for equity and equity-like instruments as provided for in IFRS 9. ESMA therefore considered that on the basis of the evidence collected, no need for amending the existing requirements for fair value measurement has been identified to address concerns with undue short-termism.
- 108 The broad overall pattern of asset allocation among the key investment categories by European insurers has remained fairly stable over the past decade, despite significant changes in regulation and economic conditions over this time horizon. Asset allocation decisions are driven by a plurality of factors, among which external financial reporting requirements might play some part but do not appear to be a key driver. [EFRAG Economic study 2018]
- 109 There is no indication that IFRS 17 in isolation would lead to any significant changes in European insurers' decisions on asset allocation or holding periods. However, some insurers have indicated that the combination of IFRS 17 and IFRS 9 may lead to changes as they see a connection between application of both standards together. The main explanation provided relates to the removal of IAS 39's AFS category in relation to equity and equity-type instruments. Entities are concerned the combination of IFRS 17 and IFRS 9 does not always portray the economic linkage between their holdings of equity investments and some of their liabilities.

- 110 EFRAG’s previous investigations on the use of the AFS category in 2018 based on 2017 financial results found that there is a high level of concentration of holdings of instruments classified as AFS in a relatively small number of entities. Some insurers make little or no use of the AFS classification and classify most or all of their equity instruments at FVPL: such entities should not be affected by IFRS 9’s requirements (on the assumption that the classification does not change because of IFRS 17).
- 111 EIOPA has provided some information about investments by the insurers in Europe on a Solvency II basis. Not all insurers in this population will prepare financial statements on an IFRS basis and these figures would not include the investments of those subsidiaries outside the supervision of EIOPA, but still provide useful information. [to be updated with 2019 numbers once available]
- 112 Analysis by type of assets:



Source: EIOPA Quarterly Solo
Reference Date: Q4 2018
Note: Look-through approach applied. Assets held for unit-linked business are excluded. Equities include holdings in related undertakings.

- 113 Type of assets by type of insurer:



Source: EIOPA Quarterly Solo
Reference Date: Q4 2018
Note: Look-through approach applied. Equities include holdings in related undertakings, which account for most equities held by reinsurers. Assets held for unit-linked business are excluded.