European Securities and Markets Authority

The Chair

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**Mr Hans Hoogervorst**
**International Accounting Standards Board**
**30 Cannon Street**
**London**
**EC4M 6XH**
**United Kingdom**

**Ref: The IASB's Exposure Draft 'Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts*'**

Dear Mr Hoogervorst,

The European Securities and Markets Authority (ESMA) thanks you for the opportunity to contribute to the IASB's due process regarding the Exposure Draft (ED) 'Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts*'. We are pleased to provide you with the following comments with the aim of improving the enforceability of IFRSs and the transparency and decision usefulness of IFRS financial statements.

ESMA appreciates the efforts of the IASB to address any concerns and possible difficulties caused by the different effective dates of IFRS 9 and the new insurance contracts Standard. While ESMA would have preferred that IFRS 9 and the new insurance contracts Standards applied at the same time, we acknowledge that this was not possible in light of the different progress of the two projects. In this context, ESMA encourages the IASB to finalise the new insurance contracts Standard without any additional delay as it is urgently needed to ensure transparency, comparability and a level playing field within the insurance industry.

ESMA strongly believes that IFRS 9 will improve the financial reporting of financial instruments in comparison with IAS 39 *Financial Instruments: Recognition and Measurement*, notably by introducing the expected loss model. Furthermore, ESMA firmly believes that it is of the utmost importance that the amendments to IFRS 4 do not create any uncertainties in the implementation process of IFRS 9 as in our view, application of IFRS 9 requirements should not be subject to any further delay. Consequently, ESMA is of the view that the application of IFRS 9 should not be delayed beyond what is needed to mitigate possible negative effects of different effective dates of IFRS 9 and the new Standard for insurance contracts that are currently in the scope of IFRS 4.

ESMA supports both the overlay approach and the temporary exemption from applying IFRS 9 as these address different issues depending on the type of business activities and group structures. While the existence of two complementary approaches further reduces comparability among entities, each of the approaches has its advantages and disadvantages when addressing the difference in the effective dates and each of them might be better suited for a different subset of entities issuing insurance contracts in the scope of IFRS 4.

In light of the diversity of activities related to issuance of the insurance contracts in the scope of IFRS 4, their pervasiveness in the overall business activities of insurance companies as well as different models for accounting for insurance contracts in the scope of IFRS 4, ESMA agrees that both approaches should be available on an optional basis. This also ensures that entities would not be prevented from adopting the improved financial reporting requirements brought by IFRS 9.

While ESMA agrees with the overlay approach, we consider that the IASB should provide additional guidance on which assets are '*related to contracts that are in the scope of IFRS 4*' and mandate additional disclosures in this respect. ESMA is of the view that the current description is not sufficiently clear and could be interpreted in different ways leading to significantly different outcomes. Furthermore, ESMA suggests that the IASB limits the range of presentation options allowed for the overlay approach and requires the presentation on the face of the statement of profit or loss in accordance with IFRS 9 with a subsequent overlay adjustment from profit or loss to other comprehensive income.

ESMA agrees that eligibility for the temporary exemption from applying IFRS 9 should be based on whether the entity's predominant activity is the issuance of contracts within the scope of IFRS 4. ESMA notes that some market participants and other organisations in Europe have suggested alternative starting points for determining the scope of the temporary exemption, such as the insurance regulation. While these alternative approaches were not fully explored by the IASB in the ED and might be associated with different costs and benefits compared to the IASB's proposals, ESMA is of the view that the predominant activity criterion reflects most appropriately the objective to address the misalignment between the effective dates between IFRS 9 and the new insurance contracts Standard and is able to provide the most relevant information for users of financial statements.

ESMA agrees with the IASB that the predominance criterion should be assessed at the reporting entity level. ESMA would not support the assessment of the predominance criterion below the reporting entity level as such an approach would allow the use of two sets of accounting policies in the consolidated financial statements. However, we are of the view that the predominance criterion should be amended in order to capture all types of liabilities an insurer is expected to carry for its insurance activities linked to issuance of insurance contracts within the scope of IFRS 4. Moreover, ESMA specifically highlights the need for clear and enforceable criteria governing the eligibility for the temporary exemption from applying IFRS 9.

ESMA places importance on sufficient disclosure requirements related to the use of the temporary exemption. In our view it is paramount that the market is sufficiently informed about the effects of the temporary exemption. Furthermore, the use of the temporary exemption from IFRS 9 requirements should not delay providing the additional information required by IFRS 7 *Financial Instruments: Disclosure* for assessing the credit quality of the financial assets held by entities that issue insurance contracts in the scope of IFRS 4.

Finally, ESMA agrees that the temporary exemption from applying IFRS 9 should have an expiry date no later than reporting periods beginning on or after 1 January 2021. In this context, ESMA strongly urges the IASB to finalise the new insurance contracts Standard in time to meet this deadline. ESMA highlights that the current requirements in IFRS 4, that were intended to be in use only for a limited time when issued in 2004, are not satisfactory and do not provide sufficient transparency and comparability of financial reporting related to issuance of insurance contracts in scope of IFRS 4.

Our detailed comments on the ED are set out in Appendix I to this letter. Please do not hesitate to contact us should you wish to discuss all or any of the issues we have raised.

Yours sincerely,

Steven Maijoor

**Appendix I – ESMA's detailed answers to the questions in the ED**

***Question 1 – Addressing the concerns raised***

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

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

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

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

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

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

1. ESMA appreciates the efforts of the IASB to address the concerns and possible difficulties raised by the insurance industry caused by the different effective dates of IFRS 9 and the new insurance contracts Standard. In the ideal world, ESMA would have preferred the two standards applied at the same time. However, ESMA acknowledges that this was not possible in light of the different progress and timeline of the two projects.

2. ESMA considers IFRS 9 to be an improvement in the financial reporting requirements for financial instruments. Consequently, we strongly believe that, in light of the difficulties to agree on the new insurance contracts Standard, the application of IFRS 9 should not be delayed beyond the scope that is necessary to mitigate possible negative effects of different effective dates of IFRS 9 and the new Standard for insurance contracts currently in the scope of IFRS 4.

3. Whereas ESMA can relate to the arguments about additional accounting mismatch, uncertainties about the future insurance contracts Standard and concerns about incremental cost, most of these arguments were unfortunately raised only late in the process of finalisation of IFRS 9 and without providing robust quantitative evidence.

4. While ESMA remains unconvinced[1] that the abovementioned difficulties (refer to paragraphs BC9-BC21 of the ED) caused by different effective dates are insurmountable (e.g. through taking use of the flexibility in the current requirements of IFRS 4 as highlighted by paragraph BC14 of the ED), ESMA accepts that the non-alignment of effective dates might have an impact on the cost benefit analysis for some entities issuing insurance contracts in the scope of IFRS 4, notably those whose insurance liabilities are predominantly measured at cost as permitted by IFRS 4.

5. Consequently, taking into account the difficulties that were highlighted by the insurance industry, ESMA accepts that the IASB needed to provide a temporary solution to address the concerns raised. However, ESMA highlights that any interim period for which the temporary solution is designed should be as short as possible in order not to further delay the improvement in financial reporting that IFRS 9 brings.

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

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

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

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

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

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

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

6. While the overlay approach allows full application of IFRS 9 and maintains comparability in accounting for all financial assets,[2] we understand that the overlay approach and the temporary exemption try to address different issues depending on

[1] Letter, ESMA's Response to EFRAG's Draft Endorsement Advice on IFRS 9, 29 June 2015, ESMA, Paris, ESMA/2015/1056
[2] While ESMA acknowledges the link between financial assets and insurance liabilities that is inherent to the asset-management of insurance companies. ESMA notes that users of financial information have highlighted that improvements in measurement of financial assets are beneficial for investors on a stand-alone basis (see e.g. CFA Institute response to EFRAG's Draft Endorsement Advice on IFRS 9, 3 July 2015, https://www.cfainstitute.org/Comment%20Letters/20150703.pdf).

the type of business activities and group structures. In this context, while the existence of two complementary approaches further reduces comparability among entities, each of the approaches has its advantages and disadvantages when addressing the difference in the effective dates and each of them might be better suited for a different subset of entities issuing insurance contracts in the scope of IFRS 4.

7. Consequently, ESMA sees the overlay approach and the temporary exemption from applying IFRS 9 as complementary temporary solutions addressing the different effective dates of IFRS 9 and the new insurance contracts Standard in a pragmatic way as further developed in paragraphs 8-12 of this letter.

8. As the overlay approach provides a solution for the accounting mismatches and temporary volatility in profit or loss, ESMA considers that this approach might be a suitable solution for financial conglomerates with significant banking activities. ESMA considers that in light of the improvements in financial reporting notably through the introduction of the expected loss model for financial assets measured at amortised cost, any reporting entity with significant banking activities needs to apply IFRS 9 for all financial assets and present financial information prepared in accordance with the recognition and measurement principles of IFRS 9 directly in its primary financial statements.

9. Furthermore, the use of the overlay approach favors comparability across industries and provides for transparency due to the fact that the effect of applying IFRS 9 as compared to IAS 39 is clearly visible.

10. ESMA understands that the overlay approach might be associated with additional costs as stated in paragraph BC 53 of the ED, but considers that these additional costs are justified for financial conglomerates with significant banking activities in order (i) to maintain and improve transparency of financial reporting, (ii) to address the G 20 recommendations in relation to the 'too little too late' problem associated with the recognition of impairment according to the incurred loss model in IAS 39 and (iii) to avoid accounting and regulatory arbitrage within the financial conglomerates. Nonetheless, as these incremental costs and operational challenges might work as a disincentive to opt for this approach. ESMA encourages the IASB to further explore the exact nature of any incremental costs and compare them with the costs of full adoption of IFRS 9. In case these were deemed sufficiently significant, the IASB could consider whether and how it could be possible to mitigate them. Nonetheless, any further changes to the overlay approach should avoid compromising the need to fully adopt IFRS 9 on a timely basis.

11. While the temporary exemption from applying IFRS 9 resolves the issues related to the different effective dates of IFRS 9 and the new insurance contracts Standard raised by the insurance industry, ESMA highlights that this option raises the questions of comparability and allows financial assets to be accounted for in accordance with IAS 39 (i.e. using the incurred loss model for the financial assets measured at amortised

cost). Consequently, ESMA is of the view that this delay in improvement in financial reporting should be available only to a narrow group of reporting entities, for whom the risks for non-application of the new accounting standard in 2018 are lower (e.g. as they do not have significant lending activities) and for which the application of different accounting standards for financial assets does not pose such significant risk of earnings management.

12. However, ESMA reminds the need for users of financial statements to be provided with sufficient transparency on the credit quality of the assets measured at amortised cost in order to maintain the cross-sector comparability. In our view transparency is particularly relevant in the current low-interest rate environment. ESMA notes that in such context insurance companies might be economically compelled to invest into higher-yielding financial assets associated with higher risk in order to be able to meet the long-term commitments to their policyholders in the form of interest rate guarantees or promises of future payments from insurance policies and pensions.[3]

13. The use of the temporary exemption from application of IFRS 9 would mean delay in the application of the expected loss model and additional disclosures about credit quality of financial assets measured at amortised cost. Therefore, as further stated in our response to Question 4, ESMA is of the view that the IASB needs to mandate sufficient additional disclosure requirements on the credit quality of financial assets that will continue to be measured at amortised cost in accordance with IAS 39 (i.e. using the incurred loss model).

***Question 3 – The overlay approach***

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

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

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

*Do you have any further comments on the overlay approach?*

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[3] See e.g., EIOPA Report: Low interest rate stock taking exercise 2014, EIOPA, 28 November 2014. In this report EIOPA concluded that while some insurers are increasing their share of higher yielding instruments or asset classes in the investment portfolio, the overall trend is not yet remarkable. At the same time Joint Committee of the European Supervisory Authorities has consistently highlighted that search for yield in the low interest rate environment incentivises engaging in higher risk assets, Hence, ESMA notes that existence of different impairment models for insurance companies (incurred loss model) and the rest of the financial market participants (expected loss model) might facilitate accounting arbitrage and thus risks reinforcing this trend.

<u>*Eligibility of the financial assets for the overlay approach*</u>

14. ESMA notes that the overlay approach could be applied when insurance entities (i) are not eligible for the temporary exemption from applying IFRS 9; (ii) do not elect to apply the temporary exemption from applying IFRS 9 even if though eligible or (iii) have ceased the application of the temporary exemption from applying IFRS 9 (either voluntarily or mandatorily by 1 January 2021 at the latest).

15. The IASB developed the overlay approach to address the accounting mismatch between financial assets and insurance liabilities in the scope of IFRS 4 and the volatility that would arise in profit or loss as a result of applying IFRS 9 before the new insurance contracts Standard. Consequently, the IASB limited this approach for a narrow type of eligible financial assets. ESMA agrees with this proposed scope of the overlay approach because it considers that the proposed scope correctly addresses the volatility stemming from the misalignment between the effective dates of IFRS 9 and the future insurance contracts Standard. In particular, ESMA notes in order to meet this objective of the overlay approach, the financial assets need to (i) relate to contracts that are within the scope of IFRS 4 and (ii) be measured at fair value through profit or loss according to IFRS 9 but would have not been measured at fair value through profit or loss in their entirety when applying IAS 39.

16. However, in order to ensure consistency across the insurance industry ESMA encourages the IASB to clarify the definition of financial assets that are '*related to contracts that are in the scope of IFRS 4*' and provide examples of such assets in the application guidance to IFRS 4. ESMA is of the view that current description is not sufficiently clear and could be interpreted in different ways leading to significantly different outcomes. It would also raise significant enforceability issues. While the IASB acknowledges in paragraph BC 39 of the ED that different entities could use different approaches to designate financial assets related to contracts that are in the scope of IFRS 4, ESMA notes that this flexibility can range from a description of a strict economic relationship of a financial asset to the insurance liability in the scope of IFRS 4 to one covering all financial assets other than those explicitly linked to the liabilities outside of the scope of IFRS 4 that an entity issuing insurance contracts can hold (i.e. including also the surplus assets that an insurance company holds to meet the regulatory or internal capital requirements).

17. In this context, ESMA notes that the definition of the relation should reflect the objective to provide a relief to a narrow type of eligible financial assets in order to address mismatch between the measurement of financial assets and insurance liabilities in the scope of IFRS 4. ESMA is of the view that such relationship should be based on an objectively verifiable economic relationship (but not restricted to a contractual link)[4] and

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[4] ESMA agrees with the reasoning in paragraph BC 36 of the ED for not restricting the application of the overlay approach to financial assets that are contractually linked to insurance contracts in the scope of IFRS 4.

should be limited to financial assets that are housed in the same legal entity as the insurance liabilities in order to avoid accounting arbitrage.

18. Finally, ESMA notes that the ED proposes that entities are permitted to change the designation of a financial asset only if there is a change in the relationship between the financial asset and the contracts within the scope of IFRS 4. ESMA agrees with this proposal as it addresses concerns related to possible earnings management. However, we suggest that the IASB explicitly states in the Basis for Conclusions that the entity is permitted to cease to apply the overlay approach to individual eligible financial assets only (i) when those financial assets are no longer eligible for the overlay approach or (ii) in situations when the entity, according to the proposed paragraph 35F of the ED, stops using the overlay approach to all qualifying assets.

*Presentation of the overlay adjustment*

19. ESMA points out that paragraphs 35A-35C of the ED are not clear about the presentation of the overlay adjustment. While paragraph 35A of the ED states that there should be a reclassification of the overlay adjustment from profit or loss to other comprehensive income, paragraph 35C of the ED[5] seems to allow several presentation options (i.e. either in the statement of profit or loss, other comprehensive income or both and thus detailed presentation on the face of the statement of profit or loss either according to IAS 39 or in accordance with IFRS 9).

20. ESMA notes that the presentation suggested in paragraph 35A is consistent with the objective of and the rationale for the overlay approach as articulated e.g., in the paragraph BC24 of the ED, where additional fair value re-measurements recognised in profit or loss in accordance with IFRS 9 (compared to those required by IAS 39) are reclassified to other comprehensive income. ESMA does not support the presentation implied in paragraph 35C of the ED as such unrestricted option in the presentation of financial statements decreases comparability of financial reporting, notably in circumstances when both overlay approach and temporary exemption from applying IFRS 9 are themselves optional.

21. Consequently, ESMA encourages the IASB to specify the presentation of the overlay adjustment on the face of the statement of profit or loss and require it to be based on the recognition and measurement principles of IFRS 9, to serve users of financial statements. Such approach aligns the presentation of the statement of profit or loss with the statement of financial position and facilitates cross-industry comparability.

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

22. In particular, ESMA is of the view that the presentation of the performance of the financial assets that are subject to the overlay approach in the profit or loss should be the same as that of other financial assets that are accounted for according to IFRS 9. Subsequently an entity applying the overlay approach should make an adjustment in profit or loss in order to eliminate the accounting mismatches caused by the application of IFRS 9 to eligible financial assets. ESMA also notes that such requirement would be aligned with the wording of paragraph 35A of the ED that states that there should be a reclassification of the overlay adjustment from profit or loss to other comprehensive income. In this respect, ESMA recommends the IASB to clarify this possible inconsistency in wording between paragraphs 35A and 35C of the ED.

<u>*Disclosures related to the overlay approach*</u>

23. ESMA believes that the overlay approach needs to contain sufficient disclosure requirements in order to ensure that all information relevant for the users of financial statements are provided in the notes to financial statements. In this context, ESMA would have expected more detailed disclosure requirements around the designation and monitoring of the relationship between financial assets and insurance liabilities in the scope of IFRS 4 than those proposed in paragraph 37D(b) of the ED.

24. We consider that as an entity is allowed to choose for each eligible financial asset whether to apply the overlay approach, the ED should require additional disclosures regarding this decision. In particular, ESMA suggests that the IASB requires disclosure on the judgments applied when choosing specific eligible financial assets for which the overlay approach is applied and excluding other eligible financial assets.

***Question 4 – The temporary exemption from applying IFRS 9***

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

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

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

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

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

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

*Assessment of eligibility for the temporary exemption*

25. As the only reason for providing the temporary exemption from applying IFRS 9 (and thus delaying the improvement in financial reporting requirements necessary after the 2007-2009 financial crisis) is the non-alignment between the effective dates of IFRS 9 and the new insurance contracts Standard, ESMA agrees that eligibility for the temporary exemption from applying IFRS 9 should be based on whether the entity's predominant activity is issuing contracts within the scope of IFRS 4. In our view this represents a simple and pragmatic criterion that should be used only for a short period of time.

26. ESMA is of the view that the eligibility for the temporary exemption from applying IFRS 9 should be based on an entity's predominant activity reflected in a defined quantitative threshold (such as one currently stated in the Basis for Conclusions). ESMA is of the view that the eligibility criteria must be clear and unambiguous so that it is clear in advance whether an entity meets those criteria or not and such assessment can be enforced.

27. ESMA notes that the activities of insurers are not limited to issuing insurance contracts in the scope of IFRS 4 as insurers also engage in activities that result in liabilities that, although not directly in the scope of IFRS 4, are closely related to insurance activities connected with issuing insurance contracts in the scope of IFRS 4. These liabilities can relate to bonuses and rebates on the life insurance contracts (amounts payable to the policyholder outside of the of IFRS 4), derivatives held as hedging instruments in qualifying hedging relationship (designed in accordance with IAS 39 requirements) related to insurance liabilities in the scope of IFRS 4, recognised deferred tax liabilities stemming from taxable temporary differences related to insurance contracts in scope of IFRS 4 or liabilities stemming from written put options over non-controlling interest for consolidated insurance funds. ESMA notes that these liabilities are not included in the IASB's proposed threshold when assessing predominance.

28. As all the above mentioned liabilities have a direct link to IFRS 4 liabilities, ESMA is of the view that they should not result in failure of the predominance test. Consequently, any predominance ratio should be able to capture all types of liabilities an insurer is expected to carry for its insurance activities linked to issuance of insurance contracts in the scope of IFRS 4.

29. Additionally, ESMA notes that insurers may have recognised liabilities from investment contracts that were voluntarily unbundled in accordance with paragraph 10(b) of IFRS 4 and that are currently accounted for at fair value through profit or loss. ESMA also notes that unit-linked investment contracts that are not considered insurance contracts under IFRS 4 are predominantly measured at fair value through profit or loss both under IAS 39 and IFRS 9 in order to mirror financial assets and financial liabilities. As, the existence of such contracts might prevent an otherwise predominant insurance entity from applying the temporary exemption, ESMA suggests that all investment contracts measured at fair value though profit or loss[6] should be taken into account when assessing predominance.

30. As ESMA believes that the predominance should be assessed on the basis of the liabilities in the scope of IFRS 4 and entities without significant liabilities in the scope of IFRS 4 should not benefit from this temporary exemption, we agree that the nominator of the test should include only the liabilities in the scope of IFRS 4. However, in order to cater for the liabilities related to insurance activities enumerated above,[7] we suggest that the denominator in the test contains adjusted total liabilities (i.e. amount calculated by deducting above mentioned amounts from the total liabilities).

31. When the predominant activities of an insurance entity are identified as described above, ESMA is of the view that the IASB could further calibrate the predominance ratio currently identified in paragraph BC 65 of the ED, in order to ensure that it captures the relevant activities related to issuance of insurance contracts in the scope of IFRS 4 and thus is consistent with the design of and rationale for the temporary exemption from applying IFRS 9. In our view such approach could help avoid situations that the temporary exemption is to be applied to entities other than those predominantly issuing insurance contracts in the scope of IFRS 4 and ensure that general liabilities (such as liabilities from post-employment benefits, income and other taxes or trade payables) do not lead to the entity failing the predominance test.

32. As a response to the proposals currently discussed in Europe, ESMA is aware of an alternative approach in which eligibility to the application of the temporary exemption could be based solely on the fact that the entity is a regulated insurance entity ('insurance regulation'). Some constituents have proposed this approach in order to allow the application of the deferral approach to financial conglomerates below the reporting entity level arguing that such an approach could ensure that IFRS 9 is applied to all parts of the financial conglomerates that do not engage in the insurance activities

[6] Measurement at fair value through profit or loss of both the investment contracts and assets that back these investment contracts is a necessary condition in order to be eligible to adjust the predominance test as it ensures that the accounting treatment both according to IAS 39 and IFRS 9 will be the same

[7] investment contracts that are measured at fair value through profit or loss (such as unit-linked investment contracts), derivative held as hedging instrument in qualifying hedging relationship related to insurance liabilities in the scope of IFRS 4, recognised deferred tax liabilities stemming from taxable temporary differences related to insurance contracts in the scope of IFRS 4, written put options over non-controlling interest for consolidated insurance funds that are classified as a liability and bonuses and rebates in the life insurance industry (amounts payable to the policyholder outside of the scope of IFRS 4).

(such as banking activities). In particular, they argue that this approach could ensure that the long-awaited expected loss model is fully applied for all banking activities and hence that the accounting for all financial assets related to banking activities is comparable.

33. ESMA is of the view that it would be beneficial that the IASB explains the Basis for Conclusions to IFRS 4 why it considers that the temporary exemption from applying IFRS 9 could not be based solely on insurance regulation. ESMA puts forward the following reasons:

(a) ESMA does not believe that an exemption, albeit temporary, should be tailored for a specific industry, but rather address the accounting for the same economic transactions engaged in by any entity. Indeed, ESMA has consistently argued against industry specific standards. Granting a temporary exemption from applying IFRS 9 on an industry basis (rather than applying to all entities facing the same accounting difficulties) could be seen as a precedent for development of industry-specific standards.

(b) The definition of an insurer according to insurance regulation does not match with an accounting definition of a liability that is in the scope of IFRS 4 (or the new insurance contracts Standard). That means that while some entities are considered to be insurers according to the insurance regulation they do not issue contracts in the scope of IFRS 4. On the other hand, some entities that issue contracts in the scope of IFRS 4 (e.g. some banks but also other financial companies) are not regulated as insurance companies, as their activities do not match the regulatory definition of insurance.

(c) As described in BC9 – BC21 of the ED, the IASB was asked to address difficulties caused by the different effective dates of IFRS 9 and the new insurance contracts Standard (in particular, additional accounting mismatches and additional incremental implementation costs). These issues relate to entities issuing insurance contracts in accordance with IFRS 4, not to other activities insurers defined by insurance regulation in individual jurisdictions might engage in. Consequently, ESMA agrees that the scope of the temporary exemption from applying IFRS 9 should be limited to entities whose predominant activity is issuing contracts within the scope of IFRS 4 as those entities that are most affected by the difference in the effective dates.

(d) The insurance regulation in many jurisdictions (e.g. in the European Union) does not limit the activities of the insurance companies to those that in accounting terms could be considered as related to issuing contracts in the scope of IFRS 4. Indeed, insurance companies might engage in activities that are indistinguishable from activities of banks or asset management companies (e.g. issuance of investment contracts without an insurance component, provide asset management and portfolio management services or engage in trading with derivatives that are not linked to the issuance contracts (such as credit default swaps) or do not qualify as hedging instruments for hedge accounting in accordance with IAS 39 etc). ESMA doubts whether the temporary exemption from applying IFRS 9 should apply to such activities that have no link to insurance contracts in the scope of IFRS 4. ESMA also notes that some insurance schemes and regulatory environments allow a certain level of interchangeability between the financial assets that back the liabilities from insurance contracts and financial assets that are used for asset and portfolio management, thus raising concerns about earnings management.

(e) Insurance regulation differs between jurisdictions which would limit comparability. While ESMA accepts that such approach could allow greater degree of comparability for financial assets related to banking activities, such approach would hamper cross-sector comparability that is important for investors who typically hold cross-industry portfolios.[8,9]

(f) Finally, the assessment of regulation can be made only on the legal entity level, rather than the reporting entity level.[10] If the assessment of the need for deferral is made below the reporting entity level, it brings about additional complexity (see paragraphs 38-40 of this letter for discussion of the eligibility below the reporting entity level). For example, there are cases where the financial assets that are related to insurance contracts in the scope of IFRS 4 are managed within the consolidated group by a legal entity that is not regulated as an insurer (such as ultimate holding company). In such cases, transactions between the regulated and unregulated legal entities could lead to accounting arbitrage that could not be addressed through prudential regulation (as that captures only the regulated part of the group).

34. While ESMA disagrees with an approach solely based on insurance regulation for the above-stated reasons, if such approach is nonetheless further pursued and developed by the IASB, ESMA is of the view that such approach should be conditional to the explicit approval of the relevant insurance supervisor. Such approval would be indispensable in order to maintain the integrity of financial reporting, as only the

[8] ESMA does not consider the issue of comparability for the insurance industry as (i) the optional nature of the overlay approach and the temporary exemption from IFRS 9 do decrease comparability for entities issuing insurance contracts in the scope of IFRS 4 and (ii) current requirements of IFRS 4 do not facilitate comparability within the insurance industry as they allow a choice of accounting policies for insurance liabilities ranging from those based on historical cost to those based on current value. Furthermore, as stated in footnote 2, users of financial information have highlighted that improvements in measurement of financial assets are beneficial for investors on a stand-alone basis.

[9] See e.g. CFA Institute response to EFRAG's Draft Endorsement Advice on IFRS 9, 3 July 2015, https://www.cfainstitute.org/Comment%20Letters/20150703.pdf; and CFA Institute letter to EFRAG Draft Letter to the European Commission on Adoption of IFRS 9, 20 November 2015 https://www.cfainstitute.org/Comment%20Letters/20151120.pdf)

[10] ESMA notes that application of the 'regulatory' criterion could extend to the insurance subgroup, when insurance regulation is applied on the consolidated basis. However, ESMA notes that the scope of consolidation according to prudential regulation (in order to exercise prudential supervision on consolidated basis) often differs from the scope of consolidation in accordance with IFRS. Consequently, as this difference would create additional complexity and confusion when the regulatory criterion is applied at the level of the subgroup, ESMA does not support this alternative.

regulatory approval would be able to limit the use of the temporary exemption to the intended purpose and scope. Such limitation would need to ensure that the exemption is used solely for difficulties raised by misalignment of effective dates of IFRS 9 and the new insurance contracts Standard and thus limited to entities with significant insurance liabilities in the scope of IFRS 4 (and the new insurance contracts Standard), rather than used as an excuse to delay implementation of IFRS 9 thus, inter alia, the expected loss model for financial assets held at amortised cost.

35. In that context, the IASB could further consider whether regulation could be considered as a supplementary criterion in assessing predominance (i.e. eligibility for application of the temporary exemption from applying IFRS 9 could be based on both quantitative threshold based on liabilities directly related to issuing insurance contracts within the scope of IFRS 4 and the fact that those insurance contracts are issued by legal entities that are subject to insurance supervision). However, such approach would limit the availability of the temporary exemption from applying IFRS 9 to a single industry, rather than capturing the activity of issuing insurance contracts in the scope of IFRS 4.

*Level of assessment of predominance*

36. ESMA agrees with the IASB's proposal to assess predominance at the reporting entity level. While ESMA acknowledges that the scope of this approach is narrow and will capture only certain insurers, ESMA agrees that this approach should place more weight on ensuring that the temporary exemption could not be applied by entities that have non-insurance activities than on ensuring that all insurance-related assets are included in the scope of the temporary exemption. ESMA also accepts that the IASB's proposals would mean that some minor banking activities of reporting entities predominantly issuing insurance contracts in the scope of IFRS 4 might continue to be accounted in accordance with IAS 39. While clearly not desirable from a conceptual or regulatory standpoint, this is in our view an inevitable consequence of the temporary exemption from applying IFRS 9 and the desire of the IASB to provide a pragmatic solution addressing the issue in the short time.

37. ESMA has preliminarily considered alternative proposals discussing different level for assessing predominance that were proposed by the insurance industry and are currently discussed in Europe: (i) assessment of eligibility below the reporting entity level and (ii) waterfall approach. ESMA notes that these alternative proposals were not fully developed in the same way as the assessment of eligibility at the reporting entity level by the IASB. ESMA regrets that the absence of full articulation of these proposals meant that they could not be fully compared with the IASB proposals when considering the ED.

38. ESMA acknowledges that the assessment of eligibility for the exemption from applying IFRS 9 below the reporting entity level might address some concerns associated with the IASB's proposals, notably in the financial conglomerates and ensure that financial assets related to insurance activities remain in the scope of IAS 39 but financial assets related to banking activities are accounted in accordance with IFRS 9. However, ESMA

considers that the eligibility for exemption from applying IFRS 9 should not be assessed below the reporting entity level for the following reasons:

(a) In the current low-interest rate environment, assessment of eligibility below the reporting entity level could trigger accounting and regulatory arbitrage between the banking and insurance sectors (e.g. by transferring riskier high-yielding financial assets within a reporting group into entities in the scope of the temporary exemption). This risk is particularly high within the financial conglomerates where there is a certain level of internal transfers and asset interchangeability between the banking and insurance part of the financial conglomerate. Consequently, ESMA agrees with the concerns of the users of financial statements about earnings management opportunities that would inevitably result from assessment of predominance below the reporting entity level as expressed in paragraph BC 57 of the ED.

(b) Such approach breaches the underlying concept of consistent application of accounting principles within the group[11] and thus decreases comparability in the reporting of transactions within and across reporting entities.

(c) ESMA highlights the need for cross-industry and cross-sector comparability that is important for investors who typically hold cross-industry portfolios.[12] While ESMA could accept the reduction of the comparability for pure insurers for a short period of time (e.g. considering the range of options for accounting for insurance liabilities under IFRS 4), the deferral of IFRS 9 below the reporting entity level would undermine the desirable cross-industry comparability in accounting for financial assets that is expected from adoption of IFRS 9 by entities other than pure insurers.

(d) Finally, from the alternative proposals it is not clear what should be the level of assessment of eligibility or the exemption from applying IFRS 9 below the reporting entity level – i.e. individual contracts, operating segments, reporting segments, legal entities or groups of legal entities. Each of these levels brings different trade-offs between relevance, reliability, faithful representation and comparability and is associated with a different set of costs and benefits.

39. However, ESMA considers that each of the solutions below the reporting entity level is inferior to the solution at the reporting entity level as either

[11] Application of uniform accounting policies in the consolidated financial statements is required also by IFRS 10 *Consolidated Financial Statements*.

[12] See e.g. CFA Institute response to EFRAG's Draft Endorsement Advice on IFRS 9, 3 July 2015, https://www.cfainstitute.org/Comment%20Letters/20150703.pdf; and CFA Institute letter to EFRAG Draft Letter to the European Commission on Adoption of IFRS 9, 20 November 2015 https://www.cfainstitute.org/Comment%20Letters/20151120.pdf)

(a) It does not ensure that all financial assets related to insurance activities remain in the scope of IAS 39 but all financial assets not related to insurance activities are accounted in the scope of IFRS 9 (e.g. legal entity assessment), or

(b) It is associated with unacceptable earnings management opportunities and reduces comparability (e.g. when based on segment reporting); or

(c) It is complex and costly to apply (e.g. based on individual assets related to insurance contracts in the scope of IFRS 4).

40. While some of these concerns can be addressed by additional guidance on (i) transfers that would need to require that all effects of internal transfers are eliminated on consolidation; (ii) presentation of financial statements that would need to require a presentation of primary financial statements that ensures sufficient level of transparency and comparability; and (iii) additional disclosure ensuring both relevance and transparency of the information in the financial statements, such additional guidance would be complex, difficult to understand and might delay finalisation of these amendments beyond the mandatory effective date of IFRS 9 (annual periods starting on or after January 1, 2018). In this context, ESMA strongly believes that it is of the utmost importance that the amendments to IFRS 4 do not create any uncertainties in the implementation process of IFRS 9 as ESMA believes that the application of IFRS 9 requirements should not be subject to any further delay.

41. ESMA also considered the waterfall approach, under which an entity would first assess its predominant activity at reporting entity level and

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

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

42. ESMA does not support the waterfall approach as it is complex, might further hinder understanding of financial reporting of insurance companies by users, would lead to a complete lack of comparability both within the insurance industry and within the broader financial sector and would not ensure that all financial assets related to insurance activities remain in the scope of IAS 39 but all financial assets not related to insurance activities are accounted in the scope of IFRS 9 (an identified shortcoming of the approach based on the assessment of predominance at the reporting entity level). Furthermore, such approach would also lead to different accounting standards being applied in the same set of financial statements for comparable transactions, raising further conceptual issues.

43. Consequently, ESMA is of the view that the assessment of predominance at the reporting entity level strikes the right balance between providing an exemption from applying IFRS 9 and the need to ensure cross-sector comparability and avoid industry specific standards.

44. However, while ESMA understand the costs of providing this information by entities taking benefit of the temporary exemption from applying IFRS 9, ESMA highlights the need for sufficient disclosures related to the use of the temporary exemption as it is paramount that the market is sufficiently informed about the effects of the temporary exemption and the use of the temporary exemption from IFRS 9 requirements (e.g., in terms of credit quality of the financial assets held by entities that issue insurance contracts). In this respect ESMA requests the IASB to further discuss with users of financial statements whether the disclosures proposed by these amendments are sufficient and whether a more comprehensive disclosure package is required in order to ensure comparability (including cross-sector comparability) notably for financial assets that are measured at amortised cost.

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

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

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

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

45. In light of the diversity of activities related to issuance of the insurance contracts in the scope of IFRS 4 and their pervasiveness in the overall business activities of insurance companies as well as different models for accounting for insurance contracts in the scope of IFRS 4 ESMA agrees that both approaches should be available on an optional basis. This also ensures that entities would not be prevented from adopting the improved financial reporting requirements brought by IFRS 9.

46. Furthermore, ESMA agrees that an entity should be required to stop applying the temporary exemption from applying IFRS 9 and the overlay approach when it applies the new insurance contracts Standard. Equally, entities should be permitted to stop applying both approaches before the application of the new insurance contracts

Standard as these amendments should not prevent timely application of the improved financial reporting requirements in IFRS 9.

***Question 6 – Expiry date for the temporary exemption from applying IFRS 9***

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

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

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

47. ESMA agrees that the temporary exemption from applying IFRS 9 should have an expiry date that should be no later than reporting periods beginning on or after 1 January 2021. However, ESMA notes the concerns expressed by the Alternative View of Mr. Finnegan and Mr. Mackintosh in paragraph AV7 that further delays in finalisation of the new insurance contracts Standard could result in the temporary exemption being in place longer than the three years proposed in the ED. ESMA notes that these concerns are given additional credence by the experience in application of IFRS 4 that was issued in 2004 as a temporary standard.

48. Consequently, ESMA urges the IASB to finalise the new insurance contracts Standard in a timely manner so that this deadline could be met and urges also the insurance industry to constructively engage with the IASB in order to facilitate meeting this objective. We understand that the IASB is working towards this outcome.

***Other comments:***

<u>Application of the temporary exemption from applying IFRS 9 for first time adopters of IFRS</u>

49. ESMA understands that the IASB did not extend the application of the overlay approach or the temporary exemption from applying IFRS 9 for first time adopters of IFRS. This is coherent with the objective of the proposed amendments, as first time adopters have to invest in new information systems and did not produce financial information in accordance with IAS 39 before.

50. Nevertheless, in some European jurisdictions insurers will become first time adopters of IFRS in their separate financial statements (previously prepared according to local GAAP) during the period of application of the temporary exemption. In these circumstances, the absence of the temporary exemption or the overlay approach could lead to additional costs and create an inconsistency between consolidated and separate IFRS financial statements. For these reasons we suggest the IASB to distinguish between a first-time adopter who has never prepared regular financial

information in accordance with IFRS and a first-time adopter who already provides IFRS information on a regular basis, e.g. as part of a reporting package for consolidation purposes but without preparing a complete set of IFRS financial statements. In ESMA's view the latter could be allowed to make use of the temporary exemption from applying IFRS 9 or the overlay approach if it becomes a first time adopter of IFRS in its separate financial statements during the period of application of the temporary exemption or the overlay approach. Nonetheless, ESMA suggests that in these circumstances the use of the temporary exemption from applying IFRS 9 or the overlay approach should be consistent between the consolidated and separate financial statements of the issuer.