IFRS 9 for insurers and medical schemes

IFRS 9 for Financial Instruments is coming in 2018. Implementation of the standard could be challenging for insurers (including medical schemes), particularly given the interaction with the new proposals for insurance contracts which are still being finalised. Entities should be planning how to assess the impact for their organisation.

Background

- IFRS 9 will be effective from 2018 with early adoption possible.
- Retrospective application is required (except for hedging) although there are a number of operational simplifications potentially available on transition.
- No requirement to restate comparatives.
- Potential for at least 2 years between effective dates given current status of IFRS 4 Phase II insurance contracts proposals.
- Some global industry lobbying for deferral of IFRS 9 effective date for insurers.
- Explaining the impact of IFRS 9 on performance prior to the adoption of new measurement requirements for insurance liabilities may be challenging for some insurers.
- 3 specific areas of focus:

1 Classification and measurement ('C&M') of financial assets – changes to IAS 39 categories with new tests/criteria to be met (see page 3 for decision tree)

2 New impairment model based on expected credit losses rather than incurred losses

3 New hedge accounting criteria that are intended to facilitate use of hedge accounting, but more for corporates

Who does it affect and how?

The C&M requirements are likely to result in more financial instruments being held at fair value through profit and loss ('FVTPL') than under IAS 39

- Entities who currently hold amortised cost assets and make significant use of the Available for Sale category ('AFS') under IAS 39 are likely to see the biggest impact.
- Debt instruments that fail the Solely Payment of Principal and Interest ('SPPI') criteria and most equity instruments are now expected to be classified in the residual category FVTPL including puttable instruments in Collective Investment Schemes.
- For some parts of insurers' business, C&M requirements could potentially have accounting mismatch and resulting volatility implications when applied in conjunction with future insurance contract accounting.

The new impairment model is expected to result in the earlier recognition of credit losses

- Insurers or medical schemes who are likely to hold significant volumes of amortised cost assets such as loan books or fair value through other comprehensive income ('FV-OCI') debt instruments will see the biggest impact, particularly on transition.

The new hedging requirements may have limited impact for insurers until the macro hedging proposals are complete

- Insurers who currently use or plan to use economic hedging programmes should consider the new requirements and track the development of the macro hedging proposals.

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IFRS 9 – What should insurers and medical schemes be doing now?

1

Classification and measurement

Perform impact assessment work to determine high level implications of applying new C&M requirements, including potential accounting mismatches and resulting volatility:

- Assess proportion of debt instrument portfolio that would/may fail SPPI test and equity instruments currently at AFS that would now be expected to be carried at FVTPL.
- Business model requirements drive classification – identify features underlying business model criteria and consider how criteria currently apply to investment portfolios. For example, consideration of management information used to measure and evaluate performance and nature of management compensation arrangements in place.
- Assess implications of above on asset/liability matching and profit and loss volatility in light of both current insurance contract accounting and new insurance accounting proposals (particularly given anticipated interim period between adoption of the two standards).
    - Consider ability to use different C&M categories and the application of insurance accounting options, including shadow accounting and move to current interest rates, in order to avoid mismatches.
    - If mismatches remain, consider the use of non-GAAP measures and, potentially as a last resort, changes to investment strategy/mix.

2

Impairment

Consider interpretation of new requirements and assess implications of having to apply new impairment rules to all assets not at FVTPL[1] including:

- Develop criteria for key judgements required (for example how is 'low credit risk' defined?)
- Assess whether operational simplifications for 'low credit risk' assets can be used. Intended to provide relief to entities, especially financial institutions such as insurers and medical schemes, who hold large portfolios of securities with high credit ratings.
- Assess need to collect and store credit data not currently used.
- Consider need to build models to determine both 12-month and lifetime Expected Credit Losses as well as monitor the development of changes in credit quality.

[1] Impairment requirements do not apply to equity instruments where the FV-OCI option has been elected as OCI movements are never recycled.

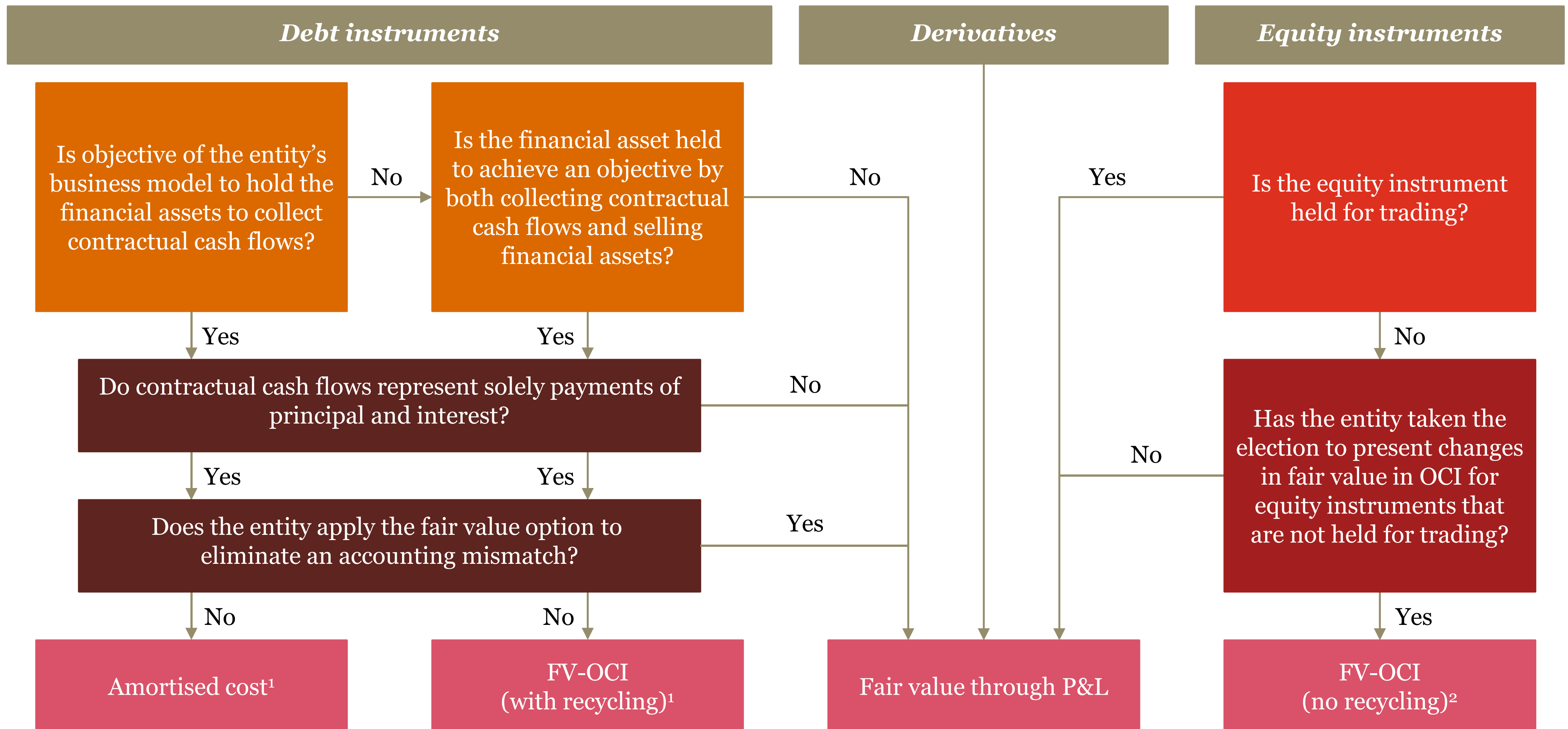
3

Hedge accounting

Consider current use of hedge accounting (if any; insurers have typically not made extensive use of IAS 39 in this regard) and monitor macro hedging proposals to assess whether they are likely to offer more opportunity to reflect economic hedging programmes in accounting.

Insurers who currently use hedge accounting under IAS39 can elect to stay with IAS 39 until macro hedging project is finalised. However, they could benefit from the IFRS 9 hedging changes such as the relaxation of the 80-125% test and hedging with options.

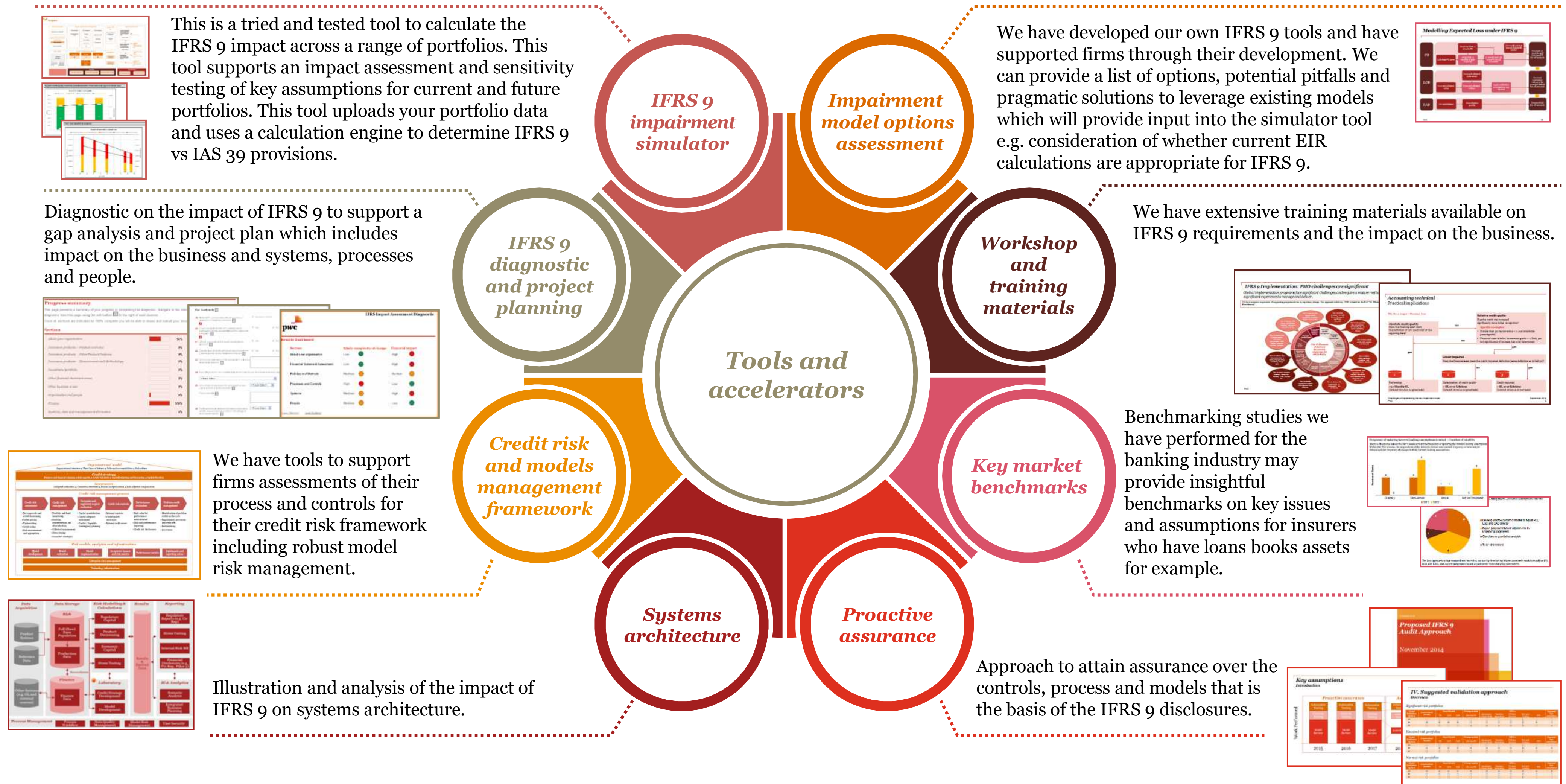
IFRS 9 – Classification overview



[1] Impairment considerations apply.

[2] Expect there to be limited attraction for insurers of using the FV-OCI option for equities given inability to recycle to P&L.

IFRS 9 Tools and accelerators



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