Hans Hoogervorst
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH

9 February 2016

Dear Hans

Re: IASB ED/2015/11 Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts*

I am writing on behalf of the Financial Reporting Council (FRC) to comment on the Exposure Draft (ED) Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts.*

The FRC appreciates the IASB's work in addressing concerns raised by the insurance industry about the misalignment of the effective dates of IFRS 9 and the new insurance contracts standard. The FRC has previously raised concerns about the additional accounting mismatches in the profit or loss of insurance companies resulting from this misalignment and is encouraged to see that the proposals in the ED go some way in addressing these concerns.

We note that the ED proposes two optional solutions: the "overlay" approach and a temporary exemption from applying IFRS 9 for certain qualifying reporting entities (the "deferral" approach). It is clear that there is no perfect solution to address the issues arising from the misalignment of effective dates and we commend the IASB for the responsiveness it has shown thus far in proposing these solutions. However, we believe further amendments are required to ensure that the temporary exemption from the application of IFRS 9 is a pragmatic and effective solution. Our detailed views on these approaches are addressed in the Appendix to this letter.

Temporary exemption from application of IFRS 9

We note that the temporary exemption from application of IFRS 9 is the preferred approach of most reporting entities affected by the misalignment of the effective dates of IFRS 9 and the new insurance contracts standard. However, given the narrow scope of that solution, many are looking to amend the predominance criteria as outlined in the ED. Within the context of a temporary solution with a clear and fixed expiry date (the so-called sunset clause), we agree that such amendments are necessary.

We explain and justify our suggested amendments in more detail in our response to question 4. In summary, we consider the ED requirements – the application of the temporary exemption at the reporting entity level only, together with the eligibility condition – create too blunt an instrument to achieve the intended objective of the deferral approach. In our view, that objective is most clearly explained in the ED Appendix B, paragraph B9(a),

> "*to ensure that financial assets that do not relate to insurance activities are accounted for under IFRS 9 and to permit financial assets that relate to insurance activities to be accounted for under IAS 39."*

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Therefore, we recommend that the IASB amends the predominance assessment for the temporary exemption such that:

1. The predominant activity is primarily determined by reference to a liability ratio test as proposed. However, to ensure the test is effective some adjustments to the ratio are required. First, if an entity has issued investment contracts where both the liabilities and the linked assets are held at fair value through profit or loss then the liabilities should be deducted from both the numerator and the denominator of the ratio. We further advocate adding to the numerator other liabilities, for example derivatives, if they are directly linked to the insurance business.

2. Whilst the liability ratio should be the primary test for the application of the exemption its conclusion should be rebuttable, if there are clear contrary indicators providing strong evidence that the predominant activity is that of an insurer and vice versa. This could include indicators such as: whether the entity is regulated as an insurance entity, whether it is listed on an exchange as an insurance entity, and whether it discloses its business model as selling insurance products to its customers.

3. The application of the predominance criteria should be permitted at the reporting entity level or below at sub-group levels. Where the predominance test is applied below the reporting entity, the exemption would be available to all the financial instruments of the qualifying sub-group.

Our proposed amendment entails application of the temporary exemption below the reporting entity level, which was rejected in the ED due to the earnings management possibilities. However, we think application below reporting entity is acceptable as a pragmatic solution that will only be available for a rigid three year period. We would recommend addressing the earnings management possibilities by requiring that transfers are made at fair value with extra disclosures on these inter-group transfers. Additionally, any financial assets already measured using IFRS 9 would retain that measurement whilst ones moving from IAS 39 to the IFRS 9 environment would change measurement to IFRS 9.

We also believe that, entities taking advantage of either solution should be required to disclose:

- the rationale supporting the conclusion that they qualify for the temporary deferral or the basis for identifying assets subject to the overlay approach, as appropriate; and
- in advance of the general effective date of IFRS 9, i.e. 2018, their intention to take advantage of the solutions.

Sunset clause

We fully support the proposal that IFRS 9 be mandatory for all companies for years commencing on or after 1 January 2021. We would not support exemption from applying IFRS 9 for an undefined period and urge the IASB to be clear that there will be no subsequent extension of the deferral period.

From our outreach with investors, we understand that some of those who support a temporary exemption from IFRS 9 for insurance companies consider that two sets of accounting changes within three years would negatively impact their trend analysis of those companies. However, these same investors are of the view that two sets of changes over a longer period (four years or more) is unlikely to have an impact on the trend analysis. As such, they believe that a gap of four years or more between the implementation of IFRS 9 and the new insurance contracts standard would not merit an exemption for insurance companies from the application of IFRS 9 on its date of implementation.

At the same time, IASB should also permit early transition to the new insurance contracts standard to ensure that the inconsistencies in financial reporting by insurance companies is phased out as soon as possible. This will only be achievable if the IASB finalises the insurance contracts standard as soon as possible and then takes swift follow on action to set up the transition resource group to help with the implementation of the new insurance contracts standard.

If you would like to discuss any of the comments made in this letter please do not hesitate to contact Seema Jamil-O'Neill (s.jamiloneill@frc.org.uk) or me.

Yours sincerely

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Appendix – Responses to the ED questions for respondents

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 (paragraph BC17–BC18).

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

The proposals in this Exposure Draft are designed to address these concerns.

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

A1. The FRC agrees that the IASB should address the concerns about the different effective dates of IFRS 9 and the new insurance contracts standard. In particular, we think that the shortcomings of the existing IFRS requirements mean that for some insurance reporting entities there will be:

a. additional accounting mismatches and temporary volatility in the profit or loss account, arising from the implementation of IFRS 9 being applied before the new insurance contracts standard;
b. challenges in communicating these results to their investors and other users of the financial statements; and
c. additional costs from the implementation of two sets of accounting changes in a short time period.

A2. We also note that in our outreach with investors, a significant number request that the two standards are implemented by the insurance industry at the same time. Their main concern tends to be trying to understand the implications for company profitability of two sets of accounting changes in a short time period.

A3. We understand that some of those who support a temporary exemption from IFRS 9 for insurance companies consider that two sets of accounting changes within three years would negatively impact their trend analysis of those companies. However, these same investors are of the view that two sets of changes over a longer period (four years or more) is unlikely to have an impact on the trend analysis. As such, they believe that a gap of four years or more between the implementation of IFRS 9 and the new insurance contracts standard would not merit an exemption for insurance companies from the application of IFRS 9 on its date of implementation.

A4. However, other investors take the view that IFRS 9 is an improvement on the current financial reporting of financial instruments under IAS 39 which should be implemented across all industries on the effective date of 1 January 2018. They believe that the insurance industry should also implement IFRS 9 on that date and explain any accounting mismatches to the users of its financial statements.

A5. On balance, we think that it is right for the IASB to address the concerns raised by the insurance preparers so long as it is for a limited time period and any interim solutions will be phased out at the earliest opportunity.

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);
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> (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).
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> Do you agree that there should be both an overlay approach and a temporary exemption from applying IFRS 9? Why or why not?
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> If you consider that only one of the proposed amendments is needed, please explain which and why.

A6. The FRC agrees that both the overlay approach and the temporary exemption from applying IFRS 9 should be available.

A7. It is clear from our discussions with the insurance industry in the United Kingdom that no two insurance companies are the same. Significantly diversity exists in terms of the countries in which they operate, the types of insurance contracts they issue, and the way the individual groups are structured and diversified. From this we conclude that no single interim solution is likely to be deemed suitable by those insurance reporting entities affected by the misalignment of the effective dates of the two standards.

A8. Internationally, the composition of financial conglomerates and the nature of their operations varies significantly. For some, the overlay approach will allow them to isolate and separately present to investors some of the impact of adopting IFRS 9 in advance of changes to the measurement of their insurance liabilities. For others, the costs of implementing the overlay approach may be considered prohibitive.

A9. We are also aware of some financial conglomerates with significant insurance businesses that intend to fully implement IFRS 9 from its implementation date of 1 January 2018. These entities consider that the standard is an improvement on current accounting requirements for financial instruments and do not wish to defer its use. We believe that any solution put forward by the IASB to address the misalignment of implementation dates of the two standards should not prevent these entities from applying IFRS 9 to their insurance activities.

A10. As such, we believe that both solutions should be available only as options during the interim period proposed in the ED.

Question 3—The overlay approach

Paragraphs 35A–35F and BC32–BC53 describe the proposed overlay approach. (a) Paragraphs 35B and BC35–BC43 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 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? (c) Do you have any further comments on the overlay approach?

A11. The FRC agrees with the eligibility criteria for the overlay approach as described in paragraph 35B of the ED. From our outreach with constituents since the finalisation of IFRS 9, we understand that these assets are the only financial assets likely to create additional accounting mismatches in the profit or loss account as a result of the implementation of IFRS 9 before the new insurance contracts standard.

A12. In relation to the presentation proposals for the amounts reclassified from profit or loss to OCI under the overlay approach, we would not recommend that the IASB provide all the alternatives currently included in the ED. Our reading of the ED would lead us to believe that at least two alternatives are available to reporting entities applying the overlay approach:

a. Alternative A – profit or loss is first determined in accordance with IFRS 9 for eligible financial assets before an adjustment is made to eliminate additional accounting mismatches; and

b. Alternative B – profit or loss is first determined in accordance with IAS 39 for eligible financial assets and an adjustment is made to align it with IFRS 9.

A13. Given the overlay approach is an option, permitting a further option would reduce comparability. As entities are expected to apply IFRS 9 under this approach and only the profit or loss from a subset of qualifying assets will be affected, it is more relevant to require presentation in accordance with Alternative A. As such, we believe that Alternative A presentation would lead to more understandable information for the users of financial statements.

A14. We note that the ED presents the overlay approach as the preferred solution to the concerns arising from the misalignment of the implementation dates of IFRS 9 and the new insurance accounting standard. During our outreach a number of investors have also noted that the overlay approach would provide them with a good compromise – measurement of financial instruments on the basis of an improved accounting standard but with the volatility due to accounting mismatches separated out.

A15. However, we do not envisage a significant take up of this option. It is clear from our discussions with the insurance industry that many view it as costly to implement (parallel running two accounting standards would require tracking, assessment and governance systems over information on two bases during the interim period), and requiring a subsequent change to the accounting for the affected financial instruments. Others who may have been able to take advantage of the overlay approach, for example, some financial conglomerates with significant insurance subsidiaries, prefer to implement IFRS 9 fully to all financial assets held as they consider that standard an improvement on current accounting requirements for financial assets.

Question 4—The temporary exemption from applying IFRS 9

As described in paragraphs 20A and BC58–BC60 the Exposure Draft 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 Exposure Draft 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 (ie 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?

A16. The ED proposes an optional temporary exemption from applying IFRS 9 to those reporting entities whose predominant activity is to issue insurance contracts within the scope of IFRS 4, where predominance is determined by comparing the liabilities within the scope of IFRS 4 to the total liabilities of the group (the 'liability ratio test').

A17. We understand that the aim of these eligibility criteria is to target the exemption to 'pure' insurance companies. However, as a result a significant number of companies widely considered to be insurance companies would fail the eligibility criteria and thereby be barred from taking advantage of the deferral approach.

A18. We note that a temporary exemption from applying IFRS 9 is the preferred choice of most insurance companies in the UK. As such, there are many different proposals for how the predominance criteria should be widened to extend the scope of the deferral approach to more of these companies.

A19. Before explaining the amendments we believe should be made to the proposal, we stress that our position is predicated on the deferral being on a strictly temporary basis. It will be clear well in advance of 2021 whether or not the new insurance contracts standard will be in place, giving the insurance industry ample time to develop alternative solutions within the requirements of the current standard allied with use of the overlay approach. With a clear and rigid final date for the temporary deferral, the IASB should be willing to be more flexible in its application and scope.

A20. More pertinently, we believe the proposal should, as far as possible, meet the objective which should be that the deferral is available for assets that relate to insurance contracts only. This appears to be the objective considered by the IASB in paragraph B9(a) in Appendix B of the Exposure Draft.

Test to determine predominant activity

A21. The proposal fails to meet this objective because the test to determine the predominant activity does not fairly take account of the differences in accounting for some investment contract liabilities arising from insurance business.

a. Under IFRS 4, issuers may choose to account for these contracts as insurance liabilities if they are not recognised separately from the insured element. However, if these are bifurcated from the insurance contract, then such liabilities are accounted for as financial liabilities. This means that depending on the insurer's accounting policy election on implementing IFRS 4, it may or may not be permitted to include these in the predominance test even though they are clearly linked to the insurance business. We think these should be included in the numerator for the liability ratio test.

b. Similarly, liabilities backed by financial assets measured at fair value through profit or loss under IAS 39 (e.g. those arising from unit-linked business) are unlikely to change their measurement category after the introduction of IFRS 9. As such, these should not impact the predominance criteria. Therefore, both the numerator and denominator should exclude these liabilities.

c. The numerator should include certain liabilities that are directly linked to the insurance business, e.g. derivatives.

A22. The amended liability ratio test should be the primary indicator of whether the deferral is available. However, there may be cases where an entity fails the test but the short-term deferral is still justified; i.e. the presumption that the temporary exemption should or should not be available to an entity passing or failing the liability test should be rebuttable. In such cases, consideration should be given to other indicators such as: whether the entity is regulated as an insurance entity, whether it is listed on an exchange as an insurance entity, whether it defines its business model as selling insurance products to its customers.

A23. We also believe that entities taking advantage of either solution should be required to disclose:

- the rationale supporting the conclusion that they qualify for the temporary deferral or the basis for identifying assets subject to the overlay approach, as appropriate; and
- in advance of the general effective date of IFRS 9, i.e. 2018, their intention to take advantage of the solutions.

A24. The FRC also considers the temporary deferral should be available at below the reporting entity level as this will also ensure it better reflects business activities. We note the reasons given in paragraphs BC56 and BC57 for not permitting application at below the reporting entity level but consider permitting the use of the exemption where it is of benefit (for example, in cases where a major insurer is held by a financial conglomerate) is, on balance, justified. The stated concerns about earnings management are, in our view, overstated given the temporary nature and duration of the exemption and can be mitigated by requiring transactions to be measured at fair value with any gain or loss being separately presented. Furthermore, if an asset is transferred from a non-insurance component of a group to its insurance component we recommend that the asset continues to be measured in accordance with IFRS 9.

A25. We believe these suggested amendments will broaden the scope of the temporary exemption to insurance companies that are truly affected by the misalignment of the two accounting standards without extending it to other non-insurance businesses.

A26. However, we also note the following issues with applying the deferral approach below the reporting entity level:

a. application of two separate accounting standards in the same reporting group. For the interim period, an extra exemption from consistent accounting policies would be required, building on that currently within IFRS 4; and

b. additional disclosure requirements, including the basis and justification for taking the exemption and information on intra-group transfers. As noted above, we recommend that transfers should be made at fair value; any financial assets already measured using IFRS 9 would retain that measurement whilst ones moving from IAS 39 to the IFRS 9 environment would change measurement to IFRS 9.

Temporary measure

A27. We re-iterate that our support for the deferral and the amendments we propose is conditional on the fact that, taken together, they provide a pragmatic solution for a clearly defined short period. We would not support exemption from IFRS 9 for an undefined period and urge the IASB to be clear that there will be no subsequent extension of the deferral period.

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

> As explained in paragraphs BC78–BC81, the Exposure Draft proposes that both the overlay approach and the temporary exemption from applying IFRS 9 would 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?

A28. We agree that the overlay approach and the temporary exemption from applying IFRS 9 should be optional in nature. As mentioned elsewhere in our response, the diversity of insurance companies is such that no single measurement solution will address all their needs. We also think that those entities considering implementing IFRS 9 from 1 January 2018 should not be prevented from full implementation of that standard. Although we accept that this will result in some lack of comparability over the interim period, this could be allayed by way of the disclosure already required under IFRS.

A29. Once the new insurance contracts standard is applied, the rationale for the interim solutions, accounting mismatches arising from misalignment in the implementation date of that standard and IFRS 9, will no longer hold. As such, we agree that reporting entities applying the overlay approach or the temporary exemption from applying IFRS 9 should be allowed to stop applying those solutions from the beginning of any annual reporting period before the new insurance contracts standards is applied.

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.
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> Do you agree that the temporary exemption 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?

A30. The FRC agrees that the temporary exemption from applying IFRS 9 should have an expiry date aligned with the current expected effective date of the new insurance contracts standard, 1 January 2021. Given that the temporary exemption is an optional solution to address the misalignment of the effective dates of the two standards we think that it is correct for it to expire by 1 January 2021 or earlier on the implementation of the new insurance contracts standard.

A31. We also note that the IASB believes that the overlay approach could replace the temporary exemption in the event the new insurance contracts standard is not finalised in time. Given the concerns we have heard from industry representatives about the ongoing costs of that approach and the concerns about communicating the resulting reporting to investors, we think it unlikely that many reporting entities will make that transition.

A32. We would also encourage the IASB to specify that from 1 January 2021 IFRS 9 will be mandatory for all reporting entities. At the same time, IASB should also permit early transition to the new insurance contracts standard to ensure that the inconsistencies in financial reporting by insurance companies is phased out as soon as possible. This will only be achievable if the IASB finalises the insurance contracts standard as soon as possible and then takes swift follow on action to set up the transition resource group to help with the implementation of the new insurance contracts standard.

A33. On a purely European level, the Solvency II regulatory regime, which requires all financial assets to be reported at fair value was implemented on 1 January 2016. This should reduce some of the resource strain on European insurers and provide a valid reference point for valuation of financial assets when implementing the new accounting standards.