EFRAG SECRETARIAT PAPER FOR PUBLIC MEETING

DRAFT
Letter from EFRAG to the European Commission

Olivier Guersent
Director General, Financial Stability, Financial Services and Capital Markets Union
European Commission
1049 Brussels
XX November 2015

Dear Mr Guersent

Further information related to the endorsement of IFRS 9

On 15 September we sent you our endorsement advice on IFRS 9 *Financial Instruments*, highlighting that a remedy to the non-alignment of the effective dates of IFRS 9 and the future insurance contracts standard was needed and that the IASB was working on it. We announced then that we would provide further advice about our views on the IASB's proposals.

The IASB is progressing options to address the issues facing the insurance industry. As of the date of this letter, we are not in a position to amend our recommendation that "all businesses other than those carrying out insurance activities are required to account for their financial instruments in compliance with IFRS 9 in 2018 and businesses carrying out insurance activities are permitted to do so in compliance with IFRS 9 from the same date".

As is explained below, a lot of uncertainty exists as to whether the IASB will provide an appropriate remedy when it makes its final decisions on the matter. These decisions will be made at the earliest in 6 to 9 months from now. We believe that all companies in Europe, including those involved in insurance activities, need clarity as a matter of urgency on how and when they have to apply IFRS 9.

What follows are our very preliminary views that are based on our observation of the IASB decision-making process. We cannot yet make a formal assessment because the IASB's requirements in their precise formulation are not yet available and, once they are available, EFRAG would need to run its full due process.

The IASB is expected to issue an exposure draft in December 2015 that will propose two optional approaches to assist entities that issue insurance contracts until the new insurance contracts standard is issued:

(a) The "deferral approach". Under this approach, the application of IFRS 9 would be deferred until 1 January 2021 at the latest and eligible entities would apply IAS 39 *Financial Instruments: Recognition and Measurement*. An eligible entity would be one whose predominant liabilities arise from insurance contracts within the scope of IFRS 4 *Insurance Contracts*.

(b) The "overlay approach". Under this approach, IFRS 9 is applied from 1 January 2018 and profit or loss is reported net of accounting mismatches that would arise from the application of IFRS 9 to insurance activities. It is intended to cater for those entities which would fail the predominance test supporting the use of the deferral approach, i.e. conglomerates including insurance activities.

Further details of the two options as decided by the IASB are included as an attachment to this letter.

First we note that granting options – and not preventing any entity from applying IFRS 9 as published by the IASB in July 2014 – meets one of EFRAG's expectations. Second we note that in terms of timing, the important date in the standard-setting process is when the IASB makes its final decisions, not necessarily when it publishes the final document. We would therefore recommend that the IASB sets as its objective that final deliberations will be completed very early in the second quarter of 2016.

Whilst EFRAG is pleased to see the IASB make proposals that aim at providing the remedy it has identified as needed, EFRAG's preliminary views on the IASB decisions made in the September meeting are that they need to be further elaborated to be deemed satisfactory. In EFRAG's view the options proposed are valuable insofar as they are likely to be applied by those who need them.

We provide below a few elements of preliminary analysis on the two proposed approaches.

1- The "deferral approach"

The deferral approach as proposed by the IASB is different from the deferral approach that we had first envisaged, as it would apply at reporting entity level, rather than aiming at isolating insurance activities.

Whilst the deferral approach at reporting entity level is simple and has limited implementation costs, keeping accounting policies homogeneous within a reporting entity produces consequences that need to be highlighted:

(a) For instance, this approach would allow banking activities to continue being reported in accordance with IAS 39 when a bank is consolidated in a group with predominant insurance liabilities. In our endorsement advice, we reported to you that IFRS 9 brings improvements to the impairment requirements for financial assets, an area of significant interest and sensitivity in banking activities; and

(b) As indicated above, the deferral approach qualifying at a consolidated reporting entity level does not seem to cater for insurance activities that are included in conglomerates, which may be significant in size for the European Union insurance internal market.

Given the advantages of this approach, as highlighted above, it is worth exploring whether different criteria may be identified that support its application to as many as entities as possible. However, in light of the reservations we have on the overlay approach (please see below), limiting the deferral approach to reporting entity level cannot cater properly for insurance activities which are included in conglomerates and may be significant. We therefore consider at this juncture that an option below the reporting level should be developed. We believe that the scope of insurance regulation may have a helpful role to play in identifying "insurers" for this option and we note that the IASB has not made any use of it. We also note that users of financial statements often indicate that they first concentrate their analysis separately on banking and insurance segments.

The IASB has considered the possibility of a deferral below the reporting entity level and rejected it, because of the perceived opportunities for earnings management that internal transfers of financial assets may trigger and the breach in uniformity of accounting policies that it suggests in the consolidated accounts. It is also more costly than a deferral approach at reporting entity level, because it requires the group to maintain at consolidation level, possibilities to aggregate assets that are accounted for, either in conformity with IAS 39 or with IFRS 9. When progressing in our further analysis, we will take these disadvantages into account.

Finally we believe that the proposed disclosures are both adequate and reasonable and the sunset clause (deferral available until 1 January 2021) does not trigger opposition, largely because all involved hope that the new insurance contracts standard will be finalised expeditiously and we are aware that the IASB is working towards this outcome.

2- The "overlay approach"

The overlay approach is intended to be a remedy for entities which carry insurance activities, albeit not as their predominant activities. Its objective is to eliminate the artificial volatility from the reporting of performance that would arise from the implementation of IFRS 9 with insurance contract liabilities remaining measured on a cost basis. Its scope of application can be deemed to achieve this.

However, we identify that, whilst this approach may partially resolve the issue identified, this would be at the expense of:

(a) Requiring companies to incur implementation costs that would be useful only up to the implementation of the new insurance contract standard. Indeed both IFRS 9 and IAS 39 would need to be run in parallel for the assets to which the overlay approach is applied throughout the reporting process, from elementary booking up to consolidation level. This would require the developments of new data-processing systems, setting up new internal controls and performance assessment processes; and

(b) Creating complexity for the users who would have first to understand the full effects of the implementation of IFRS 9, and in addition, to understand the differences in impact on profit or loss of a discrete selection of assets being measured under IAS 39 and under IFRS 9.

Despite our assessment to date being very preliminary, we have on the basis of the facts explained above significant concerns about this approach. It seems to deal with the difficulties identified in a narrow and quite mechanical manner, and we can see the risk that it would confuse users rather than help remove or mitigate the burden of making sense out of significant successive and inter-related changes. This would in particular be the case in the presentation scenario where profit or loss would first be determined in accordance with IFRS 9 before an adjustment is made to eliminate additional accounting mismatches. Furthermore it runs the risk of being the most costly of all possible approaches.

Given the costs of the overlay approach and the additional complexity of managing the relations with investors, it is plausible to anticipate that the overlay approach will be of limited interest for insurers and therefore likely to be applied in practice in very few instances, if any.

Finally we would like to highlight that the need for a deferral approach below the reporting entity level has been identified outside of Europe. Discussions at the last ASAF meeting have highlighted a strong interest from Canada and the Asia-Oceania group of standard-setters (including China, Korea and Japan).

We hope this preliminary analysis is helpful in supporting the endorsement process of IFRS 9 as initiated by the European Commission and remain at your disposal, would you require further explanations.

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

Yours sincerely

Roger Marshall
Acting President of the EFRAG Board

ATTACHMENT: Summary of the IASB proposals

2 The IASB has tentatively decided to provide two solutions for dealing with the non-alignment 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* relating to insurance contracts may be 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.

3 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.

Deferral approach

4 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.

5 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 discussion at the October 2015 IASB meeting, the threshold appears to be higher than 75%.

6 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.

7 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.

8 Applying the deferral below reporting entity level has the drawback 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 financial statements.

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

10 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.

11 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. At least one IASB member plans to dissent from the proposals in the forthcoming ED to amend IFRS 4.

Overlay approach

12 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 for assets relating to insurance contracts is removed from profit or loss and reported in OCI.

13 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.

14 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.

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

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

16 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.

IASB timetable

17 The IASB plans are to:

(a) publish the ED to amend IFRS 4 in December 2015 with a comment period of 60 days;

(b) redeliberate the proposals in Q2 2016; and

(c) finalise the resulting standard in Q3 2016.