IFRS 17 and IFRS 9: Bridging the Gap

Amit Bhana

Morgan Schaeffer

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 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.

Asset aspects

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 classification and measurement (C&M), impairment, and hedge accounting, where the impact on insurers differs 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 and the information required as well as the 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 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 insurers as it will facilitate improved performance reporting for certain business models by removing volatility in profit and loss (P&L), particularly where insurance companies hold debt instruments.

However, while insurers 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 or to 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 will likely result in more financial instruments being classified in the resid-

The authors

Amit Bhana, Senior Manager, Financial Services Advisory, Deloitte Africa.

Morgan Schaeffer, Partner, Audit & Assurance, Deloitte Switzerland.

ual category of Fair Value through Profit and Loss (FVTPL) than under IAS 39.

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 will likely not 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 hedging, 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.

Liability aspects

IFRS 17 lays out a number of requirements for the measurement and recognition of insurance contracts. IFRS 17 defines liabilities for future coverage and liabilities for incurred claims. There are three «blocks» of these liabilities to consider, namely the best estimate fulfilment cash flows, discounted to account for the time value of money and financial risks; the risk adjustment, to account for non-financial risks contained in the insurance contracts; and the Contractual Service Margin (CSM), accounted for in order to spread the expected profits as seen at point of sale smoothly across future periods. In addition to measurement, the following requirements of IFRS 17 provide options as to how insurers can manage their balance sheets and the interactions between assets and liabilities.

Portfolios
IFRS 17 requires insurers to determine portfolios of insurance contracts. At this level of aggregation, insurers will make accounting choices that will drive the initial and subsequent measurement basis and therefore impact P&L, OCI or the CSM.

Model choice
For each portfolio, insurers will need to determine whether the general measurement model (Building Block Approach, BBA), the Variable Fee Approach (VFA) or the Premium Allocation Approach (PAA) will be used. Depending on the model chosen, assumption changes might impact the CSM, the P&L or the OCI directly. The choice of the model in the light of the underlying business will impact the variability of the financial report.

Discounting
The setting of discount curves to reflect the time value of money and the financial risks relating to the cash-flows of insurance contracts is to be done at a portfolio level. Two approaches are proposed: the bottom-up approach consists of adjusting a risk-free yield curve for the liquidity characteristics of the insurance contracts. The top-down approach adjusts a yield curve of returns of an assets reference portfolio. In practice, both methods could lead to differing discount curves, providing insurers the ability to choose an approach that better controls potential volatility.

OCI option
IFRS 17 allows insurers to decide whether the impact of changes in economic / financial assumptions will be accounted for through the insurance financial result, therefore impacting the P&L, or through OCI. This option can be taken at a portfolio level.

The various options and choices proposed by IFRS 17 in conjunction with those from IFRS 9 will allow insurers to manage the volatility of the CSM, the P&L and the OCI. In Switzerland and other European countries, assets backing liabilities are currently not managed at a portfolio level as defined under IFRS 17, but at a more aggregated level, mutualizing the risks and returns of the underlying assets over large groups of policyholders. In practice, in order to fully leverage the options provided by IFRS 9 and IFRS 17, insurers might have to at least notionally allocate their assets to their insurance contract portfolios. This exercise might create another layer of operational complexity. Insurers will therefore need to analyse several scenarios and combinations of options in order to understand the detailed impacts on their financial statements and particularly on CSM, P&L and OCI. Figures 1 and 2 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. Note that the underlying assumptions is that the BBA is used. In case the VFA would be used, some changes could also impact the CSM.

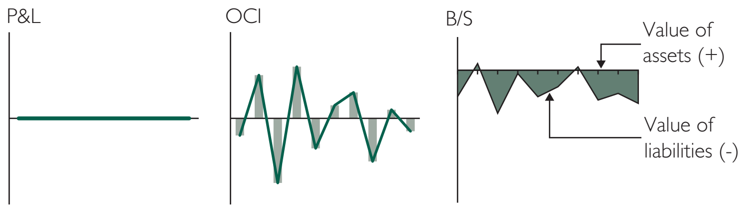
Different implementation dates

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 insurers raised this issue with the IASB, citing key concerns such as temporary increase in accounting mismatches or high costs and efforts for both preparers and users of financial statements in adopting two major standards at different time periods. Furthermore, 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.

In September 2016, an amendment to IFRS 4 was issued in which the IASB proposed to introduce two options to manage the different effective dates for IFRS 9. On the one hand, the overlay approach 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. On the other hand, the temporary exemption (deferral approach) 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». This 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.

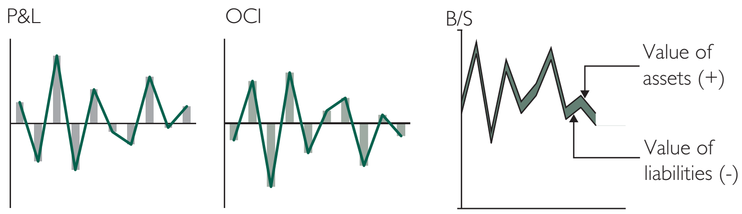
1) Amortised cost (assets) and OCI option (liabilities)

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



2) Fair value through P&L (assets) and OCI 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 OCI
- Impacts largely offset in balance sheet, but mismatch in P&L and OCI



3) Fair value through OCI (assets) and OCI 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 OCI
- Impacts largely offset in balance sheet and OCI, minimal mismatch

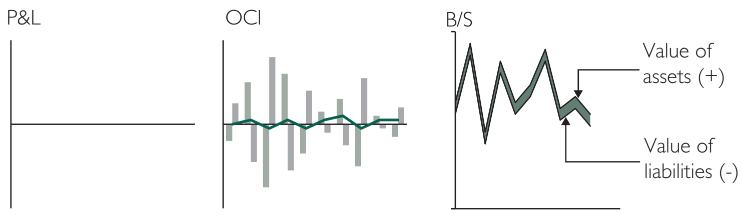


Figure 1: OCI option for liabilities combined with different asset options

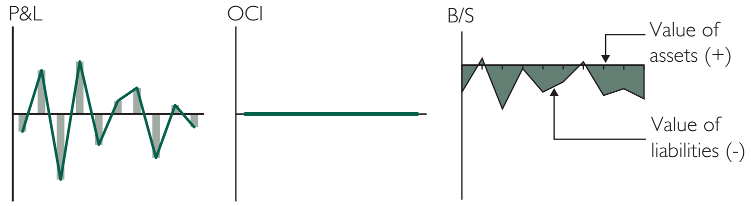
The deferral approach also has onerous disclosure requirements, including the separate disclosure of the fair value at the end of the reporting period and the fair value change during the reporting period for financial assets with contractual cash flows that are not solely payments of principal and interest («SPPI») and 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 insurers get ahead and maximise these interrelationships

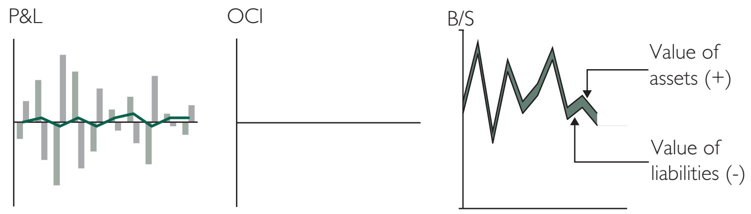
ALM considerations

When considering IFRS 9 and IFRS 17, it is important to understand the asset-liability management (ALM) of insurers which is centred on the joint management of liabilities, guarantees and related assets (including derivatives). The accounting practices should reflect this strategy. Accounting treatments dealing with components in isolation will result in different measurement as well as 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

4) Amortised cost (assets) and P&L option (liabilities)
- Value of liabilities change as a result of impact of changes in the interest rate on the discount rate (change goes through P&L)
- Accounting value of assets not affected by interest rate movements (although impacted by amortisation / impairment)



5) Fair value through P&L (assets) and 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



6) Fair value through OCI (assets) and 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

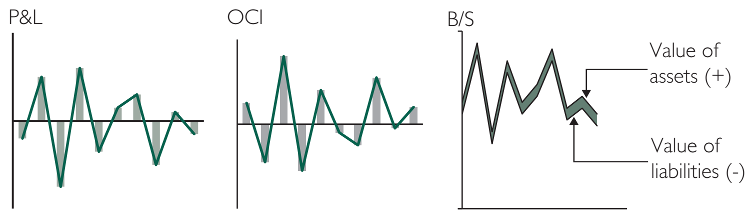


Figure 2: P&L option for liabilities combined with different asset options

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. Actuaries must be aware of FVTPL and how financial assets are accounted for, as it might change the way, for example, impairments are considered in their models.

Currently, ALM analyses mostly focus on market consistent balance sheets and seek to optimize ALM under frameworks such as Solvency II and the Swiss Solvency Test, while not completely excluding the effects on IFRS and statutory balance sheets. Going forward, given that IFRS balance sheets will come closer to market consistency, they might also be included and analysed in ALM studies.

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. This includes assessing the proportion of debt instruments that could fail the SPPI test and 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.

With the final IFRS 17 being published, insurers are also now performing impact assessment for IFRS 17 to evaluate the readiness of their systems, the availability of data, the appropriateness of their current cash flow models, and the ability of their current closing processes to address the new requirements. Financial impact assessments are also used to estimate the high-level implications of the new standard and the various measurement choices. Combining IFRS 17 and IFRS 9 assessments will provide deep insights on the interrelations of measurement for both standards and the associated accounting options and choices.

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, it is required to build models determining both 12-month and lifetime expected credit losses and monitoring a changing credit quality. Insurers currently using hedge accounting under IAS 39 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 percent test and hedging with options.

Lastly, regarding 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 implying that, regardless of which solution is chosen by the insurer, the operational requirements will still be significant since insurers must prepare both IFRS 9 and IAS 39 numbers as from the 2018 financial year. Insurers should therefore expedite preparations to implement the new standard.