

IFRS 9 for insurers

April 2020 (Updated December 2021 for IFRS 17 amendment)



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On 9 December 2021, the IASB made a minor amendment to IFRS 17 relating to the presentation of comparative information of financial assets on initial application of IFRS 17. The amendment permits an entity to apply an optional classification overlay in the comparative period(s) presented on initial application of IFRS 17 that would align the classification of financial assets in the comparative period with how the entity expects those assets to be classified on initial application of IFRS 9. This amendment should ease practical difficulties for insurers implementing IFRS 9. This publication summarises the key areas that insurers should be considering.

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 ('ECL') rather than incurred losses.

2

New hedge accounting criteria, expected to be of limited interest to insurers.

3

New presentation and disclosure requirements including updated requirements and guidance on the comparative period.

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.
- For insurers, the 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.
- The December 2021 amendment allows an entity to align the classification of financial assets in the comparative period with the way the entity expects those assets to be classified on initial application of IFRS 9. This amendment should ease practical difficulties for insurers implementing IFRS 9.
- 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.
- If not already done so, now is the time to start implementing and finalising your transition to IFRS 9.

Who does it affect and how?

The C&M requirements may 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 may 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 when they are treated as debt instruments. Most equity investments are also expected to be measured at FVTPL though an entity can elect the fair value through other comprehensive income ('FVOCI') measurement basis unless the assets are 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. Insurers can opt to measure financial assets at FVTPL to reduce such mismatches.
- Choosing the OCI option for measuring insurance liabilities as well as measuring the underlying assets at FVOCI can help to reduce accounting mismatches, however, it might not completely eliminate them and may add operational complexity.
- There may be tax impacts too, depending on local statutes.

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

- C&M of financial assets depends on the entity's business model for managing the assets and the contractual cash flow characteristics of the assets i.e. whether the cash flows meet the SPPI criteria. This needs to be considered for the deferral 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 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

Classification and measurement – Requirements

- Classification and measurement ('C&M') determine the way financial instruments are measured on the balance sheet and where gains and losses are reported (profit and loss vs other comprehensive income).
- 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 C&M 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 C&M 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.
- For insurers applying comparatives for IFRS 9, C&M considerations will also apply for those assets held in the comparative period (see page 6).
- 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.
- If the assets are managed on a fair value basis i.e. the business model is not held to collect or held to collect and sell, the assets will be mandatory classified and measured at FVTPL.

- 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 and not accounted for under IFRS 17).
- In addition IFRS 9 also applies to embedded derivatives that are separated from the insurance contract and financial reinsurance contracts which are not in the scope of IFRS 17.
- Financial liabilities can be measured at amortised cost or FVTPL; the FVOCI option does not apply.

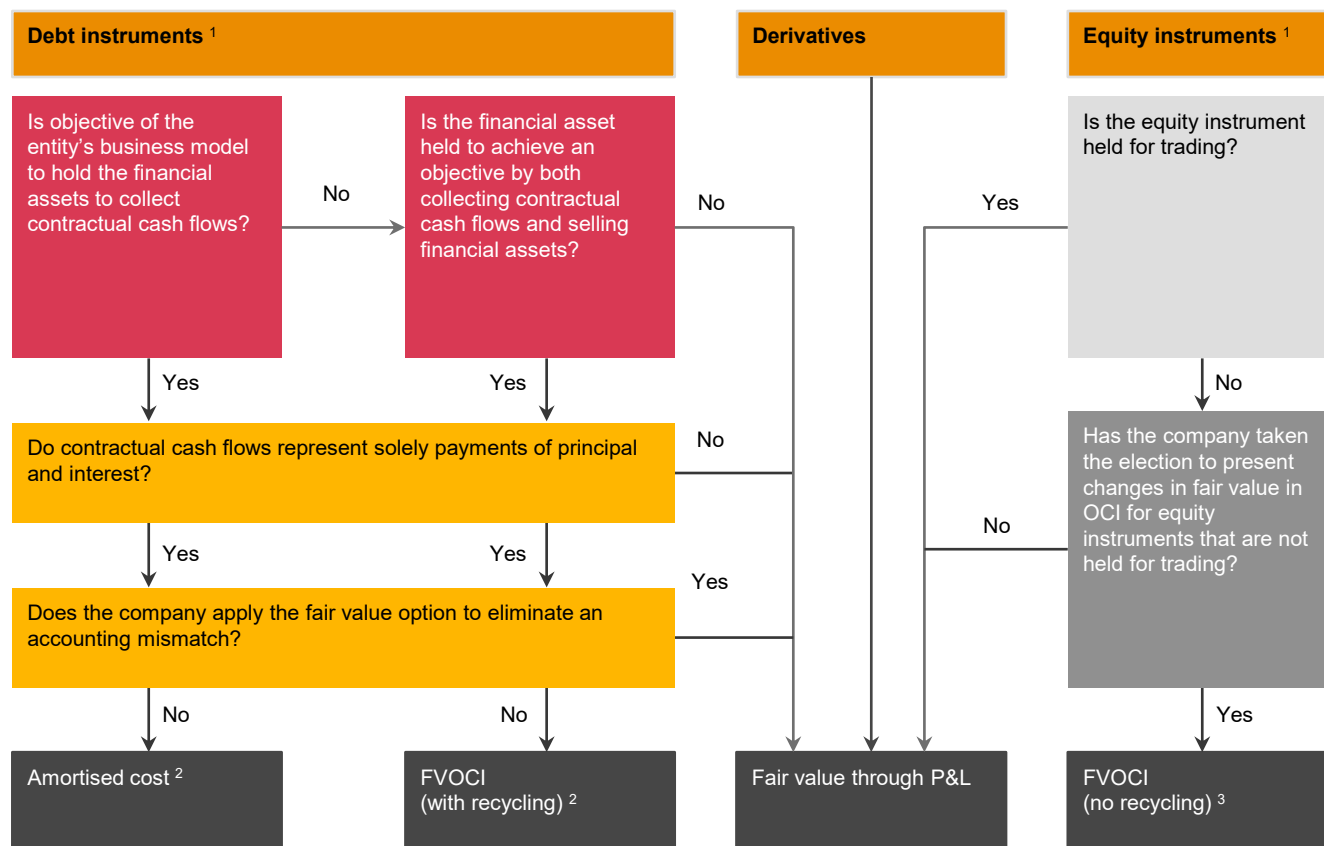
Classification and measurement – Next steps

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 other instruments are affected by the implementation of IFRS 9, i.e. those which are not related to the insurance contracts (see page 3).
- 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.
- As 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 decide whether to measure at FVTPL or FVOCI.

- 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.
- For contracts in the scope of IFRS 9, the insurer will have to analyse and understand the terms of the contract as some components of the contract may be measured as debt and some as equity. The requirements of IAS 32 Financial Instruments: Presentation, will need to be considered.
- 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, embedded derivatives and financial reinsurance arrangements:
 - 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 Financial Instruments: Presentation.

² For these assets, impairment requirements apply. However, entities applying the classification overlay approach for comparatives do not need to apply IFRS 9 impairment requirements for the comparative amounts.

³ Cannot recycle gains and losses on sale to profit or loss.

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 these assets are measured at amortised cost or FVOCI this would either create or increase a mismatch with the accounting valuation of the insurance liabilities, therefore an entity can take the option to designate these financial assets at FVTPL which will help to reduce the mismatch but it may not entirely eliminate it.
- 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 many factors including the use of reinsurance and the extent to which interest rate changes affect both financial assets and insurance liabilities.
- This is an important consideration for insurers, who will discount their insurance liabilities using current discount rates under IFRS 17.
- The OCI option under IFRS 17 can be applied on a portfolio basis, therefore 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 of IFRS 9.
- In addition, lease receivables, other contract assets, loan commitments and financial guarantees 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 likely be measured at amortised cost and therefore 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 and they do not qualify for the simplified approach.⁴

IFRS 9 impairment and hedging

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 – Considerations

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.
- Assess what additional information is needed on terms of intercompany loans. Often these can be informal arrangements with no written contracts or detailed repayment terms.

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 – Considerations

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

Requirements until adoption of IFRS 9

- Insurers can apply the temporary exemption from IFRS 9 if its activities are predominantly connected with insurance i.e. the carrying amount of these insurance related liabilities is significant compared to the total amount of the entity's liabilities.
- 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 will use amortised cost, FVOCI or choose FVTPL due to avoiding an accounting mismatch, the results of SPPI testing must be disclosed.
- If an insurer manages these assets on a fair value basis, i.e. the business model is not held to collect or held to collect and sell, the assets will be measured at FVTPL on a mandatory basis and no SPPI testing will be required.

Deferral of IFRS 9 – Considerations

- Insurers have already prepared IFRS 9 deferral disclosures for 2018, 2019 and 2020 year end financial statements and if relevant, have performed and concluded on SPPI testing. Insurers may leverage the work performed when providing the disclosures for 2021.
- Deferral of IFRS 9 may not be available to certain insurers such as new entities or those transitioning to IFRS from another local GAAP such as UK GAAP.

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 liabilities designated at FVTPL.

Disclosures

- IFRS 9 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 however entities can choose to disclose comparatives and can apply the classification overlay approach as set out in the minor amendment of IFRS 17 standard published in December 2021 (see next slide).
- 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 – Considerations

- Consider the impact on chart of accounts and pro-forma disclosures in conjunction with IFRS 17 changes.
- Consider what has changed since the deferral disclosures and if additional disclosures are required.
- Consider IFRS 9 and 17 disclosures together to ensure they are useful and understandable.

IFRS 9 comparatives

IFRS 17 narrow-scope amendment

On 9 December 2021, the IASB issued the amendment of IFRS 17 relating to the presentation of comparative information of financial assets on initial application of IFRS 17.

The amendment adds a transition option that permits an entity to apply an optional classification overlay in the comparative period(s) presented on initial application of IFRS 17.

The overlay allows all financial assets, including those held in respect of activities not connected to contracts within the scope of IFRS 17, to be classified, on an instrument-by-instrument basis, in the comparative period(s) in a way that aligns with how the entity expects those assets to be classified on initial application of IFRS 9.

The overlay can be applied by entities that have already applied IFRS 9 or will apply it when they apply IFRS 17.

IFRS 17 should be applied to annual reporting periods beginning on or after 1 January 2023, with earlier application permitted, and the amendments should be applied at the same time.

If the entity applies the classification overlay approach:

- The entity will need to disclose that it has applied the classification overlay approach.
- The entity shall use reasonable and supportable information available at the transition date to determine how the entity expects financial assets to be classified on initial application of IFRS 9.
- The entity is not required to apply the impairment requirements of section 5.5 of IFRS 9 for the comparative period.
- Any difference between the carrying amount will be shown in opening retained earnings (or other component of equity if appropriate) on the date of transition.

This approach is seen as less cumbersome than full retrospective application of IFRS 9 as it avoids having to apply IAS 39 to assets derecognised during the comparative period, while applying IFRS 9 to assets still held at 1 January 2023.

It is hoped that the classification overlay will increase users' understanding of comparative period information by reducing accounting mismatches between financial assets under IAS 39/IFRS 9 and insurance liabilities under IFRS 17.

IFRS 9 comparatives – Considerations

- Entities should decide on their transition approach regarding comparatives for IFRS 9. Will they apply IFRS 9 retrospectively, apply the classification overlay approach or use IAS 39 comparatives when IFRS 9 and 17 are implemented?
- If using the classification overlay approach, which assets will be in scope?



IFRS 9 and corporate income taxes

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- 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.



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