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IFRS Industry Insights: Insurance sector
New financial instrument standard changes financial asset classification and bad debt provisioning

Headlines

- IFRS 9 replaces the IAS 39 classification system with a new one based on the instrument's cash flow characteristics and the business model utilised to manage the assets
- For insurers the financial assets at fair value through other comprehensive income (FVTOCI) is particularly relevant as it applies to debt instruments
- Fair value through profit or loss (FVTPL) becomes the residual category of the new classification system with a fair value option limited to overcoming accounting mismatches
- A new impairment loss model is introduced based on expected credit losses rather than incurred credit losses
- Impairment losses will be recognised sooner than under IAS 39
- Provision for loan losses will be recognised on initial recognition of loan assets and other receivables leading to a "day-one" provision

What's happened?

The International Accounting Standards Board (IASB) has issued the final version of IFRS 9 *Financial Instruments* incorporating amendments to the classification and measurement model for financial assets and a new expected loss impairment model. IFRS 9 is the replacement to IAS 39 *Financial Instruments: Recognition and Measurement* and is effective for reporting periods beginning on or after 1 January 2018, with earlier application permitted (subject to local endorsement requirements).

The project to replace IAS 39 has been undertaken in stages. The IASB first issued IFRS 9 in 2009 with a new classification and measurement model for financial assets followed by requirements for financial liabilities and derecognition added in 2010. Subsequently, IFRS 9 was amended in 2013 to add the new general hedge accounting requirements. The final version of IFRS 9 issued in July 2014 supersedes all those previous versions although they remain available for early adoption for a limited time[1].

IFRS 9 retains the scope exclusion of IAS 39 for:

(a) rights and obligations arising under an insurance contract as defined in IFRS 4 *Insurance Contracts*, e.g. the right to collect cash for premiums (premiums receivables) or the right to reimbursement from reinsurers under a reinsurance contract on claims paid (reinsurance receivables);

(b) an investment contract that is within the scope of IFRS 4 because it contains a discretionary participation feature; and

(c) financial guarantee contracts which an issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has elected to apply IFRS 4 to such financial guarantee contracts, instead of IFRS 9.

1 The previous versions of IFRS 9 may be early adopted if the entity's relevant date of initial application is before 1 February 2015.

Implications for insurers

The most significant impacts from the amendments to the classification and measurement model and the new expected loss impairment model for insurers are included below. More detailed guidance on the accounting requirements and further resources are also included.

Classification and measurement of financial assets

IFRS 9 provides a new classification system that determines how insurers measure their financial assets. This system is based on a dual test of cash flow characteristics at an instrument level and a business model assessment at a higher level that considers how an insurer manages its financial assets.

A notable amendment to this system is the introduction of the category, FVTOCI, in addition to amortised cost and FVTPL. The FVTOCI category is a mandatory classification for debt instruments that pass the contractual cash flow characteristics test and are held within a business model whose objective is achieved by both holding those assets, to collect their contractual cash flows, and selling them. A fair value option is available on initial recognition as an alternative to FVTOCI if measuring the asset at FVTPL would eliminate or reduce an accounting mismatch.

The FVTOCI category for debt instruments in IFRS 9 is not the same as the available-for-sale category in IAS 39. As described above the criterion is different, plus the approach to impairment differs (see impairment section below).

It should be noted that the IASB has, in parallel with this change to IFRS 9, tentatively decided to introduce the option to account for the effect of changes in discount rate on the measurement of insurance contracts in either profit or loss, or other comprehensive income. If this decision is confirmed, insurers will need to consider carefully the combination of the IFRS 9 classification and fair value option with the accounting policy election available for insurance contracts accounting.

Analysing business models

Insurers will need to distinguish their business models for asset management to determine if they fulfil an objective to "hold to collect contractual cash flows" or to "both hold to collect and to sell". This will require careful analysis and significant judgment, and will need to be addressed early on in the implementation process, especially in cases where an insurer wishes such assets to be measured at FVTPL but such assets meet the classification requirements for FVTOCI or amortised cost. In such cases, it will be necessary to designate such assets at FVTPL by the date of the initial application (i.e. if these assets are identified as meeting the FVTOCI criteria after the date of initial application, the fair value option will no longer be available).

This may be the case for many insurers which issue investment contracts that are accounted for under IAS 39 as financial liabilities designated at FVTPL and plan to carry forward such a designation when adopting IFRS 9 in order to align the measurement bases between the liabilities and the assets backing those liabilities to reduce accounting mismatches.

Interaction with proposed insurance contracts standard

Insurers will also need to consider the interaction of IFRS 9 asset classification with the requirements of the proposed insurance contracts standard (planned to be published in 2015). Under the proposed insurance contracts standard, insurance contract liabilities will be measured using a current value measurement approach with the impact of changes in the discount rates being accounted as an accounting policy choice on a portfolio by portfolio basis either within other comprehensive income or within profit or loss. The accounting policy choice for the insurance contract liabilities may follow the way the assets backing these liabilities are accounted for prior to any fair value option being applied thus reducing or eliminating accounting mismatches without using the fair value option. However, there are multiple combinations between asset and liability accounting which require careful assessment given that accounting policy changes on the liability side do not operate in the same way as designating the fair value option or asset classifications under IFRS 9 on the asset side. For example, as part of their asset-liability management, many insurers seek to match cash outflows for claims with cash inflows from investments and premiums from policyholders. Financial assets of sufficient duration to match those of the insurance contract liabilities may not always be available. In such a scenario, insurers may hedge the duration mismatch by entering into derivatives that are required to be accounted for at FVTPL. This will result in an accounting mismatch if the accounting policy choice for the insurance contract liabilities is to account for the discount rate changes in other comprehensive income. Such a situation may justify the election of the fair value option for the non-derivative assets accounted for at FVTOCI or at amortised cost.

A thorough assessment of the measurement impacts of the combination of IFRS 9 and the new insurance standard will be needed so that profit or loss volatility is minimised by the accounting classifications and elections of both Standards.

New expected loss impairment model
IFRS 9 introduces a new expected loss impairment model which replaces IAS 39's incurred loss model which insurers will be required to apply to:

- debt instruments held, measured at amortised cost or FVTOCI;
- trade receivables;
- lease receivables within the scope of IAS 17 *Leases*; and
- contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers* (i.e. rights to consideration following the transfer of goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time, for example, the entity's future performance).

In addition, insurers that have issued loan commitments or financial guarantees that are not accounted for as insurance contracts, and are not measured at FVTPL, must also apply the expected loss model to those arrangements.

It is important to note that although reinsurance assets (the reinsurer's share of technical provisions) are not within the scope of IFRS 9, the proposed insurance contracts standard requires insurers to measure impairment on reinsurance assets on the basis of the lifetime expected loss model in IFRS 9.

Day-one provision
The credit loss allowance is recognised on initial recognition and measured in one of two ways[2]:

- 12-month expected loss allowance; or
- lifetime expected loss allowance.

Therefore, when an insurer acquires debt securities measured at amortised cost or FVTOCI, a day-one provision with a debit to profit or loss will be recognised.

Monitoring credit risk migration
When there is a significant increase in credit risk, the loss allowance moves from a 12-month expected loss allowance to an allowance for lifetime expected credit losses. This new, earlier, trigger for recognising impairment losses will mean insurers will have to establish appropriate systems and processes for identifying when there has been a significant increase in credit risk. The approach for different types of assets is likely to differ. For example, external credit ratings might be used for monitoring credit risk migration of investments in debt securities.

IFRS 9 includes a rebuttable presumption that once a payment due on an asset has become 30-days past due, there has been a significant increase in credit risk.

Measuring expected losses
Loss allowances will be measured on a probability-weighted basis, discounted by the effective interest rate (or an approximation thereof), based on information regarding past events, current conditions and a reasonable and supportable forecast of future economic conditions that is reasonably available without undue cost and effort. This measure of the loan loss allowance will demand the use of data and information not previously used under IAS 39.

Transparency
Given the number of judgments and assumptions required to apply the model, IFRS 7 *Financial Instruments: Disclosures* requires extensive disclosures to accompany the accounting requirements. These disclosures will provide transparency on the application of the model and is likely to be used to compare an insurer's provisioning amongst peers and track changes loss allowances from year to year. Consequently the messaging of these enhanced disclosures is likely to require some advance consideration.

Transition
When IFRS 9 is first applied, both the classification and measurement and the impairment requirements are to be applied retrospectively, with an option not to restate prior periods.

In addition to the exception from restating comparatives, if at the date of initial application, determining whether there has been a significant increase in credit risk since initial recognition would require undue cost or effort, a lifetime expected loss allowance is recognised until the financial instrument is derecognised (unless the credit risk is low at the reporting date). The effect of this is that an absolute measure of credit risk at the reporting rate dictates the recognition of lifetime expected losses rather than a relative measure comparing to initial recognition. The practical benefit of this approach would have to be weighed against the consequence of recognising a higher provision on transition and the burden of having two impairment approaches running in parallel for future periods.

Further information
More detailed information on the requirements of IFRS 9 can be found in Deloitte's IFRS in Focus publication, along with video interviews discussing the impact of the new Standard, at **www.iasplus.com**.

2 With the exception of purchased credit-impaired assets where expected losses are incorporated into the expected cash flows from which the (credit-adjusted) effective interest rate is derived, which is the same treatment as under IAS 39.

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