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De-coupling IFRS 9 / IFRS 4 Phase II resolved and another push towards completion of the IASB Insurance Contracts project

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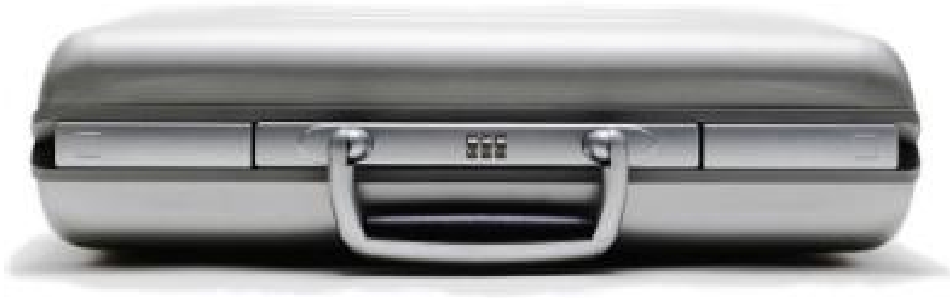

Agenda

- Highlights of the IASB meetings on 21, 23 and 24 September 2015
- Detailed analysis of the IASB Staff analysis, discussion and IASB decisions
- Next steps

Highlights

- After a rare situation with the **IASB vote ending in a tie** on Monday 21 September, **the IASB Chair used his casting vote on Wednesday 23 September** to approve an exposure draft that will seek views on whether the IASB should **defer for insurers the IFRS 9 effective date till IFRS 4 Phase II is mandatory**
- The narrow decision comes with a "sunset clause" and if the IASB does not complete IFRS 4 Phase II such that it would be effective on 1/1/2020, at the latest, the deferral will expire and IFRS 9 will be effective on 1/1/2021
- The alternative to this narrowly favoured deferral approach is the introduction of **an insurance liability adjustment to reverse the effects of IFRS 9 from P&L to OCI**. This approach was approved in July and it has now been defined as the **"Overlay Approach"**
- In the event IFRS 9 is effective at the same time as IFRS 4 Phase II the "Overlay Approach" will be available to insurers
- The IASB voted to ballot an ED with these two methods and its publication will be in the next 2-3 months

Highlights (cont.)

- The rest of the IASB meeting was dedicated to vote on several issues involving the interaction between assets and liabilities and their **presentation between P&L and OCI**.
- Insurance contracts **will always be measured using current market variables on the balance sheet**.
- The split between P&L and OCI of the changes in the liability will **follow the presentation of the discount rate**. This principle requires the **segregation of changes in assumptions due to market variables (P&L and OCI) and those from other variables (P&L and CSM)**.
- Entries in P&L and OCI **must reverse**.
- **No requirement will be imposed to calculate the P&L amounts** when the OCI solution is used. The **book yield approach is permitted** when underlying items exist to match insurance contracts' cash flows (e.g. unit-linked contracts)
- For contracts under the Variable Fee Approach the **changes in assumptions are segregated to take to P&L any portion that is covered by hedging instruments**

Different effective dates of IFRS 9 and the new insurance contracts Standard

IASB discussion - The Overlay Approach

- The Staff presented the refinements of the Overlay Approach since the decision reached in the July 2015 meeting of the IASB
- General agreement that designation of financial assets eligible for the Overlay Approach was the most practical solution.
- A Board member noted that it would be difficult to re-designate financial assets when there are both banking and insurance activities within the same legal entity.
- Another Board member expressed concern about the ability of entities to 'cherry pick' between which approach to apply on transition in order to manipulate which amounts are reported in profit or loss and which are reported in OCI.
- The staff confirmed that there will be discipline around re-designation and disclosure if management decide to discontinue the overlay approach, and entities will not be able to switch between applying IFRS 9 and reverting to applying IAS 39.

Different effective dates of IFRS 9 and the new insurance contracts Standard

Tentative decisions - The Overlay Approach

IASB members voted unanimously in favour of the staff recommendation across three of the five captions used to discuss the Overlay Approach

1. **Financial assets eligible for the overlay approach**
2. **Re-designation of financial assets**
3. **Transition**

Smaller majorities were scored for presentation and disclosure with 8 in favour of the proposal on **presentation** and 5 against and 9 against 4 on **disclosure**

Different effective dates of IFRS 9 and the new insurance contracts Standard

IASB discussion and tentative decisions - Deferral approach

- The IASB Staff proposed a series of decisions on how the Deferral Approach would be codified to give to the IASB the possibility to compare it with the Overlay Approach
- The first characteristic is that the entity must qualify because of the predominance of insurance contracts in its liabilities as at 1/1/2018. The IASB noted that there will not be a threshold but they will state that it is expected to be much higher than two thirds. When qualified the deferral applies to all assets.
- The second feature is that this qualification is temporary: if predominance is lost the requirements of IFRS 9 apply from the next financial period.
- Thirdly, the reporting entity approach means that qualifying subsidiaries in a bancassurance group may have to move to IFRS 9 when they submit their reporting packages because insurance liabilities are not predominant at consolidated level
- The option of a below the reporting entity level was rejected on complexity grounds

Different effective dates of IFRS 9 and the new insurance contracts Standard

IASB discussion and tentative decisions - Deferral approach (cont.)

- The Deferral Approach is optional
- A range of presentation and disclosure requirements would be introduced to ensure that the credit risk of those assets that would have failed the “cash flow characteristics” test in IFRS 9 is adequately covered. The IASB seems to have avoided introducing IFRS 9 via disclosure.
- Finally the Deferral Approach comes with a “sunset clause”:
  - IFRS 9 will be applicable and the Deferral Approach expired when IFRS 4 Phase II is effective;
  - If the effective date is later than 1/1/2020 the Deferral Approach expires and IFRS 9 is mandatory for all insurers from 1/1/2021
  - The IASB decided that in that event they would still allow insurers to use the Overlay Approach

Different effective dates of IFRS 9 and the new insurance contracts Standard

IASB discussion and tentative decisions - Deferral approach (cont.)

- The votes on the Deferral Approach can be summarised as follows:

Item voted	For	Against
Predominance criterion at reporting entity level	14	Nil
Predominance criterion based on liabilities total	13	1
No threshold but guidance to state substantially more than two thirds	13	1
Requirement to reassess predominance	13	1
Accounting for lost predominance	13	1
Prohibition to adopt IAS 39 after adopting IFRS 9	13	1
Presentation and disclosure requirements	13	1
Transition requirements	14	Nil

Different effective dates of IFRS 9 and the new insurance contracts Standard

IASB vote on choosing the Deferral Approach as the proposed solution

- Views expressed by IASB members were evenly divided on this issue.
- Some IASB members stated that they had changed their views since this issue was previously discussed.
- One member stated that such a deferral was not creating a precedent, but was dealing with a problem, that the package of disclosures enables users to make comparisons between entities, and that the proposal was therefore a reasonable and workable solution.
- Another member supported deferral at the entity level, as requiring systems to be put in place for the expected loss model when entities may subsequently move to a fair value model was unreasonable
- Concern expressed included the uncertainty regarding how long the deferral would be in place, the fact that the large insurers were so important in capital markets, lack of comparability, and the risk of the implementation of IFRS 9 being challenged more generally.

Different effective dates of IFRS 9 and the new insurance contracts Standard

IASB vote on choosing the Deferral Approach as the proposed solution (cont.)

- In response to a question the staff stated that the intention is to publish IFRS 4 Phase II by the end of 2016. One IASB member expressed pessimism about the likelihood of achieving such a timetable.
- The Chairman stated that a decision must be reached, as the IASB is under considerable time pressure to issue IFRS 4 Phase II. He stated that there was also strong pressure for the EC to make a ‘carve in’ to achieve a deferral of IFRS 9. He stated that he would be in favour of a clear time horizon to finish the IFRS 4 Phase II, so the IASB would get a lot of support to finalise it without re-exposure.

Tentative decision

- IASB members initially voted 7 in favour and 7 against the staff recommendation, with no abstentions.
- Following clarification of the voting rules the IASB reconvened on Wednesday 23 September and the Chairman used his casting vote in favour of proposing the Deferral Approach

Insurance contracts – Disaggregating changes arising from changes in market variables in OCI

Background

- In March 2014 the IASB tentatively decided that for contracts *without* participation features the entity may choose as its accounting policy to disaggregate changes in discount rate between profit or loss and OCI. If so:
  - the presentation of interest expense should be determined using the discount rate locked in at inception; and
  - Accordingly the difference between the insurance investment expense determined using a cost and a current measurement basis is presented in OCI

Insurance contracts – Disaggregating changes arising from changes in market variables in OCI

Objective of the various voting sessions

- The following issues are addressed for contracts with participation features on the disaggregation of changes in discount rates between profit or loss and OCI:

1. **the practical mechanics** (which would apply to all contracts under the general model and the variable fee approach);
2. whether different requirements (i.e. **current period book yield**) are needed for some specific contracts in which there are no economic mismatches between the contract and the items held by the entity;
3. whether such a disaggregation between profit or loss and OCI should be an **accounting policy choice**; and
4. **simplify transitional requirements** for the determination of the accumulated balance of OCI **when retrospective application is impracticable**.

Insurance contracts – Disaggregating changes arising from changes in market variables in OCI

Staff recommendation #1 – the mechanics of OCI

- For all contracts accounted for in the forthcoming Standard, that it should
  - specify that the objective of disaggregating changes arising from changes in market variables between profit or loss and OCI is to present an insurance investment expense in profit or loss using a cost measurement basis. Accordingly, the difference between an insurance investment expense using a cost measurement basis and current measurement basis is recognised in OCI and those amounts reverse;
  - not specify detailed mechanics for the determination of the insurance investment expense using a cost measurement basis; and
  - specify that the changes in estimates of the amounts of cash flows resulting from changes in market variables should be presented in OCI consistently with the changes in discount rates

Tentative decision

- All IASB members voted in favour except for the last item where 2 voted against

Insurance contracts – Disaggregating changes arising from changes in market variables in OCI

Staff recommendation #2 – the current period book yield approach

- The IASB approved to allow the “current period book yield” approach when there are no economic mismatches. This is when:

  1. the contract is a direct participation contract (i.e. the entity has an obligation to pay the policyholders the fair value of the underlying items and therefore, applies the variable fee approach); and

  2. the entity holds the underlying items, either by choice or because it is required to

Vote on the tentative decision

- Nine IASB members voted in favour with five against

Insurance contracts – Disaggregating changes arising from changes in market variables in OCI

Staff recommendation #2 – the current period book yield approach (cont.)

- If an entity is required to change between one approach and the current book yield approach (and vice versa), the entity shall:
  - *not* restate the opening accumulated OCI reserve;
  - maintain the release to P&L of the accumulated OCI reserve based on the assumptions that applied prior to the change of approach – effectively the prior method continues to apply to the balance in OCI that existed at the time of change
  - *not* restate prior year comparatives; and
  - disclose, in the period that the change of approach occurred:
    - an explanation of the reason for the change and the effect of the change on each financial statement line item affected; and
    - the value of the contracts that no longer qualified for the current period book yield but previously qualified (and vice versa)

Vote on the tentative decision

- This proposal was approved unanimously

Insurance contracts – Disaggregating changes arising from changes in market variables in OCI

Staff recommendation #3 – accounting policy choice

- The Staff recommendation was to adopt the same regime on accounting policy choice that had previously approved for non-participating contracts via the application to individual portfolios and with full restatement under the requirements of IAS 8

Tentative decision

- IASB members voted 13 in favour of and 1 against of the staff recommendation

Insurance contracts – Disaggregating changes arising from changes in market variables in OCI

Staff recommendation #4 – simplified transition under impracticability

- The Staff recommended to simplify the restatement of the accumulated OCI reserve at transition for participating contracts when impracticability existed. The simplification differentiates between the use of the book yield approach and the situation when it is not used:
  a) When the book yield approach is used the underlying items will be taken into account to create the accumulated OCI reserve (or the P&L reserve as the case may be under the accounting used for those items); and
  b) In all other cases of participating contracts the accumulated OCI reserve is set to zero

Tentative decision

- IASB members voted 13 in favour of and 1 against of the staff recommendation

Insurance contracts – Disaggregating changes arising from changes in market variables in OCI

Deloitte summary of where the IASB has landed

	Current period book yield	Effective yield or similar	Locked-in yield
Direct participation	Applicable	Applicable	Not applicable
Indirect participation	Not applicable	Applicable	Not applicable
No participation	Not applicable	Not applicable	Applicable

- With the new IASB decisions the mechanics that separate the effective yield and the locked-in approach are going to be based on application guidance
- The insurers will be required to exercise their judgment on situations when market variables affect only some of the cash flows and be guided by the objective that the approach must deliver a cost-based interest expense in the P&L whenever the OCI solution is elected as that insurer accounting policy choice

Accounting consequences of mitigating risks related to insurance contracts

Hedging activities for direct participating contracts

- An entity may have accounting mismatches between:
  - changes in the value of the guarantee embedded in a direct participating contract, adjust the CSM in accordance with the variable fee approach; and
  - the changes in fair value of a derivative that the entity holds to mitigate the risks resulting from this guarantee recognised in profit or loss.
- The staff recommended that hedging activities to protect the insurers' future profits against the cost of guarantees that fluctuations in financial variables could create represent a valid risk management strategy and the accounting mismatch should be addressed
- The staff confirmed that, based on outreach, insurers could separate and measure guarantees which would be taken to P&L rather than CSM, and noted that this approach would be optional.
- Two Board members felt that nothing should be done, but another member considered that a realistic measure of performance needed to be achieved. This last position was echoed by many other IASB members

Accounting consequences of mitigating risks related to insurance contracts

Hedging activities for direct participating contracts

- The staff recommendation also contained criteria that an insurer must meet to qualify for this kind of hedge accounting treatment:
  1. The hedging activity must be consistent with the insurer's risk management strategy;
  2. There should be an economic offset between the embedded guarantee and the derivative. This is not assessed via accounting measurement differences; and
  3. Credit risk does not dominate the economic offset

- Conditions to retain this accounting treatment are:
  1. Documentation of the hedging activity before the accounting starts; and
  2. Discontinue the accounting when the economic offset does not exist anymore

Tentative decision

- All of the 13 IASB members present favoured the staff recommendation.

Insurance Contracts

Project updates between IASB and FASB

Joint meeting between the IASB and the FASB

- A joint meeting was held on 23 September where the IASB and the FASB updated each other on the progress of their respective insurance contracts projects
- The matters discussed during this meeting were entirely educational and they are not addressed in this webcast.

The next steps

Remaining technical decisions and publication date

- The IASB is expected to consider the remaining technical issues during the next three meetings scheduled for 2015. In particular, the following will be considered:
  - the indirect participating contracts;
  - the differences between the IASB's general model and the variable fee approach; and
  - the presentation and disclosure requirements.
- The ED on the de-coupling of IFRS 9 will be published in late 2015. The comment period (which will be less than the 120 days needed for a new Standard) will be decided during the October IASB meeting
- The new Standard on insurance contracts is expected to be published in 2016
- Its mandatory effective date will not be considered until after the IASB has concluded its deliberations.

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