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Draft Endorsement Advice on IFRS 17, Insurance contracts

Dear Jean-Paul,

Mazars welcomes the detailed analyses performed by EFRAG in the draft endorsement Advice (hereafter DEA) on IFRS 17, Insurance contracts, issued in September 2020. We are pleased to comment on that project, with which we concur for the most part.

We support the endorsement of IFRS 17 that eventually offers a genuine and comprehensive accounting framework aiming at reflecting the underlying economics of insurance contracts, whereas IFRS 4 mainly grandfathered local GAAPs. After a long gestation, this crucial step towards a robust standard designed to last must not, however, overlook its conceptual and practical limitations. We are therefore fully supportive of the work of EFRAG when it expresses with eyes wide open, nuances or even reservations on certain provisions of the standard.

In order to achieve a high-quality standard, we believe that certain concerns or recommendations should be addressed – some immediately, some later – on the following aspects:

Annual cohorts

We suggest removing the annual cohorts' rule for VFA contracts with intergenerational sharing of risks and returns from the same set of underlying assets. Such contracts are very common in many European countries; applying the current IFRS 17 rule would imply complex calculations at an aggregation level that is unrelated with the very nature and the economics of intergenerationally mutualised contracts. As a consequence, it may impair the auditors' ability to assess whether the accounting treatment gives a true and fair view of the economics and contractual terms.

We do believe that defining an exemption in the Standard is possible and needed in order to avoid a wide variety of practices and different degree of judgement to find expedients in order to apply the annual cohorts' rule despite its lack of relevance and comparability. The lack of such an exemption in the Standard would generate additional challenges for the audit profession in terms of effort and related audit costs, as different insurers are likely to develop their own methodology to formally comply with the annual cohorts' rule.

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Other issues

Without affecting the endorsement process, we believe that the following topics still need to be addressed by IASB at the post Implementation Review or earlier:

Reinsurance contracts

We believe that entities should be allowed to apply the variable fee approach both for reinsurance contracts issued and for reinsurance contracts held, provided these contracts meet the definition of direct participating contracts. We do not understand why the reinsurance contracts have been excluded from the benefits of the VFA approach.

The standard provides limited provisions specific to the reinsurance business, the latter being rather considered as a modified insurance contract and therefore subject to the general standard's requirements. General provisions are however not literally transposable to some specificities of the reinsurance business and lead to unclear or even inappropriate accounting for reinsurance contracts held. Finally, we are concerned that missing guidance could raise numerous questions to IFRS-IC and that Committee's decisions based on current standard's provisions might provide clear answers but prove inadequate. We suggest that this issue be mentioned by EFRAG in its endorsement advice in order for Committee members to more easily and frequently consider standard setting in case of questions on reinsurance contracts.

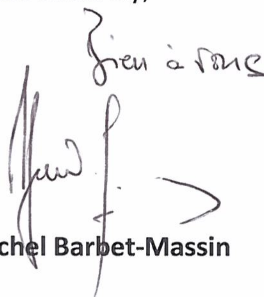
Presentation issues

Contracts may be acquired during their settlement period either through a business combination or a portfolio transfer. In both cases, IFRS 17 considers that the risk of an adverse development of the claims until settlement is such that the acquired liability for incurred claim should be recorded as a liability for remaining insurance coverage. Accordingly, insurance revenue and insurance costs must be fully released upon settlement even though insurance services have been rendered before the acquisition. We believe that such an accounting treatment is conceptually disputable and leads to inflate the presentation in the income statement, providing neither useful nor comparable information.

In our opinion, the IASB should require a separate presentation in the statement of financial position for premiums receivable, claims payable and reinsurance deposits. We consider it a useful information for readers to get a separate view on these different accruals.

Our detailed comments to the questions raised in the DEA on annual cohorts are set out in the Appendix. Please do not hesitate to contact us should you want to discuss any aspect of our comment letter.

Yours sincerely,



Michel Barbet-Massin

Head of Financial Reporting Advisory

Appendix

The annual cohorts' requirement does not meet the technical endorsement criteria for intergenerationally mutualised contracts (Q2b)

We concur with the view expressed in the EFRAG's DEA on the lack of relevance, reliability, comparability, understandability and prudence of applying annual cohorts to intergenerationally mutualised contracts because:

At any given time, the community of policyholders' as well as the entity's profit share depend on the accumulated unrealised gains and unallocated individually general participation reserves from the common pool of underlying items and management's discretionary decision to hold or sell the assets or timely allocate these reserves. It is therefore not contingent on the date when the contracts were underwritten. Splitting mutualised amounts into groups of contracts issued not more than one year apart is therefore different from how the business is contractually or legally organised and from its economics and, as a result, is artificial. The annual cohort's divider cannot provide an understandable and "appropriate depiction of the results" since any allocation process is merely based on rules/drivers and "judgment" cannot "properly be exercised", in the absence of a linkage between the requirement in IFRS 17.22 and the underlying legal or economic baseline.

In that regard, expecting that the accounting outcome with or without cohorts be the same (IFRS 17.BC138 and IFRS 17.BC139G) is neither feasible (not least because there is no "unique" outcome when applying cohorts) nor meaningful.

In an intergenerationally mutualised portfolio, there is no contractual link between a cohort and any subset of underlying assets. In addition, discretionary cash flows are fungible across generations so that profitability is not determinable on an annual cohort basis. Accordingly, for such contracts, under contractual / regulatory terms, "fair value gains and losses" from a given pool of underlying items are not attributable to a single specific cohort, since this would assume that each cohort has its own profits, which is neither required by the standard nor reflecting the business and the economic features of such contracts. Consequently, we do not believe that not using cohorts in that case will lead to a situation where "profits are blended across periods, impairing comparability of how profitability has changed".

We agree with EFRAG that IFRS 17 does not set any requirement about how to allocate the changes in: (i) the fair value of assets (for contracts under the VFA); and (ii) the entity's assumptions about its future execution of its discretion to the annual cohorts. We believe that such requirements are not desirable at annual cohort's level but should be defined by the entity at the adequate level of aggregation (generally at least at the portfolio level) according to IFRS 17.24.

Preparers are currently developing practical expedients to attempt reflecting the effect of mutualisation between groups of contracts. Applying annual cohorts to mutualised contracts requires using allocation keys/drivers that are not directly related to the business or the contractual terms and would unduly distort the profitability measured at cohort level and therewith provide a fictitious accuracy. In that regard, assessing the CSM at the broader level of the mutualised portfolio would avoid biased information at too granular a level of aggregation.

Assessing the initial impact of new contracts on an existing portfolio provides useful information that is already required, independently of the existence of cohorts, by IFRS 17.107 expecting to disclose separately the amount of CSM on B/S at initial recognition, for contracts initially recognised during the period. Such information, when compared from one period to another, will provide users with the profitability "trends" of newly issued contracts. Tracking subsequent changes in CSM at the level of

annual cohorts is on the contrary not relevant when contracts are mutualised. Finally, we agree with EFRAG (App2§89) that IFRS 17 currently requires no specific presentation or disclosure at annual-cohort level. So, we do not understand to what the "unacceptable loss of information" or to what "making visible the changes in profitability (App.3 §16)" refers.

In addition, financial guarantees are not provided on an annual cohort basis, nor are the effects of other fixed cash flows that are mutualised. There is no reason for annual cohorts to better "capture" their impact on profitability, especially when contracts are mutualised.

Specific audit consideration

Since the 12 months rule is not conceptually funded in case of intergenerationally mutualised contracts, it will be very difficult for auditors to confirm the compliance to the principles that would rely on arbitrary criteria and involve high degree of judgement in allocating the mutualisation effect at the cohort level. As a consequence, it may impair the auditors' ability to assess whether the accounting treatment gives a true and fair view of the economics and contractual terms.

Given its arbitrary nature / absence of linkage with the contractual terms and the way the cash flows are managed, the allocation by underwriting year of the mutualised fulfilment cash flows (and calculation of the CSM at annual cohort level in general) will most likely be difficult to challenge and to audit.

The annual cohorts' requirement for intergenerationally mutualised contracts is not conducive to the European public good (Q.3b)

We concur with the view expressed in the EFRAG's DEA on the inappropriate reflection of the business model, the poor cost/benefits ratio of applying annual cohorts to intergenerationally mutualised contracts and on the possible risks that these misrepresentations might generate on financial stability and social guarantees.

Because there is a common underlying pool of assets (the underlying assets are not segregated by annual cohorts), the annual cohort splitting has to be compensated by further complex/costly allocations that ignore the economics and contractual/legal terms and consequently do not provide benefits/relevant information to users.

Arguments that a lower granularity (i.e. at annual cohorts' level) provides more detailed information are not applicable to mutualised contracts (App3 §16, 17) because of the bias it generates.

As described by EFRAG (in App3§21), we believe that the resulting misrepresentation of profitability / onerous contracts (App3§25) at mutualisation level might be detrimental to the societal model.

Specific audit consideration

In the absence of standardisation, preparers will develop their own actuarial conventions and methods to compute the CSM of each annual cohort under the constraints of limiting the IT costs of their implementation. This existence of numerous possible ways to allocate cash flows will raise audit issues regarding the analysis of the retained methodology in the light of the true and fair view (especially relevance, comparability and prudence).

We think these difficulties will be even greater for mutualised contracts because of the requirement of annual cohorts than in its absence and will make the application of new ISA 540 more challenging.

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An exemption is possible and desirable (Q.20)

In line with our previous comment letters, we share the concerns raised by the preparers and believe that it is worth re-considering whether in certain cases the annual cohorts' requirement is justified. EFRAG's DEA considers that the requirement is not relevant and leads to unnecessary costs in some fact patterns, in particular for contracts with intergenerational mutualisation (i.e. the major part of the European life 'traditional with profits' insurance business). We support the EFRAG's DEA recommending an exemption for such contracts, provided it is reflective of the reporting objectives of the level of aggregation requirements in IFRS 17.

IASB itself acknowledged, in the course of its analysis, the limited relevance of annual cohorts for mutualised contracts, especially because of their discretionary features. The IASB tentative rules-based proposal to capture the appropriate population of contracts being not successful, they finally considered that no solution could be found and rejected the proposed principles-based exceptions.

We consider that the conclusion expressed in the EFRAG's DEA stating (in App2 §63) that "an exception would necessarily rely on arbitrary criteria" is not demonstrated and we do not believe that intergenerational mutualisation is "a very complex contractual arrangement".

Arguments developed in EFRAG's DEA (in App3.§26-28) against an exception finally legitimate it when "(i) the effect of any financial guarantees on returns in underlying items is shared with other policyholders, and (ii) any other fixed cash flows that were not shared is relatively small". In fact, this scope is also the one we support for an exemption and that is detailed by EFRAG's DEA (in App2.§40) exempting "from the requirement to apply annual cohorts contracts whose fixed cash flows (including guarantees) are either shared amongst policyholders, or small".

An exemption is desirable for auditability reasons

We do believe that an exemption should be defined in the Standard regarding the application of annual cohorts to intergenerationally mutualised contracts, in order to avoid a wide variety of practices and different degrees of judgement to find expedients in order to apply the annual cohorts' rule despite its lack of relevance, comparability and prudence. The lack of such an exemption in the Standard will generate additional challenges for the audit profession in terms of effort and related audit costs, as different insurers are likely to develop their own models to formally comply with the annual cohorts' rule.