EFRAG SECRETARIAT PAPER FOR PUBLIC MEETING

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Comments should be submitted by 20 January 2016 to Commentletters@efrag.org

[Date]

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Sir/Madam,

Re: IASB ED/2015/11 Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance contracts*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft, ED/2015/11 *Applying IFRS 9 Financial Instruments with IFRS 4 Insurance contracts*, issued by the IASB on 9 December 2015 ('the ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS in the European Union and European Economic Area.

EFRAG appreciates the efforts of the IASB to address the differences in effective dates of IFRS 9 and the new insurance contracts Standard. In its final endorsement advice on IFRS 9, EFRAG noted that the misalignment of the effective dates of the two standards would cause additional accounting mismatches in profit or loss, be difficult for users to understand and lead to additional costs of implementation. EFRAG notes that the IASB is proposing both an overlay approach and a temporary exemption from applying IFRS 9 (deferral approach), on an optional basis. While the deferral approach helps mitigate all negative effects of the non-alignment of the effective dates of the two standards, the overlay approach helps neutralise in profit or loss the additional accounting mismatches that arise from the implementation of IFRS 9, without addressing the other effects of the non-alignment. EFRAG has nevertheless been made aware that, given the diversity of circumstances among reporting entities which issue insurance contracts in the scope of IFRS 4, the overlay approach is found to be a suitable solution for some banks which carry insurance activities. Indeed for such entities, addressing the accounting mismatches without delaying the implementation of IFRS 9 may be the best option. Consequently, EFRAG agrees that both solutions should be pursued and should remain optional. However to avoid any possible breach in the level playing field among issuers, EFRAG believes that a deferral option should be made available to all entities that issue insurance contracts, whether at the reporting entity level insurance activities are predominant or not. Furthermore EFRAG believes that applying the deferral approach should not run the risk

of being extended to non-insurance activities, in particular banking activities. Proposals which are summarised below are made with these objectives in mind.

Temporary exemption from applying IFRS 9 at reporting entity level

EFRAG agrees with the IASB that applying the temporary exemption from applying IFRS 9 at reporting entity level is simple and has the merit of maintaining uniformity of accounting policies within the group. EFRAG therefore believes that the temporary exemption at reporting entity level should be available to all entities which, from a business practice perspective, would qualify as 'insurers'. EFRAG also agrees with the IASB that referring to a ratio of total liabilities to identify "insurers", and "insurers" only, is a good approach. Finally, EFRAG supports that to qualify for the deferral approach an entity must carry, within its total liabilities, a share of insurance contract liabilities in the scope of IFRS 4. Indeed the effective date of IFRS 9 is not causing any substantial difficulty to entities which bear no or only a few liabilities in the scope of IFRS 4.

However EFRAG observes that entities that are generally known as insurers carry a whole range of liabilities of different origins. EFRAG therefore does not support that the scope of the deferral approach at reporting entity level be designed on a ratio of total liabilities that takes into account IFRS 4 liabilities only, as it would include some, but not all "insurers". EFRAG further believes that the necessary exclusion from such a ratio of total liabilities should exist for liabilities of which accounting may change upon implementation of IFRS 9 and not for others. EFRAG would also favour a ratio that would be set at a higher level than currently intended by the IASB, in order to avoid capturing non-insurance activities, and banking activities in particular. EFRAG is therefore proposing to amend the predominance criterion proposed by the IASB, taking into account all of the above, as explained in the Appendix to this letter.

Temporary exemption below reporting entity level

As indicated above, EFRAG believes that a deferral approach should be available – to the extent feasible - to entities that issue insurance contracts in the scope of IFRS 4, even when insurance activities are one among a portfolio of business activities. To support this, EFRAG recommends that a deferral approach below reporting entity level be opened to sub-groups or legal entities within the reporting entity that meet the predominance criterion as re-defined by EFRAG. EFRAG has therefore considered how transfers of financial assets between an IFRS 9 and an IAS 39 accounting environment can be addressed.

Sunset clause

EFRAG agrees that the temporary exemption from applying IFRS 9 should have an expiry date and supports that expiry date being set at 1 January 2021 on the assumption that the new insurance contracts Standard will be effective by that date. EFRAG supports that IASB's focus on finalising the new insurance contracts Standard and urges the IASB to ensure that the new Insurance contracts Standard is effective by this date. Indeed considering that entities which have opted for the deferral approach might move to the overlay approach should not be regarded as a solution to a possible delay in the finalisation of the standard. Furthermore the very significant improvements in financial reporting that are expected from the new insurance contract standard should not be delayed.

We provide detailed comments in the appendix to this letter, both in support of our recommendations explained above and in response to the specific questions raised in the invitation to comment.

If you would like to discuss our comments further, please do not hesitate to contact Didier Andries, Sapna Heeralall, Joseba Estomba or me.

Yours sincerely,

Roger Marshall
Acting President of EFRAG Board

APPENDIX – EFRAG's responses to the questions raised in the ED

Background information for EFRAG's constituents

1 *In July 2014, the IASB issued the completed version of IFRS 9. IFRS 9 sets out the requirements for recognising and measuring financial instruments. It replaces IAS 39 and has an effective date of 1 January 2018 with earlier application permitted.*

2 *The IASB is also at an advanced stage in its project to replace IFRS 4. However, the IASB is proposing to allow an implementation period of approximately three years after the publication of a new insurance contracts Standard. Hence, the earliest possible mandatory effective date of the new insurance contracts Standard will be after the effective date of IFRS 9.*

3 *Some interested parties, in particular insurers and their representative bodies, have suggested that the IASB should permit insurers to defer the application of IFRS 9 in order to align the effective date of IFRS 9 with the effective date of the new insurance contracts Standard.*

Question 1 – Addressing the concerns raised

Paragraphs BC9 – BC21 describe the following concerns raised by some interested parties about the different effective dates of IFRS 9 and the new insurance contracts Standard:

(a) Users of financial statements may find it difficult to understand the additional accounting mismatches and temporary volatility that could arise in profit or loss if IFRS 9 is applied before the new insurance contracts Standard (paragraphs BC10 – BC16);

(b) Some entities that issue contracts within the scope of IFRS 4 have expressed concerns about having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated (paragraphs BC17 – BC18);

(c) Two sets of major accounting changes in a short period of time could result in significant costs and effort for both preparers and users of financial statements (BC19 – BC21).

The proposals made by the IASB are designed to address these concerns.

Do you agree that the IASB should seek to address these concerns? Why or why not?

Notes to constituents

4 *The following concerns have been raised about the different effective dates of IFRS 9 and the new insurance contracts Standard:*

(a) Users of financial statements may find it difficult to understand the additional accounting mismatches and temporary volatility that could arise in profit or loss on application of IFRS 9 before the new insurance contracts Standard.

(b) Some entities that issue contracts within the scope of IFRS 4 have expressed concerns about having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated.

(c) Two sets of major accounting changes in a short period of time could result in significant cost and effort for both users and preparers of financial statements.

5 *The IASB proposes to address those concerns by the introduction of:*

(a) An option for entities that issue contracts within the scope of IFRS 4 to reclassify, from profit or loss to OCI, some of the income or expenses arising from designated financial assets (the 'overlay approach'); and

(b) A temporary exemption from applying IFRS 9 for entities whose predominant activity is issuing contracts within the scope of IFRS 4. This temporary exemption from applying IFRS 9 is targeted at entities that most would identify as 'pure' insurers.

EFRAG's response

EFRAG is appreciative that the IASB has considered the difficulties caused by the non-alignment of the effective dates of IFRS 9 and the new insurance contracts Standard. In its final endorsement advice on IFRS 9, EFRAG noted that the misalignment of the effective dates of the two standards would cause additional accounting mismatches in profit or loss, be difficult for users to understand and lead to additional costs of implementation. EFRAG continues to have these concerns. Also, based on its outreach with individual analysts of insurance companies, EFRAG notes that a majority of them supported the application of the new insurance contracts Standard and IFRS 9 at the same time.

Question 1 (a)

6 During its outreach with individual users of the financial statements of insurance companies and in its participation in the outreach led by the IASB, EFRAG heard that a majority preferred that both IFRS 9 and the new insurance contracts Standard should be implemented by the insurance industry at the same time.

7 The reasons for supporting a temporary exemption from applying IFRS 9 related to, amongst others:

(a) Avoidance of accounting mismatches and artificial volatility;

(b) The difficulties of explaining volatility to potential investors; and

(c) Avoiding the need for their forecasting models to be changed more than once.

8 EFRAG notes that some analysts made their support for a temporary exemption from applying IFRS 9 conditional upon an interim period during which the deferral being applied not being too long (approximately 3 or 4 years). EFRAG is of the view that the risk of a temporary exemption from applying IFRS 9 being postponed in time is adequately addressed through the introduction of a sunset clause as discussed in our answer to Question 6 below.

Questions 1 (b) and 1 (c)

9 EFRAG's final endorsement advice on IFRS 9 reflects its analysis of the effects of the non-alignment of the effective dates of IFRS 9 and the future insurance contract standard. It is available on the EFRAG website at http://www.efrag.org/files/IFRS%209%20endorsement/IFRS_9_Final_endorsement_advice.pdf

10 EFRAG is therefore appreciative that the IASB has acknowledged the difficulties arising from the non-alignment of the effective dates of IFRS 9 and is proposing two options that are designed to address concerns.

Question 2 – Proposing both an overlay approach and a temporary exemption from applying IFRS 9

The IASB proposes to address the concerns described in paragraphs BC9 – BC21 by amending IFRS 4:

(a) to permit entities that issue contracts within the scope of IFRS 4 to reclassify from profit or loss to other comprehensive income, some of the income or expenses arising from designated financial assets that:

(i) are measured at fair value through profit or loss in their entirety applying IFRS 9 but;

(ii) would not have been so measured applying IAS 39 (the 'overlay approach') (see paragraphs BC24 – BC25);

(b) to provide an optional temporary exemption from applying IFRS 9 for entities whose predominant activity is issuing contracts within the scope of IFRS 4 (the 'temporary exemption from applying IFRS 9') (see paragraphs BC26 – BC31).

Do you agree that there should be both an Overlay approach and a temporary exemption from applying IFRS 9? Why or why not?

If you consider that only one of the proposed amendments is required, please explain which and why.

Notes to constituents

Overlay approach

11 *The IASB noted that additional accounting mismatches and temporary volatility that may arise on the application of IFRS 9 could be dealt with by amending IFRS 4 to permit entities to adjust pre-tax profit or loss to offset the effect of financial assets that would be measured at fair value but would not have been measured this way in accordance with IAS 39. Such an approach would:*

(a) *ensure that the improvements in accounting for financial instruments introduced by IFRS 9 are implemented on a timely basis;*

(b) *provide information about financial instruments comparable with the information that is provided by other entities that apply IFRS 9;*

(c) *ensure that all financial instruments within a reporting entity are reported consistently in accordance with IFRS 9;*

(d) *be effective in reducing accounting mismatches for participating and non-participating contracts and eliminate the additional volatility in profit or loss arising from applying IFRS 9; and*

(e) *provide additional information to users helping to them to understand the effects of IFRS 9, in contrast to the temporary exemption from applying IFRS 9.*

12 *The IASB acknowledges that adjusting profit or loss to offset the effects of IFRS 9 in accordance with the overlay approach would require insurers to identify and track financial assets measured at fair value through profit or loss in accordance with IFRS 9 that would not have been measured at fair value through profit or loss in their entirety in accordance with IAS 39. Thus, applying the overlay approach would*

require operational change. However, the IASB concluded that, compared to other approaches, the advantages of the overlay approach for users of financial statements would outweigh any potential costs associated with the required operational change.

Temporary exemption from applying IFRS 9

13 *Some interested parties have suggested that the IASB should permit insurers to be temporarily exempted from applying IFRS 9 until the new insurance contracts Standard is effective. Such an approach would appear to be a simple way of dealing with most of the concerns expressed by interested parties. However, the IASB concluded that a temporary exemption from applying IFRS 9 should not be provided for all entities that carry out insurance activities because:*

(a) *IFRS 9 introduces significant improvements in accounting for financial instruments; and*

(b) *A temporary exemption from applying IFRS 9 for insurers could create a different set of added costs and complexities for both preparers and users of financial statements by reducing comparability in the accounting for financial instruments.*

14 *The IASB noted the disadvantages of a temporary exemption from applying IFRS 9 would be more significant when the exemption were to be applied below reporting entity level. It would:*

(a) *Require new accounting guidance that could be complex and create operational challenges for preparers and confusion for users of financial statements; and*

(b) *Create a risk of earnings management.*

15 *The IASB noted that for most entities the disadvantages of a temporary exemption from applying IFRS 9 would in most cases outweigh the advantages. However, the IASB noted that for a small population of insurers whose predominant activity is issuing contracts within the scope of IFRS 4, the disadvantages in paragraph 14 may be less significant. Accordingly, although there are strong arguments for not providing a temporary exemption from applying IFRS 9, the IASB decided, on balance, to propose a temporary exemption from applying IFRS 9 for some insurers (i.e. the ones most affected by the different effective dates of IFRS 4 and IFRS 9).*

EFRAG's response

EFRAG supports both the overlay approach and the temporary exemption from applying IFRS 9 as complementary solutions in addressing the misalignment between the effective dates of IFRS 9 and the new insurance contracts Standard. However EFRAG believes that the deferral approach should be available to all entities that issue insurance contracts so as to avoid breaching the level playing field in the insurance sector.

Questions 2 (a) and 2 (b)

16 EFRAG assesses that the temporary exemption from applying IFRS 9 resolves all issues related to the misalignment between the effective dates of IFRS 9 and the new insurance contracts Standard as described in EFRAG's endorsement advice on IFRS 9. In contrast, the overlay approach only provides a solution for the accounting mismatches. The overlay approach does not address the successive implementation (and the related costs) of two accounting standards which for the insurance business are closely related to each other and generates supplementary

costs of its own, due to the necessary dual bookkeeping under IAS 39 and IFRS 9 that it required at financial asset level and the related supplementary internal controls.

17 EFRAG has nevertheless been made aware that, given the diversity of circumstances among reporting entities which issue insurance contracts in the scope of IFRS 4, the overlay approach is found to be a suitable solution for some banks which carry insurance activities. Indeed for such entities, addressing the accounting mismatches without delaying the implementation of IFRS 9 may be the best option. Consequently, EFRAG agrees that both solutions should be pursued and should remain optional.

18 However to avoid any possible breach in the level playing field among issuers, EFRAG believes that a deferral option should be made available to all entities that issue insurance contracts, whether at the reporting entity level, insurance activities are predominant or not.

Question to constituents

19 In preliminary outreach, EFRAG has encountered existing, albeit limited appeal for the overlay approach. Does your company wish to apply the temporary exemption from IFRS 9 or the overlay approach? Please explain the circumstances determining your view.

Question 3 – The overlay approach

Paragraphs 35A--35F and BC32–BC53 describe the proposed overlay approach.

(a) Paragraphs 35B and BC35–BC40 describe the assets to which the overlay approach can be applied. Do you agree that the assets described (and only those assets) should be eligible for the overlay approach? Why or why not? If not, what do you propose instead and why?

(b) Paragraphs 35C and BC48–BC50 discuss presentation of amounts reclassified from profit or loss to other comprehensive income in applying the overlay approach. Do you agree with the proposed approach to presentation? Why or why not? If not, what do you propose instead and why?

(c) Do you have any further comments on the overlay approach?

20 *The ED proposes that:*

(a) A reporting entity should be permitted to make an overlay adjustment in respect of financial assets that meet both of the following criteria:

(i) *The financial assets are designated as relating to contracts that are within the scope of IFRS 4; and*

(ii) *The financial assets are classified as FVPL in accordance with IFRS 9 and would not have been classified as FVPL in their entirety in accordance with IAS 39.*

(b) An entity should be allowed to designate financial assets that relate to contracts within the scope of IFRS 4 and disclose their policies for selecting such financial assets.

(c) Entities would not be able to include in the overlay approach assets clearly held in respect of activities other than those associated with contracts within the scope of IFRS 4.

(d) Entities are not required to apply the overlay approach to all eligible financial assets that relate to contracts within the scope of IFRS 4

(e) Entities that apply the overlay approach are required to apply IFRS 9 in full. However, the incremental effect of measuring qualifying assets at fair value through profit or loss rather than applying IAS 39 is removed from pre-tax profit or loss and reported in other comprehensive income.

(f) The ED proposes that entities that apply the overlay approach should present the amount reclassified from profit or loss to OCI as a separate line item in the statement of profit or loss, OCI or both.

EFRAG's response

EFRAG considers that the IASB has correctly identified the financial assets that should be eligible for the overlay approach. We do however consider that:

- **The eligibility criteria for the overlay approach should be enhanced including detailed examples that could assist entities in interpreting the criteria; and**
- **The criteria established by the IASB should limit the flexibility in presentation.**

Question 3 (a)

21 EFRAG notes that the overlay approach has been developed to address the accounting mismatch and the volatility that would arise in profit or loss as a result of applying IFRS 9 before the new insurance contracts Standard for a very specific type of eligible financial assets. According to the ED, a financial asset qualifies for the overlay approach if and only if the following criteria are met:

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

(b) It is measured at fair value through profit or loss applying IFRS 9 but would not have been measured at fair value through profit or loss in its entirety applying IAS 39.

22 EFRAG understands that the overlay approach would apply when insurance entities are not eligible for the temporary exemption from applying IFRS 9; when insurance entities, voluntarily, do not elect to apply the temporary exemption from applying IFRS 9 or when insurance entities have ceased the application of the temporary exemption from applying IFRS 9 either voluntarily or by 1 January 2021 (the sunset clause for the temporary exemption from applying IFRS 9), including conglomerates with insurance activities, until a reporting entity first applies the new insurance contracts Standard.

23 EFRAG agrees with the scope established by the IASB for the overlay approach because it addresses the concern about volatility in profit or loss that is among the concerns it has identified in the non-alignment of the effective dates of IFRS 9 and the future insurance contract standard.

24 EFRAG also agrees with the proposal to limit the scope of the overlay approach to those financial assets relating to contracts that are within the scope of IFRS 4 because, precisely, these are the only financial assets likely to create an accounting

mismatch and volatility in profit or loss as a result of the misalignment of the effective dates of IFRS 9 and the new insurance contracts Standard. The financial assets than are not within the scope of the overlay approach must be classified and measured under IFRS 9 and consequently any accounting mismatch in profit or loss would have been resolved on transition to IFRS 9.

25 EFRAG is concerned with the clarity of the wording "*as relating to contracts that are within the scope of IFRS 4*". EFRAG understands the reasons not to restrict the application of the overlay approach to financial assets that are contractually linked to contracts within the scope of IFRS 4. However, the actual wording could be interpreted as meaning a strict test of relationship of a financial asset to an insurance contract as defined in IFRS 4 or, alternatively, as relating to all financial assets other than those that are related to liabilities outside the scope of IFRS 4 as, for example, those surplus assets that an insurer holds in the normal course of carrying out insurance activities, either to meet regulatory requirements or their internal capital requirements. The two interpretations lead to significantly different outcomes.

26 Overall, EFRAG agrees with the proposed eligibility criteria established by the IASB and the way it is being presented as principle-based but would recommend the inclusion of detailed examples that could allow entities having a better understanding of the applicability of the overlay approach. For example, demonstrating whether or not financial assets need to be held in the same legal entity as the insurance contracts they relate to. EFRAG considers that holding financial assets in a different legal entity than the insurance contracts they relate to, but within the same group, should not be an impediment to the application of the overlay approach. This because EFRAG assesses the operational structure of a group should not be an impediment of assessing whether an entity should be eligible to apply the overlay approach.

Question 3 (b)

27 EFRAG notes that the overlay approach requires the presentation of the amount reclassified from profit or loss to OCI as a separate line item in the statement of profit or loss, OCI or both net of related tax effects. The effect on line items in profit or loss of the amount reclassified from profit or loss to OCI is disclosed either on the face of the statement of profit or loss or in the notes to the financial statements.

28 EFRAG understands that an entity that elects to apply the overlay approach will have the following presentation alternatives:

(a) Alternative A where profit or loss would first be determined in accordance with IFRS 9 before and adjustment is made to eliminate additional accounting mismatches; and

(b) Alternative B where profit or loss would first be determined in accordance with IAS 39 for eligible financial assets before any adjustment is made to align it with IFRS 9.

29 EFRAG assesses that Alternative A has the advantage of aligning the presentation of the statement of comprehensive income with the statement of financial position, i.e. based on IFRS 9. In addition, the overlay adjustment could be disclosed more easily as no translation from IAS 39 to IFRS 9 is to be detailed in individual line items because the statement of comprehensive income is already based on IFRS 9. Alternative A would have the disadvantage of decreasing comparability of financial statements within the insurance sector with those entities applying the temporary exemption from IFRS 9.

30 Alternative B would have the advantage that the financial assets within the scope of the overlay are being presented in the statement of comprehensive income aligned

with the way how these assets are being managed, i.e. based on IAS 39. This approach may also limit the breach in consistency arising from successive changes that is best avoided to users. In addition, it would ensure comparability within the insurance with insurers applying the temporary exemption from IFRS 9. Alternative B would have the disadvantage of requiring an extra translation disclosure from IAS 39 to IFRS 9 in explaining the overlay adjustment to users of financial statements.

31 EFRAG understands the reasons for not to being restrictive in the presentation of the overlay approach. However, EFRAG is concerned about:

(a) Flexibility in presentation. In general terms, EFRAG does not support options in presentation because they create a lack of comparability. Even in a context where different optional approaches already impair comparability among entities, EFRAG believes that additional limitations to comparability are best avoided. EFRAG is therefore concerned that entities would have different options to present the overlay adjustment in the face of the financial statements.

(b) Fulfilment of the requirements established in IAS 1 *Presentation of financial statements*. EFRAG notes that the actual wording of the IASB updates: *"…as a separate line item…"* is not aligned with the IAS 1.92 to IAS 1.96 requirements that indicate that: *"An entity shall disclose reclassification adjustments relating to components of OCI."* This encompasses the following:

(a) Allocation of tax between items that might be reclassified to profit or loss and those that will not be reclassified to profit or loss; and

(b) Specification of reclassification adjustments (for example on disposal of a foreign operation or in case of cash flow hedges of forecast cash flows).

32 EFRAG TEG members expressed their preference for Alternative A for the reasons mentioned above.

Question to EFRAG Board members

33 Do EFRAG Board members agree with the view expressed by EFRAG TEG? Please explain.

Question 3 (c)

34 EFRAG understands that, in applying the overlay approach, both IFRS 9 and IAS 39 would need to be run in parallel for the assets to which the overlay approach is applied. This would require the developments of new data-processing systems, (to support two book-keeping systems running in parallel) and setting up new internal controls and performance assessment processes.

35 In addition, entities applying the overlay approach need to 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, or where the entity allocates financial assets for particular portfolios of contracts that are within the scope of IFRS 4. However there may also be situations in which the relationship between financial assets and contracts within the scope of IFRS 4 is unclear. EFRAG considers that it would be useful if the final standard provided some guidance in these situations.

36 EFRAG understands that the concerns raised above could discourage some preparers from applying the overlay approach. However, EFRAG has also been

made aware that some preparers wish to apply the overlay approach to equity holdings classified as available for sale.

Question 4 – The temporary exemption from applying IFRS 9

As described in paragraphs 20A and BC58–BC60 the ED proposes that only entities whose predominant activity is issuing contracts within the scope of IFRS 4 can qualify for the temporary exemption from applying IFRS 9.

(a) Do you agree that eligibility for the temporary exemption from applying IFRS 9 should be based on whether the entity's predominant activity is issuing contracts within the scope of IFRS 4? Why or why not? If not, what do you propose instead and why?

As described in paragraphs 20C and BC62–BC66, the ED proposes that an entity would determine whether its predominant activity is issuing contracts within the scope of IFRS 4 by comparing the carrying amount of its liabilities arising from contracts within the scope of IFRS 4 with the total carrying amount of its liabilities (including liabilities arising from contracts within the scope of IFRS 4).

(b) Do you agree that an entity should assess its predominant activity in this way? Why or why not? If you believe predominance should be assessed differently, please describe the approach you would propose and why.

Paragraphs BC55–BC57 explain the IASB's proposal that an entity would assess the predominant activity of the reporting entity as a whole (i.e. assessment at the reporting entity level).

(c) Do you agree with the proposal that an entity would assess its predominant activity at the reporting entity level? Why or why not? If not, what do you propose instead and why?

Notes to constituents

37 *In determining which reporting entities should be permitted to apply the temporary exemption from applying IFRS 9, the IASB placed more weight on ensuring that the temporary exemption from applying IFRS 9 could not be applied by entities that have non-insurance activities (for example, entities with banking activities) than on ensuring that all insurance-related assets are included within the scope of the temporary exemption from applying IFRS 9. Hence, the ED proposes that the temporary exemption from applying IFRS 9 should only be available to entities whose predominant activity is issuing contracts within the scope of IFRS 4.*

38 *The ED does not propose a quantitative threshold for predominance. However, the IASB notes that the temporary exemption from applying IFRS 9 is targeted at the entities that are most significantly affected by the different effective dates of IFRS 9 and the new insurance contracts Standard, because they engage purely in activities that result in contracts within the scope of IFRS 4. It is not designed to apply to entities that engage in activities other than issuing contracts within the scope of IFRS 4, for example, banking or asset management activities.*

39 *Accordingly, 'predominance' is intended to be a high threshold. For example, if three-quarters of an entity's liabilities are liabilities arising from contracts within the scope of IFRS 4 and one-quarter are liabilities arising from other activities, that entity would not, for the purposes of the ED, meet the predominance condition.*

40 *The ED proposes that entities should assess whether they are eligible for the temporary exemption from applying IFRS 9 at the reporting entity level rather than below the reporting entity level because it:*

(a) Is easier for users to understand because it does not result in the simultaneous application of IFRS 9 and IAS 39 by the same reporting entity.

(b) Captures a relatively narrow population of entities and, therefore, maximises the number of entities required to apply the improved accounting required by IFRS 9.

(c) Is simpler for preparers to apply and users to understand because it avoids the need for accounting requirements for transfers of financial instruments between those parts of a reporting entity that qualify for the temporary exemption from applying IFRS 9 and those that do not.

EFRAG's response

EFRAG agrees that eligibility for the temporary exemption from applying IFRS 9 should be based on an entity's predominant activity. However, EFRAG considers that "predominant activity" should be determined on a basis wider than the issuance of contracts within the scope of IFRS 4.

EFRAG considers that the predominance condition is to be assessed at below the reporting entity level in order to focus on insurance activities and to minimise non-insurance activities being eligible for a temporary exemption from applying IFRS 9.

Question 4 (a) - Temporary exemption from applying IFRS 9 based on an entity's predominant activity of issuing contracts within the scope of IFRS 4

41 In EFRAG's view, the objective of the temporary exemption from applying IFRS 9 should be to address the concerns identified in response to Question 1 above.

42 EFRAG understands the objective of the temporary exemption from applying IFRS 9 as relating to entities issuing insurance contracts within the scope of IFRS 4, so called 'pure' insurers. EFRAG disagrees with this limitation in scope and proposes that the temporary exemption from IFRS 9 should be open to all insurers which are generally recognised as such in practice for example because they are being regulated as an insurer.

43 EFRAG observes that the activities of insurers are not limited to issuing insurance contracts within IFRS 4. Insurers also provide asset management contracts to their customers, provide provisions for premium rebates (amounts to be paid back to the policyholder), undertake hedging activities, collect debt financing, may have written put options over non-controlling interest and have operating liabilities such as tax and defined benefit liabilities.

44 EFRAG agrees that the eligibility for the temporary exemption from applying IFRS 9 should be based on an entity's predominant activity. Ideally, any predominance ratio should be able to capture all of the liabilities an insurer is expected to carry for example those ones mentioned above. EFRAG assesses that the effect of a temporary exemption from IFRS 9 for liabilities associated with asset management activities would be limited because the measurement of most of those activities would not be affected by the implementation of IFRS 9.

45 When the predominant activities of an insurer are identified as described above EFRAG would expect that the predominance ratio could be increased to a level that is substantially higher than the one identified by the IASB in its Basis for

Conclusions. This in order to avoid that the temporary exemption is to be applied to other than insurance activities.

Question 4 (b) – Predominance condition as proposed by the IASB

46 In order to appropriately identify relevant insurance companies EFRAG considers the denominator of the predominance criterion to be defined based on the total liabilities as defined by the ED.

47 As a starting point, EFRAG considers that an entity eligible for the temporary exemption from IFRS 9 should carry some level of issuing insurance contracts within the scope of IFRS 4 as otherwise the entity would not incur the accounting mismatch created by the misalignment of the implementation dates from IFRS 9 and the new insurance contracts Standard.

48 However, in determining the numerator of the predominance criterion EFRAG considers, based on paragraphs 41 to 45 above, that also the following activities are to be taken into account: asset management activities, provisions for premium rebates (amounts to be paid back to the policyholder), hedging activities, debt financing, operating liabilities such as tax and defined benefit liabilities and put-options over non-controlling interests.

Questions to constituents

49 Do you agree with the proposal in paragraphs 41 – 48 above? If not, what formula would you recommend for the assessment of predominance, and why?

50 Are there other liabilities that are generally carried by insurers and which should be included in the predominance ratio? If so, please explain why.

51 For all of the proposed components of the predominance criterion, do you think that inclusion of these elements leads to a result that is practical, auditable and comparable? Please explain.

52 Taking into account the widening of the predominance criterion, do you agree that the quantitative threshold should be at a level that is substantially higher than three-quarters of an entity's total liabilities? Please explain.

53 If you do not consider that eligibility for the deferral should be based on predominance, what principle(s) should be applied, and how would you test these principles?

Question 4 (c) - Whether to assess predominance at the reporting entity level

54 EFRAG does not agree with the IASB's proposal to assess predominance at the reporting entity level.

55 EFRAG is concerned that non-insurance activities of an entity that is in scope of the temporary exemption from applying IFRS 9 would continue to apply IAS 39. In its endorsement advice of IFRS 9, EFRAG stated that IFRS 9 brings an improvement to financial reporting compared to IAS 39. Therefore, EFRAG considers that non-insurance activities should apply IFRS 9.

56 In addition, the temporary exemption from applying IFRS 9 as proposed by the IASB does not cater for entities with insurance activities that would qualify to continue applying this exemption on a stand-alone basis but not for consolidation purposes if the consolidated entity is outside the scope of the temporary exemption from applying IFRS 9. As a result, these entities would need to provide IFRS 9 information for consolidation purposes even if they elected to use the temporary exemption from applying IFRS 9 in their own financial statements. As a result,

EFRAG considers that the objective of the temporary exemption from applying IFRS 9 would not be met.

57 Further, it would be confusing to users of financial statements if the accounting model in an entity's separate IFRS financial statements was different from the accounting model applied to the same entity in its parent's consolidated IFRS financial statements. Moreover, some users have advised EFRAG that they analyse the insurance activities and banking activities of an entity on a standalone basis. Therefore, they prefer that the temporary exemption from applying IFRS 9 should be below the reporting entity level in order to maintain comparability in the insurance entity's financial statements.

Deferral based on regulation

58 EFRAG considered identifying entities eligible to apply the deferral approached based on entities regulated as insurers by their insurance regulator. EFRAG considered that predominance could be applied at or below the reporting entity level, depending on the corporate structure of an insurer. If the entities within a group are legal entities which are regulated, these entities could then apply the temporary exemption from applying IFRS 9 in their individual financial statements and also in the consolidated financial statements.

59 However, EFRAG rejected this approach because:

(a) Regulation differs between jurisdictions which would limit comparability.

(b) Some entities that are insurers are not regulated and this approach would prevent the application of the temporary exemption from applying IFRS 9;

(c) Some entities that are regulated as insurers may not issue insurance contracts within the scope of IFRS 4 and these entities have no need for access to the temporary exemption from applying IFRS 9; and

(d) There are cases where assets that are related to insurance contracts are managed within the consolidated group by an entity that is not regulated as an insurer.

Questions to constituents

60 Do you agree with the arguments displayed above? If you do not and believe that the regulated criterion has a role to play, please explain why and how it would work.

"Waterfall" approach

61 EFRAG also considered a waterfall approach. Under this approach, an entity would first assess its predominant activity at reporting entity level using the predominance condition proposed by EFRAG in response to question 4(b) above.

(a) If the entity passes the predominance condition, then the entire reporting entity would be eligible to apply the temporary exemption from applying IFRS 9.

(b) If the entity fails the predominance condition but the reporting entity has material insurance activities, for e.g., financial conglomerates, the reporting entity would apply the predominance condition at successive lower levels until the predominance condition is passed. That level would then be eligible to apply the temporary exemption from applying IFRS 9.

62 EFRAG identified a number of advantages and disadvantages of the waterfall approach.

(a) The main advantages are that the approach targets relevant entities and financial assets that do not relate to insurance activities but are in scope of the temporary exemption from applying IFRS 9 are kept to a minimum level.

(b) The main disadvantages are complexity and lack of comparability between entities.

<u>Other approaches below reporting entity level</u>

63 As a result of not supporting deferral at the reporting entity level, EFRAG proposes that the deferral should be considered at a lower level in order to focus on insurance activities and to minimise non-insurance activities being eligible for a temporary exemption from applying IFRS 9. EFRAG suggests the following levels with its advantages and disadvantages:

(a) Legal entity level, where each legal entity would assess its predominant activity;

(b) Segment level, where predominance would be assessed based on operating segments; and

(c) Individual financial instrument level.

64 Each of the above options will suit some group structures but not all. For example, and insurer may conduct its activities over more than one legal entity, not all entities identify segments based on product lines such as "insurance" and application at the individual financial instrument level is similar to the overlay approach.

65 In all cases, it would be necessary to "roll up" the measurement applied at below reporting entity level to the reporting entity level, leading to a mix of IFRS 9 and IAS 39 measurement in the consolidated financial statements.

Question to constituents

66 How restrictive is the assessment of predominance as proposed by the IASB? Please provide quantitative evidence.

67 Should an entity assess its predominant activity at the reporting entity level or below the reporting entity level or both? Please explain your view.

68 In your view, how can deferral below the reporting entity level be determined in a way that ensures the eligibility of relevant entities and allows for comparability between entities? Please explain your view.

69 What are the expected costs involved in the implementation of the temporary exemption from applying IFRS 9 at reporting entity level or below reporting entity level (including disclosures)? Please provide evidence, including quantitative evidence to the extent feasible.

Transfers

70 One of the aspects to address if predominance is assessed below reporting entity level is the accounting for transfers of financial assets between an IAS 39 environment and an IFRS 9 environment and vice versa within a reporting entity.

71 Generally, EFRAG considers that when transferring financial assets from one accounting environment to another, accounting for the transferred financial assets should be done following the accounting requirements of the destination environment. This would avoid that entities would be required to run double accounting systems depending on whether they hold original and transferred financial assets from another accounting environment.

72 Notwithstanding the above, EFRAG has considered the following alternatives to account for transfers of financial assets:

(a) Restoring the original gross carrying amount;

(b) Transfers at fair value;

(c) Application of a tainting rule; and

(d) An asymmetrical treatment of transfers.

73 These alternatives were rejected on the basis of complexity, the creation of an impact on profit or loss by internal transactions, complexity or cost.

Questions to constituents

74 Which alternative for the accounting of transfers as stated in paragraph 72 above would be most appropriate for the temporary exemption from applying IFRS 9 below reporting entity level? Please explain why.

Applicability for first time adopters

75 Although not explicitly addressed in the invitation to comment by the IASB in the ED, EFRAG does not support the consequential amendment to IFRS 1 *First-time Adoption of International Financial Reporting Standards* that first-time adopters of IFRS should be prohibited from applying the temporary exemption from applying IFRS 9 or the overlay approach. EFRAG does not support this proposal because it would exclude entities that:

(a) Join a group that is applying the temporary exemption from applying IFRS 9/overlay approach and where the entity is required to provide a reporting package based on IFRS to the group level; or

(b) Is part of a group that applies IFRS and elects to adopt the temporary exemption from applying IFRS 9/overlay approach but, at the time of adopting the temporary exemption, is a first-time adopter in its own right.

76 EFRAG assesses that such an exemption would lead to subsidiaries within a group being required to apply both IFRS 9 and IAS 39, leading to excessive costs.

77 Therefore, EFRAG recommends that IFRS 1 permit a first-time adopter to adopt the temporary exemption from applying IFRS 9/overlay approach if they are described in paragraph 3(c) of IFRS 1. EFRAG agrees that the temporary exemption from applying IFRS 9/overlay approach should not be available to other first-time adopters of IFRS.

Question 5 – Should the overlay approach and the temporary exemption from applying IFRS 9 be optional?

As explained in paragraphs BC78–BC81, the ED proposes that both the overlay approach and the temporary exemption from applying IFRS 9 should be optional for entities that qualify. Consistently with this approach, paragraphs BC45 and BC76 explain that an entity would be permitted to stop applying those approaches before the new insurance contracts Standard is applied.

(a) Do you agree with the proposal that the overlay approach and the temporary exemption from applying IFRS 9 should be optional? Why or why not?

(b) Do you agree with the proposal to allow entities to stop applying the overlay approach or the temporary exemption from applying IFRS 9 from the beginning of any annual reporting period before the new insurance contracts Standards is applied? Why or why not?

Notes to constituents

78 *The ED proposes that the overlay approach and the temporary exemption from applying IFRS 9 should be permitted but not required for entities that issue contracts within the scope of IFRS 4.*

79 *The IASB acknowledges that making the overlay approach and the temporary exemption from applying IFRS 9 optional could reduce comparability between entities. However, the IASB expects that this concern would be mitigated by the disclosure requirements proposed. In addition, the IASB expects that any reduction in comparability would only exist for a short period of time.*

80 *An entity can stop using the overlay approach and the temporary exemption from applying IFRS 9 at the beginning of any annual reporting period.*

EFRAG's response

EFRAG agrees that both the overlay approach and the temporary exemption from applying IFRS 9 should be optional.

Question 5 (a)

81 Due to the diversity of insurance contracts across the insurance industry, some entities issuing insurance contracts may find it more beneficial to apply IFRS 9, whereas others may consider that applying either the overlay approach or the temporary exemption for applying IFRS 9 provides more relevant information in their circumstances.

82 EFRAG acknowledges that there would be a lack of comparability between financial statements of entities that issue insurance contracts as a result of permitting several options rather than requiring one or the other. Lack of comparability would however arise with entities which do not carry insurance contracts in the scope of IFRS 4. Furthermore in the context of a temporary remedy and given both the difficulties created by the non-alignment of the effective dates of IFRS 9 and the future insurance contract and the diversity of circumstances that various reporting entities may encounter, EFRAG believes that the proposed approaches are best offered on an optional basis.

83 Therefore, EFRAG agrees with the proposals that the temporary exemption from applying IFRS 9 and overlay approaches should be permitted rather than required but recommends that the disclosure requirements are enhanced by requiring disclosures that could allow users to understand the reason and the effects of ceasing the application of the overlay approach in addition to the reason and the effects of changes in designation of the financial assets eligible.

Question 5 (b)

84 The rationale for permitting a temporary exemption from applying IFRS 9 and overlay approaches would no longer exist when an entity applies the new insurance contracts Standard. Consequently, EFRAG agrees that an entity should be required to stop applying the temporary exemption from applying IFRS 9 and the overlay approach when it applies the new insurance contracts Standard. Further, entities should be permitted to stop applying both approaches before the application of the new insurance contracts Standard.

85 In relation to the overlay approach:

(a) When an entity ceases to apply the overlay approach it ceases it on a reporting entity level and accumulated OCI is transferred into retained earnings as if the overlay approach had never been applied.

(b) When an entity voluntarily designates or mandatorily de-designates individual financial assets from the overlay approach, it does so on an asset by asset basis and any accumulated OCI is transferred into profit or loss.

86 EFRAG is concerned that these different treatments may allow some degree of earnings management. However, EFRAG accepts that this cannot be easily resolved for a situation that is expected to be very short-term.

Question 6 – Expiry date

Paragraphs 20A and BC77 propose that the temporary exemption from applying IFRS 9 should expire at the start of annual reporting periods beginning on or after 1 January 2021.

Do you agree that the temporary exemption from applying IFRS 9 should have an expiry date? Why or why not?

Do you agree with the proposed expiry date of annual reporting periods beginning on or after 1 January 2021? If not, what expiry date would you propose and why?

Notes to constituents

87 *The ED proposes that entities should be prohibited from applying the temporary exemption from applying IFRS 9 for annual reporting periods beginning on or after 1 January 2021. The IASB believes that, even if the new insurance contracts Standard is not effective by that date, all entities should apply IFRS 9 by that date. This is because IFRS 9 represents a significant improvement to the accounting requirements for financial instruments.*

EFRAG's response

EFRAG agrees that the temporary exemption from applying IFRS 9 should have an expiry date. EFRAG also agrees that the expiry date should be reporting periods beginning on or after 1 January 2021 because EFRAG expects that the effective date of the new insurance contracts Standard will be no later than that date.

Question 6 (a)

88 EFRAG is in the view that the temporary exemption from applying IFRS 9 should have an expiry date to ensure that those entities that apply the approach move to IFRS 9 at some point in time. EFRAG agrees with the IASB that IFRS 9 brings a distinct improvement over the existing requirements in IAS 39, as stated in its endorsement advice on IFRS 9.

Question 6 (b)

89 EFRAG supports the proposed expiry date for the deferral approach of reporting periods beginning on or after 1 January 2021. We expect that the new insurance contracts Standard will be finalised rapidly and understand that the IASB is working towards this outcome.