IFRS 17 and IFRS 9
Bridging the Gap

The International Accounting Standards Board (IASB) has finally ended deliberations on the new Insurance Contracts Project and released the Standard in May 2017 as the International Financial Reporting Standards (IFRS) 17.

This new Insurance Standard, focusing on insurance liability reporting, will have far-reaching consequences for an insurer in terms of modelling, data, processes and systems; ultimately resulting in a fundamentally different statement of comprehensive income and more onerous disclosure requirements.

However, as insurers contemplate the expected impact of this new Insurance Standard, they need to be aware of the interrelationship with the Financial Instruments Standard – IFRS 9 – which impacts the valuation of insurers' assets for accounting purposes.

The synergy between IFRS 17 and IFRS 9 needs to be considered in terms of:
- the changes required by the two Standards; and
- the complications arising from having two separate effective dates that may be several years apart.

Hence, insurers would be ill-advised to start an IFRS 17 implementation project without a detailed assessment of the impact of IFRS 9 at the same time.

Insurance Earnings are a Consequence of both Liability and Asset Movement

With IFRS 17 making significant changes to the valuation of liabilities of insurers, IFRS 9 has made changes to the valuation and income recognition of assets. The effect of IFRS 9 can be split into three categories, namely:

1. Classification and measurement (C&M)
2. Impairment
3. Hedge accounting

The impact on insurers differ, depending on the products sold and assets held to back the liabilities of these products.

Classification and Measurement

Although the C&M requirements and conclusions under IFRS 9 may not be significantly different from those under the current Financial Instrument Standard (IAS 39), the process of reaching these conclusions, information required and prescribed method of reporting are quite different.

The C&M categories have been redefined in IFRS 9 and consideration is being given to whether the entity's business model is evaluated as one held to collect contractual cash flows, one where the intention is to hold to collect and sell or one where the intention is just sales. This assessment, combined with the assessment of the contractual cash flow characteristics, will impact the measurement option available to insurers. IFRS 9 introduces a situation where by satisfying both criteria, insurers can use the measurement options of amortised cost or fair value through other comprehensive income (FVOCI).

The introduction of the FVOCI category to IFRS 9 was seen as a positive development and represented a significant improvement to the standard, in combination with the use of FVOCI in IFRS 17, for insurance companies. The FVOCI measurement category is a critical element of accounting for financial instruments by insurance companies as it will facilitate improved performance reporting for certain business models by removing volatility in profit and loss (P&L), particularly where insurers hold debt instruments.

However, while insurers do use simple debt instruments in order to match their liabilities, their asset strategy is often more complex, involving the use of derivatives, for example, in order to diversify credit exposure and manage interest-rate risk. IFRS 9 adds a layer of complexity by looking at the business purpose of the investment for each of the product types. With the contractual cash-flow test and business model assessment being introduced to reach the amortised cost classification, the possible difficulty in satisfying the criteria for complex instruments is likely to result in more financial instruments being classified in the residual category of Fair Value through Profit and Loss (FVTPL) than under IAS 39.

IFRS 17 allows an election for the effect of changes in discount rate to be recognised through P&L or through OCI. Because of this, insurers must be cognisant of how their balance sheet management strategies, and the accounting treatment under IFRS 9 of the asset used for these strategies, will impact the presentation of their statement of comprehensive income. Choices will impact the volatility of their income statements and net asset positions.

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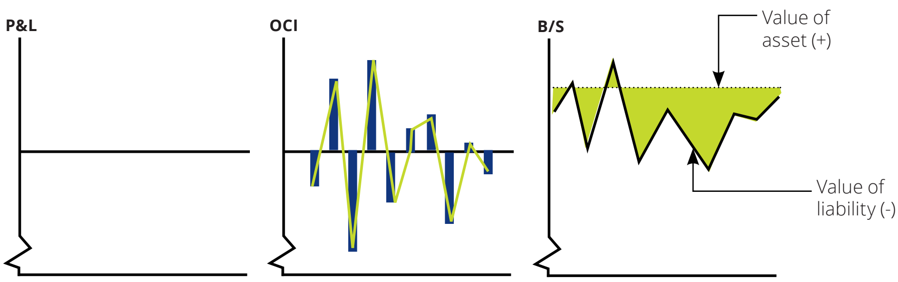
The following diagrams show the impact of the different treatment of changes in assets and liabilities resulting from interest rate movements on the P&L, OCI and Balance Sheet of Insurers.

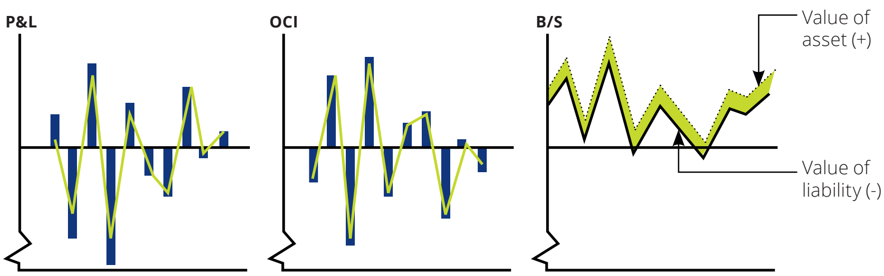
1 Amortised cost (assets) /OCI option (liabilities)

- Value of liability changes as a result of impact of changes in interest rate on the discount rate (change goes through OCI)
- Account value of asset not affected by interest rate movements (although impacted by amortisation/impairment)



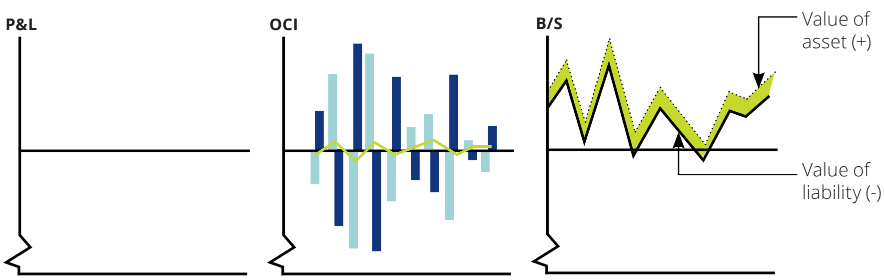
2 Fair value through P&L (assets)/ OCI option (liabilities)

- Change in value of asssets (as a result of changing interest rates) to P&l
- Change in the value of liabilities (discount rate) to OCI
- Impacts largely offset in balance sheet, but mismatch in P&L and OCI



3 Fair value through OCI (assets)/OCI option (liabilities)

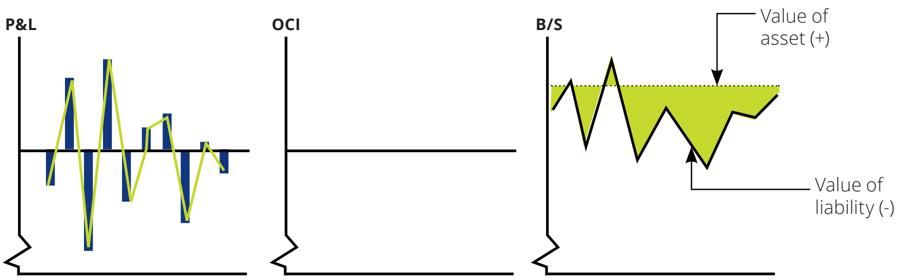
- Change in value of asssets (as a result of changing interest rates) to OCI
- Change in the value of liabilities (discount rate) to OCI
- Impacts largely offset in balance sheet and OCI, minimal mismatch



Technical Requirements

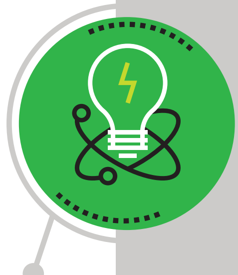
4 Amortised cost (assets)/P&L option (liabilities)

- Value of liability changes as a result of impact of changes in the interest rate on the discount rate (change goes through P&L)
- Accounting value of asset not affected by interest rate movements (although impacted by amortision/impairment)

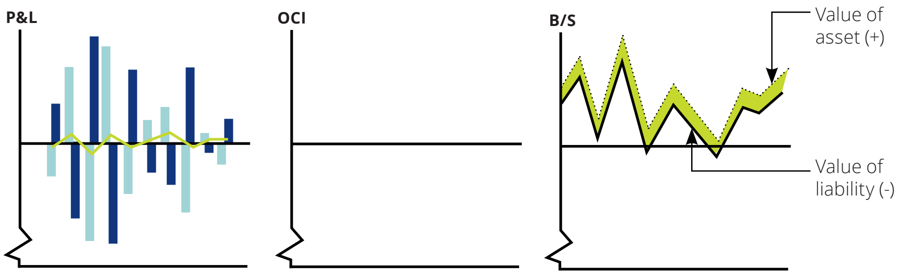


5 Fair value through P&L (assets)/ P&L option (liabilities)

- Change in value of assets (as a result of changing interest rates) to P&L
- Change in the value of liabilities (discount rate) to P&L
- Impacts largely offset in P&L and balance sheet, minimal mismatch

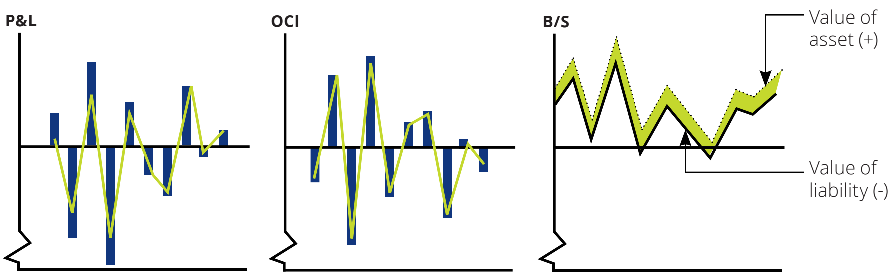


Tools and Solutions



6 Fair value through OCI (assets)/P&L option (liabilities)

- Change in value of assets (as a result of changing interest rates) to OCI
- Change in the value of liabilities (discount rate) to P&L
- Impacts largely offset in balance sheet, but mismatch in P&L and OCI



Impairment

If assets are recognised at amortised cost, there is a need to understand the new requirements because the revised impairment calculations are complex and require forward-looking information that might not currently be readily available. Most companies' existing systems will be unable to track the necessary information while their general ledgers are unlikely to be set up to produce this information on an appropriately granular level. As there is also a large amount of management estimation involved, service organisations like investment custodians won't be able to assist with the type of data involved. There are also similar data requirements under IFRS 17, and combining projects that review and change accounting systems for both IFRS 9 and IFRS 17 must be considered.

Hedge Accounting

Fortunately, the one area of IFRS 9 that is not expected to significantly impact insurers is the hedging aspect, provided insurers consider the new requirements for their existing and new economic hedging programmes. The macro-hedging proposals (which are yet to be finalised) might be of more interest to insurers. The IASB has retained the existing macro hedge accounting requirements applicable under the previous standard so adopters of IFRS 9 may, as an accounting policy choice, continue to apply the macro fair value hedge accounting model for interest rate risk as stated in IAS 39.

Different Implementation Dates

The effective dates of IFRS 9 and IFRS 17 were planned to be the same. However, prior delays in the finalisation of IFRS 17 have meant that this would not have been possible. As the Standard was being drafted, the IASB committed to provide approximately three years to adopt the new Standard after its publication. They have kept this commitment and there will be a three year gap between the effective dates of IFRS 9 (1 January 2018) and IFRS 17 (1 January 2021)

Several insurance companies raised this issue with the IASB, citing key concerns:

- Explaining the impact of IFRS 9 on performance prior to the adoption of the new measurement requirements for insurance liabilities could prove challenging for some insurers
- Temporary increases in accounting mismatches and other sources of volatility in profit and loss
- Confusion for users of financial statements
- More cost and effort for both preparers and users of financial statements in adopting two major standards at different time periods

In December 2015, an exposure draft for an amendment to IFRS 9 was issued in which the IASB proposed to introduce two options to manage the different effective dates:

1. **The overlay approach:** which would permit entities that issue contracts within the scope of IFRS 17 to reclassify, from P&L to OCI, some of the income or expenses arising from designated financial assets.
2. **Temporary exemption (deferral approach):** This temporary exemption is targeted at entities that are most affected by the different effective dates because their activities are predominantly connected with insurance and they have not applied IFRS 9 previously. Insurers wanting to elect this option must pass what is being referred to as the "predominance test".

The predominance test is focused around the proportion of insurance liabilities in proportion to the entity's total liabilities. Liabilities connected with insurance comprise liabilities arising from contracts within the scope of IFRS 17, non-derivative investment contract liabilities measured at FVTPL under IAS 39 and liabilities that arise because the insurer issues or fulfils obligations arising from the liabilities listed previously.

Each approach has its own potential shortcomings.

- The overlay approach results in additional administrative effort. It requires that insurers perform a parallel run of IFRS 9 and IAS 39 during the period between the effective dates to identify the financial instruments which meet the criteria and the amount that will be shifted from P&L to OCI.
- Some opponents to the temporary exemption argued that allowing insurers to defer implementation of IFRS 9 may lead to both the asset and the liability sides of the balance sheet being accounted for under diverse and arbitrary accounting policies as insurers would be able to choose which standard to apply – IAS 39 or IFRS 9.

Importantly, the deferral approach introduces challenges for group entities. If an entity in a group structure meets the hurdles for deferral and elects the exemption and another entity in the same group is not able to defer, the consolidation of these entities will become more complex and intricate.

The deferral approach also has onerous disclosure requirements, including the separate disclosure of the fair value at the end of the reporting period and the fair value change during the reporting period for:

1. The financial assets with contractual cash flows that are not solely payments of principal and interest ("SPPI")
2. All other financial assets i.e.: those assets with contractual cash flows that are SPPI

Therefore, an entity would need to ensure that the SPPI test, as required by IFRS 9, is still performed to comply with this disclosure requirement. Combined with the numerous other disclosure requirements, it might diminish the attractiveness of the deferral approach.

How can insurers get ahead and start maximising these interrelationships?

Asset-Liability Management (ALM) Considerations

When considering IFRS 9, it is important to understand the asset-liability management of insurance companies which is centred on ALM where liabilities, guarantees and related assets (including derivatives) are managed together. The accounting practices should reflect this strategy. Accounting treatments that deal with components in isolation will result in different measurement and presentation requirements and will not adequately reflect insurance business and the related performance in earnings.

The aim is to reflect changes in insurance liabilities and the associated backing assets in the same place, either in P&L or in OCI. If the related changes are reported in different places, performance reporting does not provide useful information. Both the asset and liability sides of the business must be understood. Actuaries must be aware of FVTPL and how various financial assets are accounted for because it might change the way, for example, impairments are considered in their models.

Impact Assessments

In the lead up to IFRS 9, many financial institutions used impact assessments to gauge the effect of the standard on their systems, target operating models and financial statements. Impact assessments could be effective in determining the high-level implications of applying the new C&M requirements for insurers. This includes assessing the proportion of debt instruments that could fail the SPPI test as well as the business model requirements. Consideration is also given to the insurer's ability to use different C&M categories and the application of insurance accounting options. If mismatches remain, changes to the investment strategy and mix might need to be considered.

Choices that need to be made

For all assets not valued using FVTPL, the criteria for the key judgements required need to be developed to allow for potential impairments. An assessment of whether the operational simplifications for "low credit risk" assets can be used, or whether there is a requirement to collect and store credit data not currently used, must occur. Finally, the need to build models to determine both 12-month and lifetime expected credit losses and monitor the development of changes in the credit quality, is required.

For hedge accounting, insurers who currently use hedge accounting under IAS39 can elect to stay with the standard until the macro hedging project is finalised. However, they could benefit from the IFRS 9 hedging changes, such as the relaxation of the 80%–125% test and hedging with options.

Lastly, with regard to the options around the implementation date of IFRS 9, if the overlay approach is adopted, an insurance entity would have to calculate its insurance liabilities by considering the impact of both an IAS 39 measurement and an IFRS 9 measurement. The deferral of IFRS 9 would likely require significant disclosures. This implies that, regardless of which solution is chosen by the insurer, the operational requirements will still be significant as they will have to prepare both IFRS 9 and IAS 39 numbers as from the 2018 financial year. Insurers should therefore expedite preparations to implement the new standard.

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