IFRS 9 for Insurers

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Aktuaaritoiminnan kehittämissäätiö

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Building a better working world

Agenda

1	Introduction – from IAS 39 to IFRS 9
2	Classification
3	Impairment
4	Hedge accounting

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What changes do we expect?

- The classification and measurement of financial assets is dependent on the contractual cash flows of the asset and the business model within which the asset is held
- The new impairment model is based on expected credit losses and applies to debt instruments at amortised cost or FVOCI, lease receivables, contract assets and certain written loan-commitments and financial guarantee contracts
- Hedge accounting can more closely reflect risk management, with more qualifying hedging instruments and hedged items
- Amendments to IFRS 7 Financial Instruments: Disclosures introduces significant additional disclosure requirements when IFRS 9 is applied

Financial instruments
The IASB's response to the global financial crisis

Overview

IFRS 9 Financial instruments was issued in July 2014

- **Classification and measurement**
  A single, logical classification approach driven by cash flow characteristics and how the portfolio is managed
- **Impairment**
  An urgently needed and strongly supported forward-looking 'expected loss' model
- **Hedge accounting**
  An improved and widely welcomed model that better aligns accounting with risk management
- **Macro hedging (not yet finalised)**
  Specific accounting for risk management strategies relating to open portfolios rather that individual contracts. Decoupled in order not to impact the effective date of IFRS 9.

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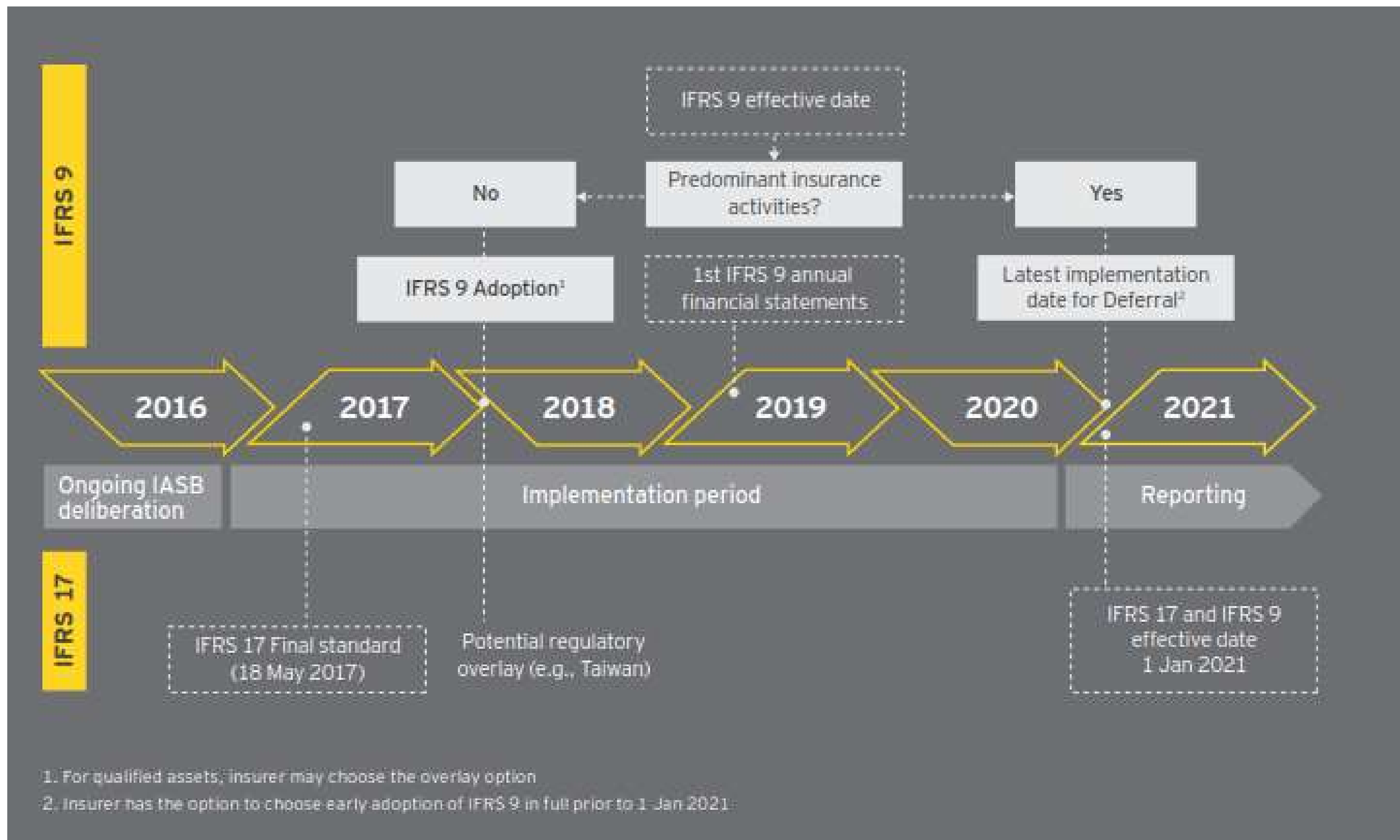
Overview of the timeline



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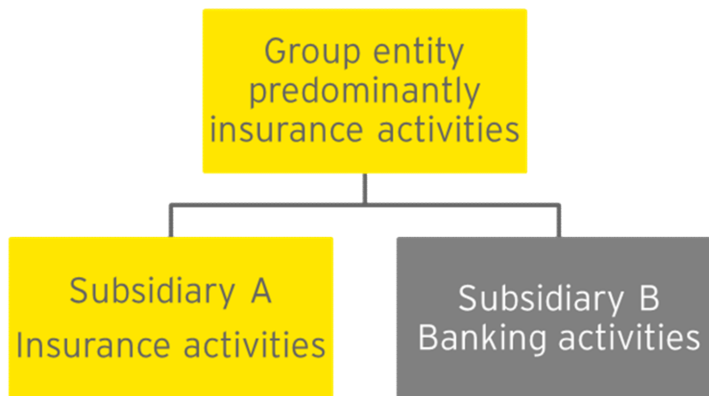
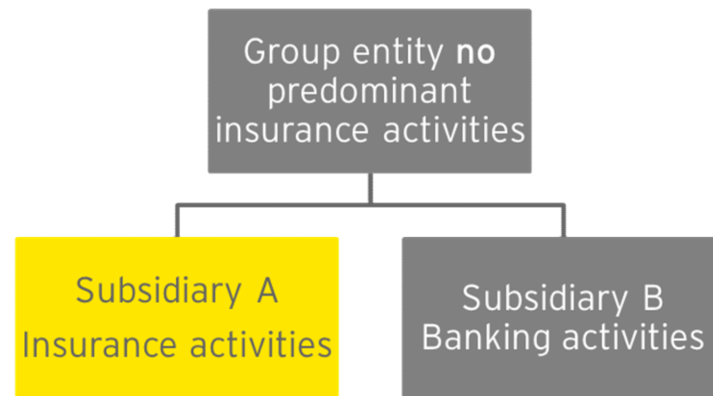
Insurance companies
Three options for IFRS 9

- Deferral
  - Continue to apply IAS 39, for entities with insurance business as predominant activity, until 2021
- Overlay approach
  - Apply IFRS 9, but exclude from P&L certain effects of IFRS 9, which would be booked in Other Comprehensive income
- Full implementation
  - No difference as compared to other entities





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Classification and measurement

New approach for financial assets

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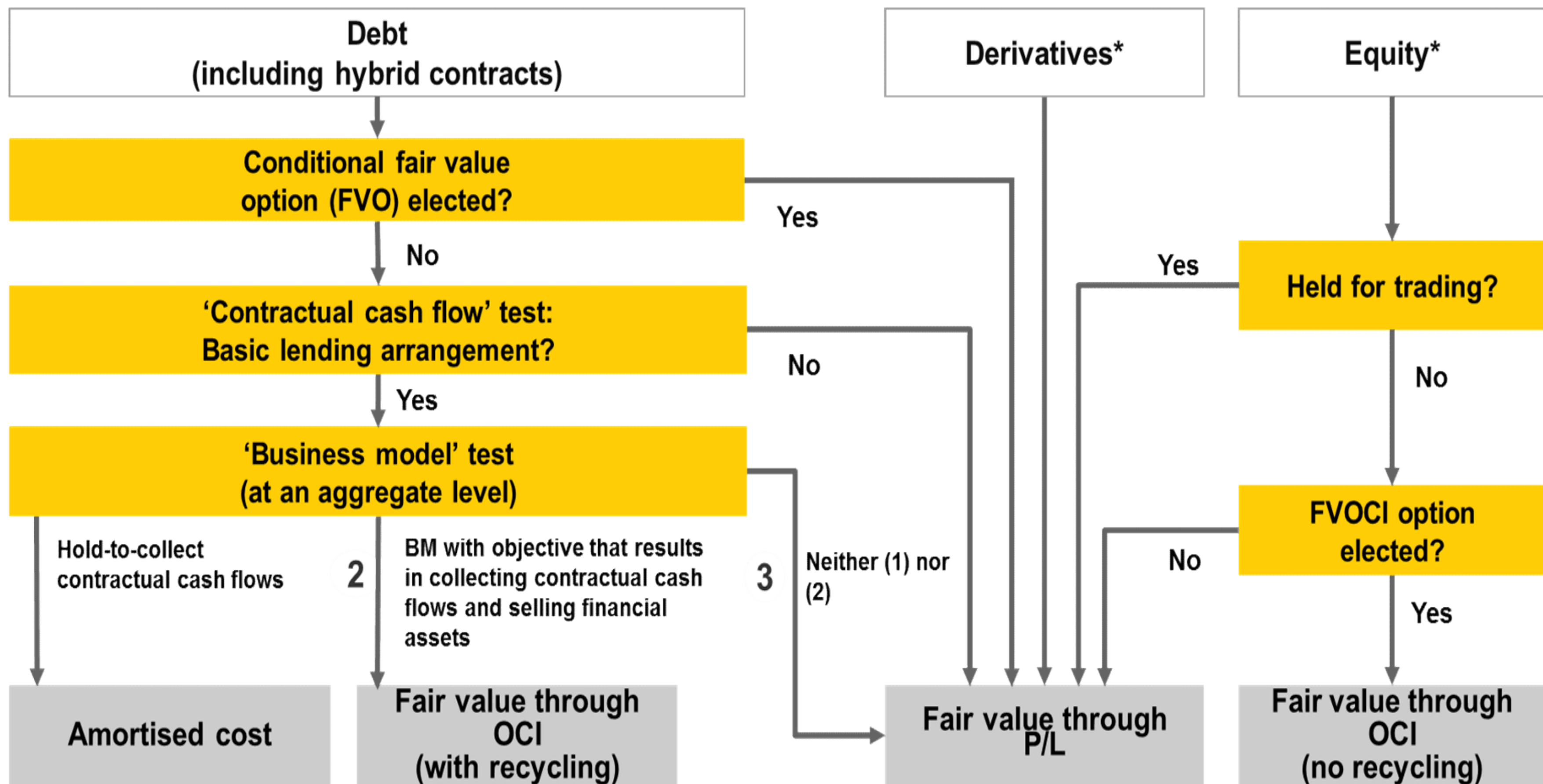
Classification and measurement of financial assets – overview of the new approach



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New criteria for classification
Business model assessment

- Business model assessment refers to how an entity manages its financial assets in order to generate cash flows and create value for the entity
  - Are the cash flows generated by collecting the contractual cash flows, selling the financial assets or both?
    - The expected frequency and value of sales are important elements of the assessment. However, information about past sales should not be considered in isolation
  - Assessment is based on reasonable expectations and not on worst or stress case scenarios and it is done at a level that reflects how groups of financial assets are managed together to achieve a particular business objective (e.g. on a portfolio level)

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Criteria for classification of financial assets

Business model assessment

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Business model assessment

Examples of considerations

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.

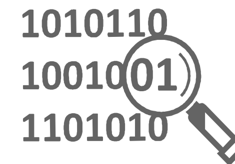
Business model 3

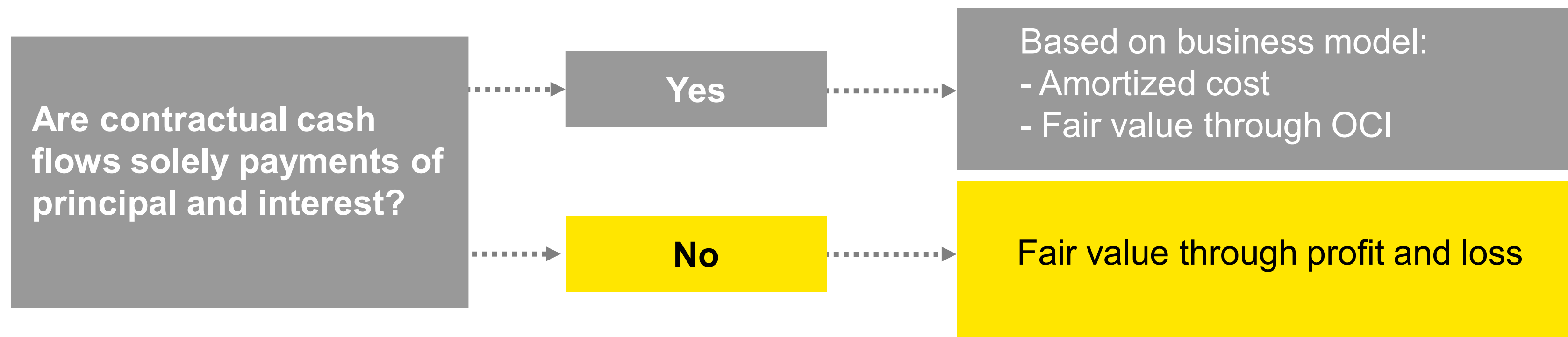
"Other strategy" – Portfolio of debt instruments that is neither business model 1 nor business model 2 (e.g., held for trading or managing the objective of realizing cash flows through active and frequent sales).

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.

New criteria for classification
Solely payment of principal and interest (SPPI test)

- Are contractual cash flows solely payments of principal and interest?
- For the purposes of applying the SPPI test
  - Principal is the '*fair value of the asset at initial recognition*' adjusted by the changes e.g. repayments of principal
  - Interest must be consistent with components of a basic lending-type return which includes, but is not limited to, appropriate consideration for:
    - 'Time value of money'
    - Credit risk
  - Assessment in the currency of the financial asset





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SPPI test
A closer look

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?

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SPPI test

Examples of cash flow assessments and considerations

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

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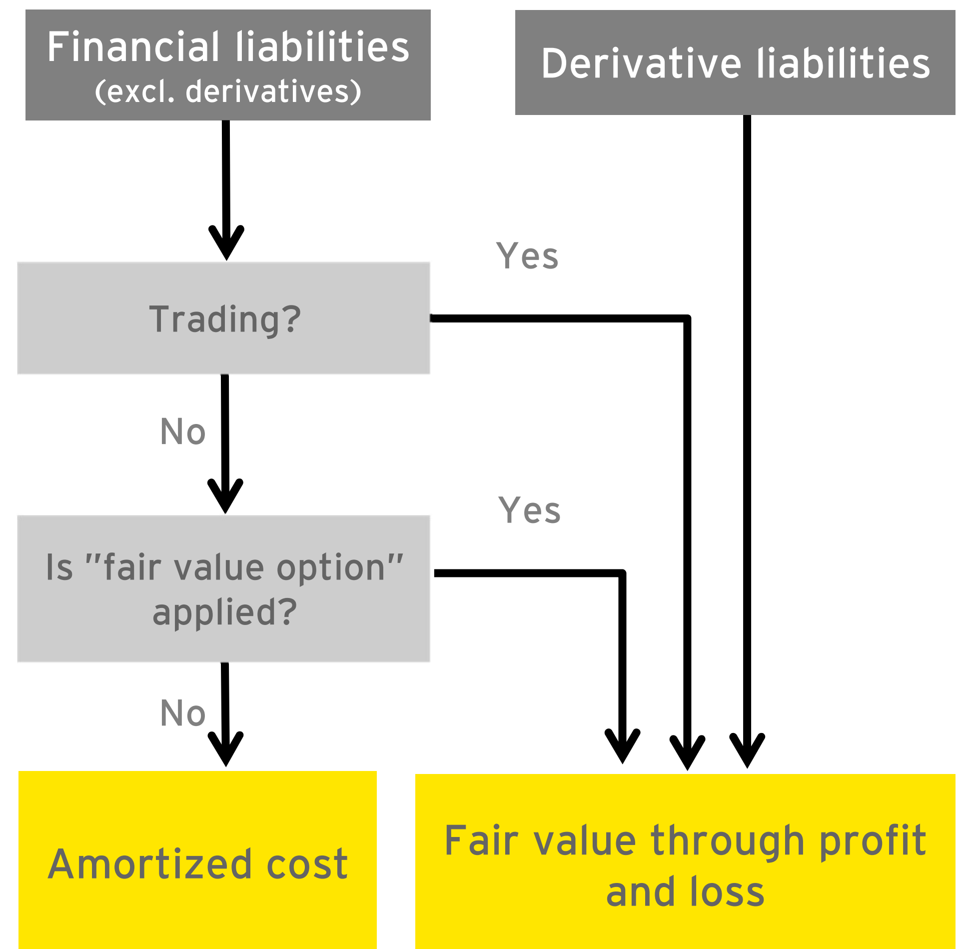
Classification of financial liabilities
New presentation

- Financial liabilities are classified as subsequently measured at **amortized cost** unless they are measured at **fair value through profit and loss**
- IFRS 9 introduces new presentation when financial liabilities are measured at fair value through profit and loss by using "fair value option"
  - Gains and losses on liabilities designated at FVPL arising from changes in own credit risk are recorded in OCI and never recycled



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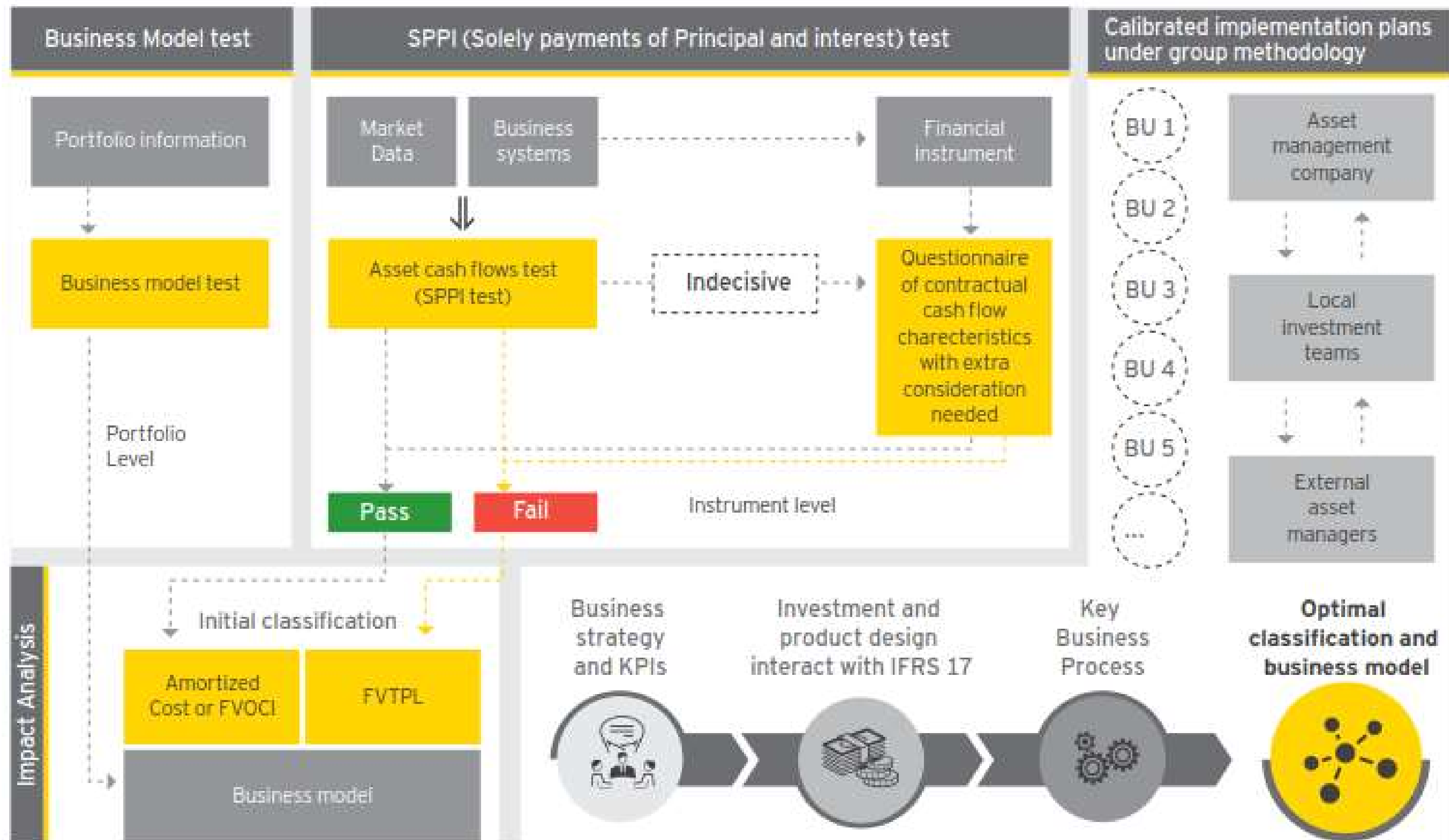
Integrated approach to design asset classification in line with related liabilities



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Impairment
From incurred to expected credit losses

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Measurement of impairment under IFRS 9
New approach

- The new impairment requirements are based on an *expected credit loss model* (“ECL”) that replaces the IAS 39 incurred loss model
- New model is designed to reflect the general pattern of deterioration or improvement in the credit quality of financial instruments
  - More timely and forward-looking information required
- When measuring ECL, entity needs to follow one of the following three approaches
  - The general approach
  - The simplified approach
  - The purchased or originated credit impaired approach

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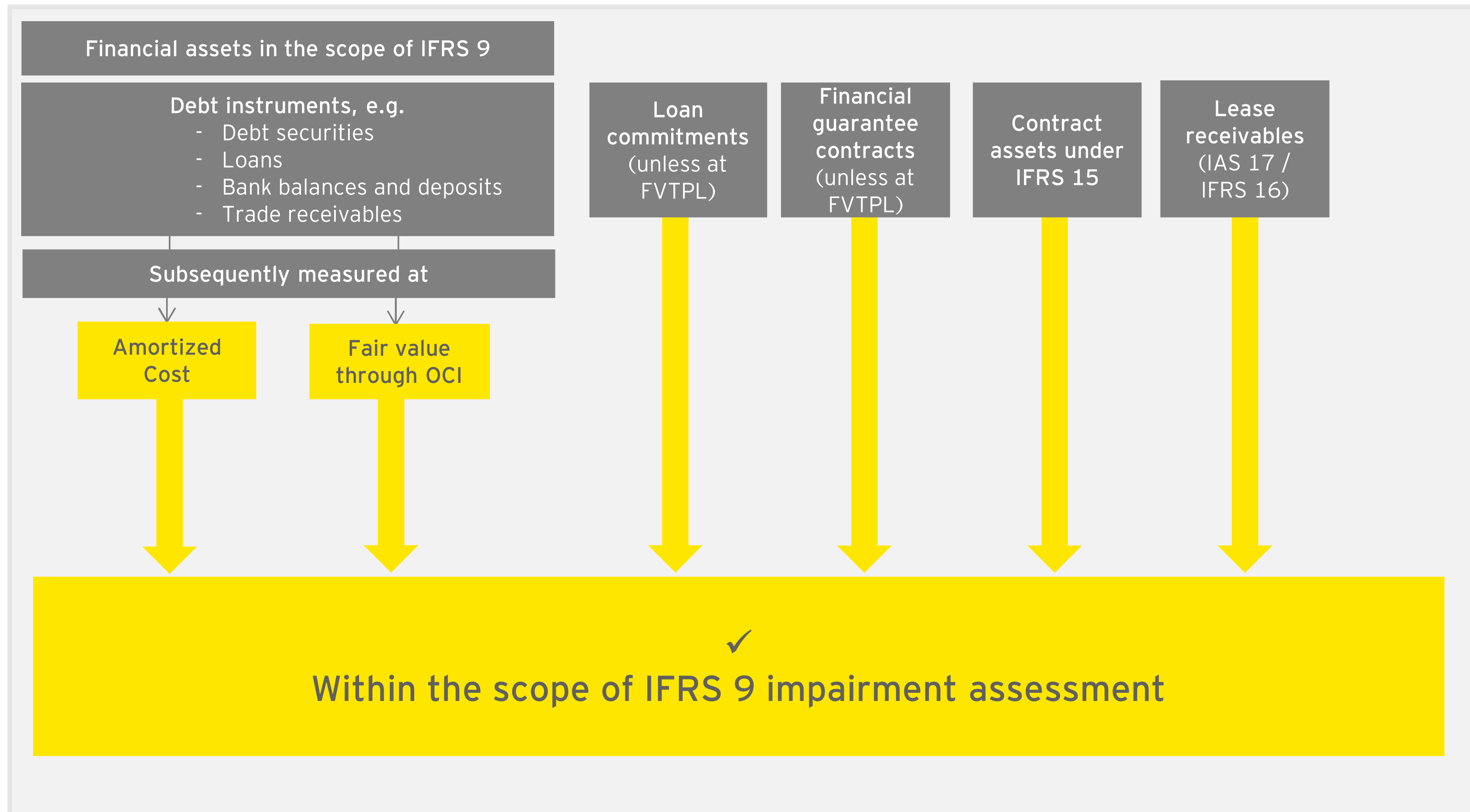
Scope of the new impairment model



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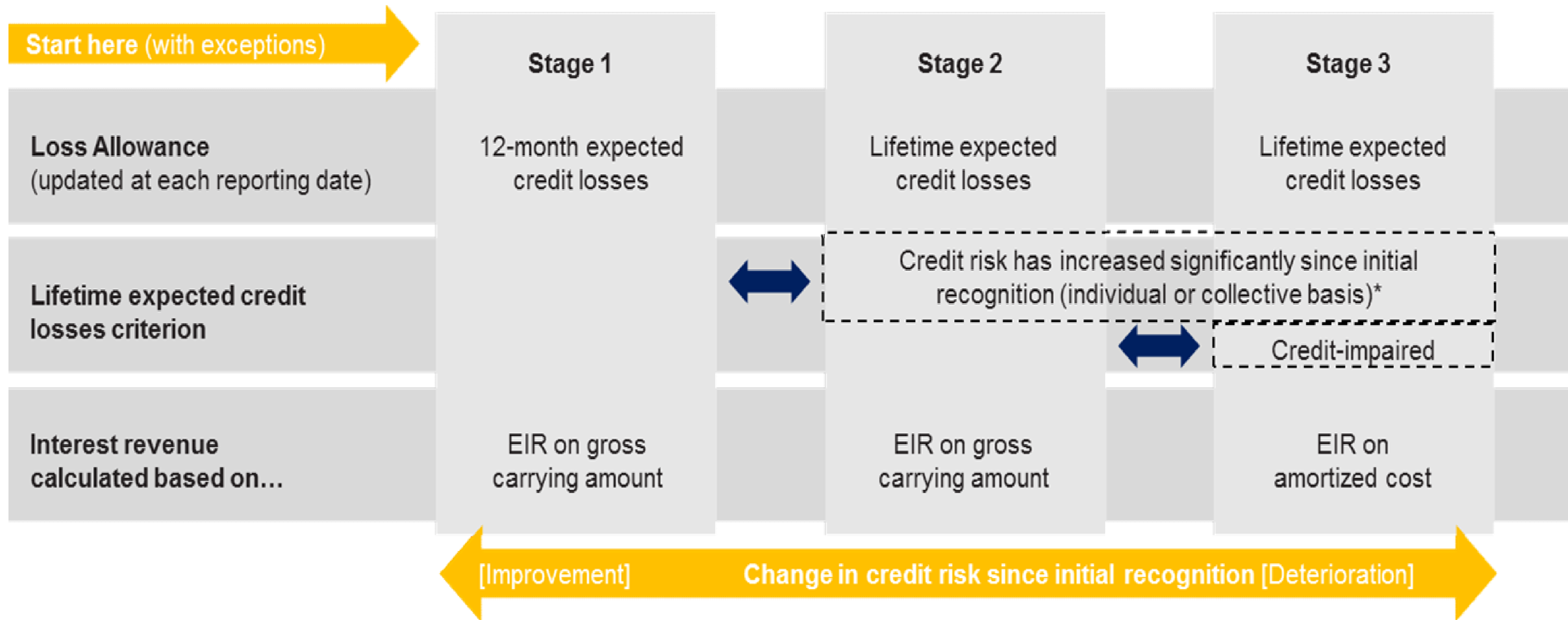
General approach
Overview



Purchased or originated credit impaired assets (POCI)

- ECL on initial recognition reflected in credit-adjusted EIR (no 'day one' 12 month ECL)
- Loss allowance based on subsequent changes in lifetime ECL

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Calculation of ECL under IFRS 9

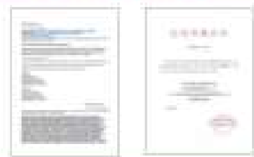
Estimation of key impairment components (PD)

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

Probability of Default (PD)

Credit Rating

Internal Rating



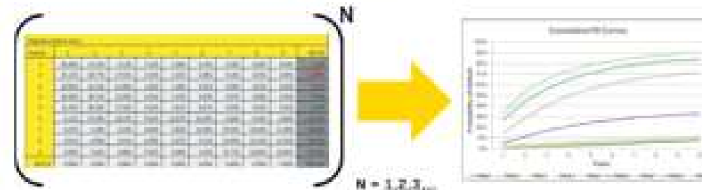
External Rating

Spread implied

PD Curve

Rating Migration Matrix

Derive PD curve from matrix exponentiation

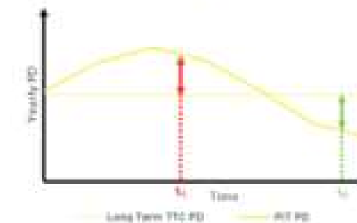


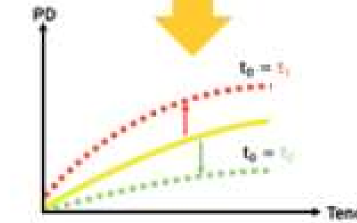
PD Curve

Apply external PD curves published by rating agencies

Forward-looking adjustment

Integrate forward- looking information into PD curve





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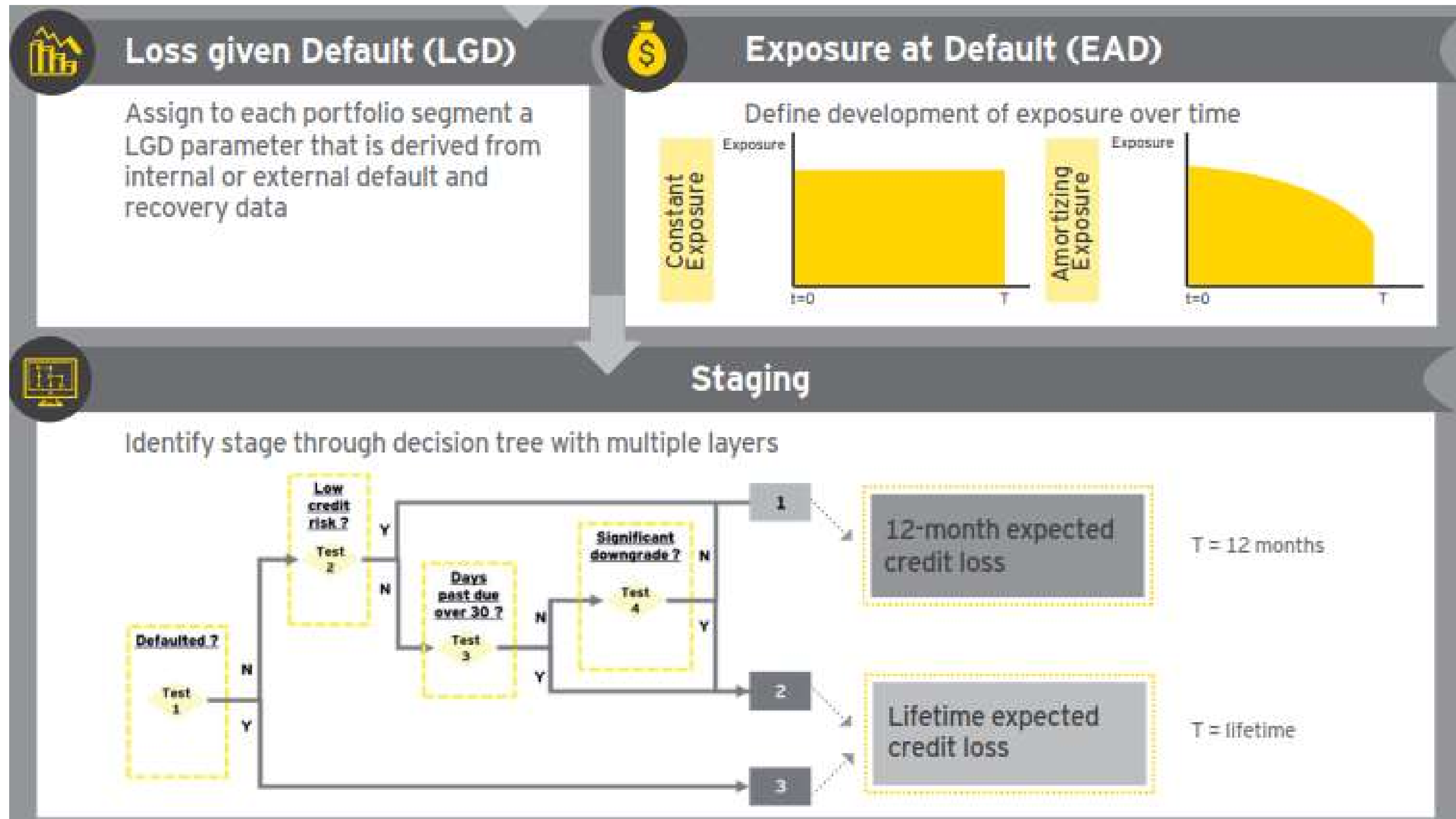
Calculation of ECL under IFRS 9

Estimation of key impairment components (LGD, EAD)



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Hedge accounting
Key differences to current model

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Hedge accounting
Key differences

Requirement	IAS 39	IFRS 9
Risk component as eligible hedged item	Financial Items	All items
80%-125% test	✓	✗
Prospective effectiveness testing	✓	✓
Retrospective effectiveness testing	✓	✗
Quantitative effectiveness test	✓	Depends
Qualitative effectiveness test	✗	Depends
All ineffectiveness must be recognised	✓	✓
Accounting for 'costs of hedging'	✗	✓
Rebalancing of hedge ratio	✗	✓
De-designation (risk management objective unchanged)	✓	✗
Discontinuation (risk management objective changed or other qualifying criteria not met)	✓	✓

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