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The proposed solution to the de-coupling of IFRS 9 and IFRS 4 Phase II

Overlay Approach and Deferral Approach

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Agenda

- Summary of the ED
- Observations on the proposals, thus far…
- Next steps

Summary of the ED

The de-coupling problem

- IFRS 9 will be effective on 1 January 2018 while IFRS 4 Phase II will not be effective before 1 January 2020
- IFRS 9 new classification regime for financial assets is more rigorous than IAS 39. For debt instruments the measurement at FVTPL is dependent on whether or not the instrument has the following characteristics:

The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding

- This test (also known as the SPPI test) is expected to move to FVTPL a substantial portion of insurers' debt securities portfolios that today are accounted for under available for sale (AFS) or amortised cost (AC)
- It is worth remembering that IAS 39 will require embedded derivatives in AFS and AC assets to be measured at FVTPL if they are not closely related to the host contract.
- IFRS 9 replaces this requirement on embedded derivatives with the new classification regime

Summary of the ED

The de-coupling problem (cont.)

- In addition, IFRS 9 stipulates that an entity has the option to choose between FVTPL and FVTOCI for investments in equity instruments
- However, unlike the accounting for investments in equity instruments under IAS 39 using the AFS category, only dividends are recognised in profit or loss if the FVTOCI measurement is used
- IFRS 9 does not require the determination of an impairment loss on these investments in equity instruments measured at FVTOCI. At the same time it removes the recycling of gains and losses from OCI to profit or loss when an investment in an equity instrument is derecognised
- The IFRS 9 FVTOCI for equity instruments may not be attractive to an entity that uses them to fund cash flows from insurance contracts that have cash flows dependent on the value of those equity instruments
- The IASB recognises that the adoption of IFRS 9 will increase the number of investments in debt and equity securities that will be measured at FVTPL
- This will have consequences on insurers prior to the adoption of IFRS 4 Phase II

Summary of the ED

The de-coupling problem (cont.)

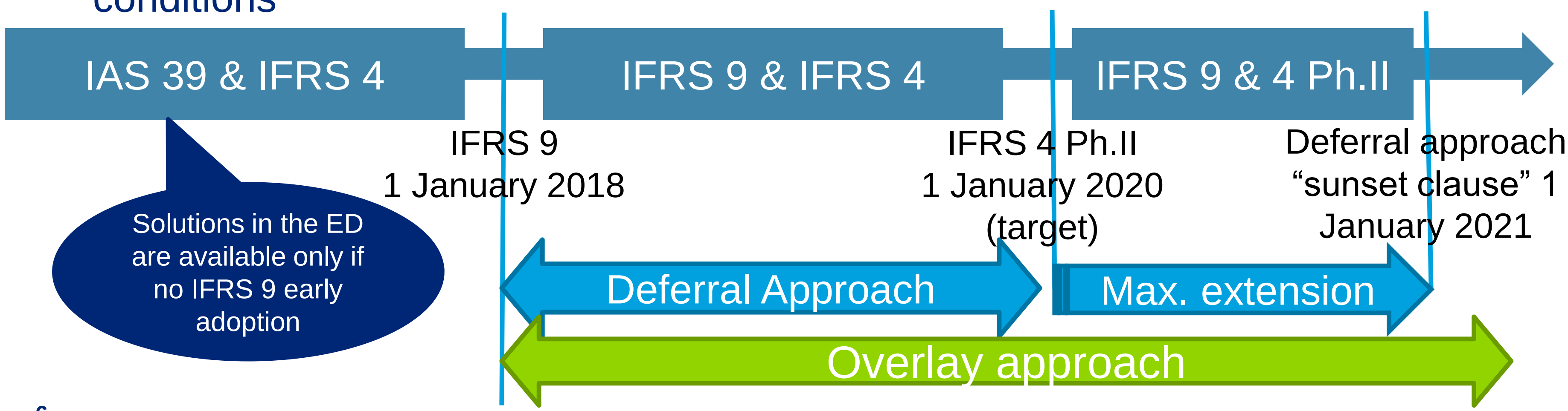
- A couple of scenarios illustrating these consequences are:

Illustrative scenario	Impact of IFRS 9	Expected solution from IFRS 4 Phase II
General insurer with undiscounted claims liabilities backed by financial assets at AFS	The portion of AFS assets that is reclassified to P&L will shift the accounting mismatch from OCI to P&L	All liabilities will have to be discounted at current market interest rates with the option to split the effect of discounting between a cost basis (P&L) and a current basis (OCI) on a portfolio-by-portfolio basis
Life insurer with fixed and guaranteed liabilities discounted at a locked-in discount rate backed by financial assets at AFS	The portion of AFS assets that is reclassified to P&L will create an accounting mismatch. Shadow accounting is not available	

Summary of the ED

The solution

- The ED proposes the combination of two optional approaches to resolve the issues from the decoupling:
  1. The deferral approach applicable from 1/1/2018 till financial periods beginning on 1/1/2021; or
  2. The overlay approach applicable from 1/1/2018
- Both approaches expire when the new IFRS for insurance contracts is mandatorily effective or early adopted by the entity
- These approaches are not mandatory and are subject to different sets of conditions



Summary of the ED

The overlay approach

- IFRS 9 applied by all entities, including insurers, from 1/1/2018
- Insurers would be permitted to include in profit or loss an amount that transfers to OCI the difference between amounts recognised under IFRS 9 and amounts that would have been recognised in P&L under IAS 39 for financial assets measured at FVPL under IFRS 9 that were not or would not have been measured at FVPL under IAS 39
- The objective of the adjustment is to remove from profit or loss any increased volatility in a transparent and consistent manner
- Conditions for the application of the overlay approach are that, at individual asset level:
  - there is a relationship between the asset and contracts within the scope of IFRS 4; and
  - the asset would not have been required to be at FVTPL under IAS 39
- The designation to generate the overlay approach amount is available for any asset meeting these conditions

Summary of the ED

The overlay approach (cont.)

- The adjustment produced by the overlay approach must be reported on one line in the statement of comprehensive income. That means either in the profit or loss or in the OCI or in both
- The effect on each line item must be disclosed on the face or in the notes
- New designation can be made after the overlay approach first application if the circumstances change and a relationship with IFRS 4 contracts arises
- De-designation is required if the relationship ceases
- On de-designation the accumulated OCI balance is recycled in profit or loss
- The decision to voluntarily stop the use of the overlay approach must be treated as a change in accounting policy under IAS 8 with restatement of comparatives
- Disclosures are required for all the new designations and de-designations made, the basis for designation, the calculation method for the overlay approach adjustment and the impact on each line item of the profit or loss statement

Summary of the ED

The deferral approach

- IFRS 9 is deferred to a later date for all financial instruments of the reporting entity
- The deferral expires at the earliest of the adoption of the IFRS 4 Phase II and 1/1/2021 (sunset clause)
- The approach is available under the condition that the reporting entity predominantly carries out insurance activities. The predominance condition is tested by measuring whether the proportion of the liabilities from contracts under the scope of IFRS 4 is in excess of 75% of the total liabilities reported by the entity
- The predominance condition is first tested on 1/1/2018 and reassessed annually if there are triggering events such as acquisitions or disposals. If the condition is lost the subsequent period becomes the first time adoption period for IFRS 9 (with or without the overlay approach adjustment)
- When the use of the deferral approach is lost due to the loss of the predominance condition it cannot be adopted for a second time if that condition is acquired again

Summary of the ED

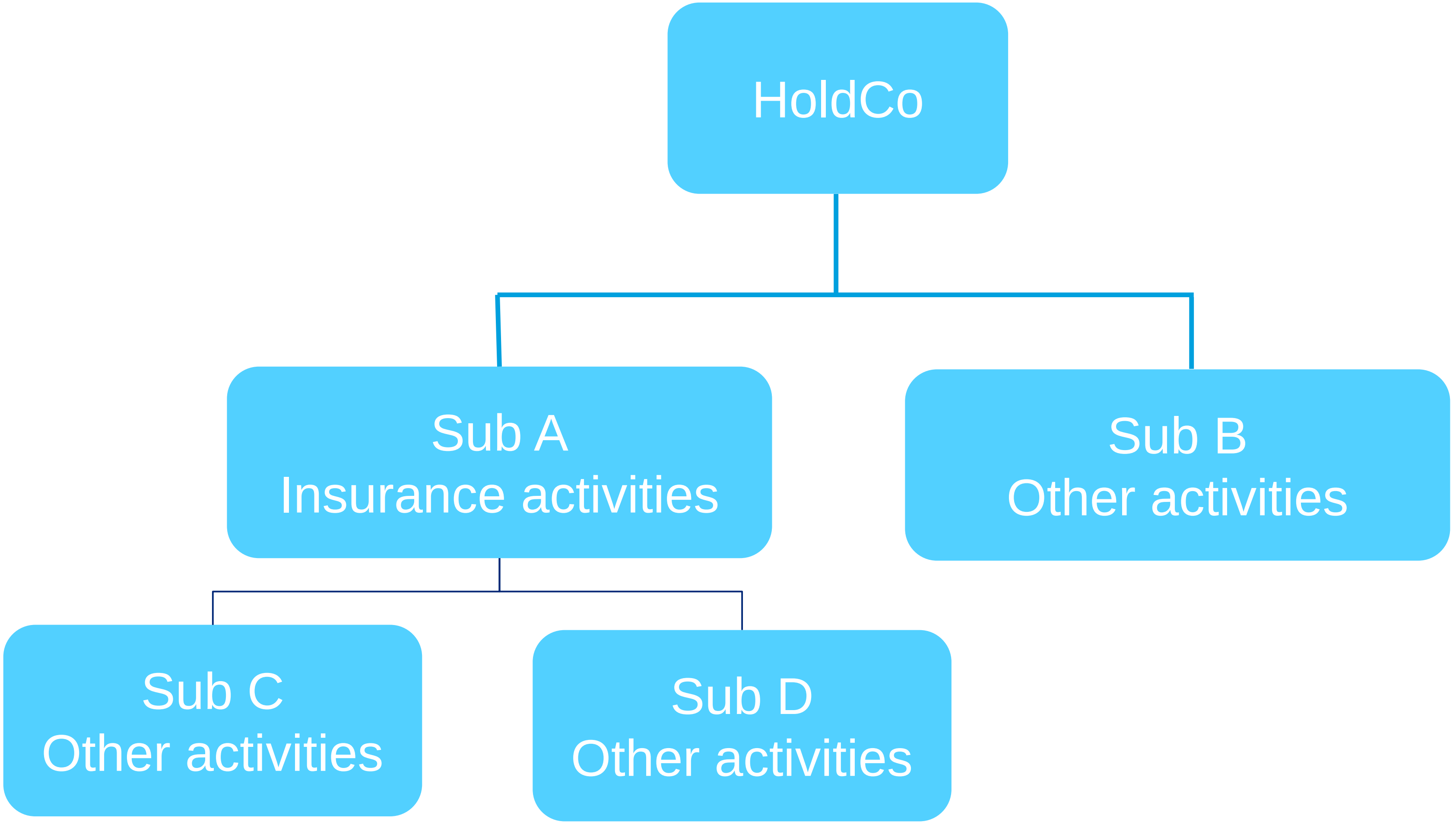
The deferral approach (cont.)

- The disclosure requirements for the deferral approach relate to the information the IASB deemed necessary to allow the appreciation that the adoption of IFRS 9 would produce
- The disclosure requirements call for certain activities necessary for the adoption of IFRS 9 to be completed to prepare these disclosures
- In particular the IFRS 9 classification of the financial assets must be completed
- For the assets that would have been reclassified to FVTPL under IFRS 9 the entity will disclose:
  - Their fair value at the reporting date
  - The changes in the fair value during the period
  - The credit risk exposure, including credit risk concentration, when these assets are not held for trading or managed on a fair value basis. This disclosure requires the gross carrying amount (i.e. before impairment provision) by credit risk rating grade

Summary of the ED

The deferral approach (cont.)

- The ED explains the approach for the deferral approach using this illustration



Observations on the proposals thus far

Alternative views from IASB members

- Mr Finnegan, Mr Mackintosh and Ms Tokar have voted against the ED because they “disagree with the proposal to provide entities whose predominant activity is issuing contracts within the scope of IFRS 4 *Insurance Contracts* with a temporary exemption from applying IFRS 9 *Financial Instruments*”
- They believe that the adoption of IFRS 9 should not be delayed any further given its importance
- The argue against the lack of comparability that the solution to the decoupling of effective dates will create
- They favour the overlay approach as the only reasonable solution to address the concerns from the insurance industry

Observations on the proposals thus far

Draft comment letter from the European Financial Reporting Advisory Group

- EFRAG has been active in the leading up to the publication of the ED owing to its work on the advice to the European Union institutions on the endorsement of IFRS 9 which EFRAG qualified on the grounds of the issues now addressed by the ED
- The draft letter highlights the deferral approach as the one that is able to "mitigate all the concerns of the misalignment of the effective dates of the two standards"
- However the overlay approach is accepted as a viable solution for certain conglomerates
- EFRAG draft letter suggests to improve the deferral approach by:
  - Making it available both at and below the reporting entity level; and
  - Avoid material banking activities being captured by the temporary exemption
- EFRAG draft comment letter supports the "sunset clause" of 1/1/2021

Next steps

A fast track approach to the amendment of IFRS 4 (Phase I)

- Comment period ends on 8 February 2016
- The IASB will conduct a number of outreach activities this month around the world to discuss live with constituents their perspectives on the ED
- The redeliberation process is scheduled to kick off at the IASB meeting in March
- The final amendment to IFRS 4 is targeted for publication before the end of the summer (September 2016)
- The IASB will continue to work on the finalisation of the IFRS 4 Phase II text in parallel with target publication of the new IFRS in December 2016
- The agenda for the IASB meeting in January includes discussion on insurance contracts (indirect participation contracts and potentially the unit of account)
- The ballot vote for IFRS 4 Phase II is likely to be held during the February 2016 IASB meeting

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