Applying IFRS in Insurance
IFRS Financial Instruments

Limited improvements to IFRS classification and measurement

The impact for insurers and next steps

March 2012

Ernst & Young
Quality In Everything We Do

What you need to know

- The IASB has confirmed its intention to consider making limited improvements to the IFRS 9 classification and measurement model.
- The scope of this project is limited, but includes investigating the use of fair value through OCI for debt securities.
- The IASB and the FASB will work together in an effort to align more closely on key aspects of their classification and measurement models.
- The IASB has confirmed 2015 as the new mandatory effective date for IFRS 9, and has decided not to require comparative figures to be amended on adoption of IFRS 9.

Overview

In November, the International Accounting Standards Board (the IASB, or Board) made the unanimous tentative decision to consider making limited changes to the IFRS 9 *Financial Instruments* classification and measurement model. An important reason for the Board to start this project is the need to consider the interaction between the accounting for insurance contract liabilities (as developed in its insurance project (IFRS 4 Phase II)) and the accounting for financial assets backing insurance contracts. The Board's other objectives are to address specific application issues raised by early adopters of IFRS 9 and those who have reviewed IFRS 9 in detail in preparation for application, and to consider differences with the FASB's[1] classification and measurement model for financial instruments.

At its December meeting, the Board decided to limit this project to three specific topics which should meet the above stated objectives:

- Re-measurement through other comprehensive income (OCI)[2] or the introduction of another business model — whether some debt instruments should be allowed or required to be re-measured through OCI and, if so, the basis for such measurement
- The contractual cash flow characteristics of the financial asset – whether additional application guidance should be provided to clarify how the principle was intended to be applied
- Bifurcation of hybrid financial assets – whether, after considering any additional guidance provided for the contractual cash flow characteristics test, there is a need to re-introduce bifurcation and, if so, the basis for the bifurcation

In our recent *IFRS Developments* publication, *Limited improvements to the IFRS 9 classification and measurement model*, we provide insights into the Board's classification and measurement project. We also discuss the interaction between IFRS 4 Phase II and IFRS 9 and the implications for insurers in more depth; not only by looking at the impact of the (proposed) accounting models, but also when to adopt those models based on recent developments on effective dates.

1 US Financial Accounting Standards Board
2 IFRS 9 already includes an OCI measurement option for equity instruments which are not held for trading. Under this irrevocable option, only dividends are recorded in profit or loss. No 'recycling' of gains and losses is permitted.

OCI approach for insurance

The release of the Exposure Draft *Insurance Contracts* (ED) in July 2010 has led to a debate on the interaction between the proposed insurance contract accounting model and the classification and measurement requirements under IFRS 9. The ED proposes that the measurement of the liability for insurance contracts would use current (i.e., updated) assumptions, with changes in those assumptions (re-measurements) from period to period being reported in profit or loss. Certain input, for example discount rates, should reflect current market conditions. Generally, respondents to the ED see this proposal, together with the classification and measurement requirements for financial instruments in IFRS 9, as a path towards a "current value" balance sheet, with all re-measurements of the carrying amounts recognised in profit or loss. In other words, respondents believe insurers would have little choice but to use a fair value through profit and loss measurement for most of their financial assets in order to achieve consistency with the model proposed in the ED and avoid accounting mismatches.

Reducing earnings volatility

Respondents to the ED raised significant concerns about earnings volatility because the period-to-period impact of re-measurements of financial assets and insurance liabilities could be very substantial, particularly those resulting from market-driven financial assumptions during times of severe market conditions. These concerns led to a request to the Board to undertake a fundamental assessment of the interaction between the proposed model for insurance contracts and the classification and measurement model under IFRS 9. Many within the insurance industry have suggested that the Board permit certain changes in the liability measurement to be reported directly in OCI as a way to reduce earnings volatility, particularly the volatility caused by financial assumptions. These same preparers have also proposed that allowing changes in the fair value of the assets backing the insurance liabilities to be reported in OCI would further reduce earnings volatility and achieve a more consistent treatment for financial assets and insurance liabilities.

The Board noted those requests and are investigating the possibility of using OCI for both assets and liabilities. This means they will be able to consider the accounting for financial instruments and the proposals for the future insurance model together, without being bound by the current requirements in IFRS 9. In this respect, such an OCI approach would function as a bridge between a "current" balance sheet measurement and a more amortised cost-oriented income statement.

Developing an OCI approach

When developing a solution that involves OCI for both financial assets and insurance liabilities, the Board will have to consider a number of important issues. For example, whether this OCI approach could be implemented in IFRS 9 by adding a separate (i.e., third) business model or through another provision that expands the use of OCI. This also raises the question, if introduced, for which types of assets a third business model (or any other expansion of OCI) could be used. The Board seems to be aiming for debt instruments only, but some insurers have requested a wider application that would include other assets backing their insurance liabilities such as equity securities and derivatives.

Other issues that would need to be addressed include:

- How would OCI be applied in relation to the characteristics of the financial asset test? For example, if the characteristics of a debt instrument do not only remunerate the holder for the time value of money and taking credit risk, would it still be eligible for OCI?
- How should impairment be applied to financial assets measured using an OCI model? Would the impairment model currently being developed in the financial instruments project for debt instruments provide a basis?
- Should the realised gain and loss on an asset be recycled when the asset is sold and, if so, how?
- Is there a need for a mechanism to recognise losses on the insurance liabilities in profit or loss under certain circumstances, sometimes referred to as a "liability adequacy test"? How should such a mechanism work?
- Should an OCI approach be required or permitted? Would it apply to non-insurers as well?

The FASB is expected to join this debate because it plans to include an OCI approach (Fair Value through Other Comprehensive Income) for certain debt instruments in its proposal to revise the accounting for financial assets under US GAAP. This makes it natural for the FASB to also consider an OCI approach for insurance liabilities, and to achieve a consistent approach for assets and liabilities. Also, the IASB and the FASB agreed at their January meetings to work together on reducing differences in their respective classification and measurement models for financial instruments, with the objective of more closely aligning key aspects of their classification and measurement models. The use of OCI for debt instruments is expected to be one of those key aspects that will be investigated.

The Boards plan to jointly discuss an OCI approach for Financial Instruments in March. In developing this approach, they will also consider its applicability to insurance.

How we see it

The decision to look at certain aspects of IFRS 9 (OCI, in particular) marks an important development for the insurance contracts project, as well as for the project on financial instruments. An OCI solution could break the lingering deadlock around the volatility issue within the insurance project. This would move the project forward substantially and may ultimately lead to fundamental changes to key aspects of the proposed insurance contracts model as well as IFRS 9. Changes to IFRS 9 may have an impact beyond the insurance industry; as such, the Board is likely to consider the OCI approach for financial assets from a broader perspective rather than as an insurance-specific issue.

The fact that the IASB will work together with the FASB on certain classification and measurement aspects of financial instruments could be an important step in their efforts to achieve a converged solution for insurance contracts. The task of reaching such a solution seems more challenging if significant differences were to remain between the Boards' respective classification and measurement models for financial instruments.

Expanding the use of OCI poses a number of challenges that the Boards will have to explore and address. We therefore encourage insurers to actively participate in the debate on OCI and consider providing input.

IFRS 9 effective date and transition

The Board recently confirmed its proposal to move the effective date of IFRS 9 to 2015 (previously 2013). It also considered other alternatives, but felt it is too early to make a decision to further defer the date. Early application of IFRS 9 would continue to be permitted.

It also decided not to require the restatement of comparative period financial statements on the initial application of the classification and measurement requirements of IFRS 9. Instead, it will ask for modified disclosures on transition that explains the effect of the initial application of IFRS 9 on the classification and measurement of financial assets and liabilities. In our Applying IFRS publication *IFRS 9 for insurers - what to do now? IASB proposes to move IFRS 9 mandatory effective date to 2015*, we provide examples of disclosures that may meet the proposed requirements and offer further insights on the recent developments around the IFRS 9 effective date.

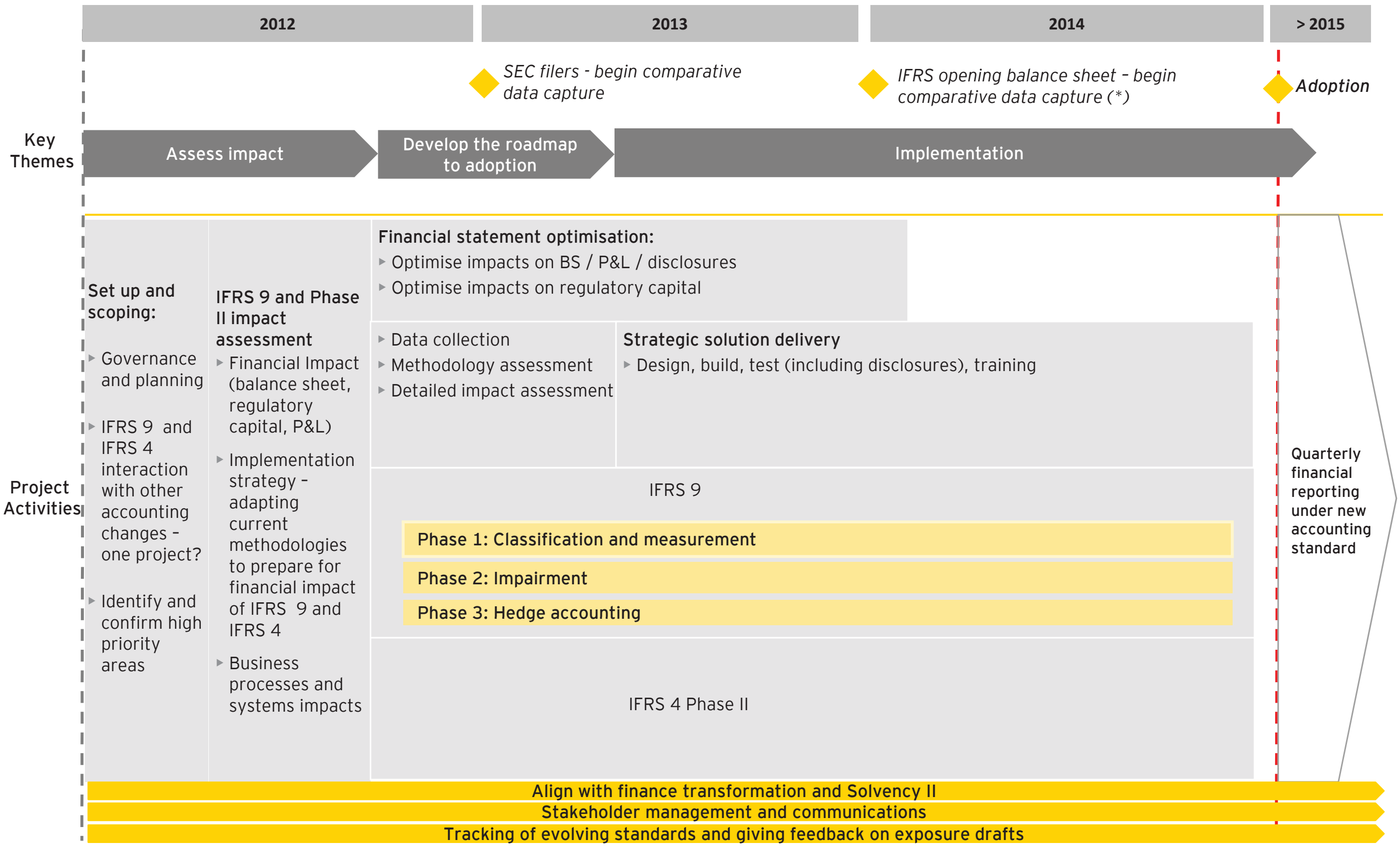
As a result of the connection between IFRS 9 and IFRS 4 Phase II, insurers are keen to synchronise the adoption of both standards. The new effective date of 2015 gives insurers more time to prepare for an aligned implementation. However, any delays in the completion of those projects could result in less time for insurers to prepare or, alternatively, a need for the Board to further revise the effective dates. The IASB plans to issue a re-exposure draft or review draft of the final standard for IFRS 4 Phase II in the second half of 2012. It is also working on exposing revisions to the IFRS 9 classification and measurement model in the second half of 2012.

How we see it

We welcome the amendments to the IFRS 9 mandatory effective date. This will potentially allow insurers to align the mandatory adoption of IFRS 9 with that of the forthcoming IFRS 4 Phase II standard, thus relieving insurers from two major implementation rounds in a short period of time. The Board's announcement also addresses a concern raised by insurers that their classification and measurement decisions, for example, a possible election of the fair value option to mitigate accounting mismatches, should be evaluated in light of the new accounting model for insurance contracts. However, this implies that if IFRS 4 Phase II is not completed in the course of 2012, the Board may need to consider whether an effective date based on 1 January 2015 would give insurers adequate time for an aligned implementation of both standards.

The Board has yet to re-deliberate on the transitional requirements for IFRS 4 Phase II. When developing those requirements, it will also have to consider the interaction with the transitional requirements of IFRS 9. For example, their decision not to require restatement of comparative numbers for IFRS 9 raises the question of whether the same approach is necessary for IFRS 4 Phase II.

What does your IFRS 9 and IFRS 4 Phase II implementation roadmap look like?



* *Voluntary for IFRS 9, to be decided for IFRS 4 Phase II.*

What does it mean for insurers?

The combined implementation of IFRS 4 and IFRS 9 will have a major impact on an insurer's financial statements and key performance measures. Implementing these two standards together will create considerable challenges and require a coherent approach. The Board's decision to reconsider certain areas of the IFRS 9 classification and measurement, the delay in the effective date of IFRS 9 and the current status of the insurance project may cause some companies to defer thinking about implementation issues. Nevertheless, considering the responses from the insurance industry, the OCI topic will be high on many insurers' IFRS accounting change agendas. The need to perform an assessment of the impact of IFRS 9 and IFRS 4 Phase II, in order to respond to the Board's outreach and participate in the debate on any proposed OCI solution is therefore, even more important.

The fact that the Board is now considering the IFRS 9 model and its interaction with IFRS 4 Phase II emphasises the importance of implementing and connecting these two projects. Determining a consistent approach to insurance liabilities and the investments backing those liabilities may require strategic planning and making key choices early. Furthermore, significant systems and process changes required by the implementation of IFRS 9 and IFRS 4 Phase II may take a number of years to be completed. The chart above is an example of a roadmap for implementing these standards, presuming an effective date of 2015.

Many insurers have included implementation of IFRS 9 and IFRS 4 Phase II as work streams within their large-scale accounting and regulatory change projects. This enables them to establish a link between the introduction of the new accounting models for financial assets and insurance contracts, and coordinate that introduction with changes in regulatory reporting frameworks such as Solvency II in Europe. We therefore strongly encourage insurers to monitor closely the developments of IFRS 9 and IFRS 4 Phase II, and continue preparing to implement these standards. As we emphasise in our publication *Facing the challenge - implementing IFRS 4 Phase II in combination with IFRS 9 and Solvency II* this implementation will require a large and complex project that will place significant demands on insurers.

How we may be able to help you

Issues and steps	How we may be able to help you
Gain a general understanding of the new or proposed accounting standards	‣ Design and deliver a training session for company personnel on the accounting implications of the new or proposed standards ‣ Share insights of the IASB views, including interpretations
Perform a preliminary assessment of the impact of the proposal on the company's financial statements and regulatory capital	Advise and provide input into: ‣ Gathering necessary scoping information to implement the new or proposed standards ‣ Calculating the income statement impact of implementing the new or proposed standards ‣ Assessing impact on key financial ratios and performance measures ‣ Identifying shortfalls in available information to implement the new or proposed standards ‣ Assessing impact on regulatory capital ‣ For non-audit clients, Ernst & Young can provide support, through the use of an automated tool, to determine the characteristics of financial assets for the IFRS 9 classification. This tool is able to run queries through large data sets and identify features to help determine classification using information from external data vendors. The use of this tool can reduce the time needed to analyse instruments that would require fair value classification based on characteristics of the instrument. This automated approach is also available for use on contractually linked instruments. For audit clients, Ernst & Young can use the tool to evaluate assessments made independently by company management
Benchmark the company against peers and others in the industry	‣ Provide observations of how others are approaching the new or proposed standards, how they are identifying problems and developing solutions ‣ Assist in the evaluation of peers, competitors and industry disclosures and expected impact on the financial statements
Assess processes for data collection, internal controls, IT systems	‣ Offer observations and insights based on leading practices regarding ways the company could design its business processes, IT systems, and internal controls to capture information necessary to apply new or proposed standards ‣ Perform an impact assessment of IFRS 4 Phase II on company's business processes and systems by using Ernst & Young web-based 'Gap-Analyser' tool ‣ Provide criteria to consider in selecting IT packages, and assist in the selection process
Assess tax positions relating to the new or proposed accounting standards	‣ Assist in analysing tax positions arising from adopting the new or proposed standards, reducing tax exposure, and determining tax effects of any accounting changes
Plan for ultimate implementation of the new or proposed standards	‣ Advise on the implementation of the new or proposed standards using an established methodology ‣ Offer advice on project maintenance and planning, including timeline, tasks, and resource allocation
Advise management during the implementation	‣ Provide guidance on where the new or proposed standards will require careful use of judgement ‣ Review and provide input into accounting manuals and policies selected by management ‣ Provide coordinated support through Ernst & Young subject-matter resources (Regulatory, Tax, Finance Transformation, etc.) on a global basis
Communicate effect of implementation to stakeholders— analysts, regulators, shareholders	‣ Offer guidance on developing a communication plan ‣ Advise on drafting communications

Contacts

Tara Kengla
EMEIA Financial Services
Financial Accounting and Advisory Services Leader
+44 20 7951 3054
tkengla@uk.ey.com

Michiel van der Lof
EMEIA Financial Services
IFRS Leader
+31 88 40 71030
michiel.van.der.lof@nl.ey.com

Country leaders

Belgium

Jean-françois Hubin
+33 2 774 9266
jean-francois.hubin@be.ey.com

Peter Telders
+33 2 774 9168
peter.telder@be.ey.com

Channel Islands

Chris Matthews
+44 1534 288 610
cmatthews@uk.ey.com

France

Amaury de la Bouillerie
+33 1 46 93 6580
amaury.de.la.bouillerie@fr.ey.com

Loic Moan
+33 1 46 93 42 02
loic.moan@fr.ey.com

Germany

Christoph Hultsch
+49 6196 996 26833
christoph.hultsch@de.ey.com

Martin Gehringer
+49 6196 996 12427
martin.gehringer@de.ey.com

Ireland

Vincent Bergin
+353 1 2212 516
vincent.bergin@ie.ey.com

Italy

Wassim Abou Said
+39 063 247 5506
wassim.abou-said@it.ey.com

Ambrogio Virgilio
+39 027 221 2510
ambrogio.virgilio@it.ey.com

Luxembourg

Aida Jerbi
+352 42 124 8614
aida.jerbi@lu.ey.com

Jasper Kolsters
+852 28499278
jasper.kolsters@nl.ey.com

Christine Holmes
+31 88 40 73876
christine.holmes@nl.ey.com

Spain

Manuel Martinez Pedraza
+34 91 572 7298
manuel.martinezpedraza@es.ey.com

Jose Carlos Hernandez Barrasus
+34 91 572 7291
josecarlos.hernandezbarrasus@es.ey.com

Switzerland

Stefan Schmid
+41 58 286 3416
stefan.schmid@ch.ey.com

John Alton
+41 58 286 4269
john.alton@ch.ey.com

United Kingdom

Sarah Williams
+44 20 7951 1703
swilliams10@uk.ey.com

Tony Clifford
+44 20 7951 2250
aclifford@uk.ey.com

Keven Griffith
+44 20 7951 0905
kgriffith@uk.ey.com

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young
Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 152,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com.

About Ernst & Young's Global Insurance Center
Insurers must increasingly address more complex and converging regulatory issues that challenge their risk management approaches, operations and financial reporting practices. Ernst & Young's Global Insurance Center brings together a worldwide team of professionals to help you achieve your potential — a team with deep technical experience in providing assurance, tax, transaction and advisory services. The Center works to anticipate market trends, identify the implications and develop points of view on relevant industry issues. Ultimately it enables us to help you meet your goals and compete more effectively.
It's how Ernst & Young makes a difference.

EYG no. AU1101

1202-1332406 NY

www.ey.com/insuranceifrs