EFRAG SECRETARIAT PAPER FOR PUBLIC MEETING

IFRS 9 and IFRS 4 – overlay and deferral approaches EFRAG TEG advice to EFRAG Board

Objective and background

1 The purpose of this note is to explain the position of EFRAG TEG agreed upon in its meeting of 7 October 2015 on the overlay and deferral approaches as proposed by the IASB. The overlay and deferral approaches are summarised in the attachment to this paper.

2 EFRAG TEG took into consideration the suggestions made by the EFRAG IAWG members in their meeting on 6 October 2015. The EFRAG Insurance Accounting Working Group (IAWG) Chairman voted on behalf of his group, in accordance with EFRAG's internal rules.

Summary of EFRAG TEG advice

3 All but one[1] EFRAG TEG member were in favour of pursuing both the overlay and deferral approaches in the upcoming ED. However the IASB proposals would need to be revised in a number of areas as explained below to be deemed supportable by a majority of EFRAG TEG members. It was noted that the approaches proposed are valuable only if they end up being applied in practice.

Overlay approach: Summary of EFRAG TEG views

4 *Scope*: The EFRAG IAWG had recommended that the scope should be extended to financial assets that relate to activities undertaken by insurers that are not insurance contracts within the scope of IFRS 4, e.g., investment contracts and assets held for regulatory purposes. However, most EFRAG TEG members (all but Geert Ewalts, Nicklas Grip, Heinz Hense) did not agree with that recommendation. This was because extending the scope does not address the objective of the overlay approach, i.e., to mitigate profit or loss volatility resulting from the misalignment of the application dates of IFRS 9 and the future insurance contracts standard. Those who supported the EFRAG IAWG's view that the scope of the overlay approach should be extended considered that the scope of the overlay approach and the scope of the deferral approach should be aligned.

5 Therefore, most of the EFRAG TEG members broadly supported the IASB's proposals as currently worded, subject to a better understanding of which financial assets relate to insurance contracts within the scope of IFRS 4.

6 *Redesignation*: EFRAG TEG members agreed that this aspect is directly related to the scope. Some EFRAG TEG members were concerned that recycling to profit or

[1] Andrew Spooner did not support the overlay approach. Another EFRAG TEG member (Sven Morich) preferred the deferral only, but agreed to support the overlay approach being pursued.

loss, when the financial asset no longer qualifies for the overlay approach, may promote transfers and restructuring. Most EFRAG TEG[2] members approved the IASB's proposals supplemented with disclosures.

7 *Presentation in profit or loss*: Based on the IASB tentative decisions, there appear to be a range of presentation options, most notably:

(a) View A: profit or loss is presented based on IFRS 9 and the overlay adjustment transfers the volatility created in profit or loss to OCI;

(b) View B: profit or loss is presented based on IAS 39 with an adjustment in OCI to align total comprehensive income with IFRS 9.

8 EFRAG TEG members were divided on whether preparers should be permitted to select a format for presenting their statement of comprehensive income or whether a specific format should be mandated. If only one were to be allowed, members were divided as to what format (precedence to IFRS 9 or precedence to IAS 39) should be selected. Those in favour of View A gave precedence for having the balance sheet and the income statement aligned. Those in favour of View B thought that View B was more consistent with the objective of limiting changes imposed on users.

View A – IFRS 9	**View B – IAS 39**
Detailed revenues and expenses – IFRS 9 +/- IFRS 9 overlay adjustment = profit or loss – adjusted	Detailed revenues and expenses – IAS 39 = profit or loss – IAS 39
-/+ IFRS 9 overlay adjustment =/- other OCI items	-/+ IAS 39 overlay adjustment =/- other OCI items
Total comprehensive income	Total comprehensive income

Deferral approach: Summary of EFRAG TEG views

9 *Scope*: Concerns were raised by some EFRAG TEG members (Christian Chiarasini, Geert Ewalts, Nicklas Grip) that the need for insurance contracts within the scope of IFRS 4 to be predominant would limit the number of insurers eligible to apply the deferral approach. Instead some concurred with the EFRAG IAWG view that developing a holistic approach using indicators would be more helpful. It was noted that the IASB appeared to be willing to change the definition of a "pure" insurer currently used.

10 Approaches to broaden the definition of a "pure" insurer were not assessed in detail in the EFRAG TEG meeting, however the following additions to insurance liabilities for the purpose of assessing predominance were suggested by EFRAG IAWG members:

(a) Liabilities of insurers that are out of scope of IFRS 4, e.g. investment contracts with or without participation features;

(b) Liabilities related to unbundled components of insurance liabilities. IFRS 4 provides the option to unbundle deposit components of an insurance contract. Those insurers that chose to unbundle their insurance contracts when first applying IFRS 4 would account for the deposit component as a financial

[2] Andrew Spooner and Françoise Flores thought that redesignation should not be allowed.

instrument and hence would recognise a lower amount of insurance liabilities than the insurers who had not chosen to unbundle;

(c) Derivatives hedging the insurance activities;

(d) Some financial debt (e.g. some insurers account for short-term payables to policy holders under financial debt); and

(e) Insurance liabilities that are backed by financial assets held in investment vehicles in separate legal entities.

11 *Deferral at or below reporting entity level*: EFRAG TEG members were divided whether deferral should be applied at or below reporting entity level. A number of EFRAG TEG members were concerned that banks that belong to groups predominantly involved in insurance activities would not be reported in the consolidated statements in accordance with IFRS 9 due to the deferral approach being applied at the reporting entity level. Others were concerned that the consolidated financial statements would include similar, or even identical, financial assets measured by applying different standards. As a result, a small majority of EFRAG TEG members were in favour of applying the deferral below reporting entity level. The use of a regulatory definition and segment reporting were suggested but not assessed in detail.

12 Five EFRAG TEG members (Anthony Appleton, Geert Ewalts[3], Tommaso Fabi[4], Günther Gebhardt, Andrew Spooner) supported deferral at reporting entity level. Six EFRAG TEG members and the chair of the IAWG voting on behalf of the group (Christian Chiarasini, Nicklas Grip, Heinz Hense, Sven Morich, Serge Pattyn, Françoise Flores, and Hans Schoen) were in favour of a deferral below reporting entity level. It was noted that the identification of insurance activities below reporting entity level could be done on the basis of the scope of insurance regulation, however that the IASB had no reference to such a possibility. Mike Ashley and Ambrogio Virgilio abstained.

13 *Sunset clause*: All EFRAG TEG members supported the use of a sunset clause, i.e. that the deferral approach would be able to be applied until 1 January 2021.

[3] Geert Ewalts considered that, In general, deferral should be applied at the reporting entity level, but if an insurer that meets the criteria is owned by a non-insurance company like a bank, it should be able to maintain the deferral of IFRS 9 in consolidated financial statements.

[4] Tommaso Fabi noted that the IASB should verify the effects on competition among entities (especially banks) arising from the application of deferral at reporting entity level.

ATTACHMENT: Summary of the IASB proposals

14 The IASB has tentatively decided to provide two solutions for dealing with the misalignment of the implementation dates of IFRS 9 *Financial instruments* and the future insurance contracts standard:

(a) **The overlay approach** that may be applied by any entity issuing insurance contracts under IFRS 4 *Insurance Contracts*. Under this solution, IFRS 9 is implemented in full and any difference between amounts recognised in IFRS 9 and amounts that would have been recognised in IAS 39 *Financial Instruments: Recognition and Measurement* are eliminated from profit or loss and reported in other comprehensive income; and

(b) **The deferral approach** that may only be applied by entities that issue contracts within the scope of IFRS 4, if that activity is predominant for the reporting entity, and would apply to all financial assets held by the reporting entity (i.e. at the 'reporting entity level'). Under this option, IFRS 9 is not implemented in the primary financial statements, even if the entity conducts some banking or other activities.

15 Both approaches are optional for the entities within the scope. For those entities, the approaches would be available at the date when they would otherwise be required to initially apply IFRS 9, i.e. for annual periods beginning on or after 1 January 2018, earlier application being permitted.

Overlay approach

16 Under this approach, IFRS 9 is implemented in full. The only difference in applying this approach compared to applying IFRS 9 is that the volatility introduced by IFRS 9 is removed from profit or loss and reported in OCI.

17 The overlay adjustment is limited to financial assets that are:

(a) designated by the entity as relating to contracts that are within the scope of IFRS 4; and

(b) classified as FVPL in accordance with IFRS 9 and would not have been classified as FVPL in their entirety in accordance with IAS 39.

18 When redesignating financial assets:

(a) An entity is permitted to apply the overlay approach to financial assets when the criteria are met; and

(b) An entity should cease applying the overlay approach when financial assets no longer meet the eligibility criteria.

19 Thirteen IASB members present agreed with the overlay approach. One IASB member was absent.

Deferral approach

20 Under this approach, IFRS 9 is not implemented by those entities that issue contracts within the scope of IFRS 4, if that activity is predominant for the reporting entity, and would apply to all financial assets held by the reporting entity.

21 Predominance of insurance activities would be determined by a threshold based on the level of gross liabilities arising from contracts within the scope of IFRS 4 relative to the entity's total liabilities. From the IASB staff papers for the September 2015 IASB meeting, the threshold appears to be higher than 67%. The IASB Board

tentatively decided that threshold should be higher but added there should be no quantitative threshold put forward.

22 The IASB considered two application levels for the deferral approach, each with specific drawbacks: (i) at reporting entity level and (ii) below reporting entity level.

23 Applying the deferral at reporting entity level has the drawback that some assets that are not related to insurance activities may remain under IAS 39. For banking activities of subsidiaries, regulators are highly likely to require application of IFRS 9 as from 1 January 2018. In that case bank subsidiaries of insurance groups could be required to apply both IAS 39 (within the insurance reporting entity) and IFRS 9 (for their separate financial statements) during the transition period.

24 Applying the deferral below reporting entity level has the drawbacks that transfers between an IAS 39 and IFRS 9 environment (or vice versa) may create opportunities for earnings management. Also, it would lead to the application of two different accounting policies within one set of consolidated accounts.

25 Overall, the IASB tentatively decided to apply the deferral at reporting entity level.

26 In addition, the IASB decided that the deferral of IFRS 9 should be applied with a sunset clause, i.e. entities can benefit from the deferral of IFRS 9 until 1 January 2021. The IASB is expected to allow three years between publication of the future insurance contracts standard and its effective date. Consequently, the IASB would need to publish the future insurance contracts standard by the end of 2017 in order to have the deferral option effective for the full transition period. In the unlikely event that the IASB does not succeed in finalising the future insurance contracts standard in time to allow implementation of the standard by 1 January 2021, entities would be allowed to change to the overlay approach.

27 The deferral approach was initially supported by 7 IASB Board members, with 7 IASB Board members being against. The IASB Chairman used his casting vote, making the final vote 8-7 in favour of the deferral approach. One IASB member plans to dissent from the proposals in the forthcoming ED to amend IFRS 4.

Comparison of the approaches

	Overlay Approach	**Deferral Approach – at reporting entity level**
Approach is optional	Yes	Yes
Implementation of IFRS 9 required	Yes	No
Scope, eligible assets	Financial assets measured at FVPL under IFRS 9 and previously under AFS or amortised cost under IAS 39.	All financial assets held by eligible entities
Entity can choose which eligible assets apply the approach	Yes	No - Approach applied to all financial assets held by the entity.
Transfers allowed	Yes – any accumulated balance in OCI from applying the overlay approach is recycled to profit or loss at the time of the transfer	Not applicable

Other alternatives already available in IFRS 4

28 In addition to the overlay and deferral approaches, the IASB has also identified the following methods already available in IFRS 4 to address accounting mismatches. While helpful, none of this would fully address the concerns raised by users and preparers.

(a) Application of shadow accounting;

(b) The use of current market interest rates; and

(c) Voluntary changes in the accounting policies for insurance contracts.

Next steps

29 The IASB plans to publish the ED to amend IFRS 4 in December 2015. The IASB staff is recommending a comment period of 60 days and this will be discussed at the October 2015 IASB Board meeting. If this timetable is maintained, EFRAG staff consider that a draft comment letter should be available for the EFRAG Board to discuss at its meeting on 24 November 2015.