

IFRS 9 deferred for insurance entities; further progress on participating contracts model

What you need to know

- ▶ The IASB plans to issue an exposure draft to give companies whose business model is predominantly to issue insurance contracts an option to defer the effective date of IFRS 9 until 2021 (the 'deferral approach'). It would also give insurers who do implement IFRS 9 on or before its effective date the option to remove from profit or loss some of the accounting mismatches and temporary volatility that could occur before a new insurance contracts standard is implemented (the 'overlay approach').
- ▶ The Board discussed disaggregation of the impact of changes in market variables within the statement of comprehensive income for those who elect not to present the full impact of changes in profit and loss. The Board decided:
 - ▶ The objective of disaggregation should be to reflect, in profit and loss, a cost measurement basis of the liability with the remainder of the change reflected in other comprehensive income (OCI)
- ▶ Not to specify detailed mechanics for how to calculate the investment expense in profit or loss related to insurance contracts
- ▶ Entities issuing participating contracts accounted for under the variable fee approach will be allowed to present, in profit and loss, the impact on insurance contract liabilities of changes in the value of certain embedded guarantees. This will enable those who use derivatives to hedge guarantee exposures an opportunity to reduce accounting mismatches.

Overview

During its September meetings, the International Accounting Standards Board (IASB or the Board) continued its re-deliberations on ways to mitigate the impact of adopting IFRS 9 *Financial Instruments* (IFRS 9) in advance of the new insurance contracts standard, IFRS 4 Phase II. The Board voted in favour of drafting an exposure draft (ED) to allow either IFRS 9 deferral for insurers or the application of the overlay approach. The latter gives insurers the option, upon implementation of IFRS 9, to remove from profit or loss some of the accounting mismatches and temporary volatility that could occur before IFRS 4 Phase II is implemented.

The IASB also made further tentative decisions on accounting for insurance contracts with participation features (participating contracts), including the following topics:

- ▶ Mechanics for disaggregating the presentation of the impact resulting from changes in market variables between profit or loss and OCI
- ▶ Limitations on the use of OCI for participating contracts in which no economic mismatches exist

- ▶ Simplifications on transition to the new standard for disaggregating the presentation of the impact of changes from market variables between profit or loss and OCI
- ▶ Solutions to avoid accounting mismatches under the variable fee approach when an insurer hedges guarantees embedded in participating contracts

The IASB also held a joint education session with the US Financial Accounting Standards Board (FASB) during which both Boards provided updates on their respective insurance contract accounting projects.

The story so far

The IASB's website provides information about tentative decisions made on the insurance contracts accounting model prior to this meeting, including:

- ▶ The cover note for the Insurance Board papers for the September meeting which contains a summary of progress so far¹
- ▶ Further information on the project and the proposed model²

Deferral of IFRS 9 for insurers and application of the overlay approach

At its September meeting, the IASB discussed the findings from the staff outreach to users of financial statements about the pros and cons of deferral of IFRS 9 and application of the overlay approach.

The overlay approach would allow an insurance entity, on adoption of IFRS 9, the option to exclude from profit or loss and recognise in OCI, the difference between amounts that would be recognised in profit or loss in accordance with IFRS 9, and the amounts recognised in profit or loss in accordance with IAS 39. The overlay approach could be applied by any entity until the new insurance standard becomes effective, but only for financial assets which are:

- ▶ Designated as relating to contracts in the scope of IFRS 4
- ▶ Classified as fair value through profit or loss (FVPL) in accordance with IFRS 9 when they would not have been classified as FVPL under IAS 39

Some users supported deferral, particularly at the reporting entity level. Some users supported deferral, but would also accept an overlay approach. Some users supported only the overlay approach, which was seen as an additional source of information rather than a possible loss of information that may occur as a result of deferral. Other users supported the implementation of IFRS 9 in full without deferral or overlay.

Having discussed the feedback from users of financial statements, the IASB agreed to produce an ED of changes to IFRS 4 *Insurance Contracts* which, if adopted, will allow insurers the option to either:

- (i) Defer the implementation of IFRS 9 until the earlier of the effective date of a new insurance standard and 2021 ('deferral approach')

Or

- (ii) Apply the overlay approach upon implementation of IFRS 9 to remove



¹ <http://www.ifrs.org/Meetings/MeetingDocs/IASB/2015/September/AP02-Insurance-contracts.pdf>

² <http://www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Pages/Insurance-Contracts.aspx>

from profit or loss some of the accounting mismatches and volatility that may occur before the new insurance contracts standard is implemented

After an inconclusive discussion on the first day, during which seven Board members voted in favour of the proposal to defer IFRS 9 for insurers with seven voting against, the IASB Chair used his casting vote in a later meeting to allow staff to draft an ED including both the deferral and overlay options. The Board gave the staff permission to draft the ED, with one Board member expressing her intention to present a dissenting view to that expressed in the ED. The ED is expected to be issued in late 2015, with a proposed implementation date of 2018, in line with the effective date of IFRS 9.

Overlay approach

At the July meeting, the IASB voted in favour of a proposal now referred to as the overlay approach. During the September meeting, the IASB considered in further detail how the approach would work.

It was agreed that the designation of assets as relating to contracts within the scope of IFRS 4 could change over time based on changes in the relationship between financial assets and the insurance liabilities. An entity will be permitted to apply the overlay approach to financial assets when the eligibility criteria are met. When a financial asset no longer meets the eligibility criteria, the remaining overlay adjustment amount in accumulated OCI will be recycled to profit or loss immediately.

A single line item for the amount of the overlay adjustment should be presented in either profit or loss or OCI, or both. Insurers applying the overlay approach will have to make disclosures about application of the option, the amount of the adjustment to profit and loss and OCI, and how the adjustment was derived. On transition to IFRS 9, the overlay approach would be retrospectively applied. If an entity restates comparatives under IFRS 9, it should also restate comparative amounts

for the overlay adjustment. When an entity stops applying the overlay approach, the remaining balance in accumulated OCI will be recycled to profit or loss at the beginning of the first comparative period presented (or, if later, the beginning of the period when the overlay approach was first applied).

The Board recognised that while the overlay approach may not be quite as elegant and precise as initially thought, and may not provide a solution in all cases, it would be an effective temporary solution that covers most situations. In a discussion about restricting the overlay approach to assets related to insurance contracts, the Board also noted the role of auditors and regulators in assessing the correct designations and preferred to retain a principle.

Deferral approach

The IASB moved on to discuss questions around the possible deferral of IFRS 9, leading up to the key question of whether or not to support deferral. After a lengthy debate, and with the Chairman using his casting vote, the Board approved a proposal to allow an optional deferral of IFRS 9 implementation until the effective date of the new insurance contracts standard. However, this deferral option will expire for reporting periods beginning on or after 1 January 2021, meaning that if the new insurance contract standard is not applied from the beginning of 2021, an entity will have to apply IFRS 9. At that moment, an entity would have to adopt IFRS 9, but could decide to apply it in conjunction with the overlay approach until the new insurance standard became effective.

The deferral approach would apply only to reporting entities with a predominant part of their business devoted to the activity of issuing contracts within the scope of IFRS 4. This would initially be determined when an entity would otherwise be required to apply IFRS 9, by reference to the percentage of total liabilities that are within the scope of IFRS 4. The IASB felt that "predominant" should represent a

high hurdle - indicating that this was likely to be more than two thirds of total liabilities implied in the staff paper. As such, the Board instructed the staff not to set a specified percentage for predominance, but to include examples that specify the levels at which an entity's activities would not be considered predominantly insurance. Entities should reassess whether the insurance activities are still predominant subsequently if there is a demonstrable change in corporate structure (e.g., acquisitions or disposals). If an entity's insurance activities would no longer be considered predominant, it would have to start applying IFRS 9 from the beginning of the next annual reporting period.

A few Board members had queries about how this condition would apply to entities with a large number of derivatives contracts, to conglomerates, or to insurers with large portions of investment contract liabilities not in scope of IFRS 4 that are already at FVPL. Most Board members agreed with the single quantitative predominance test as adding further items would add a significant layer of complexity. They also noted that the overlay approach would be available to non-qualifying entities as an alternative.

The deferral option would apply at reporting entity level. So, for example, a conglomerate financial institution would have to apply the eligibility criteria at the conglomerate level when looking at the consolidated reporting for the entire group. Subsidiaries within the conglomerate that issue their own separate or consolidated financial statements would assess the eligibility criteria at their level for the purpose of their own reporting.

Board members agreed with the staff view not to allow deferral below reporting entity, noting the existence of different regulations across the globe and difficulties in ensuring consistency, as well as dealing with transfers between different parts of the entity. The Board also agreed that deferral should be optional rather than mandatory, as long as appropriate

disclosures are required to allow comparability. If a reporting entity chooses to apply the deferral, it will disclose this fact along with:

- ▶ An explanation of why it is eligible
- ▶ The fair value of financial assets that would not meet the 'solely principal and interest' characteristic test in IFRS 9 and would therefore be measured FVPL
- ▶ Credit risk information about financial assets that would not be required to be measured at FVPL under IFRS 9 (e.g., aggregate credit ratings).

A number of Board members wanted to ensure disclosure requirements were not so onerous and costly as to negate the impact of deferral itself, but rather provided disclosures for key comparisons. They noted that some disclosures would not necessarily be useful, for example, full disclosure of the business model as this would be reassessed on applying the new insurance contracts standard, whereas disclosure about the value of structured debt and credit quality of assets would be valuable.

An entity will have the option to stop applying the deferral approach at the beginning of any annual reporting period, before the new insurance contracts standard becomes effective. An entity will be required to stop applying the deferral approach when it no longer qualifies, based on the predominance criterion (see above) or when the new insurance contracts standard becomes effective.

As noted above, the Board was split on adopting the deferral approach. Those who opposed deferral expressed strong disagreement for various reasons, including: concerns over comparability; the relative sophistication of the insurance industry and its ability to deal with IFRS 9 implementation; a deep concern over a possible long-term delay in implementation of IFRS 9 by insurers; and potential effects on other industries. One Board member also felt that the gap between implementation of IFRS 9 and IFRS 4 Phase II could be much longer than the two or three years initially thought, and therefore, there would not be a requirement to implement two new standards within a couple of years. Other

Board members, including the Chairman, saw this as an overly pessimistic view of the time frame for completion and implementation of IFRS 4 Phase II.

All IASB members confirmed they were satisfied that the IASB had completed the necessary due process and instructed staff to start the balloting process for the ED to amend IFRS 4 for deferral and the overlay approach. Only one of the Board members present who had opposed deferral indicated the intention to dissent from the publication of an ED to amend IFRS 4 (one board member was absent). The others who had opposed deferral did not plan to dissent from the publication of an ED, taking into account that an expiry date ('sunset clause') for deferral was to be included.

During the discussions about the sunset clause, the IASB restated its commitment to completing discussions on the insurance project during 2015, and publishing a standard in 2016. The Chair indicated that he was hopeful for a 2020 effective date for the new insurance contracts standard.

Further decisions on the accounting model for participating contracts

The IASB continued its discussions on accounting for insurance contracts with participation features (participating contracts). Topics discussed at this meeting included:

- ▶ Mechanics for disaggregating the presentation of the impact resulting from changes in market variables between profit or loss and OCI, and whether such disaggregation should be an accounting policy choice
- ▶ Whether there should be limitations on the use of OCI for participating contracts in which no economic mismatches exist
- ▶ Possible simplifications on transition for disaggregating the presentation of the impact of changes from market variables between profit or loss and OCI
- ▶ Possible solutions to avoid accounting mismatches under the variable fee approach when an insurer hedges guarantees embedded in participating contracts

How we see it

Many insurers will welcome the decision by the IASB to include the option of deferral in the upcoming ED, in addition to the overlay approach. Once the ED is issued, a comment period will follow, and only after consideration of comments and redeliberation will the proposals be effective.

The deferral proposal includes a requirement for disclosure of the impact of not applying IFRS 9 in the notes to the financial statements. These disclosures seem to be less onerous than might have been expected based on previous IASB meetings and do not appear to require the full parallel production of calculations as if IFRS 9 had been fully applied.

Not all entities issuing insurance contracts would qualify for the deferral as it will apply only if the predominant part of total liabilities are within the scope of IFRS 4. This requirement might be particularly difficult to meet for insurers that have a large amount of investment contract liabilities (e.g., unit linked investment business) in the scope of IAS 39/IFRS 9 rather than IFRS 4.

Entities that do not qualify for deferral are still likely to be able to make use of the overlay approach. There was strong support from the IASB for this option. However the application of the option, and the calculations required to implement it, may be quite complex. This will particularly be the case when accounting for insurance contract liabilities is affected by the amount of investment income recognised in profit and loss (for example, for insurers applying shadow accounting).

The IASB decided that, for all types of insurance contracts, entities should present changes in estimates of cash flows resulting from changes in market variables consistently with the way that the effects of changes in discount rates are presented. If the effects of discount rate changes are presented in OCI, those cash flow effects should also be presented in OCI. If the effects of discount rate changes are presented in profit or loss, those cash flow effects should also be presented in profit or loss. An entity would have an accounting policy choice at the portfolio level to record changes in market variables in either profit or loss or OCI.

The IASB also agreed that, if an OCI presentation is used, the objective to be used in determining how to disaggregate the impact of changes in market variables between profit or loss and OCI should be to present an insurance investment expense item in profit or loss that reflects a cost measurement basis for the insurance contract liability. The IASB will not provide detail on the exact mechanics of the method for determining the insurance investment expense item, although the Board requested the staff to work on application guidance and/or examples that would clarify the objective. The Board noted possible methods for determining the investment expense item would include several variations of the effective yield method mentioned in the staff papers.

At its June meeting, the IASB agreed that for certain participating contracts (referred to as “direct participating contracts”), an entity could adjust the contractual service margin (CSM) for changes in estimates of future fees that it expects to receive (usually a percentage of assets to which the participating contracts refer). This is referred to as the variable fee approach and applies only to contracts meeting the following conditions:

- ▶ The contractual terms specify that the policyholder participates in a share of a clearly identified pool of underlying items
- ▶ The entity expects to pay to the policyholder a substantial share of the returns from the underlying items

- ▶ A substantial proportion of the cash flows that the entity expects to pay to the policyholder is expected to vary with the cash flows from the underlying items

At this meeting, the Board identified a specific subset of participating contracts within the above scope of the variable fee approach: those where the entity holds the underlying items in which policyholders are entitled to participate (either by choice or as the result of a requirement). The Board agreed that under these conditions (i.e., qualifying for the variable fee approach and holding the underlying assets), an economic mismatch cannot exist between the liability and the underlying items. To reflect the objective to eliminate accounting mismatches in profit or loss, entities could, as their accounting policy choice, determine the expense item in profit or loss for the insurance liability consistently with the accounting returns reflected in profit or loss for those underlying assets. The OCI amounts for the insurance liability would be equal and opposite to the OCI amounts recognised on the underlying items (this is referred to as ‘the current period book yield approach’). However, the Board decided that an entity could also choose as its accounting policy for these contracts to fully recognise the impact of changes in market variables in profit or loss.

For contracts within the scope of the variable fee approach where the entity does not hold the underlying items in which policyholders are entitled to participate, the current period book yield approach described above cannot be used. For these contracts, an entity can apply an effective yield approach or recognise all changes from market variables in profit or loss. An entity is required to change between the current book yield method and the effective yield method when it no longer meets the requirements for application. When changing, the entity recognises the related accumulated OCI amount for the insurance liabilities in profit or loss over time using assumptions that applied prior to the change. At the time of change, neither the accumulated OCI amount nor the comparatives are restated.

The Board further agreed on transition simplifications in case retrospective application of the standard is impracticable for participating contracts:

- ▶ For participating contracts not in scope of the variable fee approach (indirect participating contracts) and direct participating contracts that do not apply the current period book yield approach, an entity would use the interest rates at transition as the rates for determining the expense item in profit or loss. Accordingly, the accumulated OCI amount on transition for these insurance liabilities would be nil, whereas the assets backing these liabilities generally would have a positive OCI amount if the underlying assets were carried at fair value through OCI.
- ▶ For contracts that apply the current period book yield approach, considering the direct link between the insurance liabilities and the underlying assets, an entity should assume, on transition, that the accumulated OCI amount is equal and opposite to the accumulated OCI amount relating to the underlying assets. Accordingly, the combined amount in OCI for direct participating insurance liabilities and the assets underlying these liabilities would be net nil.

The Board also discussed the possible accounting mismatches under the variable fee approach when hedging the risks from embedded guarantees. When applying the variable fee approach, the impact in profit and loss of changes in embedded guarantees in insurance contracts is deferred over the period of the contract through the CSM. However, entities may economically hedge risks arising from embedded guarantees by entering into derivative instruments. Under IFRS 9, derivative instruments (which do not qualify for hedge accounting) are measured at fair value through profit and loss. In order to prevent an accounting mismatch in such cases, the Board decided that entities should be permitted to recognise the changes in the measurement (fulfilment value) of embedded guarantees in

insurance contracts in profit or loss if the following criteria are met:

- ▶ The risk mitigation is consistent with the entity's risk management strategy
- ▶ An economic offset exists between the embedded guarantee and the derivatives (i.e., their values generally move in opposite directions)
- ▶ Credit risk does not dominate the economic effect

The entity should incorporate the above in its documentation and should discontinue to recognise the changes in the fulfilment value of the guarantee in profit or loss when the economic offset does not exist anymore.

One Board member commented that she did not like the solution, but recognised it was needed based on previous decisions taken on the variable fee approach. Others

queried how entities could separate and measure the relevant cash flows of the embedded derivatives from the host insurance contract, if they previously had stated they could not do so. The staff noted that separation would be limited to the embedded guarantees only and that different degrees of sophistication exist in practice on how to separate these guarantees.

How we see it

There is clearly a determination by the IASB to complete deliberations and issue a standard as soon as possible. These decisions move the participating model forward quite significantly.

For indirect participating contracts, the decision about disaggregating the effects of changes in market variables means that the accounting will differ from that for direct participating contracts. The Board does not intend to provide detailed guidance on the exact mechanics, including how to calculate the effective yield. This means entities will have to carefully assess possible ways for determining the effective yield, in particular, how this would affect accounting for the shareholder share.

There are still important aspects of accounting for indirect participating contracts that need to be clarified, for example, how to distinguish between the effect of changes in future cash flows resulting from the exercise of management discretion that can be offset against the CSM, and changes in future cash flows that result from changes in market variables recognised in the statement of comprehensive income.

The decision to allow entities to report the effect of embedded guarantees in profit or loss under the variable fee approach demonstrates the Board's willingness to find practical solutions in order to complete the project and will be welcomed by a number of insurance groups.

What's next?

The Board's next meeting on insurance contracts is expected to be in October. The topics have not yet been announced, but are likely to include further discussion on participating contracts, with a view to concluding on remaining topics this year. The IASB also expects to discuss the comment letter period for the forthcoming ED on IFRS 9 deferral for insurers and the overlay approach during its October meeting.

The IASB expects to finalise re-deliberations by the end of 2015 and issue the new standard in the course of 2016.

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