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EFRAG's Letter to the European Commission Regarding Endorsement of *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4*

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European Commission
1049 Brussels

[dd Month] 2017

Dear Mr Guersent,

Adoption of *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4*

Based on the requirements of the Regulation (EC) No 1606/2002 of the European Parliament and of the Council on the application of international accounting standards, EFRAG is pleased to provide its opinion on the *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4* (the Amendments), which was issued by the IASB on 12 September 2016. An Exposure Draft of the Amendments was issued on 9 December 2015. EFRAG provided its comment letter on that Exposure Draft on 15 February 2016.

The objective of the Amendments is to address the concerns of insurance companies and users of their financial statements about the different effective dates of IFRS 9 *Financial Instruments* and the forthcoming insurance contracts Standard. The Amendments aim to meet this objective by providing two alternatives, optional accounting treatments that an entity can select subject to specified eligibility criteria.

The Amendments become effective for annual periods beginning on or after 1 January 2018. A description of the Amendments is included in Appendix 1 to this letter.

In order to provide our endorsement advice as you have requested, we have first assessed whether the Amendments meet the technical criteria for endorsement, in other words whether the Amendments would provide relevant, reliable, comparable and understandable information required to support economic decisions and the assessment of stewardship, lead to prudent accounting and are not contrary to the true and fair view principle. We have then assessed whether the Amendments would be conducive to the European public good.

We provide our conclusions below.

Do the Amendments meet the IAS Regulation technical endorsement criteria?

EFRAG has concluded that, in the specific circumstances arising from the misalignment of effective dates referred to above, the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship and lead to sufficiently prudent accounting. EFRAG has also assessed that the Amendments do not create any distortion in their interaction with other IFRS, especially in that they were developed to address concerns arising from the misalignment of effective dates and that these concerns were raised in EFRAG's endorsement advice on IFRS 9. EFRAG has also concluded that all necessary disclosures are required. Therefore EFRAG has concluded that the Amendments are not contrary to the true and fair view principle. EFRAG's reasoning is explained in Appendix 2 to this letter.

Are the Amendments conducive to the European public good?

EFRAG has assessed that the Amendments would serve to reduce the negative financial reporting and cost consequences that would otherwise arise from implementing IFRS 9 before the forthcoming insurance contracts Standard and would reach an acceptable cost-benefit trade-off.

EFRAG's analysis is that the Amendments address the main concerns of groups whose activities are predominantly related to insurance ("predominant insurers"). EFRAG further notes that predominant insurers are the most significantly affected by the issues arising from the misalignment of the effective dates of IFRS 9 and the forthcoming insurance contracts Standard. On that basis, EFRAG assesses that adopting the Amendments would be conducive to the European public good. EFRAG's reasoning is explained in Appendix 3 to this letter, which includes certain elements of an impact analysis.

To what extent do the Amendments address the concerns raised in EFRAG's endorsement advice on IFRS 9?

EFRAG's conclusion on whether endorsement of IFRS 9 would be conducive to the European public good was positive, except for the impact on the insurance industry of the misalignment of effective dates referred to above. EFRAG's endorsement advice on IFRS 9 stated:

EFRAG has confirmed its preliminary view that the benefits to users of consistent financial reporting until IFRS 9 and the future insurance contracts standard are both applied, together with the cost savings for preparers and users, made a strong case for having the IASB defer the effective date of IFRS 9, so as to align it with the effective date of the future insurance contracts standard, albeit only for entities undertaking insurance activities and as an option. ... Furthermore, in the absence of uniform accounting policies for insurance liabilities, and considering that some insurance activities are conducted in the context of conglomerates, the impact of the non-alignment of the effective dates of IFRS 9 and the future insurance contracts standard varies from one company to the other. Therefore any remedy provided to mitigate the negative impact of the non-alignment of effective dates should be granted on an optional basis.

EFRAG assesses that the Amendments address many of the concerns raised in its endorsement advice on IFRS 9. In particular, the Amendments provide an optional, temporary exemption from the application of IFRS 9 for predominant insurers. However, this option is not available to entities undertaking insurance activities that are not predominant insurers.

The Amendments also provide an alternative approach (the overlay approach) that would be available to all entities undertaking insurance activities and which can substantially mitigate the financial reporting-related concerns arising from the misalignment of effective dates referred to above. The main drawback of the overlay approach is that it would not

provide the cost savings referred to in our endorsement advice on IFRS 9 and would in fact increase costs for entities compared to implementing IFRS 9 in the normal way. Accordingly, EFRAG considers that the Amendments would not result in a completely level playing field among all entities undertaking insurance activities.

For these reasons EFRAG considers that the Amendments address many of the concerns in our endorsement advice on IFRS 9 but do not address the cost concerns of entities undertaking insurance activities that are not predominant insurers.

In making these observations, EFRAG notes that the misalignment of effective dates is a unique and short-term situation. This situation gives rise to a complex set of concerns, the impact of which varies from one entity to another. There is unlikely to be any single, perfect solution to these concerns (especially given the short time available to develop one) and any solution put forward would inevitably reflect certain trade-offs between competing factors.

EFRAG's reasoning is further explained in Appendix 3.

Our advice to the European Commission

As explained above, we have concluded that the Amendments meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support economic decisions and the assessment of stewardship, raise no issues regarding prudent accounting, and are not contrary to the true and fair view principle. We have also concluded that the Amendments are conducive to the European public good for the period for which they are needed. Therefore, we recommend the Amendments for endorsement.

Without qualifying our advice, we note that the Amendments address many of the concerns raised in our endorsement advice on IFRS 9 but do not address the cost concerns of entities undertaking insurance activities that are not predominant insurers.

On behalf of EFRAG, I would be happy to discuss our advice with you, other officials of the European Commission and the Accounting Regulatory Committee as you may wish.

Yours sincerely,

Jean-Paul Gauzès
President of the EFRAG Board

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Appendix 1: Understanding the changes brought by Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4

A - Background of the Amendments

- 1 The amendments contained in *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4* ("the Amendments") are designed to address the concerns of insurance companies and users of their financial statements about the different effective dates of both IFRS 9 and the forthcoming insurance contracts Standard. These concerns have been described as follows¹:
- (a) *Accounting mismatches.* If entities undertaking insurance activities were required to change the accounting for financial assets by applying IFRS 9 *Financial Instruments* without a corresponding change in the accounting for insurance liabilities backed by those financial assets, it would result in accounting mismatches for those entities undertaking insurance activities applying the cost model under IFRS 4 *Insurance Contracts*. This is because some debt instruments currently accounted for at amortised cost or at fair value through other comprehensive income and most equity instruments currently accounted for at fair value through other comprehensive income with recycling are likely to be accounted for at fair value through profit or loss when applying IFRS 9. Fair value movements on these assets would be recognised in profit or loss, while insurance liabilities backed by those assets remain measured at cost, resulting in accounting mismatches in profit or loss even where the insurance liabilities are perfectly matched by financial assets.
 - (b) *Information needs of users of financial statements.* Users will find difficulties in understanding the financial performance and position of entities undertaking insurance activities during the period between the adoption of IFRS 9 and the forthcoming insurance contracts Standard. Entities undertaking insurance activities are likely to provide non-GAAP measures to explain the impact of accounting mismatches caused by a change in the measurement of financial assets that is not accompanied by a change in the measurement of the insurance liability. This is likely to require users to perform complex analyses to understand the results of an entity undertaking insurance activities by linking non-GAAP measures to the financial statements.
 - (c) *Costs for preparers.* In the event IFRS 9 is implemented before the forthcoming insurance contracts Standard, entities undertaking insurance activities would incur additional costs for having to first implement IFRS 9 and then reassess that implementation when implementing the forthcoming insurance contracts Standard.

B - How the issues have been addressed

- 2 The Amendments provide two options that will permit qualifying entities to take alternative approaches to the application in full of IFRS 9 in order to mitigate the concerns described above:
- (a) An optional temporary exemption from IFRS 9 which permits an insurer to continue using IAS 39 *Financial Instruments: Recognition and Measurement* if

¹ See EFRAG's Endorsement Advice on IFRS 9 *Financial Instruments*, Appendix 3 relating to European public good, dated 15 September 2015, pp. 79-83.

- its activities are predominantly connected with insurance (“the temporary exemption from IFRS 9”); and
- (b) An optional overlay approach that permits insurers that issue contracts within the scope of IFRS 4 to apply IFRS 9 to designated financial assets and then to reclassify, from profit or loss to other comprehensive income, some of the income or expenses arising from these designated financial assets (“the overlay approach”).
- 3 The result of introducing these options is that an entity that meets the relevant qualifying conditions may apply one of the following approaches to their financial assets:
- (a) IFRS 9 – this is available to all entities;
 - (b) the temporary exemption from IFRS 9 – available to entities whose activities are predominantly connected with insurance; and
 - (c) the overlay approach – available to all entities that issue contracts within the scope of IFRS 4 and may be applied to financial assets that are not held in respect of an activity that is unconnected with those contracts.

C - What options have been introduced?

Temporary exemption from IFRS 9

- 4 An entity is permitted to apply the temporary exemption from IFRS 9 when:
- (a) The entity has not previously applied any version of IFRS 9 (except for the “own credit” requirements in isolation); and
 - (b) The entity’s liabilities are predominantly connected with insurance, determined at the level of the reporting entity (i.e. at consolidated level for the purpose of the consolidated financial statements). Liabilities connected with insurance comprise:
 - (i) Liabilities arising from issuing contracts within the scope of IFRS 4 (including deposit components or embedded derivatives that are unbundled from insurance contracts and financial instruments that contain a discretionary participation feature) and these contracts give rise to liabilities whose carrying amount is significant compared to the total carrying amount of all the entity’s liabilities;
 - (ii) Non-derivative investment contract liabilities that are measured at fair value through profit or loss (FVPL) by applying IAS 39; and
 - (iii) Liabilities that arise because the insurer issues, or fulfils obligations arising from, the contracts in (i) and (ii) above.
- 5 An entity’s activities are treated as being predominantly connected with insurance if, and only if, the entity’s so-called predominance ratio meets specified thresholds. The predominance ratio is calculated as the ratio of :
- (a) the sum of the carrying amounts of the liabilities referred to in paragraph 4(b) above to
 - (b) the total carrying amount of all the entity’s liabilities.
- 6 An entity’s activities are deemed to be predominantly connected with insurance only if the predominance ratio:
- (a) is greater than 90 per cent; or

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- (b) is less than or equal to 90 per cent but greater than 80 per cent and the entity does not engage in a significant activity that is unconnected with insurance.
- 7 In order to assess whether it qualifies for the temporary exemption from IFRS 9, an entity is required to compute the predominance ratio by using the carrying amounts of the liabilities reported on the entity's balance sheet, in accordance with IFRS Standards, at the annual reporting date immediately prior to 1 April 2016.
- 8 If there is a significant change in the entity's activities during the reporting period:
 - (a) an entity that previously qualified for the temporary exemption shall reassess whether its activities are still predominantly connected with insurance; and
 - (b) an entity that previously did not qualify for the temporary exemption is permitted to subsequently reassess whether its activities are predominantly connected with insurance at an annual reporting date before 31 December 2018.
- 9 First-time adopters of IFRS are permitted to apply the temporary exemption when fulfilling the criteria in paragraph 4 above.
- 10 When using the equity method to account for an entity's investments in associates and joint ventures, the entity is granted relief from using uniform accounting policies. That relief is available on an investment-by-investment basis and is valid (i) when the entity uses IFRS 9 in its financial statements and the associate or joint venture uses the temporary exemption from IFRS 9; or (ii) the entity uses the temporary exemption from IFRS 9 but the associate or joint venture uses IFRS 9.
- 11 An entity that applies that temporary exemption from IFRS 9 will be required to disclose information to enable users of financial statements to understand how the insurer qualified for the temporary exemption and to compare with entities applying IFRS 9.
- 12 In particular, an entity shall disclose fair value information about financial assets that would be measured at FVPL in accordance with IFRS 9. In doing so, the entity shall differentiate between:
 - (a) financial assets that have cash flows that are solely payment of principal and interest (excluding financial assets that are held for trading as per IFRS 9 or that are managed and whose performance is evaluated on a fair value basis); and
 - (b) financial assets that do not have such cash flows including financial assets that are held for trading as per IFRS 9 or that are managed and whose performance is evaluated on a fair value basis.
- 13 Entities are also required to disclose information about the credit risk exposure, including significant credit risk concentrations, inherent in the financial assets referred to in paragraph 12(a) above and that do not have low credit risk in accordance with IFRS 9.
- 14 The temporary exemption from IFRS 9 will be available for annual reporting periods beginning on or after 1 January 2018 and ends no later than for annual reporting periods beginning on or after 1 January 2021.
- 15 Entities may cease to apply the temporary exemption from IFRS 9 at any time. When doing so, they may at the beginning of any subsequent annual period irrevocably elect to apply IFRS 9.

Overlay approach

- 16 An entity that issues contracts within the scope of IFRS 4 and applies IFRS 9 is permitted, but not required, to reclassify from profit or loss to other comprehensive

- income, an overlay adjustment equal to the difference, for qualifying financial assets, between:
- (a) the amount reported in profit or loss by applying IFRS 9; and
 - (b) the amount that would have been reported in profit or loss by applying IAS 39.
- 17 Financial assets qualify for the overlay approach when they are designated as not being held in respect of an activity that is unconnected with contracts that are within the scope of IFRS 4. In addition, these designated financial assets are measured at FVPL in accordance with IFRS 9 but would not have been measured at FVPL in their entirety in accordance with IAS 39. Qualifying financial assets include surplus assets that an entity holds for the purposes of regulatory requirements or internal capital objectives.
- 18 An entity may apply the overlay approach to any or all eligible financial assets. First-time adopters of IFRS are permitted to apply the overlay approach to qualifying financial assets.
- 19 Presentation in profit or loss of gains or losses on financial assets to which the overlay approach is applied must reflect the application of IFRS 9, with a separate line item for the overlay adjustment. In addition, entities will be required to present, in other comprehensive income (OCI), the overlay adjustment separate from other components of OCI, consistently with IAS 1 *Presentation of Financial Statements*.
- 20 An entity that applies that overlay approach is required to disclose sufficient information to enable users of financial statements to understand how the amount of the overlay adjustment is calculated and the effect of the adjustment on the financial statements.
- 21 The overlay approach may only be first applied when an entity first applies IFRS 9 (other than the “own credit” requirements in isolation) and this approach does not have a fixed expiry date. Entities may cease to apply the overlay approach at any time. When doing so, the accumulated effect of the total overlay adjustment is reclassified to retained earnings without impacting profit or loss. In addition, the future insurance contracts Standard will replace IFRS 4 and, accordingly, the overlay approach in IFRS 4 will no longer be available when an entity first applies that future Standard.

Appendix 2: EFRAG's technical assessment on Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4

Does the accounting that results from the application of the Amendments meet the technical criteria for endorsement in the European Union?

- 1 EFRAG has considered whether the Amendments meet the technical requirements of the European Parliament and of the Council on the application of international accounting standards, as set out in Regulation (EC) No 1606/2002 (The IAS Regulation), in other words that the Amendments:
 - (a) are not contrary to the principle of 'true and fair view' set out in Article 4 (3) of Council Directive 2013/34/EU (The Accounting Directive); and
 - (b) meet the criteria of, relevance, reliability, comparability and understandability required of the financial information needed for making economic decisions and assessing the stewardship of management.
- 2 EFRAG's assessment on whether the Amendments are not contrary to the true and fair view principle set out in Article 4(3) of Council Directive 2013/34/EU is based on the assessment of whether they meet all other technical criteria and whether they lead to prudent accounting. EFRAG's assessment also includes assessing whether the Amendments do not interact negatively with other IFRS and whether all necessary disclosures are required. Detailed assessments are included in this appendix in the following paragraphs:
 - (a) relevance: paragraphs 8 - 30;
 - (b) reliability: paragraphs 31 - 43;
 - (c) comparability: paragraphs 44 - 69;
 - (d) understandability: paragraphs 70 - 79;
 - (e) whether overall it leads to prudent accounting: paragraphs 80 - 87; and
 - (f) whether it would not be contrary to the true and fair view principle: paragraphs 88 - 93.
- 3 In its endorsement advice on IFRS 9, EFRAG assessed: "*that the mismatch in timing of the future insurance contracts Standard and IFRS 9 would create disruptions in the financial reporting by many entities undertaking insurance activities during the period until the forthcoming insurance contracts Standard is applied, which will make financial reporting less understandable for users while increasing costs for preparers*".
- 4 These disruptions arise because the business model of entities undertaking insurance activities is based on asset/liability management, with the objective of investing in assets in order to generate income and capital appreciation to cover insurance liabilities and provide profit for shareholders.
- 5 EFRAG's assessments below take into account this interrelationship between assets and liabilities as managed by insurers. In providing its assessments on whether the Amendments result in relevant, reliable, comparable and understandable information, EFRAG has relied on the fact that the Amendments do not introduce any recognition or measurement requirements. Instead, the Amendments either affect the

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timing of the full implementation of IFRS 9 (the temporary exemption), or affect the presentation of certain gains or losses arising from the application of IFRS 9 (the overlay approach), and contain disclosure requirements to explain the effect of these approaches.

- 6 EFRAG has focused its assessment on those aspects of the Amendments it considered most significant in relation to each of the criteria. EFRAG has accordingly focused on guidance that:
 - (a) is fundamental to the options in the Amendments;
 - (b) has been subject to substantial debate (evidenced by the comments EFRAG has received from constituents);
 - (c) may be problematic to apply; or
 - (d) relates to the issues raised by the European Commission in its request for endorsement advice dated 13 October 2016.

- 7 EFRAG has assessed the Amendments against each of the technical criteria for each of the following requirements (where relevant):
 - (a) providing two options – the overlay approach and the temporary exemption from IFRS 9;
 - (b) temporary exemption from IFRS 9 (the temporary exemption); and
 - (c) overlay approach.

Relevance

- 8 Information is relevant when it influences the economic decisions of users by helping them evaluate past, present or future events or by confirming or correcting their past evaluations. Information is also relevant when it assists in evaluating the stewardship of management.
- 9 EFRAG considered whether the Amendments would result in the provision of relevant information – in other words, information that has predictive value, confirmatory value or both – or whether it would result in the omission of relevant information.

Providing two options – the overlay approach and the temporary exemption from IFRS 9

- 10 When alternative accounting options are made available, it is reasonable to expect that entities will select the option that is appropriate to their circumstances and that this selection will take into account the relevance of the resulting information for the users of their financial statements. As a result, EFRAG expects that:
 - (a) entities that are eligible for both the overlay approach and the temporary exemption from IFRS 9 will consider which approach (applying IFRS 9 in the normal way or applying one of the options in the Amendments) provides the most relevant information for their users, while also taking into account cost-benefit considerations; and
 - (b) entities that are eligible for the overlay approach but not for the temporary exemption from IFRS 9 will consider whether the overlay approach provides more relevant information for their users than applying IFRS 9 in the normal way, again while also taking into account cost-benefit considerations.
- 11 It follows that the inclusion of two options in the Amendments does not inhibit the provision of relevant information in the specific circumstances in which the Amendments have been developed. Given the options in IFRS 4 for the measurement of the insurance liability, and the short period until the forthcoming insurance contracts Standard is effective, allowing some flexibility for continuity in financial reporting has the potential to provide relevant information.

The temporary exemption from IFRS 9

Scope and eligibility criteria

- 12 The temporary exemption is intended to target those insurance entities that are most significantly affected by the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard (i.e. those that are predominant insurers). Entities that conduct both insurance activities and substantial other activities, including bank-led groups that undertake insurance activities, are not eligible to apply the temporary exemption in their consolidated financial statements because they fail the predominance test described in Appendix 1, paragraphs 5 - 6.
- 13 The qualifying criteria in the Amendments reflect the complexity of the insurance business model and recognise that the activities of insurers are not limited to issuing insurance contracts as defined in IFRS 4. As a result, the types of liability regarded as being connected with insurance for the purpose of the predominance test have been extended to address the range of contracts entered into by many insurers. For example, the accounting for non-derivative investment contracts, if measured at FVPL, would be the same under IAS 39 and IFRS 9. Because these contracts are common in an insurer's business model, including them in the predominance test supports the relevance of the predominance test in assessing eligibility to apply the temporary exemption from IFRS 9.

- 14 There may be insurers that are regarded by the market as predominant insurers but that fail the 90 per cent predominance test. EFRAG notes that the Amendments also include a second test of predominance. This second test is met if less than or equal to 90 per cent but more than 80 per cent of an entity's liabilities are connected to insurance and the entity does not engage in a significant activity that is unconnected with insurance. EFRAG considers this second test smooths the bright line that could arise from a single quantitative threshold.

Reassessment of eligibility for the temporary exemption from IFRS 9

- 15 An entity is required to reassess its application of the temporary exemption from IFRS 9 if and only if there is a change in the entity's business activities during the reporting period. This reassessment provides relevant information by ensuring that an entity that ceases to be a predominant insurer will start to prepare financial statements on the same basis as other entities that are not predominant insurers.
- 16 In addition, an entity that did not initially qualify for the temporary exemption is permitted to reassess whether its activities are predominantly connected to insurance at an annual reporting date before 31 December 2018 if, and only if, there was a change in the entity's business activities during that reporting period. This reassessment provides relevant information by ensuring that an entity that becomes a predominant insurer before the effective date of IFRS 9 will be permitted to use the same option as other entities that are predominant insurers.

Disclosures

- 17 The Amendments require disclosure of fair value information for (i) financial assets that give rise to cash flows that are solely payments of principal and interest (SPPI) on the principal amount outstanding (excluding any financial assets that meet the definition of held for trading in IFRS 9, or that are managed and whose performance is evaluated on a fair value basis); and (ii) all other financial assets.
- 18 EFRAG assesses that disclosure of this fair value information is relevant to users of financial statements because the entities that rely on the temporary exemption from IFRS 9 would not apply the impairment requirements in that Standard. Therefore, the fair value of these financial assets will provide relevant information such as an indication of expected credit losses under IFRS 9.
- 19 The Amendments also require an entity to disclose information about credit risk exposure for financial assets that meet the SPPI test. EFRAG considers that this disclosure requirement provides relevant information because of the different impairment requirements under IFRS 9 and IAS 39.
- 20 Finally, the Amendments require disclosure of the fair value and the gross carrying amount under IAS 39 for financial assets that do not have low credit risk. This does not require the collection of new information because fair value disclosures are already required by IFRS 7 *Financial Instruments: Disclosures*. EFRAG considers that fair values (compared to the carrying amounts when applying IAS 39) will be relevant for users of financial statements in assessing the credit risk exposure for those riskier assets and the potential effect of applying the expected credit loss requirements in IFRS 9 because the fair values may provide a potential indication of impairment of the financial assets.

Temporary exemption from specific requirements in IAS 28 and for first-time adopters

- 21 The Amendments include additional exemptions in specific situations which may affect the relevance of information provided. These additional exemptions include:
- (a) a temporary exemption from requirements in IAS 28 *Investments in Associates and Joint Ventures* to use uniform accounting policies for the purpose of applying the equity method. This exemption could result in entities that apply

IFRS 9 in their own financial statements using financial statements of an investee that are based on IAS 39 for the purpose of applying the equity method; and

- (b) a temporary exemption from IFRS 9 for first-time adopters subject to the qualifying criteria being met. First-time adopters may have similar concerns about the misalignment of effective dates of IFRS 9 and the forthcoming insurance contracts to other entities undertaking insurance activities. This may be especially relevant for those first-time adopters that have previously applied requirements for financial instruments under national GAAPs that are not significantly different to IFRS Standards.
- 22 EFRAG acknowledges that one of the reasons for these additional exemptions is the potential significant practical difficulties and/or additional costs that may arise for affected entities. EFRAG considers that the Amendments include adequate disclosures to compensate for the potential reduction in relevant information.

Effect of the application of the temporary exemption

- 23 In assessing whether the temporary exemption addresses the issues summarised in Appendix 1, EFRAG considers that classifications, designations and assessments made on application of IFRS 9 on its effective date might not be the same as those that would have been made had the forthcoming insurance contracts Standard been applied at the same time as IFRS 9. Predominant insurers will be in a position to implement IFRS 9 with more complete information, and thereby achieve a higher quality implementation, if doing so in conjunction with the forthcoming insurance contracts Standard. This supports an assessment that the temporary exemption from IFRS 9 is conducive to the provision of relevant information for users of the financial statements of predominant insurers.

The overlay approach

Scope and eligibility criteria

- 24 The overlay approach permits the reclassification from profit or loss to other comprehensive income (OCI) of the additional accounting mismatches and temporary volatility in reported earnings that could arise from the application of IFRS 9 to specific financial assets before the forthcoming insurance contracts Standard is applied. The Amendments permit the entity to apply the overlay approach to any or all eligible financial assets.
- 25 The overlay approach provides entities with additional optionality by permitting flexibility to select the qualifying financial assets to which it is applied. This additional flexibility could detract from the relevance of the resulting information. EFRAG however considers this potential detriment to relevance should be assessed against the background of the very specific circumstances in which the Amendments have been issued. As discussed above, the overlay approach has been developed to address very specific short-term concerns, and eligible entities can be expected to consider the relevance of the resulting information in selecting their approach.
- 26 Additionally, EFRAG notes that the designated financial assets will be accounted for under IFRS 9. This results in a balance sheet that is fully consistent with the application of IFRS 9 in the normal way. The application of the overlay approach results in some changes in fair value being recognised in OCI rather than profit or loss. However, the presentation and disclosure requirements in the Amendments make the effect of the overlay approach transparent.
- 27 In these circumstances, EFRAG assesses that the scope and eligibility criteria for the overlay approach are conducive to the provision of relevant information for users. These criteria serve to limit the application of the overlay approach to financial assets

where IFRS 9 introduces additional accounting mismatches and temporary volatility. Accordingly, the overlay approach can substantially mitigate the financial reporting-related concerns expressed about the different effective dates of IFRS 9 and the forthcoming insurance contracts Standard.

Presentation

- 28 The amount reclassified from profit or loss to OCI is presented as a separate line item in both profit or loss and OCI. The effect on individual line items in profit or loss of the reclassified amount is also disclosed.
- 29 EFRAG assesses that these presentation requirements for the overlay approach provide relevant information for users. These requirements achieve transparency and thereby facilitate comparisons with entities that apply IFRS 9 in the normal way and with qualifying insurance entities that apply the temporary exemption from IFRS 9. The presentation requirements also serve to remove or reduce additional accounting mismatches and temporary volatility in earnings.

Conclusion on relevance

- 30 EFRAG's overall assessment is that the changes brought by the Amendments are conducive to the provision of relevant information.

Reliability

- 31 EFRAG considered the reliability of the information that will be provided by using the Amendments. Information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent, or could reasonably be expected to represent, and is complete within the bounds of materiality and cost.
- 32 There are a number of aspects to the notion of reliability: freedom from material error and bias, faithful representation, and completeness.

The temporary exemption from IFRS 9

Scope and eligibility criteria

- 33 EFRAG considers that a quantitative test to assess whether an entity is predominantly connected with insurance provides a simple and objective assessment because information used in the test is readily verifiable from the entity's financial statements or internal financial information.
- 34 In EFRAG's view, the identification of liabilities that arise because the insurer issues or fulfils obligations arising from contracts within the scope of IFRS 4 and from non-derivative investment contracts requires a degree of judgement. This judgement may impact whether an entity would be eligible for the temporary exemption from IFRS 9. However, EFRAG assesses that this identification is unlikely to demand excessive judgement and notes that the Amendments provide guidance. Also, an entity needs to disclose how it concluded that it is eligible for the temporary exemption from IFRS 9, which would include this judgement, if material.

Reassessment of eligibility for the temporary exemption from IFRS 9

- 35 The Amendments provide a lead time of at least one year for entities to apply IFRS 9 if they are no longer eligible for the temporary exemption subsequent to reassessment of their eligibility. This will potentially lead to a rushed implementation of IFRS 9 which may affect the quality of the resulting financial information.
- 36 However, EFRAG considers that all entities that apply the temporary exemption from IFRS 9 will be aware that the temporary exemption has a fixed expiry date. EFRAG notes that an implementation of IFRS 9 by that date would require preparation in advance, thus entities would be expected to be preparing for the implementation. In addition, the level of experience of IFRS 9 implementation available in the market (including consultants and experienced personnel) is expected to increase significantly from the time that IFRS 9 was issued in 2014 to the time that an entity ceases to be eligible for the temporary exemption.
- 37 Based on the above reasons, EFRAG is of the view that a lead time of at least one year for implementing IFRS 9 after reassessing and failing eligibility for the temporary exemption would not prevent the provision of reliable information.

Disclosures

- 38 The Amendments require an entity to disclose the fair value at the end of the reporting period and the fair value change during the reporting period separately for financial assets that are not SPPI (excluding any financial assets that meet the definition of held for trading in IFRS 9, or that is managed and whose performance is evaluated on a fair value basis) and for all other financial assets. This requires the entity to perform the SPPI test under IFRS 9.
- 39 Application of the SPPI test requires judgement to ensure that financial assets are appropriately classified. However, IFRS 9 includes substantial guidance on the application of the SPPI test as well as several illustrative examples. Further, EFRAG

has no reason to believe that the assessment is more difficult for an entity applying the temporary exemption than for other entities. Therefore, EFRAG assesses that the criterion is expected to be applied reliably.

The overlay approach

Scope and eligibility criteria

- 40 Entities applying the overlay approach determine which financial assets relate to contracts within the scope of IFRS 4. In some cases, it could be easy to identify financial assets relating to particular contracts within the scope of IFRS 4, e.g. where those contracts reference specific financial assets, are contractually linked or where the entity allocates financial assets to particular portfolios of contracts that are within the scope of IFRS 4. However, there may be situations in which the relationship between financial assets and contracts within the scope of IFRS 4 is unclear or less robust such as in non-participating contracts.
- 41 However, EFRAG considers that minimising the number of criteria needed to identify the financial assets that are eligible for the overlay approach makes the approach easier to understand and apply consistently. This is particularly important given the temporary nature of this relief. Therefore, EFRAG assesses that the eligibility criteria for financial assets is conducive to the reliability of the resulting information, considering the balance of materiality and cost.
- 42 The overlay approach provides flexibility as to which eligible financial assets it is applied to. This flexibility could detract from the completeness of the resulting information as the overlay will not necessarily be applied to all eligible financial assets. However, EFRAG considers this potential detriment to reliability should be assessed against the background of the very specific circumstances in which the Amendments have been issued. Moreover, the overlay approach provides additional information over and above that provided by applying IFRS 9 in the normal way.

Conclusion on reliability

- 43 EFRAG's overall assessment is that the changes brought by the Amendments are conducive to the provision of reliable information.

Comparability

- 44 The notion of comparability requires that like items and events are accounted for in a consistent way through time and by different entities, and that unlike items and events should be accounted for differently.
- 45 EFRAG has considered whether the Amendments result in transactions that are:
- (a) economically similar being accounted for differently; or
 - (b) transactions that are economically different being accounted for as if they are similar.

Introducing two options – the overlay approach and the temporary exemption from IFRS 9

EFRAG's endorsement advice on IFRS 9 Financial Instruments

- 46 In considering the benefits and drawbacks of a temporary exemption from IFRS 9 for entities undertaking insurance activities, in the section of its IFRS 9 endorsement advice assessing European public good, EFRAG stated:

The loss of comparability between entities undertaking insurance activities and other entities, banking entities in particular, relating to financial instruments amounts, cannot be denied; however, it is to be put in the perspective of the currently low level of comparability of the financial statements of entities undertaking insurance activities – among each other or with others – that results from the current situation under IFRS 4. The measurement of insurance liabilities currently differs between entities undertaking insurance activities because the current IFRS 4 has grandfathered previous national GAAP to the point that different GAAPs may be used in a same set of financial statements for the accounting of various insurance liabilities. Therefore, with or without a deferral option, the financial statements of insurance businesses will not reach any acceptable level of comparability before the new insurance contracts standard is introduced. As a result, the effects of the loss of comparability between companies and entities undertaking insurance activities on financial instruments amounts are not, in EFRAG's view, commensurate with the disruptive effects on financial statements as a whole that successive changes and accounting mismatches could have on users.

Impact of two options

- 47 The Amendments introduce two options, i.e. the overlay approach and the temporary exemption from IFRS 9. Entities may also opt to apply IFRS 9 in the normal way. An entity can therefore choose from up to three possible approaches, depending on its circumstances. EFRAG generally considers that options may reduce comparability between entities' financial statements. However, in this case EFRAG observes that the particular options are designed to mitigate the disruptive effects of the misalignment of effective dates of IFRS 9 and the forthcoming insurance contracts Standard. These disruptive effects would affect different entities in different ways and could therefore have a negative effect on comparability.
- 48 EFRAG also considers that the impact of these particular options should be assessed in the context of the currently low level of comparability referred to in the above extract from our endorsement advice on IFRS 9. This low level of comparability arises mainly from the variety of approaches currently available for measuring insurance liabilities, whereas the two options provide greater flexibility in the accounting for financial assets. However, for entities undertaking insurance activities the measurement of financial assets and presentation of related gains and losses is at least partially linked to the accounting for financial liabilities.

- 49 EFRAG expects that entities will select an option that provides the most relevant information given the circumstances of that entity, taking into account cost and benefit considerations. EFRAG also notes that: (i) entities applying the overlay approach will also use IFRS 9; and (ii) the required disclosures result in the provision of information that will enable users to compare entities applying the temporary exemption and entities applying IFRS 9 (with or without the overlay approach). Finally, for bank-led groups undertaking insurance activities, EFRAG's assessment can be found in Appendix 3 below.

The temporary exemption from IFRS 9

- 50 EFRAG considers that the availability of the temporary exemption from IFRS 9 only to entities that are predominant insurers at reporting entity level could affect the ability of users to make meaningful comparisons between the financial statements of predominant insurers and the insurance components of other entities undertaking insurance activities that are not predominant insurers. EFRAG understands that the ability to make "insurer-to-insurer" comparisons is for some users more important than broader comparability issues (such as comparability between pure banks and bank-led entities that undertake insurance activities).
- 51 As noted in paragraph 46, EFRAG considers that the level of comparability among insurance entities' financial statements is unsatisfactory due to the variety of accounting policies used on the insurance liability side. In addition, in Appendix 3 EFRAG sets out an analysis of the extent to which the consolidated financial statements of bank-led entities undertaking insurance activities include separate information on the financial position and performance of their insurance activities. This indicates that, in many cases, the consolidated financial statements of such entities do not provide separate, detailed information on the insurance activities. For these reasons, EFRAG considers that making comparisons between the financial statements of predominant insurers and the insurance components of other entities undertaking insurance activities that are not predominant insurers is challenging at present. Any negative effects on the ability of users to make "insurer-to-insurer" comparisons arising from the scope of the temporary exemption should be considered in this context.
- 52 EFRAG also notes that the significance of this potential reduction in comparability needs to be weighed against the complexities that would arise from allowing the use of a temporary exemption (and hence different accounting policies for similar financial assets within similar business models) for different components of the same reporting entity.

Predominance ratio

- 53 EFRAG considers that the predominance ratio being quantitative can be computed consistently because the calculation is simple and objective to apply. As a result, using such a ratio will increase comparability because entities will have a similar basis to assess whether they are eligible to apply the temporary exemption from IFRS 9.

Disclosures

- 54 The disclosures for the temporary exemption from IFRS 9 promote comparability between entities that apply the temporary exemption from IFRS 9 and entities that apply IFRS 9:
- (a) an entity applying the temporary exemption from IFRS 9 is required to provide fair value information separately for (i) financial assets that give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding and (ii) all other financial assets. Financial assets that meet the definition of held for trading in IFRS 9, or that are managed and whose

performance is evaluated on a fair value basis, are not included in the first category.

- (b) entities applying the temporary exemption are required to provide information about credit risk exposure for financial assets that meet the IFRS 9 SPPI test. This disclosure enables users of financial statements to compare the credit exposure of financial assets between entities that apply the temporary exemption from IFRS 9 and those that do not.
 - (c) entities are required to disclose the fair value and the gross carrying amount of financial assets that do not have low credit risk at the end of the reporting period. This disclosure enables users of financial statements to compare the amounts of impairment and credit risk of financial assets between entities who apply the temporary exemption from IFRS 9 and those that do not.
- 55 There will be a reduction in comparability between the financial statements of entities applying IFRS 9 in the normal way, those applying the overlay approach and those applying the temporary exemption from IFRS 9. However, EFRAG considers that the disclosure requirements for the temporary exemption from IFRS 9 will enable the users of financial statements to make comparisons among these three categories of entity. The disclosures for the temporary exemption from IFRS 9 are similar to some of the disclosures required by entities applying IFRS 9.

Effect of the application of the temporary exemption

- 56 Entities that are eligible for the temporary exemption from IFRS 9 and elect this option will continue to apply IAS 39. As a result, no changes will be needed for comparative information. Therefore, the financial statements would be accounted for in a consistent way through time.
- 57 EFRAG assesses that users of financial statements may avoid the difficulties in predicting long-term economic performance of insurance entities and forecasting earnings based on profit or loss information if a predominant insurer applies the temporary exemption from IFRS 9 instead of applying IFRS 9 before the forthcoming insurance contracts Standard. This results from the insurance entity continuing relevant trends until IFRS 9 is applied at the same time as the forthcoming insurance contracts Standard.
- 58 In addition, the valuation models for users of financial statements would not need to be changed twice in a short period of time, i.e. due to the effective date of IFRS 9 in 2018 and subsequently the implementation of the forthcoming insurance contracts Standard. Therefore, as a result of avoiding two significant consecutive changes, the users of the financial statements of these entities would continue to have trend information that is important for their analysis.

The overlay approach

Difference between de-designation of specific financial assets or ceasing to use the overlay approach

- 59 An entity that applies the overlay approach shall de-designate a previously recognised financial asset as relating to contracts within the scope of IFRS 4 only when there is a change in the relationship between that financial asset and the contracts within the scope of IFRS 4. If a financial asset is de-designated, the accumulated effect of the overlay adjustment is reclassified to profit or loss.
- 60 In contrast, an entity applying the overlay approach may stop applying the approach and the accumulated effect of the total overlay adjustment is reclassified to retained earnings without impacting profit or loss.

- 61 Consequently, the accumulated effect of the overlay adjustment could be allocated to profit or loss or to retained earnings. However, this difference responds to situations that are economically different.
- 62 EFRAG notes that designation and de-designation of financial assets as relating to specific liabilities is an established business practice whereby – for a particular time period – the performance of identified (financial) assets can be assigned to the policyholders of (most frequently) participating insurance liabilities. Although the scope of the overlay approach is wider than assets supporting participating insurance liabilities, EFRAG assesses that the economic effects of this business practice are different from ceasing to apply the overlay approach in its entirety. In the former case, an insurer may replace the performance of one (financial) asset with the performance of another financial asset in order to ensure the promised return to the policyholder. In the latter case, the insurer no longer applies the overlay approach because it considers the reasons for doing so have disappeared or are balanced by other effects.
- 63 An entity that applies the overlay approach also applies IFRS 9. Hence, an entity that stops applying the overlay approach will as from the next annual period, apply IFRS 9 fully. Transitioning back to IAS 39 is not permitted. EFRAG assesses this as leading to comparable information over time for those particular entities.

Disclosures

- 64 The overlay approach isolates the impact of the difference between applying IFRS 9 and IAS 39 in a single line both in profit or loss and OCI. Therefore, EFRAG assesses that the disclosures will provide users with the information needed for a comparison of the impact on an entity using the overlay approach with the impact on entities that do not apply the overlay approach to all (or some of) their financial assets. Hence, applying the overlay approach can be compared to applying either the temporary exemption from IFRS 9 or IFRS 9 in the normal way.

Applicability of the overlay approach and the temporary exemption from IFRS 9 to first-time adopters of IFRS

- 65 A first-time adopter of IFRS is permitted to apply either the temporary exemption from IFRS 9 or the overlay approach when it meets the qualifying criteria.
- 66 EFRAG considers that, for a first-time adopter of IFRS that applies the temporary exemption, its separate financial statements would be comparable to other entities that also apply the temporary exemption. In addition, it would also be comparable to its parent company if the parent company also applies the temporary exemption.
- 67 For the overlay approach, EFRAG notes that a first-time adopter applying the overlay approach would also apply IFRS 1 *First-time Adoption of International Financial Reporting Standards*. As for any first-time adopter, the restatement of comparative information makes the financial statements of the entity comparable over time and between entities.
- 68 Therefore, EFRAG assesses that extending the scope of the overlay approach and the temporary exemption for applying IFRS 9 to first-time adopters of IFRS would result in comparable information, in the light of entities' business models.

Conclusion on comparability

- 69 EFRAG's overall assessment is that the Amendments, taking into consideration the applicable disclosure requirements, may slightly reduce comparability among entities undertaking insurance activities and between such entities and other entities that are not affected by the Amendments. However, EFRAG also considers that this slight reduction in comparability is balanced by the relevance of the resulting information

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and the fact that the proposed options address many of concerns arising from the misalignment of the effective dates referred to elsewhere. Given the arguments identified above, EFRAG considers that the slight reduction in comparability is acceptable.

Understandability

- 70 The notion of understandability requires that the financial information provided should be readily understandable by users with a reasonable knowledge of business and economic activity and accounting, and the willingness to study the information with reasonable diligence.
- 71 Although there are a number of aspects related to the notion of 'understandability', EFRAG believes that most of the aspects are covered by the discussion above about relevance, reliability and comparability.
- 72 As a result, EFRAG believes that the main additional issue it needs to consider, in assessing whether the information resulting from the application of the Amendments is understandable, is whether that information will be unduly complex.
- 73 It is recalled that, in its endorsement advice relating to IFRS 9, EFRAG assessed that the information resulting from IFRS 9 was not unduly complex as the requirements in that Standard are generally built upon clear principles.

Temporary exemption from IFRS 9

- 74 For those entities applying the temporary exemption from IFRS 9, the disclosures will enable users of financial statements:
- (a) to understand how the insurer qualified for the temporary exemption; and
 - (b) to compare insurers applying the temporary exemption with entities applying IFRS 9.
- 75 EFRAG assesses that the additional disclosures relating to how the insurer qualified for the temporary exemption are easy to understand because they are based on the carrying amounts of an insurer's liabilities or, in case of a reassessment, are based on a factual change in business activities.

The overlay approach

- 76 For those entities applying the overlay approach, the disclosures will enable users of financial statements to understand:
- (a) how the total amount reclassified from profit or loss to OCI in the reporting period is calculated; and
 - (b) the effect of that reclassification on the financial statements.
- 77 EFRAG assesses that the additional disclosures relating to how the insurer has applied the overlay approach are easy to understand because they are based on the carrying amounts of the designated financial assets. EFRAG understands that designation and de-designation of financial assets to particular insurance liabilities from time to time is an established business practice and assesses that the effects of this business practice are not new to specialised users of financial statements of insurers and consequently well understood by them.

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- 78 Entities will apply IFRS 9 in the normal way unless they are eligible, and elect, to apply the temporary exemption from IFRS 9 or the overlay approach. For those entities, EFRAG's earlier assessment, as noted in paragraph 73, remains valid.

Conclusion on understandability

- 79 EFRAG's overall assessment is that the changes brought by the Amendments are conducive to the provision of understandable information.

Prudence

- 80 For the purpose of this endorsement advice, prudence is defined as caution in conditions of uncertainty. In some circumstances, prudence requires asymmetry in recognition such that assets or income are not overstated and liabilities or expenses are not understated.
- 81 The Amendments introduce no new recognition and measurement requirements. Instead, the Amendments rely on the recognition and measurement requirements of IAS 39 and IFRS 9.

Temporary exemption from IFRS 9

Eligibility criteria

- 82 The temporary exemption from IFRS 9 is available to those entities whose activities are predominantly connected with insurance.
- 83 EFRAG has, in its IFRS 9 endorsement advice, assessed that IFRS 9 improves prudence in several areas. The most important area is the more forward-looking expected credit loss model for measuring loan loss provisions in IFRS 9, in comparison to the incurred loss model in IAS 39. In allowing predominant insurers to delay the application of this more prudent accounting, the temporary exemption is not conducive to prudence. However, in our endorsement advice in IFRS 9 we noted that insurance entities' holdings in debt-type assets are typically concentrated in assets of investment grade. This factor helps to mitigate any negative effects on prudence, although we understand that the effect of the expected credit loss model could be material to the financial statements of at least some entities undertaking insurance activities.
- 84 In addition, this negative effect on prudence should be balanced against the fact that, by applying the temporary exemption, predominant insurers can avoid accounting mismatches in their financial statements that would arise from applying IFRS 9 before the forthcoming insurance contracts Standard. The scope of the temporary exemption is intended to ensure that only entities that are significantly affected by accounting mismatches and resulting volatility will be able to use it. EFRAG assesses that this limitation in scope further serves to restrict the negative effects on prudence.

The overlay approach

Eligibility criteria

- 85 Examples of financial assets that would be measured at FVPL under IFRS 9 but would not have been measured at FVPL in their entirety when applying IAS 39 are debt-type financial assets that fail the SPPI test, equity instruments currently measured according to the available for sale category or equity instruments measured at cost in line with the cost exemption under IAS 39.
- 86 The overlay approach involves first applying IFRS 9 in the normal way, then reclassifying certain of the fair value changes from profit or loss into OCI through the mechanism of an overlay adjustment. The overlay adjustment could have a positive or a negative effect on profit or loss depending on the particular circumstances. However, this incremental information will have no effect when considered at the level of total comprehensive income. For this reason EFRAG assesses that the overlay approach is neutral to prudence. EFRAG also notes that the overlay approach results in the provision of additional information in comparison with applying IFRS 9 in the normal way.

Conclusion on prudence

- 87 EFRAG's overall assessment is that the options introduced by the Amendments either have no effect on prudence (overlay approach), or postpone certain improvements in prudence (temporary exemption from IFRS 9). The negative effect on prudence of the temporary exemption is however: (i) mitigated by the fact that insurance entities' holdings in debt-type assets are typically concentrated in assets of investment grade (and to a lesser extent in non-investment grade assets); and (ii) balanced against other considerations such as the reduction in accounting mismatches that would otherwise arise. EFRAG therefore considers that the Amendments lead to sufficiently prudent accounting.

True and Fair View Principle

- 88 A Standard or Amendment will not impede information from meeting the true and fair view principle when, on a stand-alone basis and in conjunction with other IFRS, it:
- (a) does not lead to unavoidable distortions or significant omissions in the representation of that entity's assets, liabilities, financial position and profit or loss; and
 - (b) includes all disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss.
- 89 EFRAG assesses that the Amendments provide relevant, reliable, understandable information, lead to some reduction in comparability and lead to sufficiently prudent accounting, taking into account the unusual and short-term circumstances that gave rise to them (i.e. the misalignment of the effective dates of two Standards both of which have a very significant impact on a particular sector).
- 90 EFRAG assesses that the Amendments do not create any negative interactions with other IFRS and are specifically designed to complement IFRS 4 and IFRS 9. Accordingly, EFRAG assesses that the Amendments do not lead to unavoidable distortions or significant omissions and therefore do not impede financial statements from providing a true and fair view.
- 91 EFRAG also concludes that the disclosures that are necessary to provide a complete and reliable depiction of an entity's assets, liabilities, financial position and profit or loss are required.
- 92 As a result, EFRAG concludes that the application of the Amendments would not lead to information that would be contrary to the true and fair view principle

Conclusion

- 93 Accordingly, for the reasons set out above, EFRAG's assessment is that the Amendments meet the technical requirements for EU endorsement as set out in the IAS Regulation.

Appendix 3: Assessing whether the Amendments are conducive to the European public good

Introduction

- 1 EFRAG considered whether it would be conducive to the European public good to adopt *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts: Amendments to IFRS 4* ("the Amendments"). In addition to its assessment included in Appendix 2, EFRAG has carried out an impact analysis that considers a number of issues in order to identify any potential negative effects for Europe on the application of the Amendments. In doing this, EFRAG considered:
 - (a) whether the Amendments improve financial reporting. This requires a comparison of the Amendments with the existing requirements and how they fit into IFRS as a whole;
 - (b) the costs and benefits associated with the Amendments; and
 - (c) whether the scope of the temporary exemption from IFRS 9 could give rise to competition issues in the EU.
- 2 These assessments allow EFRAG to draw a conclusion as to whether the Amendments are likely to be conducive to the European public good. If the assessment concludes there is a net benefit, the Amendments will be conducive to the objectives of the IAS Regulation.

Whether the Amendments are likely to improve the quality of financial reporting

- 3 EFRAG notes that the Amendments have been developed to address a very specific, short-term situation, being the misalignment of the effective dates of IFRS 9 and the forthcoming insurance contracts Standard. In order to achieve the desired impact, the Amendments provide options that can be selected, depending on the circumstances of each entity, to minimise the adverse impact of that misalignment. A number of options for the measurement of financial assets is not necessarily inappropriate given the range of options for measuring insurance liabilities that is available in accordance with IFRS 4. EFRAG expects that the range of options currently available for measuring insurance liabilities will be much reduced under the forthcoming insurance contracts Standard.
- 4 EFRAG has therefore concluded that the Amendments are a necessary, even if unusual, solution to this very specific situation. EFRAG assesses that, without any remedy, the misalignment of effective dates would impact the quality of financial reporting by affected entities to varying degrees depending on their circumstances. Accordingly, the Amendments will serve to improve the quality of financial reporting relative to the situation without any remedies enabling insurers to reduce the impact of the misalignment.

Costs and benefits of the Amendments

- 5 EFRAG has considered whether, and if so to what extent, implementing the Amendments in the EU might result in incremental costs for preparers and/or users, and whether those costs are likely to be exceeded by the benefits to be derived from its adoption.

Costs for preparers

- 6 In applying the Amendments, depending on their circumstances entities have the ability to choose to apply IFRS 9 in the normal way or to select between up to two alternative options.

Temporary exemption from IFRS 9

- 7 When initially applying the temporary exemption from IFRS 9, preparers will incur costs to educate users and, more particularly, market participants about the reasons for applying the temporary exemption from IFRS 9. EFRAG assesses that preparers may have to organise special briefings for users and other affected parties in order to provide that education.
- 8 Preparers will also incur additional costs to provide users with information about their financial assets that would otherwise have resulted from applying IFRS 9. EFRAG assesses that users may have additional information needs resulting in requests to preparers to provide that information. Such additional information needs may be based on the granularity of information that is provided by entities applying IFRS 9 and which is not provided to the same extent by entities applying the temporary exemption from IFRS 9.
- 9 Preparers that apply the temporary exemption will implement IFRS 9 later than its normal effective date and will continue to apply IAS 39 in the meantime. At this later date, these preparers will have more complete information about the effects of the forthcoming insurance contracts Standard. If preparers were instead required to apply IFRS 9 on its normal effective date, they may need to revisit certain of their assessments and designations made on initial application of IFRS 9 when the forthcoming insurance contracts Standard comes into effect. Accordingly, use of the temporary exemption will to some degree reduce overall IFRS 9 implementation costs by avoiding this additional work.
- 10 Some preparers may further benefit from synergies in running a single project to implement both IFRS 9 and the forthcoming insurance contracts Standard at the same time, rather than running separate projects for each Standard in fairly quick succession, thereby reducing costs.

Overlay approach

- 11 When applying the overlay approach, preparers also apply IFRS 9. Preparers will incur costs in applying IFRS 9 and also incur incremental costs in applying the overlay approach. These incremental costs relate to the record-keeping required in order to track information about eligible financial assets under both IAS 39 and IFRS 9 at financial asset level and the related supplementary internal controls. The extent of these costs will vary. EFRAG understands that many bank-led entities undertaking insurance activities consider these costs to be too high to make the overlay approach a viable option, particularly in view of the short period during which any necessary systems and other investments would be used. By contrast EFRAG also understands that, for some highly integrated bank-led entities undertaking insurance activities, incremental costs of the overlay approach are expected to be insignificant.

- 12 Preparers will also incur incremental costs in providing the disclosures required under the overlay approach that aim to ensure that users fully understand the impact of the overlay in the specific circumstances of the entity.

Conclusion – cost for preparers

- 13 Overall, EFRAG's assessment is that both options will result in additional costs for preparers. However, the temporary exemption will also lead to certain cost mitigations compared to implementing IFRS 9 on its normal effective date and implementing the forthcoming insurance contracts Standard at a later date. These cost mitigations might exceed the additional costs required to implement the options. In any case, EFRAG expects that entities will consider the costs and benefits of each option that is available to them and select the option that is appropriate to their specific circumstances and in doing so take into account the relevance of the resulting information for users.

Costs for users

Temporary exemption from IFRS 9

- 14 EFRAG assesses that the IAS 39 requirements are well known by specialist users and thus there will be no additional cost relating to their continued application. However, EFRAG assesses that specialist users may incur additional costs in understanding the basis for the application of the temporary exemption from IFRS 9.
- 15 EFRAG is aware that some users (mostly users who are not specialists in insurance) have concerns about the costs to them of permitting the continued use of IAS 39. They argue that this will create difficulties in comparing entities undertaking insurance activities with other entities. However, EFRAG understands that the majority of users that follow entities undertaking insurance activities are specialist users. EFRAG further considers that the views of these specialist users should be given more weight in this particular case.

Overlay approach

- 16 EFRAG assesses that users will incur costs in understanding the amount of the overlay adjustment, its composition and its effects. EFRAG further assesses that in the case of newly designated or de-designated financial assets to the overlay approach, users will incur costs in understanding the reasons for such changes in designation and the impacts on the overlay adjustment.

Conclusion – cost for users

- 17 Overall, EFRAG's assessment is that both options will result in additional costs for users in understanding the reasons for and the impact of the approach chosen by the preparers in their specific situation. Further, some generalist users will incur additional costs in comparing entities undertaking insurance activities with other entities.

Benefits for preparers and users

Temporary exemption from IFRS 9

- 18 EFRAG assesses that the temporary exemption will allow preparers to avoid recognising the volatility in profit or loss and accounting mismatches that would result from applying IFRS 9 before the forthcoming insurance contracts Standard. As noted above, preparers will also avoid the costs relating to a consecutive implementation of two related accounting standards.
- 19 Users will benefit from the temporary exemption because they can continue using their existing models until IFRS 9 and the forthcoming insurance contracts Standard

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are applied. EFRAG expects that the IASB will continue to make its best endeavours to issue the forthcoming insurance contracts Standard in sufficient time that the two standards can be applied at the same time by insurers electing to apply the temporary exemption from IFRS 9.

Overlay approach

- 20 EFRAG assesses that the overlay approach will allow preparers to remove the volatility resulting from the misalignment of the effective dates of IFRS 9 and the forthcoming insurance contracts Standard, from profit or loss for the selected eligible financial assets.
- 21 Users will benefit from relevant and transparent information provided under IFRS 9 and will receive complementary information in order to understand the effects of the overlay adjustment. They will further benefit in that volatility from additional accounting mismatches will not appear in profit or loss during this interim period before the application of full IFRS 9.

Conclusion – benefits for preparers and users

- 22 Overall, EFRAG assesses that the benefits for both users and preparers are likely to exceed the costs of applying the Amendments for the reasons stated above.

Potential competition issues within the EU

Temporary exemption from IFRS 9

- 23 EFRAG's endorsement advice on IFRS 9 was positive, except for the impact on the insurance industry of the misalignment of effective dates referred to elsewhere in this letter. As noted in Appendix 1 to this letter, the Amendments provide two optional reliefs one or both of which will be available to all entities that undertake significant insurance activities. In that respect, some form of solution is available to the entire insurance industry.
- 24 However, one of the options in the Amendments -- the temporary exemption from IFRS 9 -- is available only to entities that are predominant insurers. EFRAG has assessed that most entities with both significant insurance and significant non-insurance activities will fail the predominance test and not be able to apply the temporary exemption from IFRS 9.
- 25 It should be noted that the IASB's decision to limit the optional temporary exemption from IFRS 9 to the reporting entity level is consistent with the long-established and fundamental principle that consolidated financial statements should be prepared using consistent accounting policies. EFRAG assesses that the Amendments provide for the use of consistent accounting policies for financial assets in the entity's financial statements. As a result, similar financial assets would be accounted for in a consistent way within the same reporting entity.
- 26 In order to provide additional context for this assessment, EFRAG reviewed the 2015 consolidated financial statements of 50 European-based groups that conduct significant insurance activities. Based on disclosed insurance liabilities, EFRAG estimated that the entities that are eligible for the optional temporary exemption from IFRS 9 in their consolidated financial statements represent approximately 75-80% of the total insurance activity within this sample. Accordingly, entities representing approximately 20-25% of the total insurance activity within this sample are not able to use the temporary exemption. These entities include bank-led groups with significant insurance activities in their consolidated financial statements. EFRAG acknowledges that that percentage may be higher in some jurisdictions.
- 27 EFRAG has therefore considered whether this difference in the availability of the options in the Amendments could give rise to competition issues within the European insurance sector. Specifically, EFRAG has considered the extent to which bank-led groups that undertake insurance activities could be placed at a competitive disadvantage compared to predominant insurers that are eligible for the temporary exemption from IFRS 9. In this regard, EFRAG has been made aware of the following arguments that could be relevant from a competition perspective:
- (a) Some argue that the inability to use the temporary exemption from IFRS 9 would have an adverse effect on entities' investment strategies, including a disincentive to invest in equities, relative to those entities that are able to use the temporary exemption because:
 - (i) The investment strategy of some entities undertaking insurance activities is based on several indicators, one of which is IFRS profit or loss. For other entities undertaking insurance activities, their investment strategy is based mainly on regulatory requirements;
 - (ii) IFRS 9 does not allow recycling to profit or loss of gains and losses for equity instruments held at fair value through OCI on disposal, in contrast to the treatment of the available for sale category in IAS 39. As a result, some argue that if entities undertaking insurance activities are required to apply IFRS 9 on its normal effective date, they might choose to invest

in financial assets that show less volatility such as bonds which overall also provide a lower return;

- (iii) Predominant insurers that are able to use the temporary exemption from IFRS 9 will have more time to realise and report in profit or loss the unrealised gains on assets measured at cost or classified as available for sale under IAS 39. For bank-led groups that undertake insurance activities and apply IFRS 9 in 2018, pre-2018 unrealised gains will be “frozen” in retained earnings.
- (b) Due to the non-recycling of gains and losses on equities held at fair value through OCI to profit or loss, some argue that entities undertaking insurance activities that are not predominant insurers would have no practical choice but to report less relevant information about their performance; and
- (c) The cost mitigations available to predominant insurers that are eligible for the temporary exemption would not be available to bank-led groups that undertake insurance activities.

Adverse effect on investment strategies

28 In its endorsement advice on IFRS 9, EFRAG assessed that IFRS 9 may not optimally reflect the business model of long-term investors in equities. However, EFRAG notes that this is a broader issue that extends well beyond entities undertaking insurance activities. Moreover, in the context of the arguments made on disincentives to invest, EFRAG's endorsement advice on IFRS 9 noted that “*EFRAG believes that broader economic considerations such as the need for entities undertaking insurance activities to obtain a yield on their asset portfolio sufficient to meet their obligations to policy holders are likely to outweigh any accounting concerns in deciding whether or not to invest in equity investments*”.

29 In addition, EFRAG notes the following:

- (a) the Amendments are of a temporary nature. The temporary exemption expires in 2021 or, if earlier, when the forthcoming insurance contracts Standard is applied. This contrasts with the long-term nature of the business model of entities undertaking insurance activities;
- (b) the forthcoming insurance contracts Standard requires measurement of insurance liabilities at current value, as do the Solvency II requirements. Some industry experts have informed EFRAG that Solvency II requirements are now a much more important factor in determining investment strategies than IFRS profit or loss;
- (c) the business practice of reallocating financial assets may help in reducing any accounting mismatches. This is because very volatile financial assets can be re-allocated and replaced with less volatile financial assets within the same measurement category; and
- (d) application of the overlay approach can mitigate the effect of unrealised gains on certain financial assets becoming frozen in retained earnings from 2018 if IFRS 9 is applied from that date.

Less relevant information on performance

30 As noted in paragraph 27 above, EFRAG reviewed the 2015 financial statements of 50 European-based groups that undertake insurance activities, some to a large extent, some to a lesser extent as described hereafter. Of this sample, 20 were classified as either pure insurers or insurance-led groups, and 30 as bank-led groups. Based on the 2015 financial statements, 19 of the 20 of the pure insurers and insurance-led groups would clearly have the option to apply the temporary exemption

- from IFRS 9 in their consolidated financial statements. The other (which is a reinsurer) would also have the option to apply the temporary exemption subject to being able to demonstrate that it does not engage in a significant activity unconnected with insurance. The temporary exemption would not be available to the 30 bank-led groups in the sample in their consolidated financial statements.
- 31 In the case of the 30 bank-led groups in the sample, more than half did not identify their insurance business as a reportable segment in accordance with IFRS 8 *Operating Segments*. The extent to which these entities would elect to apply the temporary exemption if it were available to them is unclear. Some presented their insurance business as a sub-segment while others mentioned explicitly in their financial statements that the insurance business was part of one or more of their banking segments or as part of the "Other" segment. To the extent that information is available, for some bank-led groups the insurance liabilities were less than 20 per cent of the entity's total liabilities, raising the question of the significance of insurance activities to these entities.
- 32 The main elements of information that were provided in the financial statements of the entities in the sample that failed the predominance test related to the technical provisions supporting the insurance activities and investment contracts, the income and expenses related to insurance activities and the risk management of the insurance activities. However, this information was not provided by all of them and, when it was provided, it was not provided in a consistent way.
- 33 In its endorsement advice on IFRS 9, EFRAG considered that the temporary exemption should not be available to banking or other businesses unrelated to insurance within a group. EFRAG additionally assessed that, for those bank-led groups in the sample that do not report separately on their insurance activities in their consolidated financial statements (e.g. as a reportable segment in accordance with IFRS 8), the impact of applying or not applying the temporary exemption from IFRS 9 would be less visible. This is because this impact would be subsumed within information that relates to both insurance and non-insurance activities.
- 34 EFRAG has heard an argument that information on the insurance activities of some bank-led groups is provided to certain specialised users such as analysts following the company and that the impact of applying or not applying the temporary exemption from IFRS 9 would therefore be fully visible. EFRAG notes however that its assessments against the endorsement criteria in the IAS Regulation are based on financial reporting in accordance with the Regulation and not on any supplemental reporting that entities might choose to provide to particular users. EFRAG therefore assesses that this argument is not relevant to its endorsement advice.
- 35 EFRAG acknowledges that the recognition of losses on equity instruments in OCI without any recognition in profit or loss, even when the instrument can be deemed impaired, may not appropriately reflect an entity's performance in the view of those investors who expect to have all impairment losses included in profit or loss. However, this is an issue for all entities applying IFRS 9 and is not specific to entities that undertake insurance activities.

Cost mitigations available to predominant insurers

- 36 EFRAG notes that all entities that undertake insurance activities will in due course be required to implement both IFRS 9 and (presumably) the forthcoming insurance contracts Standard, and will incur costs in doing so. Any differences in the cost burden between those entities that undertake insurance activities that are eligible for the temporary exemption and those that are not therefore relate only to the timing of the implementation activities rather than the need to undertake them. However, as

noted above, predominant insurers that are eligible to use the temporary exemption from IFRS 9 will be able to make use of certain cost mitigations that are not available to other entities that undertake insurance activities.

- 37 These entities that undertake insurance activities will be able to use the overlay approach which will mitigate the effects on profit or loss of the misalignment of effective dates (with the exception of the effects of the IFRS 9 expected loss model). However, implementing the overlay approach will lead to additional costs in excess of those incurred in implementing IFRS 9 in the normal way. Many bank-led groups that undertake insurance activities regard these costs as too high to make the overlay approach a viable option. Predominant insurers that can use the temporary exemption from IFRS 9 will be able to avoid the financial reporting effects without incurring these costs.
- 38 Set against these factors, EFRAG notes that bank-led groups that undertake insurance activities will need to implement IFRS 9 on its normal effective date and that this would remain even if the temporary exemption had been made available in their non-insurance divisions. These bank-led groups will therefore need to establish an IFRS 9 implementation project in line with the normal effective date for the purpose of their consolidated financial statements, which is not the case for predominant insurers that are eligible to use the temporary exemption from IFRS 9. Implementing IFRS 9 through the entire group is expected to result in synergies for bank-led groups that undertake insurance activities that will serve to mitigate the costs of implementing IFRS 9 within the insurance sub-group. For example, EFRAG has been informed that the most significant cost incurred in IFRS 9 implementation arises from the need to upgrade or develop systems and models to apply the expected credit loss requirements, and that many entities are managing this on a centralised basis.
- 39 EFRAG notes that requiring bank-led entities that undertake insurance activities to apply IFRS 9 throughout their consolidated financial statements at the same time as other bank-led entities will avoid competition issues between bank-led groups and pure banks. Applying IFRS 9 throughout an entity's consolidated financial statements avoids the use of different accounting policies for financial assets within same group and consequential structuring opportunities (such as transferring non-investment grade financial assets from the banking to the insurance part of the business).

Overlay approach

- 40 EFRAG notes that entities that undertake insurance activities that are not predominant insurers are able to use the overlay approach. This approach can substantially mitigate the accounting mismatches and volatility in profit or loss that would arise from applying IFRS 9 before the forthcoming insurance contracts Standard by using the overlay approach.
- 41 EFRAG notes that the overlay approach does not eliminate all effects of moving from IAS 39 to IFRS 9 in the statement of profit and loss and other comprehensive income. Specifically the overlay approach does not address volatility in OCI that arises from financial assets measured at amortised cost under IAS 39 that would be measured at FVOCI under IFRS 9. In addition, if the overlay approach is applied to financial assets that are measured at cost or amortised cost but at fair value through profit or loss under IFRS 9, it shifts volatility into OCI. Nonetheless EFRAG assesses that the main financial reporting-related concerns relate to additional accounting mismatches and temporary volatility in profit or loss. Also, the evidence made available to EFRAG indicates that typically only a small proportion of insurers' investment portfolios is measured at cost or amortised cost under IAS 39, hence any additional volatility in OCI from application of IFRS 9 combined with the overlay approach should be limited.

- 42 In addition, the overlay approach does not allow an entity to eliminate the effects of the application of IFRS 9's expected credit loss model from profit or loss. Entities that undertake insurance activities that are not predominant insurers will be required to apply the expected loss model in 2018 while predominant insurers that qualify for the temporary exemption will be able to defer it.
- 43 EFRAG notes that the expected credit loss model is widely seen as an improvement over the current impairment requirements of IAS 39. Consequently, EFRAG assesses this aspect of the overlay approach as positive.
- 44 EFRAG further understands that insurers' holdings in debt-type assets are typically concentrated in assets of investment grade, which helps to mitigate any effect of IFRS 9's expected loss model. However, the effect of the expected credit loss model could still be material to the financial statements of at least some entities.
- 45 EFRAG considers that the main drawback of the overlay approach is that it involves implementation costs above the costs of applying IFRS 9. As noted, some bank-led entities that undertake insurance activities consider these costs to be too high to make the overlay approach a viable option.

Conclusion on competition issues

- 46 EFRAG assesses that the scope of the optional temporary exemption from IFRS 9 has the effect that certain cost mitigations available to predominant insurers are not available to bank-led groups that undertake insurance activities.
- 47 EFRAG further assesses that the optional overlay approach substantially addresses the concerns of bank-led groups that undertake insurance activities relating to additional accounting mismatches and volatility in profit or loss but will result in additional implementation costs for most of these entities. EFRAG has not been able to quantify these matters and is not in a position to conclude on whether they amount to a material competition issue from an economic perspective.

Conclusion on European public good

- 48 EFRAG considers that the Amendments will generally bring improved financial reporting when compared to a mandatory application of IFRS 9 at the same time as all other entities, with an acceptable cost-benefit trade-off. As such, their adoption is conducive to the European public good in that improved financial reporting improves transparency and assists in the assessment of management's stewardship.
- 49 EFRAG has not identified that the Amendments could have any adverse effect on the European economy, including financial stability and economic growth.
- 50 Furthermore, EFRAG has considered whether there are any other factors that would mean adoption is not conducive to the European public good and has not identified any such factors. EFRAG acknowledges that the Amendments do not address the cost concerns of entities undertaking insurance activities that are not predominant insurers.
- 51 Having considered all relevant aspects, including the trade-off between the costs and benefits of implementing the Amendments, EFRAG assesses that adopting the Amendments is conducive to the European public good.