POSITION PAPER

EFRAG Draft Endorsement Advice on IFRS 17 ‘Insurance Contracts’ as amended in June 2020

ESBG (European Savings and Retail Banking Group)

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ESBG Transparency Register ID 8765978796-80

January 2021

ESBG

ESBG welcomes the opportunity to comment on the Draft Endorsement Advice issued by EFRAG. We represent the locally focused European banking sector, helping savings and retail banks in 21 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. ESBG unites at EU level around 900 banks that provide retail banking services, including for certain banks the provision of insurance coverage and related services to their clients. This letter represents the consensus view of ESBG, including the financial conglomerates that are represented.

ESBG supports a high-quality standard for insurance contracts accounting; however, we continue to believe that IFRS 17 as amended in June 2020 does not correctly reflect certain contracts issued by our members that represent long-term life-saving products managed under cash flow matching and, to a certain extent, participating contracts[1], through its measurement nor its presentation requirements.

We have shared previously the main accounting deficiencies that IFRS 17 has in our view and acknowledge that the requirement of annual cohorts is the most transversal issue, that creates inconsistencies for almost all entities that issue insurance contracts with how these contracts are managed. However, at this current stage ESBG cannot neglect that the accounting deficiencies not addressed by the IASB in the final standard altogether will lead to negative consequences in the prudential field for financial conglomerates.

More particularly, what worries ESBG financial conglomerates most is the consequences that endorsing IFRS 17 will have on their solvency ratios for the banking groups[2]. This is a significant issue that certain ESBG members – i.e. the financial conglomerates affected by this issue – already highlighted to EFRAG and the European Commission within its letter of 23 July 2020. A copy of this document is provided in Appendix 1 to this letter.

In this context, we support endorsement of IFRS 17 provided that there is (i) an appropriate prudential solution that addresses the volatility arising in OCI for financial conglomerates and (ii) an accounting solution for the annual cohorts issue. Both issues must be resolved as part of the endorsement process, addressing the first issue as a change in the Capital Requirements Regulation (CRR), and both should not impact the 1 January 2023 effective date of IFRS 17.

Regarding the volatility in OCI, given it is an issue arising from the application of IFRS 17 that affects prudential requirements for financial conglomerates, ESBG requests that EFRAG recommend the European Commission to consider specific changes in the CRR made in conjunction with the IFRS 17 endorsement process.

Volatility arising in OCI for financial conglomerates

There are several requirements in IFRS 17 that will lead to volatility in OCI for financial conglomerates. Whilst pure insurers will experience the same volatility in their equity, they will not have any consequences in terms of their solvency level.

However, the same will not happen for financial conglomerates. It is expected that life insurers may experience high volatility in OCI arising from different sources, some of them derived from

[1] Hereafter referred as 'intergenerationally-mutualised contracts'.
[2] Financial conglomerates led by a bank have to measure two different solvency ratios:
a) The solvency ratio for the Banking Group: it is the banking solvency, based on CRR (reported to competent authorities through COREP and disclosed to market on a regular basis, including through the Pillar III report), and
b) The solvency ratio for the Financial Conglomerate: it is the solvency as a financial conglomerate based on FICOD (reported to competent authorities through ad-hoc reportings as stated by FICOD and disclosed to the market through the Pilar III Report).

the interaction between IFRS 9 Financial instruments and IFRS 17, while others come directly from IFRS 17 requirements. This volatility will arise even if insurers have implemented and use sophisticated asset-liability management techniques that under Solvency II are valid and accepted to mitigate asymmetries between the measurement basis of financial instruments and technical liabilities.

The above referred volatility arises mostly from the following sources are:

- Changes in discount rates do not affect OCI for the Contractual Service Margin (CSM)
- There is not yet a common consensus among the Big Four companies on the availability to use macro hedge accounting on insurance contracts and its effectiveness.

ESBG is aware that IFRS 17 seeks to significantly increase the comparability in accounting for insurance contracts between companies from different countries and business models, as well as to enhance the quality of financial information. We agree with achieving these objectives but not if this causes a significant prejudice to certain of our ESBG members.

Only if there was an amendment in the CRR introduced by the prudential supervisor this volatility could be disregarded. In contrast, in the case of insurance companies or insurance-led groups, the same volatility in OCI will not impact their solvency ratios because they will be estimated under the Solvency II regime, which is disconnected from the IFRS balance sheet. ESBG advocates for a level-playing field across any type of company that issues insurance contracts, so that one particular group is not prejudiced in terms of prudential requirements.

As explained in more detail below, except for annual cohorts, we believe that the requirements in IFRS 17 that lead to such volatility in OCI should not impact the endorsement process. That is, although these requirements were highlighted in the past by ESBG to be addressed by the IASB within the project to amend IFRS 17, and for which we proposed solutions, our view is that they should not impact the endorsement process of IFRS 17 in the European Union.

Accordingly, we propose to address the volatility in OCI for financial conglomerates as a change or amendment of the requirements in CRR which should be addressed in parallel and in conjunction to the endorsement process, so that financial conglomerates are able to apply them once IFRS 17 enters into force.

In this regard, two different approaches that could be further analysed are the following:

1. Change in the CRR so that the CSM is considered as eligible own funds, at least in part,

2. Propose a filter on amounts recognised in OCI arising from a particular type of contract together with the amounts arising from the backing assets to those contracts. The scope could be aligned with the contracts that we are asking to be scope out from the annual cohort requirement.

ESBG is at the disposal of the European Commission and any other interested party to work together on how the CRR could be changed and explain the solutions that its members envisage to address the volatility in OCI issue.

Annual cohort requirement in IFRS 17

The second condition for ESBG to be supportive of the endorsement of IFRS 17 in the European Union is that an adequate solution to the issue of ‘annual cohorts’ is provided as part of the endorsement process for cash-flow matched and intergenerationally-mutualised contracts. We envision a solution based on defining in the European Commission Regulation a scope exemption to the annual cohorts’ requirement to reflect mutualization of long term life savings products measured through the Building Block Approach model and the intergenerationally-mutualised contracts. Such a solution should be optional so that companies that have to or will report under IFRS 17 as issued by the IASB are able to do it. We are aware that different groups

of stakeholders and organisations have provided their views on how to define this scope exception. For instance the ICAC, ANC and CFO Forum provided separately their proposals to define in practice the exception. This material could be used as a starting point and we urge the European Commission to work closely with the insurance industry to fine tune the proposals and assess the most convenient way to define the type of contracts that should be optionally exempted.

Other accounting issues in IFRS 17

As mentioned before, the final standard IFRS 17 as amended in June 2020 still contains a number of unresolved issues that ESBG highlighted earlier. Under a strictly accounting point of view, from all of these issues, of particular importance is the application of annual cohorts to cash flow-matched and intergenerationally-mutualised contracts. The arguments provided by ESBG to EFRAG in our response to the IASB's ED/2019/4 amendments to IFRS 17 of 4th September 2019 are still valid.

The other issues (including in particular amounts to be recognised in OCI at transition under the Fair Value Approach in IFRS 17 for contracts measured under the general model, separating components from an insurance contract, and the interaction between IFRS 17 and IFRS 9 when entities invest in equities), while they are priority topics for ESBG and have not been resolved by the IASB in the final Standard issued in June 2020, they should not impact the endorsement process of IFRS 17 in the European Union, but rather be addressed by the IASB throughout a post implementation review, or sooner as part of other current on-going projects such as the Dynamic Risk Management new model for macro hedging.

We include below ESBG responses to EFRAG's 'Invitation to comment'. We would like to highlight that although we have responded 'No' to certain questions based on the reasons explained before, if such issues - prudential solution that addresses the volatility arising in OCI for financial conglomerates and accounting solution for the annual cohorts issue – where addressed as part of the endorsement process in the European Union, we would support the endorsement of IFRS 17 as amended in June 2020.

INVITATION TO COMMENT ON EFRAG'S ASSESSMENTS ON IFRS 17 INSURANCE CONTRACTS AS AMENDED IN JUNE 2020

1. Once filled in, this form should be submitted by 29 January 2021 using the 'Comment publication link' available at the bottom of the respective news item. All open consultations can be found on EFRAG's web site: Open consultations: express your views.

EFRAG has been asked by the European Commission to provide it with advice and supporting material on IFRS 17 *Insurance Contracts* as amended in June 2020 ('IFRS 17' or 'the Standard'). In order to do so, EFRAG has been carrying out an assessment of IFRS 17 against the technical criteria for endorsement set out in Regulation (EC) No 1606/2002 and has also been assessing the costs and benefits that would arise from its implementation in the European Union (the EU) and European Economic Area.

A summary of IFRS 17 is set out in Appendix I.

Before finalising its assessment, EFRAG would welcome your views on the issues set out below. Please note that all responses received will be placed on the public record, unless the respondent requests confidentiality. In the interests of transparency, EFRAG will wish to discuss the responses it receives in a public meeting, so it is preferable that all responses can be published.

In order to facilitate the EFRAG process, it is strongly recommended to use the structure below in your responses.

EFRAG's initial assessments, summarised in this questionnaire, will be updated for comments received from constituents when EFRAG is in the process of finalising its *Letter to the European Commission* regarding endorsement IFRS 17.

Your details

1 Please provide the following details:

(1) Your name or, if you are responding on behalf of an organisation or company, its name:

ESBG

(2) Are you a:

☐ Preparer ☐ User ☐ Other (please specify)

Bank Association

(3) Please provide a short description of your activity:

Banking

(4) Country where you are located:

Belgium

(5) Contact details, including e-mail address:

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Part I: EFRAG's initial assessment with respect to the technical criteria for endorsement

Note to the respondents: *Appendix II presents EFRAG's reasoning with reference to all requirements in IFRS 17 apart from the application of the annual cohorts requirement to some contracts specified in paragraph 6 of Annex A within Annex 1 (those contracts are conventionally referred to in this questionnaire, in the Cover Letter, in its Appendices and Annex as 'contracts with intergenerationally mutualisation and cash-flow matched contracts'[3], or 'intergenerationally mutualised and cash flow matched contracts'. Annex 1 presents content of this requirement that contribute positively or negatively to the technical criteria on this matter.*

2 EFRAG's initial assessment of IFRS 17 is that:

- The EFRAG Board has concluded on a consensus basis that, apart from the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts, as explained in the attached Cover Letter, on balance, all the other requirements of IFRS 17 meet the qualitative characteristics of relevance, reliability, comparability and understandability required to support 'economic decisions and the assessment of stewardship and raise no issues regarding prudent accounting. EFRAG has concluded that all the other requirements of IFRS 17 are not contrary to the true and fair view principle.
- EFRAG Board members were split into two groups about whether the requirement to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts meet the qualitative characteristics described above.
  - (i) Nine EFRAG Board members consider that overcoming in a timely manner the issues of IFRS 4 brings sufficient benefits despite the concerns on annual cohorts. They believe that, in the absence of an alternative principles-based approach to grouping of contracts, on balance the annual cohorts requirement provides an acceptable conventional approach that enables to meet the reporting objectives of the level of aggregation of IFRS 17.
  - (ii) Seven EFRAG Board members consider that in many cases in Europe the requirement to apply annual cohorts for insurance contracts with intergenerational mutualisation and cash-flow matched contracts will result in information that is neither relevant nor reliable. This is because the requirement does not depict an entity's rights and obligations and results in information that represents neither the economic characteristics of these contracts nor the entity's underlying business model. These EFRAG Board members also consider that this requirement is not conducive to the European public good because it (i) adds complexity and cost and does not bring benefits in terms of the resulting information, (ii) may lead to unintended incentives to change the way insurers cover insurance risks and (iii) may produce pro-cyclical reporting effects.

EFRAG's reasoning and observations are set out in Appendix II, Annex 1 and the Cover Letter regarding endorsement of IFRS 17.

(1) Do you agree with this assessment for all the other requirements of IFRS 17 apart from the requirement to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts?

☐ Yes ☒ No

[3] For a description of the affected contracts please refer to paragraphs 8 to 28 of Annex A to Annex 1 of the endorsement package relating to IFRS 17.

If you do not agree, please provide your arguments and what you believe the implications of this could be for EFRAG's endorsement advice.

We do not completely agree with this assessment because we believe other issues remain (apart from annual cohorts) that, although would not block the endorsement of IFRS 17, they will have a negative impact on the true and fair view principle on which the endorsement is based.

Please note that ESBG provided in September 2019 a description of the main issues that financial conglomerates would face if they were not resolved by the IASB in the Amendments to IFRS 17 published in June 2020. In addition, ESBG would like to make a reference to a letter which was subscribed by the main financial conglomerates within ESBG that are also represented at the Pan- European Conglomerate Group of July 2020. This letter sent to the EFRAG and European Commission (please see Appendix 1) focused on three main points:

- The way life savings and retirement contracts are managed conflicts with the IASB obligation to group the contracts by annual cohorts
- IFRS 9 and IFRS 17 will introduce artificial P&L and solvency ratio volatility for the financial conglomerates requiring an amendment to CRR
- Transition methods will have a negative impact on shareholders' fund and on the financial conglomerate solvency ratio at transition date

Some of the accounting issues communicated in September 2019 may be fixed by the IASB in the context of the post implementation review of IFRS 17, for example separating components from an insurance contract. However, there are other issues that arise from the current requirements in IFRS 17 that need an immediate response at European level. In particular, ESBG is significantly concerned about the consequences that the volatility arising from IFRS 17 will have on the prudential ratios of the financial conglomerates it represents (solvency ratio of the banking groups). This impact in the prudential area arises because the prudential equity is based on the IFRS book value of equity. Given that financial conglomerates cannot wait until such an issue is maybe resolved as part of a post implementation review, ESBG urges the European Commission to explore a solution based on amending the current requirements in the CRR.

Accordingly, **ESBG requests that EFRAG recommend the European Commission to consider specific changes in the CRR made in conjunction with the IFRS 17 endorsement process.**

We believe that this issue on the volatility of prudential ratios for financial conglomerates was shared with EFRAG at an early stage of the endorsement process, before the IASB initiated its amendments published in June 2020, therefore it is a shame that it has not been resolved by the IASB in the current requirements in IFRS 17, and at the current stage only a change in the CRR will mitigate the consequences in the prudential field.

ESBG believes that only if there is an appropriate prudential solution that addresses the volatility arising in OCI for financial conglomerates, the assessment for all the requirements (other than the 'annual cohorts') necessary for the endorsement process would be met. That is, we support the endorsement of IFRS 17 only if a solution to this issue is envisaged at European level.

As a summary of the main sources of this volatility, we would like to highlight the following ones related to the IFRS 17 requirements:

1. Changes in discount rates do not affect OCI for the Contractual Service margin (CSM):

   The full fair value changes of all the assets of the investment portfolio will impact in OCI for FV-OCI portfolios, while only the impact in the fulfilment cash flows (not in CSM) from the insurance contracts, generated by changes in the discount rates are recognised in OCI. That introduces differences in the absolute amounts on which OCI is calculated and means that the amounts of OCI arising from the financial instruments will not be offset by the same amount of OCI arising from the measurement of the insurance contract.

   Currently under the requirements in IFRS 4, entities that issue insurance contracts are able to mitigate the volatility in OCI (and in P&L if applicable) by using the 'shadow accounting'. This is particularly relevant for financial conglomerates as such an accounting approach helps mitigate any undue volatility in their equity and consequently, this volatility does not affect their prudential ratios.

2. Uncertainties regarding the application of macro hedge accounting for risk mitigation purposes:

   For those contracts measured under the general measurement that are not eligible for the risk mitigation option, the interaction between IFRS17 and IFRS 9 Standards presents some challenges in terms of mitigating volatility and accounting mismatches. To date, there are still relevant uncertainties regarding whether the fair value macro hedge approach will mitigate the referred volatility in an effective way, and whether the auditors will agree on such implementation for the insurance business.

Regarding the other priority issues that remain unresolved, communicated in September 2019, we believe they should not block the endorsement of IFRS 17 by the European Union in time for the 2023 effective date and, therefore, should not lead to amendments to IFRS 17 as part of the European endorsement process. We recommend to re-evaluate these issues in the context of a post implementation review of IFRS 17, or sooner if possible within the context of other IASB projects such as Dynamic Risk Management.

We provide below a summary of the most relevant ones as communicated previously to EFRAG:

1. Current rate versus locked-in rate to remeasure the CSM: Under the general measurement model (both PL and FV-OCI option) changes in the IFRS 17 discount rate after initial recognition do not lead to a remeasurement of the CSM, given that the CSM is measured at inception with the locked-in rate and not remeasured to reflect changes in this rate.

Even if the expected cash flows from an insurance contract are economically and perfectly matched with non-contractually disclosed financial assets that replicate those cash flows, including any long-term interest rate guarantee, an insurer will recognize in PL / OCI amounts that go beyond the credit risk

spread. This arises as a consequence of the CSM not being remeasured at each reporting date for changes in the discount rate.

2. Differences in the locked-in discount rate used to measure the liabilities and the acquisition yield rate of the underlying assets: considering the long-term nature of the life insurance business focused on retirement products/solutions, if insurers invest in debt instruments, changes in the fair value of the assets – regardless of whether they are measured at fair value through P&L or through OCI – will not have the same equivalent offsetting amount in the liability side for different reasons such as credit spread risk, liquidity risk, or because the estimated expected profit of these contracts is not remeasured over time, leading to significant amounts of volatility in other comprehensive income (OCI) or profit and loss.

3. Transition: Under the Fair Value Approach ("FVA") at transition, the final requirements in IFRS 17 lead to an accounting mismatch in the accumulated amount of OCI for those products without direct participation features (i.e. business measured through IFRS17 BBA model) but managed under cash flow matching techniques as per local regulatory requirements. This accounting mismatch arises from the different treatment on the asset side (financial instruments whose changes are recorded in OCI) compared to the liability side (potentially no OCI impact at Transition where implementing the IFRS17 Standard) leading to a negative impact on Equity.

Under local commercial regulation of certain jurisdictions, this negative impact on equity could prevent companies from distributing dividends to shareholders. It is our belief that for these contracts, the locked-in rate to be used at transition should be based on the rate of the underlying assets. In more specific terms, ESBGs proposal was to amend paragraph C24(c) so this option under the FVA at transition could also be available for contracts measured under the BBA model and managed through cash flow matching techniques and not only for insurance contracts with direct participation features to which paragraph B134 applies.

4. Separating components from an insurance contract: There may be similar insurance risks combined in one legal insurance contract for which separation and separate measurement of each risk would provide more useful information. The Standard should permit the separation of different insurance risks contained in a single insurance contract. In the same way, not allowing to change from VFA to the general model in contracts that change naturally over time may impair the understandability of the product and the information provided to users.

(2) Having considered the technical arguments for those that support and those that oppose the application of annual cohorts to intergenerationally-mutualised contracts, as described in Annex 1, and having considered the two views from the EFRAG Board above does the requirement to apply annual cohorts to intergenerationally-mutualised contracts (within the context of paragraphs B67-B71 of IFRS 17) meet the qualitative characteristics described above? Please explain your technical reasons for supporting your view.

☐ Yes ☒ No

IFRS 17 recognises the existence of intergenerationally-mutualised contracts for determining the fulfilment cash flows (FCF), yet refuses to extend this mutualisation principle to the contractual service margin of the same contracts.

For intergenerationally-mutualised contracts, the requirement to divide them into annual cohorts does not provide information that is relevant, reliable or "prudent" because it is not possible to determine objectively how the entity's share of returns should be allocated to each cohort.

Such allocation would neither reflect the legal and economic features of these contracts nor the way they are monitored by the entity.

When the contracts of a portfolio are contractually or legally sharing the overall returns of the same pool of underlying assets, new policyholders acquire rights in the assets purchased with the premiums of the existing policyholders, and conversely the existing policyholders have rights in the return of the new assets paid by the premiums of the newcomers. For such contracts, there is no reason to follow the profitability at a lower level of granularity than the portfolio, such as an annual cohort, because every contract within the portfolio is contractually or legally entitled to the returns of the same underlying items whatever the underwriting date. Conversely, no subset of contracts becomes onerous until the portfolio as a whole becomes onerous. This is why a division into cohorts will not be relevant or "prudent".

Since these contracts, according to regulatory requirements and contractual terms, are monitored as a whole, there is currently no established mechanism of allocation by cohort, and no basis to do so. Thus, setting up such a mechanism would be artificial, and not reliable.

This is why we believe that the contractual service margin of these contracts should be determined at the level of the portfolio, overriding the current requirement of §22, so as to achieve the accounting objective of IFRS 17 which "is to ensure that an entity provides relevant information that faithfully represents those contracts".

Because the majority of our life and savings portfolios correspond to intergenerationally-mutualised contracts (either in France, Italy or Luxemburg), this issue is extremely important for us, and we consider that a European solution to this issue should be proposed as part of the European endorsement process, so that it should not delay the implementation of IFRS 17 on 1st January 2023 at the latest.

The solution may be based on the proposals already provided by the French standard setter (ANC), or the CFO Forum, or on a new one, if it correctly addresses this issue.

(3) Having considered the technical arguments for those that support and those that oppose the application of annual cohorts to cash-flow matched contracts, as described in Annex 1, and having considered the two views from the EFRAG Board above does the requirement to apply annual cohorts to cash-flow matched contracts meet the qualitative characteristics described above? Please explain your technical reasons for supporting your view.

☐ Yes ☒ No

IFRS 17 will not adequately reflect the economic nature of certain insurance contracts that, in the case of Spain, are cash flow-matched over different generations of policyholders. The Spanish insurance business model is based on the active management of the interest rate (reinvestment) and insurance (longevity/survival) risks of a large pool of contracts by matching cash flows from the pool of assets to the expected benefits to policyholders.

The fact that longevity risk is estimated on the basis of internal models that group together a large number of elements covering a population of multi-year contracts, their grouping by cohorts introduces distortions in the profitability of these contracts that do not exist in a broader one-year view and will not provide useful information because of the pricing, the business and risk management techniques applied to these portfolios are done at portfolio level and not on an annual cohort basis.

Having a reduced number of contracts in the cohort together with a different profile composition (for example, significant differences in the individual amount of the liability for remaining coverage for each policyholder) are factors that generate more variability in the adjustments in the contractual service margin – CSM – and increase the scope for "onerous" cohorts when based on actuarial assumptions supporting the product there would be a compensation across cohorts. Senior cohorts have a reduced number of policies from policyholders with a more similar age over time, resulting in a sample of contracts that are not representative of the expected behaviour of the global insured population, included in actuarial assumptions. Therefore, cohorts would generate this "artificial" variability in performance, not aligned with the economic performance of the product, that is expected to provide a stable margin with no significant deviations from the assumptions used in pricing in relation to longevity risk of the global population. The financial information provided would not be easily understandable by users, this can confuse them, as they could perceive that the company does not have a good risk management framework in place.

Therefore, we believe that the requirement to apply annual cohorts to cash-flow matched contracts does not meet the technical criteria. Not addressing this issue will increase significantly the cost of preparing the financial reporting and the resulting financial information will not be as useful, as it would be desirable by different interest parties and stakeholders. We believe this significant issue should be resolved as part of the endorsement of IFRS 17 by the European Union. We believe that a potential simple solution to address the issue described above would be that an entity is not required to apply paragraph 22 to contracts where contracts and related assets meet the conditions set out in Article 77b of the Solvency II - Directive 2009/138/EC (i.e. eligible for the matching adjustment). However, it may be a new proposal, if an alternative solution correctly addresses this issue.

However, we believe that the solutions developed to resolve the annual cohorts issue for intergenerationally-mutualised contracts and cash-flow matched contracts should be optional (to allow users to also comply with IFRS as issued by the IASB) and furthermore should not delay IFRS 17's effective date of 1 January 2023.

(4) Are there any issues that are not mentioned in Appendix II, Annex 1 and the Cover Letter regarding the endorsement of IFRS 17 that you believe EFRAG should take into account in its technical evaluation of IFRS 17? If there are, what are those issues and why do you believe they are relevant to the evaluation?

The main relevant issues have already been mentioned in question (a). In particular, we would like to stress the importance of including a mention in the cover note where EFRAG recommends that the European Commission consider specific changes in the CRR made in conjunction

with the IFRS 17 endorsement process to address the volatility issue described.

In addition, it is worthwhile to note that during the implementation of IFRS 17 (in combination with IFRS 9) ESBG financial conglomerates have encountered several issues that demonstrate the (unnecessary) complexity of IFRS 17 in certain areas and the misalignment between the detailed requirements in IFRS 17 and the fundamental nature of insurance business. Whilst this implies that financial results under IFRS 9 and IFRS 17 will not always be reflective of the economics of the underlying businesses, we do not believe that these issues are sufficient to block the endorsement of IFRS 17 by the European Union in time for the 2023 effective date. However, we do believe that a tough post implementation review will be needed.

Also, the implementation of IFRS 17 in combination with the participation of certain entities represented by ESBG in the EFRAG's field test on the IASB Exposure Draft on Primary Financial Statements, has highlighted the fact that the requirements in IFRS 17 are very different from those in IFRS 9, which used to report the performance of the insurance and banking activities respectively. We are concerned that for financial conglomerates the core revenues that would be shown in the PL will not be comparable between both businesses and would not portray faithful information on the return of those activities.

Finally, it should be noted that we are aware of the current on-going dialogue between the IASB and several audit companies regarding the possibility to implement macro hedge accounting for insurance contracts. We regret that many companies have made relevant progress for implementing both standards (IFRS 17 and IFRS 9) and that there is still no certainty on whether or under what conditions such accounting would be possible as a risk mitigation technique.

Part II: The European public good

Note to the respondents: *EFRAG's reasoning and conclusions with reference to all the other requirements of IFRS 17 is presented in Appendix III, apart from the observations on the requirement to apply annual cohorts to intergenerationally mutualised and cash flow matched contracts, which are presented in Annex 1 (refer to the section titled Appendix III in Annex 1).*

3 In its assessment of the impact of IFRS 17 on the European public good, EFRAG has considered a number of issues that are addressed in Appendix III and Annex 1 regarding the endorsement of IFRS 17.

- The EFRAG Board has on a consensus basis assessed that, apart from the requirement to apply annual cohorts to intergenerationally-mutualised and cash-flow matched contracts, all the other requirements of IFRS 17 would improve financial reporting and would reach an acceptable cost-benefit trade-off. EFRAG has not identified any other requirements of IFRS 17 that could have major adverse effect on the European economy, including financial stability and economic growth. Accordingly, EFRAG assesses that all the other requirements in IFRS 17 are, on balance, conducive to the European public good.

(1) Do you agree with this assessment for all the other requirements apart from the requirement to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts?

☐ Yes ☒ No

If you do not agree, please provide your arguments and what you believe the implications of this could be for EFRAG's endorsement advice.

> As we have mentioned in Part I of this questionnaire, other problems remain (apart from annual cohorts) that would have a negative impact if not resolved.
>
> For those issues that affect the calculation of the regulatory capital requirements for financial conglomerates, an appropriate solution should be found before IFRS 17 enters into force.
>
> Regarding the other unresolved priority issues, we believe they should not block the endorsement of IFRS 17 by the European Union. Addressing the concerns on these unresolved issues would significantly improve the quality and usefulness of IFRS 17. However, we agree that these remaining issues should not block the endorsement of IFRS 17 by the European Union in time for the 2023 effective date and, therefore, should not lead to amendments to IFRS 17 as part of the European endorsement process. We recommend to re-evaluate these issues in the context of a post implementation review of IFRS 17, or sooner if possible within the context of other IASB projects such as Dynamic Risk Management.

- EFRAG Board members were split between two groups, as described in the Cover Letter and above, with reference to the requirement to apply annual cohorts for contracts with intergenerational mutualisation and cash-flow matched contracts.

(2) Having considered the technical arguments for those that support and those that oppose the application of annual cohorts to intergenerationally-mutualised contracts, as described in Annex 1, and having considered the two views from the EFRAG Board above, is the requirement to apply annual cohorts to intergenerationally-mutualised contracts (within the context of paragraphs B67-B71 of IFRS 17) conducive to the European public good? Please explain your technical reasons for supporting your view.

☐ Yes ☒ No

> The standard allows for transferring FCF among groups of contracts that are mutualised (see B70). However, the implementation of such requirements would be highly costly and would imply a significant level of subjectivity. The identification of amounts to be reclassified between the groups of contracts requires a specific allocation pattern and an extensive historic follow-up, while it will eventually not reflect the management expectations as these are in practice defined at a higher level than the annual cohorts.
>
> Because the profitability of intergenerationally-mutualised contracts should remain the same at annual cohort or at aggregated level, and no cohort can become onerous unless the whole mutualised portfolio becomes onerous, applying the requirements of §22 would require setting up complex allocation mechanisms for no benefit.
>
> There is a consensus within the French insurance market (and other countries concerned by the issue) that the implementation of annual cohorts will come at a certain cost. Ultimately, there is a risk that this cost will affect the policyholders, without providing relevant information to the users.
>
> The operational costs related to the application of the annual cohorts are material both at implementation and in the running phase, because of the volume of data to be managed. These are long-term contracts, which can stay in

force over several decades, thus storing and processing the corresponding data by cohort will require a significant increase in IT capacities.

Closing activities related to the preparation and control of input/output data of both actuarial and accounting processes would be multiplied accordingly, and would increase continuously over time as new groups of contracts are underwritten, requiring more resources and more costs.

Monitoring the profitability of intergenerationally-mutualised contracts by annual cohort for pure accounting purposes would be costly, complex and artificial.

Consistent with the annual cohorts' requirements, asset-liability management may be performed at the cohorts' level, and would result in a significant efficiency loss because it has no economic or contractual substance.

The performance of the entity would be difficult to explain when decomposing the profitability of contracts by generation and trying to link it to individual assets on which policyholders have no direct share.

Ultimately, the negative impact on the European public good should not be underestimated since part of the additional costs may affect the policyholders.

It should be reminded that the current legal and contractual terms and conditions governing intergenerationally-mutualised contracts, as issued in France and some other countries, reflect the willingness of the regulator and of the insurers to share equitably the return of the underlying assets across generations. Over the long term, the annual cohorts' requirements could influence, for sole accounting purposes, the design of insurance products, modify the financial asset management policy and the current coverage system, which has been designed to provide a safe and stable framework to the policyholders to manage long-term savings and retirement benefits.

We have not identified any practical benefit of applying the annual cohorts' requirements to intergenerationally-mutualised contracts. None of the IFRS 17 disclosures requirements has this level of granularity, and they will not be part of the financial communication of insurance companies. The IFRS 17 indicators of the annual cohorts will not be useful for these contracts because they result from an artificial allocation of cash flows below the portfolio level. An accounting requirement that ignores the economic consequences of the legal and contractual terms will most likely be of no interest to investors and analysts.

(3) Having considered the technical arguments for those that support and those that oppose the application of annual cohorts to cash-flow matched contracts, as described in Annex 1, and having considered the two views from the EFRAG Board above, is the requirement to apply annual cohorts to cash-flow matched contracts conducive to the European public good? Please explain your technical reasons for supporting your view.

☐ Yes ☒ No

As we mentioned in Part I, IFRS 17 will not adequately reflect the economic nature of certain insurance contracts that, in the case of Spain, are cash flow-matched over different generations of policyholders.

The fact that longevity risk is estimated on the basis of internal models that group together a large number of elements covering a population of multi-

year contracts, their grouping by cohorts introduces distortions in the profitability of these contracts that do not exist in a broader one-year view.

Having a reduced number of contracts in the cohort together with a different profile composition (for example, significant differences in the individual amount of the liability for remaining coverage for each policyholder) are factors that generate more variability in the adjustments in the contractual service margin – CSM – and increase the scope for "onerous" cohorts when based on actuarial assumptions supporting the product there would be a compensation across cohorts.

Consequently, the Profit and Loss statement of insurers which will be obtained by adding the individual results of each cohorts for long-term contracts may not portray the performance of the product, especially when there are senior cohorts. This effect may be significant depending on the adjustments to future cash flows that relate to senior cohorts.

All this can lead to a negative impact on the European public good. Unjustified impacts on profitability may cause groundless concerns in equity markets about the insurers. That in conjunction with the persistent low interest rate environment, could lead to discouraging the sale of this type of insurance business in favour of unit-linked type of products where policyholders bear the investment risk. Additionally, given that in this type of contracts, entities invest in financial assets that provide sufficient risk-adjusted returns to secure those guarantees, this protects the financial strength and stability of the insurance industry.

In terms of cost benefit, increased resources will be required to allocate underlying assets to cohorts, as well as costs related to data storage and approval of disclosure amounts and it is considered that the efficiency of ALM will be lost as there will be difficulties in justifying the link between certain types of investments and the contracts of a specific cohort.

In conclusion, maintaining this requirement can be costly, may not accurately reflect their economics and the way they are managed for legal and contractual purposes, and will therefore be of little value to users. In addition, the insurers may want to discontinue that kind of contracts.

We believe this significant issue should be resolved as part of the endorsement of IFRS 17 by the European Union.

We believe that a potential simple solution to address the issue described above would be that an entity is not required to apply paragraph 22 to contracts where contracts and related assets meet the conditions set out in Article 77b of the Solvency II - Directive 2009/138/EC (i.e. eligible for the matching adjustment).

Several organizations have presented documents in recent months describing this issue. Please, for more detail about this type of contracts see Appendix 1and the description provided in Annex A of DEAs Annex 1.

However, we believe that the solutions developed to resolve the annual cohorts issue for intergenerationally-mutualised contracts and cash-flow matched contracts should be optional (to allow users to also comply with IFRS as issued by the IASB) and furthermore should not delay IFRS 17's effective date of 1 January 2023.

Part III: The questions in Part III relate to all the other requirements in IFRS 17 apart from the requirement to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts

Notes to the respondents: *In this Part, "IFRS 17" or "requirements in IFRS 17" or "the Standard" is intended to be referred to all the other requirements in IFRS 17 apart from the requirement to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts (your views on the latter requirement are to be covered in Part IV).*

The European Commission and the European Parliament asked EFRAG to provide its views on a number of specific matters, that are presented below.

Improvement in financial reporting

4 EFRAG has identified that, in assessing whether the endorsement of IFRS 17 is conducive to the European public good, it should consider whether the Standard is an improvement over current requirements across the areas which have been subject to changes (see paragraphs 15 to 27 of Appendix III). To summarise, for all the other requirements in IFRS 17 apart from the requirement to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts, EFRAG considers that they provide better financial information than IFRS 4.

Do you agree with this assessment?

☐ Yes ☒ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

In general, the standardization of the disclosure requirements contributes positively to enhance the comparability between competitors. However, the principle-based nature of the Standard also means that companies could adopt different approaches. Thus, comparability is not entirely granted by the IFRS 17 Standard.

Additionally, as we mentioned in Part I of this questionnaire, other problems persist (in addition to the annual cohorts) therefore, if they are not resolved, they will not provide better information than IFRS 4 for that specific topic. Although they should not block the approval of IFRS 17 by the European Union in time for the effective date of 2023, those that affect the calculation of the regulatory capital requirements of financial conglomerates, they should be resolved before IFRS 17 enters into force with a change in CRR.

Please also see the answer in question referring to procyclicality and volatility.

Costs and benefits

5 EFRAG's initial assessment is that taking into account the evidence obtained from the various categories of stakeholders, the benefits of all the other IFRS 17 requirements in IFRS 17 exceeds the related costs.

Do you agree with this assessment?

X Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

Given the complexity embedded in the IFRS17 Standard we believe that it would take some time for internal users and external stakeholders to fully understand and use the new financial statements in an active manner where making

business decisions. It is very difficult to quantify and measure the benefits of IFRS 17 – compared to the incurred cost of implementing the standard – and believe that the benefits of IFRS 17 may be more visible at a European industry level than for individual companies in a certain jurisdiction; however we note that this improvement in consistency in financial reporting amongst insurers could have been achieved at a much lower cost.

For example, in those jurisdictions where a dual accounting system will be kept temporarily (i.e. local GAAP and IFRS) additional costs and burdens are expected to be faced during the first years after the implementation date.

Finally, the consolidation reporting process (especially for financial conglomerates) is expected to be more demanding given the additional effort which is required to aggregate and disclose the insurance results in the consolidated financial statements. It is worth mentioning that from a cost and operational perspective, the IFRS17 calculations will be done only once at legal entity level (i.e. insurance company level) and will be then consolidated at group level including the necessary intercompany adjustments (e.g. treatment of acquisition costs paid to the bank distributor which is part of the Group). Any other operating model which might require additional IFRS17 calculations at Group level is regarded as unbearable from a cost and time perspective and would change our conclusion on whether the benefits exceed the costs.

Other factors

Potential effects on financial stability

6 EFRAG has assessed the potential effects on financial stability based on the ten criteria set out in the framework developed by the European Central Bank "*Assessment of accounting standards from a financial stability perspective*" in December 2006. Based on this assessment, EFRAG is of the view that, on balance, IFRS 17 does not negatively affect financial stability (Appendix III paragraphs 428 to 482).

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

We agree with this assessment, but if the issues mentioned in Part I are not resolved, they will affect the stability of some companies.

Potential effects on competitiveness

(Appendix III paragraphs 227 to 286)

7 EFRAG has assessed how IFRS 17 could affect the competitiveness of European insurers taking into account the diversity in their business models vis-à-vis their major competitors outside Europe.

Article I. EFRAG concludes that the underlying economics and profitability will always be more decisive in taking up a business in a particular region or a particular insurance product than changes to the accounting that is used to report on it.

Do you agree with this assessment?

X Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

Although the underlying economics and profitability will always be more decisive in taking up a business in a particular region or launching a particular insurance product, accounting is also relevant and it could be a competitive disadvantage compared to entities' competitors if the later are not required to apply IFRS 17. However, the potential effects on competitiveness should not block the endorsement of IFRS 17 by the European Union in time for the effective date of 2023.

Potential impact on the insurance market (including impact on social guarantees)

8 EFRAG has assessed the potential impact on the insurance market in Appendix III paragraphs 287 to 325.

EFRAG commissioned a study from an economic consultancy. This study ('Economic Study') stated that entities may re-consider both their pricing methodologies and product offers when applying IFRS 17 for the first time. The effect on pricing may be more significant than the effect on product offers. However, EFRAG does not have any quantification of the extent of changes in pricing or product design that would result from it.

As per the Economic Study, a majority of stakeholders interviewed (i.e. supervisory authorities, insurers and external investors) agreed that IFRS 17 alone would not impact the asset allocation of insurance undertakings, because this activity is more driven by risk management and/or asset/liability management.

Furthermore, EFRAG has considered how IFRS 17 could affect small and medium-sized entities (SMEs). EFRAG concludes that the number of small insurers that would be affected by IFRS 17 in producing their individual financial statements is very limited (between 27 and 35 depending on the option chosen based on the proposed[4] EIOPA quantitative thresholds).

(a) Do you agree with the assessment on pricing and product offerings?

☒ Yes ☐ No

(1) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(2) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

As mentioned in the commissioned study, both the pricing methodologies and product offerings may vary when we apply IFRS 17 for the first time, but it is difficult to have a quantification of the scope and impact of the changes.

(b) Do you agree with the assessment on asset allocation?

☐ Yes ☒ No

(3) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(4) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

[4] Reference is made to EIOPA's publicly consulted Consultation Paper on the Opinion on the 2020 review of Solvency II to amend the thresholds for applying Solvency II.

ESBG believes that the asset allocation of insurance companies under IFRS 9 and IFRS 17 will be based mainly on risk management, ALM management but also the accounting treatment of certain financial instruments (for example, insurers may use more or less derivatives depending on the conclusion of whether they are able to apply macro fair value hedges of interest rate risk, or invest less in equities than currently given that there is no recycling in P&L under IFRS 9 and this will create an accounting mismatch for certain insurance products.

(c) Do you agree with the assessment on SMEs?

☐ Yes ☒ No

(5) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(6) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

While this matter should not block the endorsement of IFRS 17 with a 1 January 2023 effective date, EFRAG's analysis on SMEs affected by IFRS 17 is misleading. To define "small" insurers, EFRAG uses EIOPA's definition of small insurers for which Solvency II requirements do not apply. This means that EFRAG's analysis focuses only on extremely small insurers and fails to consider the large number of small and medium unlisted insurers which apply IFRS as part of the option under article 5 of the IAS regulation in Europe. In addition, for those small and medium sized insurers for whom Solvency II does apply there are a range of exemptions and proportionality principles which are intended to facilitate a significant reduction in burden. There is no such relief in IFRS 17, so all insurance companies in Europe who will be under IFRS 17 will have to apply the full standard irrespective of their size.

Presentation of general insurance contracts

9 EFRAG is of the view the presentation requirements of IFRS 17 would provide relevant information. EFRAG also concludes that providing separate information for contracts that are in an asset, from those in a liability, position would provide useful information to users. (Appendix II paragraphs 118 to 125, 360 to 362).

Do you agree with this assessment?

☐ Yes ☒ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

IASB is working on a new Primary Financial Statements standard. We believe that the interaction of this new standard with IFRS 17 will present the following issues, especially for financial conglomerates:

- The IASB has not provided clear guidance in the exposure draft of the new future standard about how entities with different business activities should prepare their financial statements. No reference is included also in IFRS 17. Currently there is diversity in how financial conglomerates across different jurisdictions in Europe prepare its P&L, therefore we are not sure whether IFRS 17 will provide more comparative information.
- The exposure draft on Primary Financial Statements requires an analysis of expenses using either a by nature or by function presentation, based on whichever method provides the most useful information. Given that the Insurance

Service Result is net of direct attributable expenses, if we decide to present expenses by nature, it may convey the message that the banking business is our predominant activity, and that most of the non-attributable expenses relate exclusively to this business.

- The Insurance Service Result will be not comparable with the current information provided in the annual report regarding business information (IFRS 8); as it is difficult to explain and reconcile.
- The identification of acquisition and other costs attributable to insurance contracts at consolidated level is complex and will require sophisticated analytical developments. Financial conglomerates should be able to allocate the costs by businesses even when market-based commissions (intragroup transactions that are eliminated) may be used as reasonable proxy of the costs incurred in order to avoid having two different CSM (consolidated level and insurer stand-alone separate level). Such allocation is not required for the banking business – IFRS 9 only allows for incremental transaction costs to be deducted in the EIR – which leads to question whether the resulting P&L for financial conglomerates will provide useful information to users.

We do not believe that these should block the endorsement of IFRS 17 by the European Union in time for the 2023 effective date, but they should be resolved in the new IFRS referring to Primary Financial Statements.

Interaction between IFRS 17 and Solvency II

10 EFRAG concludes that in implementing IFRS 17, there are possible synergies with Solvency II, but the extent of such synergies varies between insurers. In addition, no synergies are expected for building blocks that are specific to IFRS 17 such as the contractual service margin which is not an element of the measurement approach for insurance liabilities under Solvency II. Synergy potential is available in areas that have a high degree of commonality under the two frameworks, i.e. the building blocks for the measurement of the insurance liability needed to establish the cash flow projections, and actuarial systems to measure insurance liabilities. The potential depends, to an extent, on the differences in the starting position of insurers and the investments already made in the implementation of Solvency II. It also depends on the amount of effort to adapt existing actuarial systems, that were developed for the Solvency II environment, to the IFRS 17 reporting requirements. (Appendix III paragraphs 401 to 412).

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

No additional comments

Impact of the new Standard on financial stability, long-term investment in the EU, procyclicality and volatility

11 On financial stability, refer to the conclusions in paragraph 6 of this Invitation to Comment.

On long-term investment in the EU, EFRAG's view is that asset allocation decisions are driven by a variety of factors, among which external financial reporting requirements might play some part but do not appear to be a key driver. There is no indication that IFRS 17 in isolation would lead to any significant changes in European insurers' decisions on asset allocation or holding periods (Appendix III paragraphs 96 to 123).

On procyclicality and volatility, EFRAG believes that IFRS 17 has mixed effects on procyclicality. IFRS 17 may result in more volatile financial performance measures because of the use of a current measurement. However, from the evidence collected, it is not likely that this volatility has the potential to play a specific role in producing pro-cyclical or anti-cyclical effects. EFRAG also assesses that IFRS 17 does not have the potential to reinforce economic cycles, such as overstating profits and thus allowing dividends and bonus distributions in good times, as there is no linkage between the accounting equity (cumulative retaining earnings) and amounts available for distributions, which are defined within the requirements of Solvency II or within the requirements at national level, independently from the IFRS accounting. Finally, EFRAG notes that the transparent nature of the IFRS 17 information has the benefit for investors to be able to react timely to any changes at hand, thereby avoiding cliff-effects. (Appendix III paragraphs 483 to 507).

(a) Do you agree with the assessment on long-term investment?

☒ Yes ☐ No

(1) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(2) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

No additional comments

(b) Do you agree with the assessment on procyclicality and volatility?

☐ Yes ☒ No

(3) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

As mentioned in EFRAG's Appendix III in case of insurers that are part of a financial conglomerate, as the IFRS book values of equity of the banking parent company are the basis for the prudential ratios, volatility would affect other comprehensive income and thus the basis of calculating regulatory capital requirements.

Despite the fact that EFRAG justifies that this finding is related to prudential regulation, and therefore, it does not pronounce on the matter, the source of this volatility originates with the final requirements in IFRS 17 as explained in Part I, therefore ESBG believes it is necessary to find a solution before IFRS 17 enters into force, without impacting the 1 January 2023 effective date of the standard.

As explained in our cover letter, this is a condition for ESBG to support the endorsement of IFRS 17 in Europe and leads us to request that EFRAG recommend the European Commission to consider specific changes in the CRR made in conjunction with the IFRS 17 endorsement process.

ESBG is at the disposal of the European Commission and any other interested party to work together on how the CRR could be changed and explain the solutions that its members envisage to address the volatility in OCI issue.

In this regard, we detail below two different approaches that could be further analysed:

1. Change in the CRR so that the CSM is considered as eligible own funds, at least in part.

2. Propose a filter on amounts recognised in OCI arising from a particular type of contracts together with the amounts arising from the backing assets to those contracts. The scope could be aligned with the contracts that we are asking to be scope out from the annual cohort requirement.

(4) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

No additional comments

IFRS 17 and IFRS 9

12 EFRAG is of the view that mismatches reported by preparers that contributed to EFRAG's assessment do not arise solely from the application of IFRS 17 and IFRS 9 but are mostly economic in nature. EFRAG considers that reporting the extent of the economic mismatches in profit or loss provides useful information.

In EFRAG's view, asset allocation decisions are driven by a variety of factors and disentangling the impact of accounting requirements from other factors is difficult. When defining the accounting for financial assets under IFRS 9, an insurer would not apply business models determined in isolation, but rather business models that are supportive of or complementary to their business model for managing insurance contracts. EFRAG notes that the interaction between each of an entity's internal policy decisions will determine the importance of any accounting mismatches remaining in the financial statements and this may differ largely from one insurer to another.

EFRAG has assessed the different tools that both standards offer to mitigate accounting mismatches. EFRAG assesses that:

(1) there is no conceptual barrier against the application of hedge accounting in the context of IFRS 17. However, given the lack of experience and systems by the industry, it would require significant investment both in time and systems development to achieve hedge accounting in this context (Appendix III, Annex 5);

(2) the treatment of OCI balances and risk mitigation at transition will not, on balance, negatively impact the usefulness of the resulting information.

(a) Do you agree with the assessment on the application of hedge accounting?

☐ Yes ☒ No

(1) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

We disagree with this assessment. As we mentioned in Part I there are still relevant uncertainties regarding whether the fair value macro hedge approach on interest rate risk will mitigate the referred volatility in an effective way, but also there are uncertainties whether the auditors will agree on such implementation for the insurance business. Accordingly, we do not agree with the assessment that the application of hedge accounting is only hindered by the lack of experience and systems in the insurance industry and could be resolved by investing significant time and systems development. Even insurance companies that are subsidiaries of banks in the context of financial conglomerates may not benefit of the extended use of hedge accounting carried out at the parent entity level (for the banking business) having at their disposal IT systems that could be used for hedge accounting.

This is a problem for long term savings business that are managed through cash flow matching techniques, including the use of derivatives to mitigate interest rate risks and are measured through the general model. Derivatives may also be used to manage financial risk in other saving contracts and not for trading purposes. We are concerned about not being able to offset the underlying impacts on the measurement of liabilities with the corresponding impacts on the asset side. It is the objective of ESBG members to protect P&L and OCI from any volatility arising from changes in the measurement of assets and liabilities.

(2) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

No additional comments

(b) Do you agree with the assessment on the treatment of OCI-balances and risk mitigation?

☐ Yes ☒ No

(3) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

As we have mentioned in Part I of this questionnaire and in the question related to procyclicality and volatility, the treatment of OCI-balances and risk mitigation will have a negative impact on the usefulness of the resulting information. Although they should not block the approval of IFRS 17 by the European Union in time for the effective date of 1 January 2023, those that affect the calculation of the regulatory capital requirements of financial conglomerates should be resolved before IFRS 17 enters into force with a change in CRR.

(4) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

No additional comments

Application of IFRS 15

13 In some instances, an entity (including insurers) may choose to apply IFRS 15 instead of IFRS 17 to contracts that meet the definition of an insurance contract but that have as their primary purpose the provision of services for a fixed fee. EFRAG concludes that this option would probably be made by those entities that do not operate in the insurance business. EFRAG concludes that for these entities accounting for these contracts in the same way as for other contracts would provide useful information and that applying IFRS 17 to these contracts would impose costs for no significant benefit (Appendix III paragraphs 68 to 76).

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

No additional comments

Implications of transitional requirements

14 Considering the extent of the information available for each particular group of insurance contracts at transition, EFRAG assesses that the existence of three transition approaches does not result in a lack of relevant information. The alleviations granted under the modified retrospective approach are still leading to relevant information as they enable achieving the closest outcome to a full retrospective application without undue cost or effort. In addition, EFRAG acknowledges that the possible use of three different transition methods may affect comparability among entities and, for long-term contracts, over time. However, the practical benefits of the modified retrospective and fair value approach, which were introduced by the IASB to respond to operational concerns of the preparers, may justify the reduced comparability (Appendix II paragraphs 129 to 155, 228 to 237, 300 to 303, 372 to 374, 398 to 400).

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

ESBG agrees that the existence of three transition approaches in IFRS 17 should not be considered to result in a lack of relevant information in financial reporting of insurers. Each entity issuing insurance contracts may face different restrictions at the transition date (for example, lack of or impossibility to re-estimate certain past cash flows consistent with IFRS 17 requirements) and these limitations will impact the transition approach used when implementing the standard.

We support the existence of the modified retrospective approach and fair value approach as practical expedients for transition where obtaining the information required for the fully retrospective approach is impracticable. We note that the modifications permitted under the modified retrospective approach, as set out in paragraphs C9 to C19 of IFRS 17, are too restrictive and do not provide the simplifications that make retrospective application possible in practice, accordingly ESBG members expect to use the fair value approach as the only available way to implement IFRS 17.

Article I. Impact on reinsurance

15 EFRAG concludes that the separate treatment under IFRS 17 of reinsurance contracts held and underlying direct contracts reflects the rights and obligations of different and separate contractual positions. Furthermore, EFRAG acknowledges that reinsurance contracts issued or held may meet the variable fee criteria even though IFRS 17 states that they cannot be insurance contracts with direct participation features. However, EFRAG assesses that the risk mitigation option would largely address the accounting mismatches, thereby balancing relevant information. In addition, for reinsurance contracts held that are used to recover losses from the underlying contracts, EFRAG considers that the Amendments provide relevant information as they aim at reducing accounting mismatches which is present under the original version of the Standard (Appendix II paragraphs 63 to 74, 210 to 216, 274 to 275, 349 to 352, 395 to 397).

Do you agree with this assessment?

☒ Yes ☐ No

If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

No additional comments

Implementation timeline

16 Feedback from the Limited Update to the Case Studies shows that the delay to the effective date of IFRS 17 to 1 January 2023 results in higher one-off implementation costs for preparers. However, the delay is also helping preparers to adjust their project approaches to the operational difficulties of the Covid-19 crisis. EFRAG understands from preparers that they may choose to avoid these costs by revisiting solution designs or may make more use of internal (cheaper) resources. Furthermore, according to the Limited Update to the Case Studies and other feedback from insurance associations, most of the participants did not intend to early apply IFRS 17, whereas a small minority wanted to have this possibility. EFRAG is not aware of any European insurer having taken a firm commitment to early apply the Standard. Finally, EFRAG notes that IFRS 17 requires a presentation of restated comparative information when applying the Standard for the first time. However, IFRS 9 does not have similar requirements for financial assets and liabilities (Appendix III paragraphs and 609 to 613).

(a) Do you agree with the assessment relating to delay of IFRS 17 implementation till 2023?

☒ Yes ☐ No

(1) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(2) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

No additional comments

(b) Do you agree with the assessment relating to early application?

☒ Yes ☐ No

(3) If you do not agree, please provide your arguments and indicate how this could affect EFRAG's endorsement advice.

(4) Do you have any other observations that you think is relevant for EFRAG's endorsement assessment on this topic? Please explain.

No additional comments

17 Do you agree that there are no other factors to consider in assessing whether the endorsement of the Standard is conducive to the European public good?

☐ Yes ☒ No

If you do not agree, please identify the factors, provide your views on these factors and indicate how this could affect EFRAG's endorsement advice.

In order to conclude that IFRS 17 is conducive to the European public good, the European Commission should address the volatility in OCI issue explained in ESBG' cover letter and in Part I.

Part IV: The questions in Part IV aim at collecting constituents' inputs (Questions to constituents in Annex 1) and views relating to the requirement in IFRS 17 to apply annual cohorts to intergenerationally mutualised and cash-flow matched contracts

Notes to the respondents: *Respondents are reminded that responses to this Invitation to Comment will be made public on EFRAG's website. EFRAG is also inviting respondents to share quantitative data and to allow confidentiality of this information, constituents are kindly invited to submit these data separately from the Invitation to Comment. Such quantitative data can be sent to ifrs17secretariat@efrag.org. Only aggregated resulting data will be made public in the subsequent steps of the due process and will be presented in an anonymous way.*

The intergenerationally-mutualised and cash-flow matched contracts are specified in paragraph 6 of Annex A within Annex 1.

18 As stated in paragraphs 5 to 9 of Annex 1:

(1) What is the portion of intergenerationally-mutualised contracts and cash-flow matched contracts of all life insurance liabilities and all insurance liabilities? Please report the results for these two types of contracts separately where relevant.

> As mentioned in Annex I of the DEA, in Spanish insurance market technical provisions subject to the matching adjustment on total technical life provisions is 69.6% and technical provisions subject to the matching adjustment on the total technical provisions is 61.49%.

(2) Please indicate the proportion of contracts with intergenerational mutualisation (within the context of paragraphs B67-B71 of IFRS 17) for which the requirement around annual cohorts is considered a significant issue. Please specify the share that would qualify for VFA.

> As mentioned above, the requirements regarding annual cohorts are an issue for all French life and health contracts and investment contracts with discretionary participation features which are not unit-linked. 100% of these contracts would qualify for VFA.

(3) Please describe the approach you envisage to implement the annual cohorts requirement to contracts with intergenerationally-mutualised contracts (within the context of paragraphs B67-B71 of IFRS 17).

> We are unable to answer this question as we do not envisage an approach to implementing the current annual cohort requirements for these types of contracts that will provide meaningful results. We believe this significant issue should be resolved as part of the endorsement of IFRS 17 by the European Union.

(4) Please indicate the proportion of cash-flow matching contracts for which the requirement around annual cohorts is considered a significant issue. Please specify how the features of the contracts compare with the description provided in Annex A of Annex 1.

> The requirement around annual cohorts considered a significant issue is for the proportion indicated in the section (a) for Spanish insurance market. The description provided in Annex A of DEAs Annex 1 on Spanish contracts includes the characteristics of these contracts.

(5) Please describe the approach you envisage to implement the annual cohorts requirement to cash-flow matched contracts.

We are unable to answer this question as we do not envisage an approach to implementing the current annual cohort requirements for these types of contracts that will provide meaningful results. We believe this significant issue should be resolved as part of the endorsement of IFRS 17 by the European Union.

Part V: Questions to Constituents raised in Appendix III

19 As stated in paragraphs 532 to 534 of Appendix III:

(1) In your view, how will the Covid-19 pandemic affect the impacts of IFRS 17 on the insurance market (see a description of some expected impacts in paragraphs 518 to 527 in Appendix III) and indirectly, on the European economy as a whole?

In our opinion, at this time, the Covid-19 pandemic should not impact the decision on endorsement of IFRS 17 by the European Union in time for the 2023 effective date.

(2) Is the Covid-19 pandemic affecting your implementation process for IFRS 17 and IFRS 9? Please explain in detail the impacts such as project ambitions, budget for implementation and ongoing costs, resources, speed of implementation. Please also explain whether this relates to the IT systems implementation, or rather the actuarial or accounting aspects of implementation.

No. In our opinion, at this time, the Covid-19 pandemic should not impact the decision on endorsement of IFRS 17 by the European Union in time for the 2023 effective date

(3) Are there other aspects around the implications of Covid-19, not yet addressed in the DEA that you want to expand on?

Not at this time.

Part VI: EFRAG's overall advice to the European Commission

20 Do you have any other comment on, or suggestion for, the advice that EFRAG is proposing to give to the European Commission?

ESBG has shared previously the main accounting deficiencies that IFRS 17 has, in our view, and acknowledge that the requirement of annual cohorts is the most transversal issue, that creates inconsistencies for almost all entities that issue insurance contracts, with how these contracts are managed. However, at this current stage ESBG cannot neglect that the accounting deficiencies not addressed by the IASB in the final standard altogether will lead to negative consequences in the prudential field for financial conglomerates.

More particularly, what worries ESBG financial conglomerates most is the consequences that endorsing IFRS 17 will have on their solvency ratios for the banking groups[5]. This is a significant issue that certain ESBG members – i.e. the financial

[5] Financial conglomerates led by a bank have to measure two different solvency ratios:
a) The solvency ratio for the Banking Group: it is the banking solvency, based on CRR (reported to competent authorities through COREP and disclosed to market on a regular basis, including through the Pillar III report), and
b) The solvency ratio for the Financial Conglomerate: it is the solvency as a financial conglomerate based on FICOD (reported to competent authorities through ad-hoc reportings as stated by FICOD and disclosed to the market through the Pilar III Report).

conglomerates affected by this issue – already highlighted to EFRAG and the European Commission within its letter of 23 July 2020. A copy of this document is provided in Appendix 1 to this letter.

In this context, we support endorsement of IFRS 17 provided that there is (i) an appropriate prudential solution that addresses the volatility arising in OCI for financial conglomerates and (ii) an accounting solution for the annual cohorts issue. Both issues must be resolved as part of the endorsement process, addressing the first issue as a change in the Capital Requirements Regulation (CRR), and both should not impact the 1 January 2023 effective date of IFRS 17.

Regarding the volatility in OCI, given it is an issue arising from the application of IFRS 17 that affects prudential requirements for financial conglomerates, ESBG requests that EFRAG recommend that the European Commission consider specific changes in the CRR made in conjunction with the IFRS 17 endorsement process.

As explained in more detail below, except for annual cohorts, we believe that the requirements in IFRS 17 that lead to such volatility in OCI should not impact the endorsement process. That is, although these requirements were highlighted in the past by ESBG to be addressed by the IASB within the project to amend IFRS 17, and for which we proposed solutions, our view is that they should not impact the endorsement process of IFRS 17 in the European Union but rather be addressed by the IASB throughout a post implementation review, or sooner as part of other current on-going projects such as the Dynamic Risk Management new model for macro hedging.

Appendix 1: Letter submitted by Pan-European Conglomerate Club to EFRAG and European Commission

Pan-European Conglomerate Club

To
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23 July 2020

IFRS 17 implementation – Annual cohorts and negative impacts on solvency ratios issues

Dear Sirs,

In the context of the upcoming IFRS 17 implementation decision in Europe, we consider that functioning of private solidarity mechanisms established by history and European culture as well as the life insurance sector's stable contribution to the financing of the economy through long-term investment in shares and bonds should not be weakened by a change in an accounting standard.

The IASB has issued its Amendments to IFRS 17 on 25 June 2020. Yet several major issues remain unresolved despite the repeated comments or proposals of many stakeholders.

The way life savings and retirement contracts are managed conflicts with the IASB obligation to group the contracts by annual cohorts

High in the list is the annual cohort requirement for contracts with intergenerational sharing of risks or cash flows. This is a major issue for life saving and retirement contracts in several European countries. In France and Italy, the legal and contractual frameworks require that the policyholders have the same potential right to the return of the underlying assets whatever their underwriting year. Broadly similar contracts exist in other jurisdictions such as Germany or Luxembourg. In Spain, the regulations require an asset-liability management for long term retirement contracts based on cash flow matching techniques, which provides for an intergenerational sharing of risks. Both cases are different, but the

way they are managed conflicts with the obligation set by the IASB to group the contract by annual cohorts. This is detailed in the annual cohort appendix.

IFRS 9 and IFRS 17 will introduce artificial P&L and solvency ratio[6], volatility for the financial conglomerates requiring an amendment to CRR

Life saving and retirement contracts (but also long term P&C contracts) are based on a long term holding of the underlying assets. The simultaneous application of IFRS 9 and IFRS 17 conflicts with this business model. Under IFRS 9, equity investments are normally measured at fair value though P&L, because the alternative approach of fair value through OCI prohibits the OCI recycling upon disposal of the equity (we believe the OCI recycling upon disposal should be allowed again in order to stop penalising investments in equity assets). This introduces volatility in the P&L which is not compensated when insurance contracts are measured using the general model. When the saving and retirement contracts are measured using the variable fee approach (VFA), the sole measurement model in IFRS 17 which recognizes an asset-liability linkage, the mechanism of the VFA only provides for an efficient compensation of the change in the fair value of the underlying assets if the contractual service margin remains positive. This means that sudden brutal unfavourable financial markets evolutions may trigger an immediate loss on the liability side, even if this loss is only temporary and will not affect the fulfilment of its obligations by the insurer. An illustration is provided in appendix 2.

In addition, considering the long-term nature of the pension business, if insurers invest in debt instruments, changes in the fair value of the assets – regardless of whether they are measured at fair value through P&L or through OCI – will not have the same equivalent offsetting amount in the liability side for different reasons such as credit spread risk, liquidity risk, or because the estimated expected profit of these contracts is not remeasured over time, leading to significant amounts of volatility in other comprehensive income (OCI) or profit and loss.

On these volatility issues that will impact prudential ratios of financial conglomerates, we believe that a European solution should be developed. Such a solution may be based through exploring any alternatives to change the future requirements included in the CRR once IFRS 17 has been endorsed at European level. Any change should have as objective to portray the economics of the insurance contracts in terms of the solvency of the conglomerate.

Transition methods will have a negative impact on shareholders' fund and on the financial conglomerate solvency ratio at transition date

Additionally, the transition from the current standards to IFRS 9 and IFRS 17 creates specific issues. IFRS 17 provides for several transition methods (a full retrospective approach, a modified retrospective approach and a fair value approach). The second and third methods are supposed to alleviate the cost of the transition, yet some of the simplifications introduced may have a negative effect on the level of the shareholders' fund at transition date. An example is provided in appendix 3. From a higher perspective, the effect of the transition on the shareholders' fund creates a specific issues for financial conglomerates for which the banking solvency ratios are based on the IFRS consolidated accounts,

[6] Financial conglomerates led by a bank have to measure two different solvency ratios:
a) The solvency ratio for the Banking Group: it is the banking solvency, based on CRR (reported to competent authorities through COREP and disclosed to market on a regular basis, including through the Pillar 3 report)
b) The capital adequacy for the Financial Conglomerate: it is the capital adequacy based on FICOD (reported to competent authorities through ad-hoc reportings as stated by FICOD and disclosed to the market through the Pilar 3 Report)
This letter refers to the effects on a) the solvency ratio for the banking group

and may be affected by the change in accounting standards. Pure European insurance groups are much less affected because their solvency margin requirements are based on Solvency 2, a regulatory standard distinct from the IFRSs whereas financial conglomerates are subject to the CRR banking regulation which is based on the IFRSs (all IFRS equity impacts translate into the Solvency ratio unless a filter is in place).

These unresolved technical issues will lead to massive disposals of equity portfolios and changes in the debt instruments investment strategy

The most probable effects of the major unresolved technical issues (i.e. annual cohorts for intergenerational mutualised insurance contracts and earnings/equity volatility, please refer to annexes) will lead to massive disposals of equity portfolios and divert life insurers from any current and future initiatives to strengthen the financial structure of European companies over the long term. Additionally, those insurers that invest in sovereign and corporate debt may be forced to change the type of insurance products currently being offered to limit themselves to those businesses that fit better under the accounting requirements of IFRS 17 and IFRS 9 in order to limit the volatility recognised in other comprehensive income (OCI) or profit and loss.

A European solution to the IFRS 17 annual cohorts' requirement is needed

Therefore, so as not to penalize the policyholders and not to create impediments to the financing of the economy that would be contrary to the European public good at a time when long term financing support towards our corporates is needed, we call for a solution to the annual cohorts requirement when endorsing IFRS 17. We would propose to provide an optional exemption from the annual cohorts' requirement for insurance contracts with intergenerational sharing of risks between policyholders and contracts that are cash flow-matched over different generations.

A CRR solution is also required to solve the negative impacts on the financial conglomerates' solvency ratio

We also remain at your disposal to jointly explore other complementary reliefs that may be provided in the context of reviewing the CRR for the referred volatility in OCI and P&L and negative impact issues on the solvency ratio of the financial conglomerate.

We hope these major concerns and the solution proposed will hold your attention and we would be pleased to provide any further information you may require.

If you would like to discuss our comments further, please do not hesitate to contact our coordinators: Michel Bilger (michel.bilger@credit-agricole-sa.fr) & Nicolas Patrigot (nicolas.patrigot@bpce.fr).

Signed by the following conglomerate groups belonging to the Pan-European Conglomerate Club:
1. Banca Intesa Sanpaolo,
2. BNP Paribas,
3. BPCE,
4. CaixaBank,
5. Crédit Agricole,
6. Crédit Mutuel,
7. DZ Bank,
8. La Banque Postale,
9. Société Générale.

Pan-European Conglomerate Club

Issue 1 - The annual cohort issue for contracts with intergenerational sharing of risks between policyholders

In a nutshell, life and saving participating contracts can be split between :
(i) the unit-linked contracts (for which the policyholder holds identified units of designated assets),

(ii) the “euro” saving contracts (for which the policyholder has a right on the return of an identified pool of assets, but no specific right over any of these assets),

(iii) the “euro” annuities contracts (under which the beneficiary receives an annuity until death with a guaranteed interest rate; being part of them as a result of employer’s pension commitments with their personnel).

Under IFRS 17, (i) and (ii) categories will be measured using the Variable Fee Approach, although their characteristics are very different, and (iii) will be measured under the General Model.

According to the IFRS 17, contracts should be grouped for measurement purpose by portfolios (similar risks managed together), profitability groups (onerous, few chance to be become onerous, and others), and by “annual cohorts” (the group should not include contracts issued more than one year apart).

'Euro' saving contracts

In the “euro” saving contracts, the policyholders share most of the returns of the same underlying items across generations, independently from their underwriting year. If some contracts provide for a minimum rate, this financial guarantee is usually deducted from the return available to the other policyholders sharing the same pool of assets, and thus implicitly financed by them.

Such contracts are including an intergenerational sharing of financial risks between policyholders. In France or Italy, the regulation require this intergenerational sharing of risks, and the assets are managed at portfolio level for all contracts sharing the same assets, whatever the fee structure or underwriting year.

For the “euro” contracts, applying the annual cohorts’ requirement will be largely artificial and will not provide a relevant information to the users, as it will not appropriately model the economics of these contracts and their legal and contractual terms.

'Euro' annuities contracts

In addition to “euro” saving contracts, life annuities are also a widespread type of insurance contracts used to promote the long-term savings of European population, which can be both immediate and deferred annuities, and being promoted by the employees or subscribed directly by individuals.

Although life annuities may have different features across Europe, in certain countries like in Spain, insurers provide a long-term fixed guarantee on interest rate to policyholders that does not change over time even if the market interest rates change.

This guaranteed interest rate credited to the policyholder is set by companies based on the observable market yield of the investment portfolio assigned for the expected duration of the benefits (life expectancy in life annuities) when the contract is underwritten.

Considering the above pricing methodology, insurers earn an expected constant financial margin in these contracts that is the difference between the internal rate of return of financial assets and the guaranteed interest rate credited to the policyholder, while they are exposed to other non-financial risks (basically, deviation from the assumptions used in pricing in relation to longevity risk, to the risk margin or to operating expenses) that would determine the overall margin.

In the specific case of Spain, in order to provide the guaranteed interest rate along the life of the beneficiary the Spanish regulation incorporated financial immunization and asset-liability management (ALM) as methodologies for covering interest rate and spread risks for this type of contracts for more than 20 years ago. This has played an effective role in the control of the interest rate provided to the policyholder and the spread credit risk assumed by life insurance undertakings even through different macroeconomic environments (high and low interest rates, different phases in the business cycle…). It is relevant to mention that the losses incurred as a consequence of asset default would be assumed by the insurer. This is the reason that justifies the strong restrictions included in the Spanish regulation regarding which financial investments are eligible for this methodology. Only under exceptional circumstances, the policyholder will surrender. If this is the case, the amount of surrender will be closely linked with the market value of the underlying portfolio (i.e. insurance companies do not bear the underlying market risk in case of a surrender benefit payment).

Under cash flow matching techniques, insurers group contracts issued more than one year apart. The groups are mainly defined considering the aggregation of homogenous insurance and financial risks. The optimization of the asset and liability management mechanism and the underlying cash flows require that the size of these groups of assets and policies are big enough. The objective of these techniques is to ensure that the expected cash flows to be paid to policyholders match the future proceeds arising from the financial assets held by insurers (mainly fixed-debt instruments), in terms of timing, amount and currency. Calculations are prescribed by regulation and require monitoring the matching of the cash flows in monthly buckets until the extinction of the in-force group of contracts. There are also compulsory quarterly reviews to ensure there is not a mismatch. By applying these techniques, there is an intergenerational risk sharing among policyholders, in particular longevity and financial risks, which is also the basis on which the pricing of these contracts is based and how are built the internal actuarial statistical models used to estimate expected cash flows.

The management of the in-force contracts is consistent with how the contracts are grouped under the cash flow matching. Indeed, the above referred cash flow matching techniques are not only used for managerial and prudential purposes but also with an accounting perspective as financial reporting does not require to group contracts differently.

To sum up, based on the above descriptions the main features of the insurance contracts to which cash flow matching techniques are applied across generations are the following:
a) long-term life-saving contracts with a guaranteed interest rate which are only eligible to be measured under the general model,

b) managed under cash flow matching techniques which are regulated and compulsory for insurers if they want to provide a guaranteed interest rate,

c) there is intergenerational risk sharing of longevity and financial risk, but

d) they do not share the features described in paragraphs B67-B71, as the cash flows to be received by one policyholder are not affected by cash flows of other policyholders or contracts or affect them.

One last remark is that the contracts featured above have been granted a particular treatment under the prudential regime of Solvency II, using a matching adjustment when measuring the insurance contracts that permits insurers to adjust the risk-free rate term structure to avoid volatility in the Solvency II own funds. To be eligible for the matching adjustment, insurers must have in place robust and sound cash flow matching techniques, which reinforces the adequacy of these techniques to manage groups of contracts, and at the same time provide evidence that are generally accepted at European level.

IASB requirements

For the IASB, the annual cohorts are necessary to provide an information of the users of the financial statements on the profitability trend of the contracts, and to avoid combining profitable contracts in force with less profitable new business.

However, this assumption relies on the basis that the financial assets can be attached to each annual cohort. This is correct for the unit-linked contracts, but not for the "euro" saving contracts and "euro" annuities contracts where no such segregation of assets currently exists, and will have to be determined solely for applying the annual cohort requirement of IFRS 17.

This issue has been raised in several occasions by several stakeholders, including the EFRAG and the preparers (notably the CFO Forum). The ANC and the ICAC also submitted this issue to the IASB. Yet the IASB Board has refused to provide for a solution for the contracts with an intergenerational sharing of risk and has not considered this issue in the revised standard[7] issued on 25th June 2020. The last refusal dates 5 June 2020 after specific proposals had been submitted to the EFRAG and the IASB by the ANC, the ICAC and the CFO Forum.

We remain convinced that a solution for the annual cohort requirement can and should be found, with no material effect on the information provided by the standard. Otherwise, the allocation of the Contractual Service Margin by annual cohort to comply with IFRS 17 requirement may be costly, may not correctly reflect their economics and the way they are managed for legal and contractual purposes, and thus will be of little value for the users. In addition, the insurers may want to discontinue that kind of contracts, which are currently representing a large amount of the life and saving business in France, Italy and Spain.

A solution could be found by providing an option to apply or not this IASB annual cohorts requirement, as we understand those listed groups and companies that want to apply the requirement for different reasons (because of their implementation projects, to be fully compliant with IFRS).

Accordingly, in terms of the solution to be adopted by the European Commission we would propose to provide an optional exemption from the annual cohorts' requirement for insurance contracts with intergenerational sharing of risks between policyholders and contracts that are cash flow-matched over different generations.

[7] Although the IASB staff admitted in February 2020 that the cost of tracking "annual cohorts" are high, and expected benefits are low or reduced

Issue 2 - Impacts of IFRS 17 in crisis context

IFRS 17 requires insurers to use approaches consistent with current market conditions for liability valuation purposes.

The longer insurance obligations, the more likely they are sensitive to economic fluctuations. This is particularly true for life insurance obligations (savings and pensions).

IFRS 17 also deeply modifies performance measurement by the creation of a new indicator: the "CSM" (Contractual Service Margin). The purpose of the CSM is to prevent upfront profits, as a deferred profit liability concept. It is gradually allocated into the income statement as insurance or investment services are provided. It may not be negative: when an increase in the cash flows exceeds the carrying amount of the CSM, the CSM is reduced to zero. The excess is immediately recognized as a loss in the income statement (i.e. « loss component » in the terms of IFRS 17).

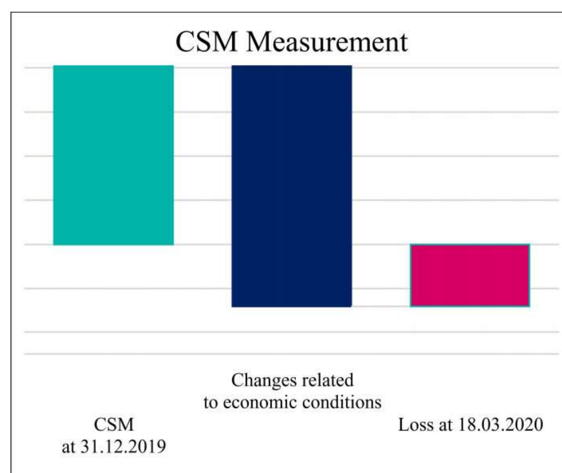
Every economic variation will subsequently affect the income statement or other comprehensive income statement until a potential improvement of the economic situation, making them particularly volatile. These impacts will affect the equity of the insurance undertaking and the solvency of its parent banking company.

The relevance of this point can be illustrated by two examples

Example 1 – equity as underlying financial assets

This example considers the financial conditions as of march 18th 2020 during the Covid-19 pandemic (fallout of European equity markets and ongoing low level of interest rates).

If IFRS 17 had been in force, the measurement of the CSM of a life insurance company would have taken into account these economic conditions. Changes in cash flows related to economic conditions between the last financial disclosure (i.e. December 31st 2019) and March 18th 2020 would have drastically impacted the level of CSM setting it to nil and even below. The excess amount would have been recognised as a loss, resulting in a significant impact of the income statement of the company. The IFRS accounting income would have been reduced by three times its current income.



IFRS 17 - CSM measurement due to economic variations

Example 2 – debt as underlying financial assets

This example is based on a life-long annuity product measured under the IFRS17 general model. Based on IFRS17 requirements the CSM is measured with the corresponding locked-in rates while the liability cash flows are re-measured based on actual rates. Based on high-level estimates, a parallel shift of 20bps interest rate decrease would lead to an increase of liabilities of c.a. 2.5%. This increase in the value of liabilities would be recorded in OCI leading to an Equity volatility which would, consequently, lead to a decrease in the Group´s available resources (i.e. CET1 ratio)

Issue 3. Transition – An illustration of negative impacts of the Fair Value Approach on the shareholders' fund for contracts measured with the general model

Regarding the Fair Value Approach ("FVA") at Transition, current IFRS17 requirements lead to an accounting mismatch in the accumulated amount of OCI for those products without direct participation features (i.e. business measured through IFRS17 BBA model) but managed under cash flow matching techniques as per local regulatory requirements (please see issue1). This accounting mismatch arises from the different treatment on the asset side (financial instruments whose changes are recorded in OCI) vs on the liability side (potentially no OCI impact at Transition where implementing the IFRS17 Standard) leading to a negative impact on Equity.

It is our belief that for these contracts, the locked-in rate to be used at transition should be based on the rate of the underlying assets. In more specific terms, our proposal is to amend paragraph C24(c) so this option under the FVA at Transition would also be available for contracts measured under the BBA model and managed through cash flow matching techniques and not only for insurance contracts with direct participation features to which paragraph B134 applies.

Issue 4. Interaction with IFRS9 Standard – Financial and operational impacts of the limitation to the Risk mitigation (hedging techniques under IFRS 17)

Current IFRS17 risk mitigation techniques are focused on participating products. However, long term savings business are managed through cash flow matching techniques, including the use of derivatives to mitigate interest rate risks and are measured through the general model. Derivatives may also be used to manage financial risk in other saving contracts.

The interaction between IFRS17 and IFRS9 presents some challenges when it comes to mitigate risks. Although there has been progress on the possibility to use fair value macrohedges on interest rate risk for some portfolios of insurance contracts (in a similar way as the referred "EU carve out" which is already being used by the banking sector), insurance companies are still assessing whether it is an effective alternative to manage volatility. Current analysis indicate that the risk mitigation options included in IFRS 9 might not be applicable to the whole universe of insurance contracts which are currently being measured under IAS39 and IFRS4.

We are concerned about not being able to offset the underlying impacts on the measurement of liabilities with the corresponding impacts on the asset side. Our aim is to protect the Profit and Loss and Other comprehensive income statements from any volatility arising from changes in the measurement of assets and liabilities.

About ESBG (European Savings and Retail Banking Group)

ESBG represents the locally focused European banking sector, helping savings and retail banks in 21 European countries strengthen their unique approach that focuses on providing service to local communities and boosting SMEs. An advocate for a proportionate approach to banking rules, ESBG unites at EU level some 900 banks, which together employ more than 650,000 people driven to innovate at roughly 50,000 outlets. ESBG members have total assets of €5.3 trillion, provide €1 trillion in corporate loans (including to SMEs), and serve 150 million Europeans seeking retail banking services. ESBG members are committed to further unleash the promise of sustainable, responsible 21st century banking. Our transparency ID is 8765978796-80.

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Published by ESBG. January 2021