EFRAG SECRETARIAT PAPER FOR PUBLIC MEETING

Deferral of IFRS 9 for Insurers
Revised Paper

Objective

1 At its meeting on 3 June, EFRAG Board decided to further develop its views on whether to recommend to the European Commission that they approach the IASB to request deferral of IFRS 9 *Financial Instruments* for insurers until the future insurance contracts standard is applied. As input, the EFRAG Board requested a summary of the impact of recommending such a deferral and sought additional financial information from the industry.

2 The direction in the draft endorsement advice and the presentation from the insurance industry provide the case for a deferral of IFRS 9 until the future insurance contracts standard is applied. This paper summarises and assesses the arguments provided by those who oppose the deferral. For convenience of members of EFRAG Board, the relevant part of the draft endorsement advice is attached to this paper.

3 This paper relies on information provided by the insurance industry for impacts such as the level of holdings of high quality investments.

The case against a deferral

Arguments against a deferral	Assessment arising from past EFRAG IAWG and EFRAG TEG discussions
IFRS 9 provides higher quality information than the information provided by IAS 39.	• EFRAG has in its draft endorsement advice assessed that IFRS 9 will bring different but still relevant accounting for financial instruments other than basic lending instruments compared to IAS 39. • However the quality of financial reporting provided by insurers cannot be assessed by considering the accounting for certain assets related to life insurance independently from the accounting for liabilities. This would not be true for non life or other insurance activities. • EFRAG has assessed that IFRS 9 brings distinct improvements in accounting for impairment. Most insurers hold high quality investment portfolios and as a result expect recognised credit losses to be low in normal times, even if they are subject to significant percentage increases from the existing zero impairment allowance once the new impairment model is applied; on the other hand IFRS 9 is expected to give better information for impairments of other, lower quality, financial assets and indeed higher quality assets in stressed situations. • EFRAG has assessed that IFRS 9 would bring a distinct improvement in hedge accounting.
A deferral of IFRS 9 would mean that the financial statements of insurers are not comparable with the financial statements of other entities.	• This is true on the asset side. • Given that (i) IFRS 4 grandfathers diverse accounting practices; and (ii) assets and liabilities in certain elements of insurers’ life businesses are linked, a lack of comparability will remain until the future insurance contracts standard is implemented.

Arguments against a deferral	**Assessment arising from past EFRAG IAWG and EFRAG TEG discussions**
Developing a standard to implement deferral is highly complex. IFRS 4 and the future insurance contracts standard apply to insurance contracts, and not to insurance entities. Further, there are complex issues related to insurers that are part of a conglomerate, either as a parent entity or as a subsidiary. Other standards would need to be amended to allow, for example, the use of inconsistent accounting policies in bancassurers.	• EFRAG has already analysed a number of critical issues that will assist in this process. The only truly complex issue, transfers between insurers and other parts of a conglomerate, is more theoretical than real, as transfers are rare and any accounting impact could be effectively prohibited by imposing heavy 'tainting' penalties. . • A deferral standard needs to address the scope of the deferral, including how to identify insurers, both separate from and within conglomerates. However, standard-setting effort is already necessary in order to determine the scope of assets (in particular within a conglomerate) to which the IFRS 9 "fresh-start" transition relief would apply upon implementation of the new insurance contracts standard. • We have not yet evaluated whether amending existing IFRS 4 to increase the scope of shadow accounting to assist in the interim period would require a significant standard-setting effort.
Insurers are already able to improve their approach to measuring insurance liabilities.	• This is true although there is a cost for insurers to develop new accounting policies for liabilities when those policies will have a limited life, and costs for users to understand the information. On the other hand users will be exposed to cost in continuing to follow an out of date accounting standard and in understanding different accounting policies for different segments of bancassurers.
European insurers could use the measure of liabilities in Solvency II.	• Solvency II does not address the recognition of income and expense. Solvency II is not applicable to insurers outside Europe and therefore would not assist global insurers that have operations outside Europe.

Arguments against a deferral	**Assessment arising from past EFRAG IAWG and EFRAG TEG discussions**
No convincing evidence has been brought to justify that the problem is real. Indeed, the industry is not completely unanimous in requesting the deferral.	• The CFO Forum has provided aggregated indications of the effect on profit or loss of some of the largest and most affected continental European insurers that would be caused by the application of IFRS 9 in 2018. This shows that the life segments would have shown significant accounting volatility in the income statement which may not have been shown under the current proposals for the future insurance contracts standard. On the other hand, the non life segments would have shown on average greater volatility in the income statement which would remain under the future insurance contracts standard. Deferring IFRS 9 for more than life segments would result in this volatility for non life segments and other businesses not being shown.
Given that the aggregated evidence provided is based on an initial review of the balance sheets of some of the largest and most affected continental European insurers, it is not clear that the results are representative of the industry as a whole.	• The evidence provided covers 25% of the assets held by European insurers and is sufficiently material to acknowledge that there is an issue that may need to be addressed.

Question to EFRAG Board members

4 Do EFRAG Board members consider that they should revisit, or that they should maintain, the initial view in the draft endorsement advice on IFRS 9? This view was that EFRAG should recommend to the EC that the EC ask the IASB to grant insurers the option to defer the application of IFRS 9 until the future insurance contracts standard is applied? Any decision would be subject to responses from constituents which are due on or before 30 June 2015. The input from users will be particularly important.

APPENDIX
EXTRACT FROM IFRS 9 DRAFT ENDORSEMENT ADVICE

Inter-relationship between IFRS 9 and the future insurance contracts standard

100 The business model of some insurers[1] 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. It follows that both IFRS 9 and the future insurance contracts standard will play a very interactive and pervasive role in presenting an insurer's financial position and performance.

101 IFRS 9 is to be applied for annual periods beginning on or after 1 January 2018. In contrast, the IASB is currently deliberating the future insurance contracts standard. Although the future insurance contracts standard is expected to be issued before IFRS 9 becomes effective, it would be extremely difficult for an insurer to apply IFRS 9 and early adopt the future insurance contracts standard at the same time. Recognising the extent of the changes for some entities that are brought by the future insurance contracts standard, the IASB has decided that it will allow approximately three years between finalising the future insurance contracts standard and its mandatory effective date.

102 Requiring an insurer to apply IFRS 9 before the future insurance contracts standard has the potential to significantly reduce the quality of information available to users. Any accounting mismatches between IAS 39 and existing IFRS 4 have been addressed by insurers. However, the adoption of IFRS 9 before the adoption of the future insurance contracts standard is expected to lead to accounting mismatches that would be difficult, or even impossible, to address until both standards are applied.

103 The IASB has so far tentatively decided not to consider deferring the mandatory effective date of IFRS 9 for insurers[2] in order to align it with the application date of the future insurance contracts standard. This may be because IFRS 9 provides more relevant information about financial instruments compared to IAS 39; it is difficult to identify the scope of the insurance entities that might be eligible for such a deferral; and the technical hurdles to be overcome in drafting such a deferral.

104 In the event there is no deferral of IFRS 9, the IASB is considering additional transitional reliefs, including fresh start accounting for applying the IFRS 9 business model assessment to reduce accounting mismatches at the time the future insurance contracts standard is applied. However, such reliefs will not have any impact during the period between adopting IFRS 9 and subsequently the future insurance contracts standard as they will only be effective from the date the future insurance contracts standard is applied.

[1] For the purpose of this draft letter, an insurer is an entity (or a component of an entity such as an operating segment) whose principal activity is to issue insurance contracts (as defined in IFRS 4).

[2] See IASB Update at: http://media.ifrs.org/2015/IASB/January/IASB-Update-January-2015.pdf

A - __Potential benefits and drawbacks of deferring IFRS 9 for insurance entities__

A.1. Potential benefits of a deferral

105 EFRAG considers that the benefits of deferring the application of IFRS 9 for insurance entities that apply cost models to their insurance liabilities include:

(a) *Information needs of users.* Users will find difficulties in understanding the financial performance and position of insurers during the period between the adoption of IFRS 9 and the future insurance contracts standard. Insurance entities 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 insurer's results by linking non-GAAP measures to the financial statements.

(b) *Costs for preparers.* In the event IFRS 9 is implemented before the future insurance contracts standard, insurers would incur additional costs for having to first implement IFRS 9 and then reassess that implementation when implementing the new insurance contracts standard. Reassessment would however be limited to possible changes in conditions having occurred since IFRS 9 was first implemented.

(c) *Accounting mismatches.* If insurers were required to change the accounting for financial assets by applying IFRS 9 without a corresponding change in the accounting for insurance liabilities backed by those financial assets, it would result in accounting mismatches for those insurers applying the cost model under the existing 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. 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. A deferral of IFRS 9 until the future insurance contracts standard is implemented would allow changes in the accounting requirements for financial instruments and insurance liabilities to be applied at the same time, thereby avoiding expensive (and not necessarily effective) adjustments or accounting mismatches during the interim period.

A.2. Potential drawbacks of a deferral

106 While there are benefits for insurers of aligning the effective dates of IFRS 9 and the future insurance contracts standard, EFRAG notes that a deferral of IFRS 9 is not without drawbacks, including:

(a) *Delaying the provision of improved financial information.* IFRS 9 is generally considered an improvement over IAS 39. Delaying the application of IFRS 9, particularly the improved impairment model, for an unknown number of years is an issue of concern. Allowing insurers to continue applying the IAS 39 incurred loss model, which has been criticised as providing for "too little, too late" loss allowances, instead of the IFRS 9 forward looking expected credit losses model, might be seen as a significant drawback in light of the G20 recommendation at first glance. However, given that many financial assets held by insurers are investment grade assets, the application of the IFRS 9 impairment model is not expected to result in significantly higher provisions than the IAS 39 incurred loss model. This is because the 12-month expected credit loss allowances for those investment grade assets are not expected to be material in absolute terms.

(b) *Reduction in comparability.* Some argue that a deferral of IFRS 9 would reduce comparability in the treatment of financial assets between insurance and banking entities. EFRAG considers that this is not a major drawback because the measurement of insurance liabilities currently differs between insurers because of the provisions of IFRS 4 and consequently the impact of the different business models between insurers and other financial institutions impacts the measurement of financial assets.

(c) *Impact on conglomerates*. It has been suggested that allowing a deferral of IFRS 9 would be difficult for conglomerates if recognising in the consolidated financial statements some financial assets using IFRS 9 and other financial assets using IAS 39 results in the conglomerate applying non-uniform accounting policies which is not in accordance with IFRS 10 *Consolidated Financial Statements*. In EFRAG's view, this concern may be addressed by acknowledging the dissimilar circumstances through presenting and disclosing financial instruments recognised and measured in accordance with IAS 39 separately from those recognised and measured in accordance with IFRS 9.

A.3. CONCLUSION ON POTENTIAL BENEFITS AND DRAWBACKS

107 Having duly considered the possible drawbacks and assessed their significance, EFRAG is of the view that the benefits to users of consistent and understandable financial reporting until IFRS 9 and the future insurance contracts standard are applied at the same time, together with the cost savings for preparers and users, make a strong case for the deferral of IFRS 9 for insurers. However, EFRAG considers that any deferral of IFRS 9 should be optional as some insurers, such as conglomerates, may take the view that, in their circumstances, the drawbacks of a deferral outweigh the benefits.

B - Quantitative assessment

Note to constituents

EFRAG has reached its preliminary position on the basis of all of the above and a first set of quantitative data received from the European insurance industry shortly before the draft endorsement advice was approved. EFRAG considers that a more in-depth understanding of the magnitude of the potential effects of IFRS 9 being implemented in advance of the future insurance contracts standard is critical to the finalisation of its endorsement advice to the European Commission. EFRAG is therefore calling on constituents to provide more evidence and insights on this issue.

108 EFRAG has reached out to the insurance industry in order to understand the likely effect of adopting IFRS 9 before the adoption of the future insurance contracts standard.

109 In this regard, EFRAG received a joint preliminary high level quantitative assessment from the European insurance industry showing an initial review of the balance sheets of some of the largest and most affected continental European insurers. This suggests that between 8 and 20 per cent of the assets currently accounted for at amortised cost or on an available-for-sale basis, with a value of more than € 250 billion, will be accounted for at fair value through profit or loss on adoption of IFRS 9. Fair value movements on these assets would be recognised in profit or loss. With the measurement methodology for insurance liabilities remaining unaltered until the future insurance contracts standard is implemented this will give rise to significant accounting mismatches resulting in fluctuations in reported net income unrelated to changes in the entity's performance. For example, based on an analysis by some of the larger continental European insurers for the years 2011 to 2014 there would have been fluctuation in profit or loss of up to 20 per cent.

C - Conclusion

110 Based on the above analysis and quantitative assessment, EFRAG thinks that there are reasonable grounds to believe that a deferral of IFRS 9 for insurers would be conducive to the European public good. EFRAG therefore advises the European Commission to request the IASB to open an option to defer the application date of IFRS 9 for insurance businesses. EFRAG is ready to assist the IASB in designing the scope of such an option.