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Letter from EFRAG to the European Commission

Olivier Guersent
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European Commission
1049 Brussels
XX December 2015

DRAFT

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. Following your request to be updated on, and have some preliminary analysis from EFRAG of the IASB's progress before the next Accounting Regulatory Committee meeting, we are providing information below that we hope will meet your request.

Although the IASB has not issued any exposure-draft yet, and therefore EFRAG is still due to run a full due process when the proposals are formally issued, we have issued this letter in draft form for a short public consultation, running for no more than 10 days. EFRAG has received more than 20 comment letters from a variety of stakeholders: banking and insurance industries, accounting profession, user representative organisations, national standard-setters and ESMA. We have also heard from other observers on the EFRAG Board, ECB, EBA and EIOPA, having the benefit of the participation of their representatives in our meetings. In this public consultation, stakeholders have reaffirmed views they had strongly expressed when providing comments on our draft endorsement advice in the course of the summer:

(a) Bringing a solution to the insurance issue should not be a cause of delay of endorsement of IFRS 9; in particular a swift endorsement process of IFRS 9 is critical for the banking industry;

(b) The solution should ideally be found in amendments to IFRS issued by the IASB, rather than a European-only solution; and

(c) 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.

Despite our short public consultation, what follows should be regarded as very preliminary views that should be read together with the analysis we carried out to support our endorsement advice on IFRS 9 issued on 15 September 2015. We cannot yet make a

formal assessment because the IASB's requirements in their precise formulation are not yet available. Once they are available, EFRAG will need to run its full due process.

We are very pleased that the IASB is constructively progressing options to address the issues we have highlighted in our endorsement advice to you. As is explained below, however, 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.

Hence, as of the date of this letter, we are not in a position to amend our previous 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".

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 would be applied from 1 January 2018 in the balance sheet and the effect on profit or loss arising from the application of IFRS 9 to insurance activities would be reported in other comprehensive income. All entities issuing contracts in the scope of IFRS 4 would have the option to follow this approach, in particular those entities which would fail the predominance test supporting the use of the deferral approach, e.g. conglomerates including insurance activities.

    Further details of the two options as decided by the IASB are included as Attachment 1 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 recommendations. 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.

EFRAG will contribute actively to the IASB's due process to improve the current proposals, with the aim, inter alia, of having the options in the final amendments available and 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;

(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; and

(c) The predominance criterion that allows the application of the deferral approach would, according to our analysis of the financial statements of major European insurance companies appear to exclude a number of entities that are commonly referred to as "insurers". Attachment 2 contains an analysis by the EFRAG Secretariat on the basis of available external financial reporting that illustrates this point.

Given the advantages of this approach and the potential restriction in its use, as highlighted above, it is worth exploring whether different criteria can be identified that support its application to as many relevant 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 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 as an option. In its contribution to the IASB due process, EFRAG will make proposals on how such an option could be designed.

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, the breach in uniformity of accounting policies that it suggests in the consolidated accounts, and the supplementary costs that it triggers. When progressing in our further analysis, we will take these disadvantages into account and make our own assessment of the costs involved.

Finally, we believe that the proposed disclosures are both adequate and reasonable in the context of the deferral at reporting entity level and we do not disagree with the sunset clause (deferral available until 1 January 2021), 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 would be a possible remedy for entities which carry insurance activities. Its objective is to eliminate from the reporting of performance the artificial volatility that would arise in profit or loss from the implementation of IFRS 9 with insurance contract liabilities remaining measured on a cost basis. Our preliminary view is that its scope of application is suitable to achieve this outcome.

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 contracts standard. Indeed, we have heard from some insurers that both IFRS 9 and IAS 39 would need to be run in parallel for the financial 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;

(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 some assets being measured under IAS 39 and others under IFRS 9; and

(c) Some have suggested that whilst the effect of additional accounting mismatches would be eliminated from profit or loss, those additional accounting mismatches would continue to impact equity.

Despite our assessment to date being very preliminary, on the basis of the facts explained above, we have concerns about this approach. It deals with the volatility in profit or loss without addressing other concerns, 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 optional 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. The incremental costs need to be carefully investigated as we are hearing divergent views. Having said that, our limited public consultation has shown that there is at least some interest expressed, in particular by some bank conglomerates. We expect to form a more informed view when we run our due process after the IFRS 4 amendment exposure draft is issued.

Finally, we would like to highlight that the need for a deferral approach, including a deferral approach below the reporting entity level, has been identified outside of Europe. Discussions at the last ASAF meeting have highlighted interest from participants outside Europe. The Asia-Oceania group of standard-setters has written to the IASB in this matter. A discussion in the ASAF meeting in December has now been scheduled.

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 1: Summary of the IASB proposals

1 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 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.

(b) **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 an entity that chooses this approach will be able to recognise adjustments to remove any or all of the differences between amounts relating to financial assets backing insurance contracts recognised in IFRS 9 at fair value through profit or loss and amounts that would have been recognised in IAS 39 *Financial Instruments: Recognition and Measurement* on another measurement basis from profit or loss and reported them in other comprehensive income.

2 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

3 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.

Predominance test

4 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, we understand that the threshold appears to be higher than 75%.

5 As shown in Annex 2 this requirement, if left unchanged, is likely to exclude a significant number of large European insurers. This is because many insurance company liabilities, such as those arising from investment contracts and derivatives, do not arise from contracts within the scope of IFRS 4.

At or below reporting entity level

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. It would also prevent a level playing field between those insurers that are part of a financial conglomerate and those that are not.

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.

Sunset clause

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

13 The overlay adjustment is applied 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 fair value through profit or loss (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 (on an instrument by instrument basis) 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 accounting requirements

	Overlay Approach	**Deferral Approach – at reporting entity level**
Approach is optional	Yes	Yes
Implementation of IFRS 9 required	Yes	No, except for limited disclosures
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.

ATTACHMENT 2: Analysis of Insurance companies' financial statements

Purpose of this attachment

1 This attachment provides a summary of the potential impact on the financial statements of major European insurers.

2 The analysis provides Information on:

   (a) Whether deferral is needed at reporting entity level or below reporting entity level; and

   (b) The percentage of insurers that might pass a quantitative test of predominance, based on different interpretations of predominance.

3 The data has been collected from published financial statements. Given the level at which information is summarised, and that there is no requirement to provide information that would be completely accurate for the purpose of this paper, it has been necessary to make assumptions about the classification of the reported liabilities. Further, IFRS does not mandate a specific basis for measuring liabilities related to insurance contracts within the scope of IFRS 4 *Insurance Contracts*. As a result, the percentages below can only be taken as a guide, rather than being considered accurate in all respects.

Entities selected

4 The analysis is derived from the financial statements of the 20 largest insurers, based on assets held, that published their financial statements in accordance with IFRS as adopted in the EU. "Assets held" was used as the basis for the selection of insurers because it is more likely that assets are measured on a comparable basis by the companies involved than other bases such as revenue.

5 All five European insurers classified as "systemically important insurers" by the Financial Stability Board are included in the sample.

6 Six of the insurers are on the 2013 EU financial conglomerate list.

At or below reporting entity level

7 Of the 20 insurers analysed:

   (a) The 6 financial conglomerates are the top company of their group;

   (b) 11 insurers are the top company of their group; and

   (c) 3 are not the top company of the group to which they belong.

8 Decisions about whether deferral should be provided at or below the reporting entity cannot be based solely upon information about large insurers because other conglomerates that are not classified principally as insurers or who do not contain a large insurer may seek access to the deferral approach. To meet these cases, at least an option for deferral below the reporting entity level would be necessary.

Predominance test

9 This section considers the number of insurers that would pass the predominance test if it were set at a range of levels.

10 To assess the impact of a predominance test, two definitions have been used. The tests that have been used, together with supporting justifications that might be proposed to the IASB when commenting on the forthcoming Exposure Draft are:

(a) Contracts within the scope of IFRS 4; and

(b) Contracts within the scope of IFRS 4 plus investment contracts that were bifurcated when IFRS 4 was first applied. This approach can be justified on the basis that it provides a level playing field between entities that elected to bifurcate and those that elected not to bifurcate.

Predominance test	**Number passing the predominance test at:**					
	>90%	**>85%**	**>80%**	**>75%**	**>70%**	<=**70**%
(a) IFRS 4 only	0	2	5	6	11	9
(b) IFRS 4 plus bifurcated	0	2	7	10	13	7