# IFRS 9 for insurers

April 2020

# IFRS 9 for insurers

**The IASB has agreed to another one year delay extending the effective date of IFRS 17 and the IFRS 9 temporary exemption to 1 January 2023 for qualifying insurers, subject to the IASB's due process. The IASB acknowledged the benefits of not requiring companies to make two major accounting changes in a short period of time. Insurers should take this opportunity to update plans and align the implementation of IFRS 9 with IFRS 17 to understand the linkages between and the impact on assets and liabilities, and ensure efficiency in implementing common elements such as Chart of Accounts and pro-forma disclosures at the same time.**

**Specific areas of focus:**

| | |
|---|---|
| Classification and measurement ('C&M') of financial assets – changes to IAS 39 categories with new tests/criteria to be met (see page 3 for decision tree). 1 | New impairment model based on expected credit losses rather than incurred losses. 2 |
| New hedge accounting criteria, expected to be of limited interest to insurers. 3 | New presentation and disclosure requirements. 4 |

## Background

- **IFRS 9 Financial Instruments** replaced IAS 39 with effect from 1 January 2018, although insurers meeting specific criteria are eligible to defer its application until 1 January 2023 (based on the agreement by the IASB board in March 2020).
- For insurers, the proposed deferral aligns implementation of IFRS 17 and IFRS 9. This highlights how important it is that insurers consider IFRS 9 alongside IFRS 17.
- IFRS 9 introduces new requirements for classification and measurement, and impairment, of financial instruments.
- Hedge accounting under IFRS 9 is not yet mandatory, with entities having the option to continue using IAS 39 hedge accounting.
- Insurers that take the option to defer the application of IFRS 9 are required to disclose specific information relating to the deferral in their financial statements from 2018 onwards.
- IFRS 9 and IFRS 17 will require extra data and are expected to tighten reporting timetables. Aligning IFRS 9 and IFRS 17 implementation can provide an important foundation for modernising the finance function, enabling insurers to proactively address these challenges.
- The potential benefits of modernisation include faster year-end close, real-time performance data and deeper insights into commercial threats and opportunities. One of the key benefits of the extra year to prepare is the ability to bring the twin accounting challenges together and move forward on one front.
- Now is the time to ensure that the operational, financial reporting and cost implications of IFRS 9 are understood and plans are in place to deliver an effective IFRS 9 solution that works in conjunction with IFRS 17.

## Who does it affect and how?

The C&M requirements are likely to result in more financial instruments being held at fair value through profit and loss ('FVTPL') than under IAS 39:

- Insurers who currently hold amortised cost assets or make significant use of the Available for Sale category ('AFS') under IAS 39 are likely to see the biggest impact.
- Debt instruments with contractual cash flows that do not represent Solely Payments of Principal and Interest ('SPPI') will be measured at FVTPL. This includes holdings of units in mutual funds. Most equity investments are also expected measured FVTPL though an entity can elect FVOCI (unless held for trading).
- For many insurers, C&M requirements could cause accounting mismatches, with resulting volatility in profit and loss when applied in conjunction with IFRS 17. There may be tax impacts too. Insurers can opt to measure financial assets at FVTPL to reduce such mismatches.

Deferral disclosures impact every insurer that has elected to defer IFRS 9:

- Biggest impact on those that currently hold AFS or amortised cost assets as they will need to do SPPI and business model testing to produce the disclosures.

The new impairment model is expected to result in the earlier recognition of credit losses:

- Insurers who hold debt instruments that will be measured at amortised cost or fair value through other comprehensive income ('FVOCI') will see the biggest impact, particularly on transition.

IFRS 9's new hedge accounting requirements are optional until the IASB's macro hedging project is completed:

- Insurers who use economic hedging programmes should consider whether to adopt IFRS 9's hedge accounting requirements now or wait until they become mandatory.

# IFRS 9 classification and measurement

## What should insurers be doing now?

### Classification and measurement – Requirements

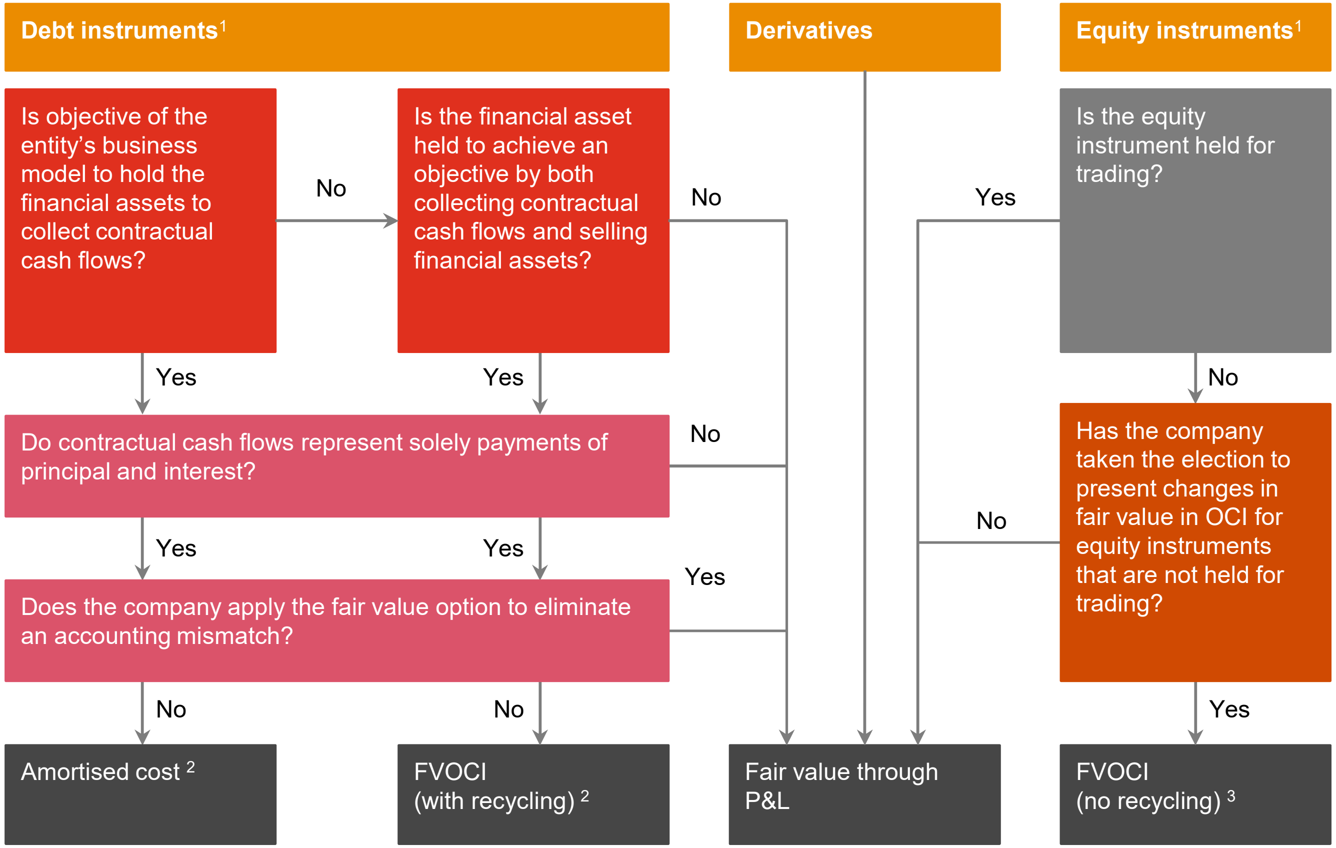
- Classification and measurement determines the way financial instruments are measured on the balance sheet and where gains and losses are reported (profit and loss vs OCI).
- It is expected that insurers will aim to minimise accounting mismatches between financial assets measured using IFRS 9, and insurance liabilities, measured using IFRS 17.
- The measurement bases for financial assets in IFRS 9 are:
  - Amortised cost.
  - Fair value through other comprehensive income (‘FVOCI’).
  - Fair value through profit or loss (‘FVTPL’).
- Debt instruments can be measured on any of the three bases, depending on the business model the instrument is held in and whether the contractual cash flows are Solely Payments of Principal and Interest (‘SPPI’).
- The classification and measurement decision process (see page 3) must be applied for all financial assets held on 1 January 2023 and all new financial assets acquired/originated subsequently.
- There is an option to:
  - Measure financial instruments at FVTPL if measurement at amortised cost or FVOCI would either create or increase an accounting mismatch.
  - Measure equities at FVOCI (unless held for trading purposes, in which case they must be measured at FVTPL) but there is no recycling of realised gains or losses to profit or loss when sold. Investments in funds are generally not equities and are therefore not eligible for this option.
- IFRS 9 also applies to insurers’ financial liabilities, including:
  - Investment contracts without discretionary participation features
  - Distinct investment components separated from insurance contracts under IFRS 17.
  - Financial guarantee contracts (if this is the chosen accounting policy)
- Financial liabilities can be measured at amortised cost or FVTPL; the FVOCI option does not apply to liabilities.
- It is expected that many insurers will measure investment contract liabilities at FVTPL.
- The impact on fair value of changes in the credit risk of financial liabilities measured at FVTPL is recognised in OCI rather than profit or loss, unless doing so either creates or increases an accounting mismatch between assets and liabilities.

### Classification and measurement – Next steps

Perform an impact assessment to determine the high level implications of applying the new C&M requirements, including potential accounting mismatches and resulting volatility:

- Assess the financial reporting and operational impacts of IFRS 17 and IFRS 9 measurement choices (e.g. use of OCI).
- Assess which debt instruments held may fail the SPPI test. For example, a ‘vanilla’ government or corporate bond with a fixed duration and interest rate will have little risk of SPPI failure whereas a holding in a mutual fund will likely fail SPPI.
- Business model requirements drive classification of SPPI debt investments – review business model criteria in IFRS 9 and consider how to apply to existing investment portfolios. For example, it may be necessary to consider management information used to measure and evaluate performance and the nature of management compensation arrangements in place.
- Assess equity instruments currently classified as AFS and whether to measure at FVTPL or FVOCI.
- Assess implications of the above on asset/liability matching and profit and loss volatility in light of insurance contract accounting under IFRS 17:
  - Consider in combination the option under IFRS 9 to measure debt instruments at FVTPL or FVOCI, and the option in IFRS 17 to disaggregate insurance finance income and expense between profit or loss and other comprehensive income (the OCI option), in order to minimise potential accounting mismatches.
  - Consider other options for reducing mismatches, including: the optional designation of financial assets investment contracts and distinct investment components at FVTPL; and the application of insurance accounting options under IFRS 17, such as different methods for calculating discount rates.
  - If mismatches remain, consider the use of non-GAAP measures and, potentially as a last resort, changes to investment strategy/mix.
- Consider the impact of IFRS 9 on financial liabilities measured at FVTPL:
  - Assess whether recording changes in credit risk in OCI creates or increases an accounting mismatch; and if this is not the case
  - Consider the operational impact of the requirement to record changes in credit risk in OCI.

# IFRS 9 asset classification overview




[1] Distinction between debt and equity instruments as defined in IAS 32.

[2] Impairment considerations apply.

[3] Expect most insurers not to use the FVOCI option for equities given inability to recycle gains and losses on sale to P&L.

[4] See PwC's In depth: IFRS 9 impairment practical guide: intercompany loans in separate financial statements (February 2018).

## Financial assets that back insurance liabilities

- If measurement at amortised cost or FVOCI would either create or increase a mismatch with the accounting valuation of liabilities, an entity can take the option to designate financial instruments at FVTPL.
- This is an important consideration for insurers, who will discount their insurance liabilities using current discount rates under IFRS 17.
- It is expected that insurers that take the OCI option under IFRS 17 will look to measure the assets backing insurance liabilities at FVOCI. However, this conclusion will be influenced by the use of reinsurance and the extent to which interest rate changes affect both financial assets and insurance liabilities, as well as other factors.
- The OCI option under IFRS 17 can be applied on a portfolio basis, so insurers should ensure their investment portfolios are managed at a similar level of aggregation to their IFRS 17 liability portfolios to minimise accounting mismatches.

## Financial assets that do not back insurance liabilities

- All financial assets are subject to the same classification and measurement requirements.
- In addition, lease receivables, other contract assets are also captured in the new impairment model.
- Given that most receivables balances are held in order to collect the balance when due, they will be measured at amortised cost and subject to impairment.
- IFRS 9 offers simplifications for calculating impairment on qualifying trade receivables, contract assets within the scope of IFRS 15 and lease receivables.
- Intercompany loans are also within the scope of IFRS 9 if individual entities within a group prepare financial statements on an IFRS basis. Intercompany loans receivable will typically be measured at amortised cost, as the entity expects to hold the balance until it is settled.
- Applying the new impairment model to intercompany loans can be difficult.[4]

# IFRS 9 impairment and hedging

## What should insurers be doing now?

**Impairment – Requirements**

- An impairment provision must be calculated for all financial assets measured at amortised cost and debt investments measured at FVOCI.
- Impairment under IFRS 9 is calculated on an expected, rather than incurred, loss basis.
- Expected credit losses (ECL) under IFRS 9 are forward-looking and are influenced by a variety of factors, including the credit rating of the issuer and macroeconomic conditions.
- The scale of the ECL recognised depends on the relative change in the credit risk of the financial asset since it was first recognised. If there has been no significant increase in credit risk, the impairment provision is the 12 month ECL. If there has been a significant increase in credit risk, the impairment provision is the lifetime ECL.
- Insurers generally hold financial investments with a high credit rating. As such, many insurers will be able to benefit from the practical expedient for calculating impairment on financial instruments with low credit risk. The practical expedient allows impairment to be calculated using a 12 month ECL, without the need to assess whether a significant increase in credit risk has occurred. This option makes the impairment assessment simpler and may result in a lower impairment provision.

**Impairment – Next steps**

Consider interpretation of new requirements and assess implications of having to apply new impairment rules to all financial assets (other than equities) not at FVTPL including:

- Develop criteria for key judgements required (for example how is 'low credit risk' defined and when has there been a significant increase in credit risk?)
- Assess whether operational simplifications for 'low credit risk' assets can be used.
  These simplifications are intended to provide relief to entities, especially financial institutions such as insurers, who hold large portfolios of securities with high credit ratings.
- Assess need to collect, verify and store credit data not currently used.
- Consider need to build models to determine both 12-month and lifetime ECL as well as monitor the development of changes in credit risk.

**Hedging – Requirements**

- IFRS 9 includes a new hedge accounting model, covering all hedge accounting other than macro fair value hedges, which are the subject of a current IASB project.
- Entities can choose to either:
  - Retain IAS 39 accounting for macro fair value hedges and adopt IFRS 9 for all other hedge accounting; or
  - Retain IAS 39 for all hedge accounting.
- Hedge accounting under IFRS 9 is more closely linked to risk management and eliminates some of the restrictions that exist in IAS 39 hedge accounting, including the removal of the '80%-125%' quantitative hedge effectiveness test.

**Hedge accounting – Next steps**

Consider current use of hedge accounting (if any; insurers have typically not made extensive use of hedge accounting under IAS 39) and monitor macro hedging proposals to assess whether they are likely to offer more opportunity to reflect economic hedging programmes in accounting.

Insurers who currently use hedge accounting under IAS 39 can elect to stay with IAS 39 until the IASB's macro hedging project is finalised. Alternatively, they could benefit from some of the changes in IFRS 9 hedging such as the relaxation of the 80-125% test and the ability to apply hedge accounting to certain hedges not permitted under IAS 39.

# IFRS 9 deferral disclosures

## Requirements until adoption of IFRS 9

- Insurers deferring the adoption of IFRS 9 are required to include specific disclosures in their financial statements from 2018 onwards, as set out in the amendment to IFRS 4.
- Deferral disclosures require an insurer to disclose:
  – The fact that it is applying the temporary exemption.
  – How it concluded it is eligible for the temporary exemption (additional disclosures are required in certain cases).
  – The fair value at the end of the reporting period and changes in fair value during the period separately for:
    a. Financial assets with contractual cash flows that meet SPPI criteria, excluding those held for trading or measured at FVTPL on the grounds they are managed on a fair value basis; and
    b. All other financial assets.
  – For financial assets in (a) above:
    - The carrying amount of the assets by credit risk grade.
    - The fair value and carrying value of assets that do not have low credit risk. For this disclosure, IFRS 9 provides guidance on what is considered low credit risk.
  – References to any publicly available IFRS 9 information that is not included in the group's financial statements (e.g. included in separate financial statements of an entity in the group that applies IFRS 9).
- If an insurer currently holds financial instruments at amortised cost or as Available for Sale, and does not use the fair value option under IAS 39, it will need to complete SPPI testing in order to report the information noted above.

**Deferral disclosures – Next steps**

- Insurers have already prepared IFRS 9 deferral disclosures for 2018 and 2019 year end financial statements and if relevant, have performed and concluded on SPPI testing.
- An illustrative template is included in the Appendix.

# IFRS 9 disclosures

## Requirements from adoption of IFRS 9

**Statement of Comprehensive Income**

- New line items are required including credit impairment losses and change in fair value attributable to change in the credit risk of financial liablities designated at FVTPL.

**Disclosures**

- IFRS 9 Financial Instruments introduces extensive new disclosure requirements. Additional disclosure requirements arise principally in the following areas:
  - Investments in equity instruments designated at fair value through other comprehensive income (FVOCI).
  - Impairment, including:
    - Credit risk management practices;
    - Quantitative and qualitative information about amounts arising from expected credit losses (ECLs); and
    - Credit risk exposure.
  - Hedge accounting – These disclosures apply even if an entity elects to continue IAS 39 hedge accounting.
- Note that the incremental disclosures under IFRS 7 introduced by IFRS 9 are not required until IFRS 9 is applied.
- A number of transitional disclosures will also be required including the impact of changes in classification and measurement. Unlike IFRS 17, IFRS 9 does not require restatement of prior year comparatives.
- IFRS 7 requires an entity to disclose the financial assets which are designated at FVTPL and those which are mandatory at FVTPL. Additional disclosures relating to credit risk are also required if the entity has designated as FVTPL a financial instrument that would otherwise be measured at FVOCI or amortised cost. Therefore where an instrument has been designated at FVTPL as a result of an accounting mismatch, entities are still required to perform SPPI testing to comply with this disclosure.

**Post 2023 presentation and disclosures – Next steps**

- Consider the costs and benefits of choosing to disclose comparative information on an IFRS 9 basis to align with IFRS 17.
- Consider the impact on chart of accounts and pro-forma disclosures in conjunction with IFRS 17 changes.

# IFRS 9 and corporate income taxes

**IFRS 9 and corporate income taxes**

- As with many accounting changes, IFRS 9 may have current and deferred tax impacts for those reporting under IFRS. The nature and extent of that impact will vary depending on the accounting used in the entity and consolidated accounts, local tax rules, and the choices taken under the standard.
- Current or deferred tax impacts can arise because of different valuations, different accounting for gains and losses (though P&L or OCI), and transitional adjustments on the adoption of the standard.
- There may also be more complicated impacts to be analysed, for example if distinct investments components are recognised under IFRS 9 rather than IFRS 17 under IFRS 17's separation requirements, or if the IFRS 17/IFRS 9 OCI choices are taken.
- Tax regimes around the world are often very specific in their treatment of financial assets. Many tax regimes still tax on a realisations basis, and the tax does not follow the accounts. In those cases, the main impacts are likely to be on deferred tax.
- Other tax regimes do follow the accounts, though some apply different rules to gains and losses recognised in profit or loss and those recognised in OCI. The UK for example recently introduced rules which differentiated between profit or loss and OCI accounting for tax purposes.
- The tax impact of any accounting decisions, judgements and transitional adjustments arising from IFRS 9 will need to be understood and assessed alongside those arising from IFRS 17 to fully understand the overall impact, including on tax profile and volatility.

# Where to go for further information

**Gail Tucker**
Partner

T: +44 (0)117 923 4230
E: gail.l.tucker@pwc.com

**Alex Bertolotti**
Partner

T: +44 (0)7525 298694
E: alex.bertolotti@pwc.com

**Jessica Taurae**
Partner

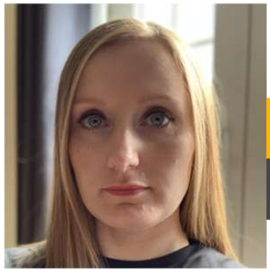
T: +44 (0)7740 166459
E: jessica.taurae@pwc.com

**Kathryn Le Coz**
Director

T: +44 (0)7725 632974
E: kathryn.lecoz@pwc.com

**Richard Goodman**
Senior Manager

T: +44 (0)7730 598929
E: richard.j.goodman@pwc.com



**Fiona Walker**
Senior Manager

T: +44 (0)7483 316728
E: fiona.walker@pwc.com

# Appendix: Example IFRS 9 deferral disclosure

**The example disclosure is based on the following assumptions:**

- A standalone insurance entity without subsidiaries or associates
- The only investments held by the entity are debt securities
- The fair value option under IAS 39 is not taken
- The entity has no investment contract liabilities measured at amortised cost

## Note X: Additional disclosures required by amendments to IFRS 4 when applying the temporary exemption from IFRS 9

The activities of ALPHA INSURER are predominantly connected with insurance. In this regard, management has assessed the following:

- ALPHA INSURER has not previously applied any version of IFRS 9.
- The total carrying amount of liabilities arising from contracts within the scope of IFRS 4 for the year ended 31 December 2015 represents 85% of total liabilities, which is considered significant.
- The total carrying amount of liabilities connected with insurance, which includes liabilities under IFRS 4 and investment contract liabilities measured at fair value under IAS 39, for the year ended 31 December 2015 is equivalent to 98% of total liabilities.

**PwC Commentary – Liabilities connected with insurance**

One of the criteria for deferring the application of IFRS 9 relates to the total carrying amount of liabilities connected with insurance. In this example, the liabilities connected with insurance include insurance contract liabilities under IFRS 4 and investment contract liabilities under IAS 39. In reality, the definition of a liability connected with insurance may not be straightforward and entities may need to disclose judgements used when applying the criteria. Examples of liabilities that will be subject to judgement include investment contract liabilities measured at amortised cost and loans used to acquire new portfolios of insurance contracts.

If the value of liabilities connected with insurance is between 80% and 90% of total liabilities at the date of assessment, an entity can defer IFRS 9 as long as it engages in no significant activity unconnected with insurance. To support this, the entity must disclose how this conclusion was made, including the information considered.

**PwC Commentary – Fair value disclosure requirements**

The amendment to IFRS 4 Insurance Contracts requires entities to disclose the fair value at the end of the reporting period and the change in fair value during the period for groups of financial assets with contractual cash flows that are solely payments of principal and interest ('SPPI') and other financial assets separately.

**PwC Commentary – Judgement in applying the SPPI criteria**

The Group does not consider applying the SPPI criteria to be an area of significant judgement for their debt instrument portfolio. However, it could be possible that there are areas of significant judgement in applying these SPPI criteria as a consequence of the nature and complexity of the debt instruments held by an entity. Examples could be bonds with prepayment features or contractually linked instruments.

There has been no change in ALPHA INSURER's activities that warrants a reassessment of the above information.

The amendment of IFRS 4 Insurance Contracts requires entities to disclose the fair value at the end of the reporting period and the change in fair value during the period for groups of financial assets with contractual cash flows that are solely payments of principal and interest ('SPPI') and other financial assets separately.

ALPHA INSURER has assessed that the following financial assets have contractual cash flows that meet the SPPI criteria:

- Government bonds backing term assurance liabilities
- Corporate bonds backing term assurance and unit-linked liabilities

The remaining financial assets held by the entity have contractual cash flows that do not represent solely payments of principal and interest. This group includes the following financial assets:

- Convertible bonds backing endowment liabilities
- Contractually-linked instruments

ALPHA INSURER does not currently use the option under IAS 39 to designate financial assets at fair value.

# Appendix: Example IFRS 9 deferral disclosure (cont'd)

**The fair value and change in fair value of the two groups of financial assets are disclosed in the following table:**

| £m | Financial instruments with contractual cash flows that meet the SPPI criteria, excluding those held for trading | | | | Other financial instruments[1] |
|---|---|---|---|---|---|
| | Amortised cost | FVOCI | FVTPL | Total | |
| **Government bonds** | | | | | |
| Opening fair value | 1,564 | 381 | - | 1,945 | - |
| Additions | 332 | - | - | 332 | - |
| Increase/(decrease) in fair value | 53 | 27 | - | 80 | - |
| Disposals | (140) | (14) | - | (154) | - |
| Closing fair value | 1,809 | 394 | - | 2,203 | - |
| **Corporate bonds** | | | | | |
| Opening fair value | 879 | - | 220 | 1,099 | - |
| Additions | 112 | - | 31 | 143 | - |
| Increase/(decrease) in fair value | 27 | - | 18 | 45 | - |
| Disposals | (34) | - | (12) | (46) | - |
| Closing fair value | 984 | - | 257 | 1,241 | - |
| **Convertible bonds** | | | | | |
| Opening fair value | - | - | - | - | 107 |
| Additions | - | - | - | - | 8 |
| Increase/(decrease) in fair value | - | - | - | - | 4 |
| Disposals | - | - | - | - | (18) |
| Closing fair value | - | - | - | - | 101 |
| **Contractually-linked instruments** | | | | | |
| Opening fair value | - | - | - | - | 191 |
| Additions | - | - | - | - | 8 |
| Increase/(decrease) in fair value | - | - | - | - | (5) |
| Disposals | - | - | - | - | (17) |
| Closing fair value | - | - | - | - | 177 |
| **Insurance debtors and other short term receivables** | | | | | |
| Opening fair value | 67 | - | - | 67 | - |
| Additions | 603 | - | - | 603 | - |
| Increase/(decrease) in fair value | - | - | - | - | - |
| Disposals | (577) | - | - | (577) | - |
| Closing fair value | 93 | - | - | 93 | |

[1] Other financial instruments are measured at fair value through profit or loss

Note: The amounts disclosed for financial assets held at amortised cost include £93m of short term trade receivables that are recorded at their IAS 39 carrying value.

## Credit risk exposure for assets that pass the SPPI test

**The following table represents the entity's exposure to credit risk on financial assets that meet the SPPI criteria:**

| Exposure to credit risk | Credit rating | | | | | | |
|---|---|---|---|---|---|---|---|
| £m | AAA | AA | A | BBB | Below BBB | Unrated | Total |
| Government bonds | 1,988 | 215 | - | - | - | - | 2,203 |
| Corporate bonds | 903 | 307 | 31 | - | - | - | 1,241 |
| Insurance debtors and other short term receivables | - | - | - | - | - | 93 | 93 |
| Total | 2,891 | 522 | 31 | - | - | 93 | 3,537 |

Note: In the case of financial assets held at amortised cost, the amounts disclosed are the carrying amounts applying IAS 39, before adjusting for any impairment allowances.

The table above includes £93m of short term receivables that are not considered to have low credit risk, as defined in Note [ ]. The fair value of these financial assets at 31 December 2018 is equal to their carrying value.

pwc.com



RITM2883282