The Chair

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Mr Jean-Paul Gauzès
President
European Financial Reporting Advisory Group (EFRAG)
35 Square de Meeûs
1000 Brussels
Belgium

Ref: EFRAG's Draft Letter to the European Commission Regarding Endorsement of IFRS 17 *Insurance Contracts* as amended in June 2020

Dear Mr Gauzès,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to EFRAG's due process related to EFRAG's draft letter to the European Commission regarding the Endorsement of IFRS 17 *Insurance Contracts* issued by the IASB on 18 May 2017 and amended by the IASB on 25 June 2020.

ESMA supports the endorsement of IFRS 17 which, in our view, will provide a consistent system of requirements to account for insurance and reinsurance contracts, thus achieving the much-needed replacement of the current IFRS 4 *Insurance Contracts* which does not provide for the necessary level of transparency and comparability to promote investor protection and financial stability.

In ESMA's view, IFRS 17 has the benefit of providing transparency on those aspects of insurance accounting that have for a long time remained unregulated under IFRS due to the continued application of IFRS 4. In fact, at the time of its publication in 2004, IFRS 4 was intended as a temporary solution and its continued application has *de facto* prevented the application of an accounting model that could provide for clear principles on how to recognise, measure and present amounts relating to insurance contracts on the basis of commonly understood accounting principles. This situation has led some to consider insurance accounting as a 'black box'.

IFRS 17 introduces a current measurement of insurance contracts and, for the first time, clear principles for performance reporting which will better align insurance accounting with the principles applicable to other transactions under IFRS. ESMA expects that these principles will greatly improve the available information and the level of transparency of the insurance sector as a whole.

ESMA highlights that a key role in promoting greater transparency and consistency in accounting for insurance contracts in accordance with IFRS 17 is played by the principles for the aggregation of contracts that form an integral part of the new measurement model. These requirements, including the so-called 'annual cohort' requirement, aim at ensuring that the measurement of contracts and the reporting of profitability are performed at a sufficiently granular level to ensure that: (i) profitability of insurance contracts is recognised as services are provided; (ii) losses are recognised on onerous contracts as soon as an issuer determines that losses are expected; and (iii) timely information about changes in profitability is reported.

ESMA notes that for some contracts with intergenerational mutualisation and for cash-flow matched contracts, the application of the annual cohort requirement has raised significant concerns by some stakeholders, including insurance undertakings, with respect to its cost-benefit balance, the level of judgement involved and its relevance, as reported in Annex 1 of EFRAG's Draft Endorsement Advice. These stakeholders have called for a scope exemption from the annual cohort requirement for the above-mentioned contracts. Other stakeholders, however, have expressed supporting arguments on this requirement and highlighted the risks associated with any scope exemption. In this respect, in our 2019 comment letter on the IASB's Exposure Draft *Amendments to IFRS 17,* ESMA already indicated that "*should further evidence emerge that the effectiveness and efficiency of these requirements can be improved while still pursuing these objectives, we recommend the IASB to consider it as part of the post-implementation review of IFRS 17, or earlier if feasible without impacting the timely implementation of the Standard*". Following the lengthy re-deliberation process conducted by the IASB and the multiple exchanges with the insurance industry and other parties, including EFRAG and some national standard setters, we are of the view that, at this stage, the alternatives proposed cannot be considered to be more effective and efficient than the annual cohort requirement.

ESMA is concerned by EFRAG's decision not to provide a view in its Draft Endorsement Advice on the endorsement of the annual cohort requirement in relation to certain types of contracts. We note that IFRS 17 is built around a set of *checks and balances* which have been carefully developed and it may not be appropriate to assess selected requirements in isolation from the others. ESMA therefore encourages EFRAG, following the public consultation, to consider all requirements in IFRS 17 for the purpose of providing a full assessment of the Standard as a whole when providing their advice to the European Commission.

More in general, ESMA notes that IFRS 17 is a rather articulated standard which reflects the complexity of the underlying insurance and reinsurance business and which results in the extensive application of professional judgement. While such extensive judgement, if not properly exercised, may impair the level of reliability and comparability of the reported figures, in ESMA's view overall it remains acceptable given the expected increased relevance of the resulting information and the improved adherence to the underlying business models. ESMA expects that the accompanying disclosures will have a key role in providing the necessary complementary information on how management has exercised this judgement, and how consistent the resulting estimates are across issuers and over time.

For the reasons set out above, on balance ESMA considers that IFRS 17 will be conducive to the European public good and, in particular, have a positive impact on investor protection and financial stability. ESMA also emphasises the importance of the swift adoption of IFRS 17 in order to ensure the application by insurance undertakings of IFRS 9 *Financial Instruments* which has for long been delayed to the detriment of investor protection.

More detailed considerations relating to investor protection and financial stability are set out in the Appendix to this letter. In case you have any questions or comments please do not hesitate to contact me or Evert van Walsum, Head of the Investors and Issuers Department (Evert.vanWalsum@esma.europa.eu).

Yours sincerely,

Steven Maijoor

Appendix – Impact of adoption of IFRS 17 on Investor Protection and Financial Stability

1. When assessing the expected impact of IFRS 17 on investor protection and financial stability, ESMA considers that the assessment needs to be done on a relative basis, comparing the current requirements of IFRS 4 as well as their application by the issuers with the requirements of IFRS 17.
2. In the following paragraphs ESMA sets out some considerations in relation to investor protection and financial stability of what ESMA deems to be key aspects of the Standard. The order of topics is not indicative of their relative importance.

a. <u>Impact of IFRS 17 on Investor Protection</u>

3. In assessing IFRS 17 in relation to investor protection, ESMA considered whether the Standard enables investors to make better informed decisions than on the basis of IFRS 4, and whether it meets the fundamental qualitative characteristics of relevance, reliability, comparability and understandability and the extent to which its requirements are enforceable so as to ensure their consistent application.
4. ESMA generally supports EFRAG's assessment with regards to the qualitative characteristics, except for the fact that ESMA would support a more definitive and positive assessment of all the requirements on the level of aggregation, including the annual cohort.
5. The introduction of common principles for measurement will also eliminate much of the diversity in practice that exists when applying IFRS 4, thus improving the understandability and comparability of reporting practices. In particular, the use of current assumptions, the explicit assessment of risk and profit allocation requirements based on the pattern based on which services are provided, in ESMA's view, ensures a relevant and consistent treatment of different types of contracts and risks.
6. ESMA considers that the principles underlying the measurement model also adequately reflect the economic substance of the main different types of (re)insurance transactions thus assisting investors in understanding the different aspects of the insurance business model which include contracts of short duration, contracts with and without direct participation features and contracts with discretionary participation features.
7. Another important feature of IFRS 17 is the possibility to reflect the features of those contracts whose cash flows affect or are affected by cash flows to policyholders of other contracts, an effect that is generally referred to as mutualisation. ESMA notes that factoring into the measurement of insurance contracts the effect of mutualisation requires the exercise of judgement which is, however, justified in order to ensure the fair reflection of the specificities of the underlying business.
8. ESMA also notes that further transparency to assess current and future profitability will come from the establishment of a Contractual Service Margin (CSM) at inception of the contract and released over time as the insurer provides insurance services. ESMA notes that, unlike today, the CSM will provide investors with a common accounting basis for calculating performance metrics and be able to more effectively compare insurance undertakings.

9. The assessment of the time value of money as part of the measurement of fulfilment cash flows introduces a fundamental element to ensure the economic valuation of insurance liabilities and the consistency with measurement approaches for other liabilities under IFRS. However, ESMA notes that the level of judgement involved in determining the appropriate discount rate may require additional care by management and others with a responsibility over financial reporting to ensure that the resulting information is relevant and reliable.

10. Another key element of the fulfilment cash flows is the treatment of insurance acquisition cash flows which relate to sale and distribution of the product. In ESMA's view, the principles set out in IFRS 17 cater for the appropriate reflection of the economics underlying the different sale and distribution business models. However, with regards to the establishment of an asset for insurance acquisition cash flows dependent upon the future expected renewals of contracts, ESMA notes that the Standard does not provide a definition of renewals and a methodology regarding the allocation of the insurance acquisition cash flows to future contractual renewals. In ESMA's view it will be important to carefully assess how this requirement is applied in practice to prevent the exercise of arbitrary judgement.

11. With regards to reinsurance contracts, IFRS 17 generally requires a company to apply to these contracts an approach that is consistent with that for the underlying insurance contracts while requiring separate accounting for the reinsurance contracts and the underlying direct contracts. In ESMA's view, this approach provides a faithful representation of the entity's rights and obligations under these contracts. ESMA notes that, in particular, the requirement to recognise income for a group of reinsurance contracts held when the entity recognises a loss on initial recognition of an onerous group of underlying insurance contracts is intended to reduce accounting mismatches between reinsurance contracts held and the related underlying contracts. However, ESMA notes that this approach may result in structuring opportunities resulting in the deferral of losses on reinsurance contracts held and therefore it will be important that complementary disclosure will provide adequate explanation for these transactions.

12. Another key feature of IFRS 17 is the establishment of clear principles for the level at which contracts shall be aggregated for the purpose of their measurement. Currently existing insurance practices vary widely depending on jurisdiction-specific requirements, types of contracts as well as company-level practices. Most insurers do not specify whether and on what basis insurance contracts are aggregated for measurement purposes. The lack of clarity in this regard is particularly concerning when it comes to contracts which may have specific features, such as minimum guaranteed benefits or where the profitability of certain generations of contracts may impact that of other generations, i.e. when there is a mutualisation component across different contracts.

13. In this respect, ESMA notes that the level of aggregation requirements of IFRS 17 provide clear guidance to address the above-mentioned issues, while still leaving some room for management's judgement in the allocation of profits across different generations of contracts, especially when the profitability of one or more generations of contracts is closely linked with the performance of other generations.

14. In particular, the requirement to group contracts no more than one year apart, the so-called 'annual cohort' requirement, aims at achieving key objectives of performance reporting, such as: (i) profitability of insurance contracts is recognised as services are provided; (ii) losses are recognised on onerous contracts as soon as an issuer determines that losses are expected; and (iii) timely information about changes in profitability is reported. In the absence of requirements pursuing these objectives, key information will be lost on how management exercised judgement on the profit allocated to the different generations, the pattern of its release and any changes occurring thereof and on how the development of external economic circumstances affect in-force and future insurance contracts.

15. ESMA also acknowledges that the annual cohort requirement is an accounting measure aimed at providing additional granularity in the reporting of the performance of insurance contracts. ESMA notes that in its Draft Endorsement Advice, EFRAG has reported the concerns of some stakeholders questioning the relevance of the reported information and the cost-benefit balance linked to the additional granularity of the annual cohort requirement especially for contracts with intergenerational mutualisation and for cash-flow matched contracts.

16. EFRAG has also reported the views of stakeholders supporting this requirement. ESMA notes that it would be important to consider the efficiency and effectiveness of this requirement following its initial application by market participants to assess whether it delivers on its intended objectives or whether a more suitable requirement can be identified to replace it.

17. At this stage, ESMA notes that no alternative workable solutions to the annual cohort requirement which may provide a simpler approach at a lower cost while achieving the same objectives mentioned above have been identified. ESMA therefore stresses that the mere removal of the annual cohort requirement without an appropriate replacement would not serve investor protection for the reasons explained in the previous paragraphs. It is also important to note that, in our view, the level of aggregation requirements are integral to the functioning of the entire standard and, due to their pervasiveness, in order to express a balanced assessment regarding the endorsement of IFRS 17 it is advisable to consider all requirements as a whole.

18. With regards to presentation requirements, ESMA considers that the introduction of clear requirements to present items of insurance revenue excluding investment components provides more comparable and understandable information. Similarly, the requirements to disclose amounts in the statement of profit or loss and other comprehensive income into an insurance service result component and insurance finance income or expenses component is expected to facilitate analysis and comparability of insurers' financial statements. ESMA also highlights that, in accordance with IFRS 17, an entity can choose where to present the effect of changes in discount rates and other financial variables, either in profit or loss or disaggregated between profit or loss and other comprehensive income on a portfolio basis. In our view, this option will help reflect the interplay between IFRS 9 *Financial Instruments* and IFRS 17, however it may also add complexity to insurers' financial statements thus making it more difficult for users to understand their performance.

19. The disclosure requirements in IFRS 17, in ESMA's view, also play a key role in promoting investor protection and in helping the enforceability of the Standard given the level of judgement involved in multiple areas of IFRS 17, (e.g. discounting, risk adjustment, acquisition cash flows and contractual renewals, CSM allocation patterns and determination of the coverage units, etc.). The disclosures on assumptions and methodologies will improve the understandability and comparability of the recognised amounts. Similarly, the availability of a choice to present the effect of changes in discount rates and other financial variables – either in profit or loss or disaggregated between profit or loss and other comprehensive income – will benefit from the requirement to disclose an explanation of the methods used to determine the insurance finance income or expenses recognised in profit or loss, if the entity chooses to disaggregate insurance finance income or expenses, and this can contribute substantially to the transparency and better understandability of the recognised amounts. In addition, the increased transparency about risks arising from insurance contracts required by IFRS 17, in ESMA's view, will provide relevant information especially for long-tail insurance contracts.

20. Lastly, in relation to transition, ESMA notes that while the full retrospective approach provides the most complete information, the choice of transition methods may result in some diversity of practice across entities and in a lack of comparability of transition amounts. In ESMA's view, this reflects the necessary balance between relevance, comparability and practicability considerations. However, the disclosure requirements upon transition and subsequently may help promote comparability. ESMA expects that issuers will exercise care in performing any approximations allowed by the transitional requirements in IFRS 17 and will duly justify them.

b. <u>Impact of IFRS 17 on Financial Stability</u>

21. The considerations developed in relation to investor protection in the previous section could largely be applied to the financial stability assessment of IFRS 17. In particular, ESMA considered that the provision of more transparent information on how (re)insurance contracts affect the performance, financial position and cash flows of insurers has a beneficial effect on ensuring that financial market participants receive comparable and timely information thereby contributing to a more rational allocation of capital and ultimately to a good functioning of the market as a whole.

22. ESMA notes that one feature of IFRS 17 that is particularly conducive to financial stability is its effectiveness in depicting economic mismatches that may arise from the interplay between insurance liabilities and financial and non-financial assets backing those liabilities. On the contrary, ESMA is not aware of any material accounting mismatches introduced by IFRS 17 that may provide misleading signals to market participants, thus being detrimental to financial stability.

23. In ESMA's view the current measurement approach adopted by IFRS 17, coupled with its level of aggregation requirements, including annual cohorts, allows for a timely recognition of losses and potential onerous contracts and the fair depiction of the impact that fixed cash flows, for example financial guarantees, may have on the performance of insurance undertakings. In this respect, ESMA notes that IFRS 17 is expected to reflect the volatility

to which insurers are exposed, while at the same time allow for the fair reflection of any hedging strategies put in place by insurers to mitigate such volatility. In ESMA's view, any remaining volatility depicted by the statement of profit or loss will be a reflection of economic reality.

24. Finally, ESMA notes that financial stability implications of IFRS 17 were also assessed by EIOPA in its 2018 *Analysis of IFRS 17 Insurance Contracts*[1]. ESMA notes that EIOPA's detailed analysis constitutes a useful reference when considering the potential effects of IFRS 17 from an economic perspective.

[1] https://www.eiopa.europa.eu/sites/default/files/publications/pdfs/aeiopa-18-717_eiopa_analysis_ifrs_17_18_10_2018.pdf