POSITION PAPER

Comments to Tentative Agenda Decision: Transfer of Insurance Coverage under a Group of Annuity Contracts (IFRS 17)

ESBG (European Savings and Retail Banking Group)

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ESBG

ESBG welcomes the opportunity to comment on the Tentative Agenda Decision – Transfer of Insurance Coverage under a Group of Annuity Contracts (IFRS 17).

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 is writing to comment on the IFRS Interpretations Committee's Tentative Agenda Decision regarding Transfer of Insurance Coverage under a Group of Annuity Contracts (IFRS 17 Insurance Contracts).

ESBG considers that it is relevant before evaluating the Tentative Agenda Decision itself to contextualize the moment in which it occurs:

- The date of initial application of IFRS 17 is 1 January 2023. Most European insurers will also apply IFRS 9 for the first time on that date.
- IFRS 9 and 17 implementation projects are well underway and on track to meet the requirements by 1 January 2023.
- Implementing IFRS 9 and 17 is a major project of unprecedented effort; entities will therefore need all the time to 1 January 2023 to finalise the implementation.
- Entities have been committing significant resources and effort to the implementation of IFRS 9 and 17 and need a period of stability ahead of the standards' entry into force. Any disruption to this process should be avoided.
- A number of interpretations issues are being finalised by companies internally and with auditors. Whilst ongoing, these do not put the initial application of IFRS 9 and 17 at risk and further guidance/intervention by regulators is not deemed necessary and it could threaten the finalisation of the IFRS 17 implementation projects.

ESBG supports a high-quality standard for insurance contracts accounting, however, we firmly believe that this Tentative Agenda Decision (TAD) does **not correctly portray the insurance service provided under these contracts**, **is not aligned with a principle-based standard** **and** **puts at risk IFRS 17 implementation on time for January 2023 for companies affected by this TAD**.

ESBG elaborates further in the next section on each of these points.

It is important to highlight that although this topic has arisen in response to a question arising from the UK, other countries are affected by this Tentative Agenda Decision. One example is Spain, where the so-called "approach B" is the one used by almost all Spanish Insurers in the IFRS17 implementation projects (both from a methodology and an IT development point of view).

The insurance service provided under the contracts is a stream of expected cash flows until policyholder's death

In ESBG view, both Approaches A and B are valid methodologies to allocate the CSM depending on (i) facts and circumstances of the contracts under the scope of the TAD, and (ii) how insurance companies apply their judgement when determining the service that they provide policyholders with these contracts.

While in Approach A the CSM allocation is determined based on the periodic benefit payable in each period that services are provided, in the Approach B the service in a period is based on the value to the policyholder of surviving to the end of the period which includes both the annuity payment in the period as well as the continued access to receive a continuous stream of future payments.

Companies represented through ESBG consider that Approach B better reflects the quantity of insurance contract services provided by their contracts. When a policyholder buys the type of insurance policy covered under the TAD, their main objective is to ensure a financial security for the remainder of their life (i.e. the annuity policy provides a lifelong income protection element since every term that the policyholder survives the policyholder is accruing annuity benefits and that is the value placed on the annuity contract) . This perception of service has commercial substance to the policyholder and market evidence supports the fact that policyholders are willing to pay an additional amount for a life contingent service. The policyholder has exchanged an insurance premium (generally an up-front premium) to get protection against the risk of surviving for an unexpected period of time. Accordingly, the value (and hence the service) the policyholder obtains from the insurance contract is continuous over time. As long as the policyholder is still alive the insurance company provides protection against the risk of their savings pot not lasting once retired.

Our view is that Approach A fails to accurately capture that transfer of service in the form of continuous insurance coverage to the policyholder for as long as their contract survives. Additionally, the use of Approach A would not reflect the differences between a life contingent annuity and a fixed term annuity. Consequently, we believe Approach A is not representative of the underlying economics and pricing mechanism of our TAD annuity contracts and would result in a material overstatement of the CSM accounting balance recognised in the balance sheet for many years once the contract has been issued due to the fact that Approach A underestimates the services transferred to the policyholder in the first stages of the annuity.

The long tail nature of the liabilities arising from the TAD annuity contracts must be taken into account, as well as the importance of defining a coverage unit method which best reflects the profit pattern for this business. Companies represented through ESBG will estimate under IFRS 17 the CSM for the TAD annuity contracts as the difference between (i) the generally up-front premium paid, (ii) the expected annuity terms that will be paid until the policyholder's death which include any financial guarantees provided under the contracts, and (iii) the required risk adjustment. Leaving aside for one moment the risk adjustment, the CSM will be ultimately determined by the age of the policyholder when underwriting the contracts – i.e. for how long the insurance companies expects to pay annuity terms – and the financial yield that can be earned according to the markets conditions and will not be passed to the policyholder. Based on this, we conclude that Approach B works better at reflecting the true economics of these portfolios, how they are priced and how the insurance company earns the margin measured under the CSM.

The above considerations are valid regardless of how insurance companies estimate the risk adjustment for these TAD annuity contracts which is deducted from the CSM and separately released into profit or loss. The risk adjustment is the compensation estimated under IFRS 17 that insurance companies require for bearing the uncertainty about the amount and timing of the cash flows that arises from non-financial risk as the entity fulfils insurance contracts. How the risk adjustment is released by companies should not obscure what is captured under the CSM for these TAD annuity contracts which is the main focus on the TAD.

In this regard, we do not agree with the argument supported by the IFRIC Committee that the risk adjustment represents the margin of the insurance contract. We note that when IFRS 17 was a joint project between the IASB and FASB the idea of a single margin was completely rejected by the IASB, concluding that the risk adjustment measures uncertainty separately from the expected profit and that should have a separate pattern of release. When estimating the risk adjustment entities should consider not only negative deviations but also positive ones due to the fact that cash flows arising from insurance contracts are uncertain but should there only be negative deviations.

Another point to take into consideration is that if clients perceived the insurance service to be only the benefit payable in each period, there would be no single premium contracts, or they would always ask for an option to surrender the contract which is not the case for the TAD annuity contracts being discussed. Again, this is not the case because the client pays a premium to have access to a life contingent annuity until its death.

IFRS 17 should remain a principle-based standard

IFRS 17 is a principle-based standard and does not prescribe a method for determining the quantity of the benefits provided under a group of insurance contracts, therefore, we believe that the IFRS Interpretations Committee has gone beyond the principle of how to recognise insurance services as defined in paragraph B119 of IFRS 17 by elaborating the way how coverage units are to be recognised. ESBG believes that the standard's requirements with respect to the coverage units to be recognised in profit and loss are broad enough that both approaches can be used based on facts and circumstances.

Paragraph B119 of IFRS 17 determinates that the amount that an entity recognises in profit and loss in each period depends on the number of coverage units, that it is the quantity of insurance contract services provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage period. This paragraph does not provide detailed guidance on what the insurance service is, and it does not seem reasonable that the IFRS Interpretation Committee is in a better position -compared to insurance companies - to conclude what insurance service is being provided in each geographical jurisdiction in which IFRS are applied. Neither it is appropriate that this Committee rather adds requirements to the Standard than it interprets them because paragraph B119 does not provide detailed guidance on what the insurance service exactly is. ESBG considers that based on facts and circumstances both approaches A and B could be acceptable under this paragraph.

We would also like to note that paragraphs 109 and 117 of IFRS 17 require entities to disclose quantitative and qualitative information, whereas paragraph BC366B in the Basis for Conclusions explains that these disclosures aim to enhance users' understanding on the determination of the quantity of benefits provided by insurance contracts for the purpose of recognising the contractual service margin in profit or loss due to the complexity and the judgement that insurance companies need to apply. ESBG believes that if these disclosures are provided by companies, including disclosures regarding future CSM by appropriate time bands, there will be not a lack of comparability.

One final comment relates to the cross-cutting consistency with other IFRS which are also developed as principle-based standards, in particular with IFRS 15 *Revenue from Contracts with Customers*. We note that this standard requires entities to consider the terms of the contracts and all relevant facts and circumstances when determining performance obligations, whereas the TAD may seem to go back to a cash-basis accounting which clearly IFRS 15 departs from.

The TAD puts at risk the implementation of IFRS 17 as of 1st January 2023

ESBG questions the timing of bringing a TAD less than one year before the date of first application of IFRS 17. Preparers are in need for a period of calm exactly at this stage. We note that the IFRS 17 Transition Resource Group has not addressed issues since April 2019 which has allowed preparers the much-needed stability in preparing for implementation.

There are financial conglomerates within ESBG that have implemented Approach B for determining the quantity of the benefits of insurance coverage to estimate the amount of the CSM to be recognised in profit or loss in a period and there is no enough time and human resources (in terms of Actuarial Department's dedication) to make any changes in the IT systems (i.e. actuarial calculation engines), as parallels and dry-runs are currently being performed and are further planned until the end of the year. Any potential change now will not only bring unforeseen costs but also require lead time in implementation as it requires updates to the IT-systems as well as testing beforehand and such timing is not compatible with the application of Approach A for entities that have implemented Approach B.

The above comments go beyond the current issue and are valid also for any other topics in the IFRIC pipeline regarding IFRS 17 before or immediately after its implementation.

In this context it is important to remember that when the amendments of IFRS 17 published in June of 2020 were prepared, constituents (included ESBG) demanded changes to IFRS 17 which were disregarded by the IASB. The IASB decided that amendments would only be justified if those amendments would not unduly disrupt implementation already under way as implementation should be the focus. Two years have passed since the publication of these amendments, we are now in the year 2022, the date of initial application of IFRS 17 will be 1 January 2023 and the transition date will be 1 January 2022. Companies have mostly completed their implementation phases and we assume some of them have implemented approach A and others approach B, since IFRS 17 does not establish a specific method. Even some companies may have already produced the opening-balance sheets as of 1 January 2022. Any TAD at this stage that only accepts one of the two approaches will be completely disruptive for insurance companies that have chosen the other approach and will be contrary to the main principle which guided the IASB to accept making only limited changes in May 2020 to IFRS 17.

As previously said, ESBG believes **that both Approach A and B represent permissible interpretations of the principles of IFRS 17. However, if despite the above-mentioned arguments, the IFRS Interpretations Committee still believes that only one approach is a valid interpretation of IFRS 17 principles, then ESBG would recommend this issue to be addressed in a post-implementation review** together with other issues that were pending to be addressed as well as others that may arise in the future. As the due

Process Handbook mentions, when the Board undertakes a post-implementation review it has an opportunity to understand the effects of the change in financial reporting by comparison to those identified by the Board when it issued the new requirements. Once the standard is implemented, it will be possible to assess whether it is necessary to clarify the application criteria of paragraph B119.

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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