What IFRS 9 means to insurers

Developing insurance specific business capabilities
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Executive summary

The wait is over, the time to act is now! Over the last 3 years, International Accounting Standard Board (IASB) issued series of new accounting standards which will fundamentally change the financial reporting for insurance companies. In July 2014, IASB issued IFRS 9 Financial Instruments and more recently in May 2017, IFRS 17 Insurance Contracts was also issued. The new reporting standards aim to improve the comparability and transparency of accounting practices, whilst promoting better alignment between finance, risk and actuarial functions through enhanced disclosure of financial position, performance and risk information, and on application of principles-based accounting.

IFRS 9 Financial Instruments introduces changes to the accounting treatment of financial assets to address criticism regarding weaknesses in the existing accounting standard on financial instruments, IAS 39. The criticism related to the high level of complexity and the delayed recognition of credit losses on financial instruments, which emerged during the financial crisis.

IFRS 9 applies to all entities and various types of financial instruments, and will be effective from 1 January 2018. While a recent IASB amendment allows qualifying insurance entities to defer implementation to the effective date of the final IFRS 17 standard, 1 January 2021, it is crucial that insurers fully understand the financial and operational impacts as well as prepare for any changes in investment strategies as a result of IFRS 9.

Local regulators (e.g., Taiwan) may require early adoption through regulatory overlay requirements. At the same time, for insurers who qualify and elect the deferral approach, they will need to fulfill certain disclosure requirements for financial reports issued after 1 January 2018. Insurer also has the option to choose voluntary early adoption and/or overlay approach.

IFRS 9 effective date
No
Predominant insurance activities?
IFRS 9 Adoption1
Yes
1st IFRS 9 annual financial statements
Latest implementation date for Deferral2

1. For qualified assets, insurer may choose the overlay option
2. Insurer has the option to choose early adoption of IFRS 9 in full prior to 1 Jan 2021
This paper will discuss some practical challenges and approach for all insurers when designing and implementing IFRS 9 changes. In particular:

- Bridging the gap between assets and liabilities
- Smart and effective impairment approach
- Optimal target operating model (TOM) under IFRS 9

Together with IFRS 17, the accounting changes impose new challenges and opportunities for asset allocation, asset-liability management (ALM), performance measurement and business management. Insurers also need to educate both internal and external stakeholders on the impacts of the new standards and how profits emerge.
Bridging the gap between assets and liabilities

Fixed income assets usually constitute the majority of an insurer’s investment portfolio. The accounting classification of these assets should be considered together with the insurer’s specific business strategy, liability profile, decisions expected to be made on IFRS 17 and business process.

Integrated approach to design asset classification in line with related liabilities

Under IFRS 17, insurers have the option to recognize insurance liabilities’ volatility due to changes in financial assumptions (including discount rates) over the period in other comprehensive income (OCI). This provides insurers (especially those with long-duration business) the opportunity to take some volatility out of reported profit or loss, if designed in conjunction with the business model under IFRS 9. In addition, an entity may at initial recognition designate a financial asset to be measured at fair value through profit and loss (FVPL). In doing so, it could significantly “bridge” the accounting classification gap between the assets and liabilities.
The key classification considerations are discussed below:

**SPPI test – nature of cash flows generated by investments**

The objective of cash flow assessments is to evaluate at an instrument level whether the contractual cash flows **Solely Payments of Principal and Interest (SPPI test)** upon initial recognition. The test also assesses whether the investor will only be exposed to risks of basic “lending” arrangements. Although the analysis of contractual terms is also essential, that alone may not be sufficient for the SPPI test. It is possible to reach different conclusions for the same assets that have been acquired at different times. The questions to be considered in the assessment include but are not limited to:

1. **Is it an investment in equity or derivatives?**
2. **Does it include a non-recourse instrument?**
3. **Will the instrument be leveraged?**
4. **Has the “time value of money” element been modified?**
5. **Is the instrument subordinated to other instrument of the debtor?**
6. **Is there any modification which may lead to risks unrelated to a basic “capital lending” arrangement?**

Examples of cash flow assessments and considerations:

<table>
<thead>
<tr>
<th>Examples</th>
<th>Pass SPPI</th>
<th>Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Government Bond</strong></td>
<td>Yes</td>
<td>Plain vanilla bond paying a fixed interest rate with no embedded derivatives</td>
</tr>
<tr>
<td>• 10 years government bond</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Fixed interest rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Listed on active market</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Purchased at 110%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Floating rate bond with cap and floor</strong></td>
<td>Yes</td>
<td>Variable rate instrument with the embedded interest corridor. The interest</td>
</tr>
<tr>
<td>• 5 years term</td>
<td></td>
<td>corridor is reducing the cash flows volatility rather than increasing it</td>
</tr>
<tr>
<td>• Standard variable rate interest with no</td>
<td></td>
<td></td>
</tr>
<tr>
<td>maturity mismatch</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Floor of 1% cap of 6%</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Non-standard interest rate reset bond</strong></td>
<td>Maybe</td>
<td>SPPI test is met as the cash flows resulting from the interest rates with a</td>
</tr>
<tr>
<td>• 5 years corporate bond in USD</td>
<td></td>
<td>tenor mismatch is not significantly different from the cash flows that would</td>
</tr>
<tr>
<td>• Variable rate (3month Libor plus fixed</td>
<td></td>
<td>result from an asset with a standard interest rate reset</td>
</tr>
<tr>
<td>spread)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Bond has a non-standard interest rate reset</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Listed on an active market</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Structured note</strong></td>
<td>Maybe</td>
<td>The SPPI test is very complex, not only the structured note but also the</td>
</tr>
<tr>
<td>• SPV purchased mortgage loans from Bank A</td>
<td></td>
<td>underlying pool of assets have to be assessed against many conditions before</td>
</tr>
<tr>
<td>and issued 3 types of bonds (multiple</td>
<td></td>
<td>conclusion for SPPI test for such structured note can be drawn</td>
</tr>
<tr>
<td>tranches) with different ratings</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Insurance company Y purchased B bonds</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Second tranche)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• B bonds have fixed interest rate</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• B bonds have 30 year term, prepayment</td>
<td></td>
<td></td>
</tr>
<tr>
<td>option for SPV based on payments</td>
<td></td>
<td></td>
</tr>
<tr>
<td>received from mortgage loans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• SPV hedged its interest rate risk with an</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IRS</td>
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</tbody>
</table>
Business model test – investment management strategy given the liability profile

An insurer’s business model reflects how it manages its fixed income assets in order to generate cash flows to meet policy liability obligations or to achieve a target return for the surplus capital. The business model determines whether cash flows will result from collecting contractual cash flows, selling the fixed income assets, or both. This assessment is performed on scenarios that the insurer will reasonably expect to occur, meaning it will not be performed on so-called “worst case” or “stress case” scenarios.

Example

If an insurer expects it will only sell a particular portfolio of fixed income assets under a stress case situation, this scenario will not be taken into account under the entity’s assessment of the business model for those assets, as the entity does not reasonably expect it to occur.

Business models for managing financial assets is a matter of fact and it is typically observable through particular activities that insurers undertake to achieve their stated objectives. An insurer is required to review and consider all relevant evidence that is available at the date of the business model assessment. Relevant evidence includes, but is not limited to:

- The expected frequency, volume and timing of asset sales
- Evaluation of financial asset performance
- Risk that affects the investment performance and the way investment risks are managed
- How managers of the business are compensated (e.g., whether the compensation is based on the fair value of the assets managed or the contractual cash flows collected)
Considerations in the business model assessment

Use fair value option to further reduce accounting mismatch

Insurers' business model directly relates to its asset-liability management. Accounting mismatches may occur if not all assets backing insurance contract liabilities are carried at FVPL, whilst changes in insurance contract liabilities due to change in discount rates are reported in profit or loss.

Under IFRS 9, insurers can elect the fair value through profit and loss (FVPL) classification option if by doing so, significantly reduces the accounting mismatch for changes in insurer's liability. To make such election, it is important for insurers to understand accounting mismatch on P&L via careful analysis of impacts of both IFRS 9 on assets and IFRS 17 on related liabilities.

Examples of business models assessment

**Business model 1**
“Hold-to-collect” — Portfolio of debt instruments held for collecting contractual cash flows.

- **Insurer 1** invests in a portfolio of bonds with the sole purpose of collecting contractual cash flows. A bond will be sold if the credit-worthiness of that particular bond no longer meets Insurer 1’s investment policy (e.g., the credit rating of the bond falls to a low level specified by the entity).

**Business model 2**
“Both hold to collect and sell” — Portfolio of debt instruments held both for collecting contractual cash flows and selling the financial assets.

- **Insurer 2** holds bonds to fund insurance liabilities. Insurer 2 collects bonds’ contractual cash flows to settle insurance liabilities as they are due. To ensure its cash flows are sufficient to settle liabilities, Insurer 2 regularly undertakes buying and selling activities to rebalance its portfolio of bonds.

**Business model 3**
“Other strategy” — Portfolio of debt instruments that is neither business model 1 nor business model 2 (e.g., held for trading or managing the objective of realizing cash flows through active and frequent sales).

- **Insurer 3** holds a portfolio of bonds to generate profit from changes in fair values due to changes in credit spread or yield curve by managing the portfolio of bonds actively. Based on the above objective, Insurer 3 trades the bonds very frequently. The compensation of its investment managers is linked to the changes in fair value.
For insurers, while the specific impairment scope depends on the outcome from accounting classification (impairment is only for debt investments classified under Amortised Cost and FVOCI, as well as certain credit exposures, e.g., irrevocable loan commitments and financial guarantee contracts issued). Typically, the following may be subject to impairment:\footnote{1}:

- Government bonds
- Corporate bonds (public and private)
- Irrevocable loan commitments and financial guarantee contracts issued
- Senior tranches of structured debt
- Mortgage loans

**Technical challenges**

To fulfil IFRS 9 requirements on “Expected Credit Loss (ECL)” (Section 5.5 of IFRS 9), insurers need to develop corresponding parameter estimation models. Some of the technical challenges for insurers are:

- Investments without credit rating
- Lack of internal default experience
- Lack of internal credit loss experience
- Forward-looking adjustment
- Definition of significant increase in credit risk

Unlike banks, invested credit exposures for insurers are largely publicly traded. Hence, external data from rating agencies can be used to derive specific alternatives for insurers. For private placements, simple market proxy or shadow rating methods are generally acceptable approaches\footnote{2}.
Expected Credit Loss (ECL)

\[ ECL_T = \sum_{t=1}^{T} PD_t \times LGD_t \times EAD_t \times DF_t \]

**Probability of Default (PD)**

- **Credit Rating**
  - Internal Rating
  - External Rating

- **Rating Migration Matrix**
  - Derive PD curve from matrix exponentiation

- **PD Curve**
  - Forward-looking adjustment
  - Integrate forward-looking information into PD curve

- **Spread Implied**
  - Apply external PD curves published by rating agencies

**Loss given Default (LGD)**

- Assign to each portfolio segment a LGD parameter that is derived from internal or external default and recovery data

**Exposure at Default (EAD)**

- Define development of exposure over time
  - Constant Exposure
  - Amortizing Exposure

**Staging**

- Identify stage through decision tree with multiple layers

Based on external data and insurers’ specific fixed income holding information, key IFRS 9 impairment components (highlighted above) can be estimated.
Implementation challenges

Operationally, the challenge insurers have to face is to not only design a comprehensive impairment solution which meets the IFRS 9 requirements, but also one that can be easily integrated with the existing IT infrastructure, reporting system and has the flexibility to address potential investment risk implications e.g., risk based investment performance measures.

In our experience, the following five key attributes are what insurers generally look for:

- End-to-end execution with proven methodology
- Built-in solution with agency data
- Transparency and audit trail
- Adaptability to specific credit investment practice
- Flexibility to address different investment characteristics

EY has developed an end-to-end service (EY IFRS 9 Impairment Analyzer tool) which has embedded data, risk parameter estimation, ECL computation, impairment results diagnostic and reporting. The underlying process flow and system design will support effective integration of your existing reporting system. This is a smart and effective approach specifically designed for insurers to adopt.
Building the operating model

In addition to the accounting requirements, there are a number of operational challenges insurers are facing when it comes to implementing IFRS 9 solutions. The chart below outlines these challenges from two different dimensions:

### Impairment capabilities

- **Develop and update component models**
  - Capability to develop and update IFRS 9 ECL component models

- **Deploy and use component models**
  - Capability to apply IFRS 9 ECL component models to customer and facility data

- **Generate accounting entries**
  - Capability to generate the appropriate accounting entries in general ledger structure

- **Perform external reporting**
  - Capability to generate statutory/Regulatory disclosures

- **Apply significant deterioration assessment**
  - Capability to test for significant deterioration as determined by policy and then allocate exposure to stage

- **Perform impairment calculation**
  - Capability to apply impairment calculation to customer and facility data to measure 12 month or lifetime ECL
The model development capability requires an operating model which supports the initial development of the IFRS 9 component model and once it’s live, allows for sustainable and controlled iterative development.

The model deployment capability requires an operating model which supports frequent application of data transformation, parameter calibration and the deployment of various model versions across a large data set in a controlled manner.

The significant deterioration capability requires an operating model which supports the application of changing assessment frameworks and thresholds. “Stage” status must be tracked historically and governance and controls must allow for overlays and overrides.

The ECL calculation capability requires an operating model which supports generation of “expected credit loss” under IFRS 9 and generates accounting entries and the required granularity of data for external and management information (MI) reporting.

The “classify and measure” capability requires an operating model at origination, based on the underlying products’ cash flow characteristics and the business model of the portfolio. The instrument is then measured through its lifecycle to completion. The augment and interface capability requires an operating model which supports the transformation of data (augmentation, aggregations etc.) and the interface of data from source systems to the general ledger and supporting data warehouse(s).

The capability to generate IFRS compliant results requires an operating model which ensures that the general ledger is populated, maintained and closed to meet the IFRS requirements for statutory reporting.

The management of multiple data sets capability requires a method that is able to respond to data demands from different levels of granularity to support internal, statutory and regulatory reporting.

The capability to generate IFRS reporting requires an operating model which supports the interface of data to consolidation platforms (across finance, risk and investment) to perform consolidation and intercompany eliminations as well as collating the supplementary data required to satisfy statutory disclosures. This also includes a robust control framework and integrated data set to ensure consistent reporting across the reporting landscape.
## Summary of operating model challenges

### Classification and measurement
- **Classify and measure**
  - Identifying the impact at inception and understanding the future impact on the business model of insurer’s investment portfolio
  - Application of controls to evidence that classification has linkage to a business model assessment and the cash flow characteristics of the instrument

### Augment and interface
- **Augment and interface**
  - Data quality must be managed to support subsequent reconciliation activity prior to the calculation of ECL
  - Ensuring that the appropriate amount of data is interfaced to warehouses in order to meet the needs of finance, risk and treasury analytical functions

### Generate IFRS compliant balances
- **Generate IFRS compliant balances**
  - Determining the most appropriate changes to the general ledger chart of accounts for IFRS 9 and IFRS 17
  - Understanding the impact of local GAAP adjustments to IFRS 9 and how local GAAP reporting will be supported once it’s live

### Manage multiple data sets
- **Manage multiple data sets**
  - Reconciliation of various data sets provided at different levels of aggregation
  - Ensure alignment with regulatory risk based capital principles e.g., SII, RBC, C-ROSS, etc.

### Reporting
- **Reporting**
  - Determine the impact to the Statutory reporting data model based on IFRS 9
  - Understanding the qualitative and quantitative disclosure needed to on the IFRS 9 credit risk model methodology, significant deterioration framework, SPPI Test and Business Model under IFRS 9
  - Ensure consistency reporting across various requirements (local, group, internal)
  - Implementation of an agile approach which is able to respond to regulatory changes quickly

### Impairment
- **Model development**
  - Finalizing model methodology, build first wave of IFRS 9 component models to meet compliance deadline
  - Strategic data acquisition and persistence, such that the origination of models is aligned to the production data models enabling rapid deployment and control
  - Co-existence of Regulatory and IFRS 9 Models, regression impacts associated with data transformation rules etc.

- **Model deployment**
  - Agile deployment of augmentation rules and versions of models, driving the need for flexible data acquisition process
  - Managing workflow per portfolio/sub portfolio for production and simulated runs

- **Signification deterioration**
  - Determining the signification deterioration/cure business rules
  - Acquiring the data at “origination” for the back book to support assessment

- **ECL calculation**
  - Application of appropriate governance pre-accounting to ensure control but not to delay ledger close
  - Meeting dynamic reporting ask for statutory, regulatory and MI reporting period on period
  - Supporting business partnering and capital calculation process
  - Integrating existing specific impairment process with the overall IFRS 9 approach

### Capability

### Key challenges

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Conclusion

The principle-based approach of IFRS 9 requires the careful use of judgement in its application. The revised accounting policies under IFRS 9 will be driven by an insurers' business plan, existing liability profile and ALM/investment strategy.

It is important for insurers to perform integrated scenario analysis with IFRS 17 to understand potential financial impact, identify potential gap in their existing operating model and design tailored approach to address both technical and operational requirements.

Contacts

Asia-Pacific

Jonathan Zhao
Managing Partner,
Asia-Pacific Insurance Leader
jonathan.zhao@hk.ey.com
+852 2846 9023

Martyn van Wensveen
Partner,
APAC Insurance IFRS Change
martyn.van.wensveen@my.ey.com
+60 3 7495 8632

Greater China

Samuel Feng
Partner, Financial Accounting Advisory Service
samuel.feng@cn.ey.com
+86 10 5815 2016

Philip Guo
Partner, Audit
philip.guo@cn.ey.com
+86 21 2228 2399

Doru Pantea
Partner, Audit
doru.pantea@hk.ey.com
+852 2629 3168

James Lin
Senior Manager,
Insurance advisory
james.a.lin@hk.ey.com
+852 9635 5391

Singapore

Patrick Menard
Partner, Audit
patrick.menard@sg.ey.com
+65 6309 8978

Gary Mellody
Partner, Risk
gary.mellody@sg.ey.com
+65 6309 6519

Kieren Cummings
Partner, Financial Accounting Advisory Services
kieren.cummings@au.ey.com
+61 2 9248 4215

Australia

John O’Sullivan
Director
Insurance advisory
john.o.sullivan@au.ey.com
+61 3 9288 8692
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