



IFRS 9 creates specific challenges for insurers

kpmg.ca/insurance

IFRS 9 creates specific challenges for insurers

Don't wait for IFRS 4 to starting implementing IFRS 9

As financial services companies start down the path of IFRS—transforming changes over the next few years, challenges—both expected and unexpected—continue to emerge. IFRS 9, for instance, has led to some complex adoption challenges, particularly for insurance companies. IFRS 9 addresses accounting for financial instruments, which is made more complicated for insurers due to the industry's use of asset/liability matching in their business models. While other industries can apply the new IFRS 9 standard independently, the asset/liability interaction for insurers requires insurers to consider invested assets against insurance contract liabilities, with the overall aim of avoiding asset-liability mismatches and reducing risk.

While this is a prudent approach to manage the economic implications, it raises an accounting issue because IFRS 4—the standard that deals with accounting for insurance contract liabilities—is being revised and not yet finalized. Insurers are faced with a catch-22: many are hesitant to begin their transition projects on IFRS 9 before IFRS 4 is ready, but the fact is, IFRS 9 must be used starting January 1, 2018. Since comparatives from 2017 must be aligned with 2018 for the December 31, 2018 statements, companies must actually have their planning process completed by January 1, 2017—less than two years away. As a result, even though they must continue using existing insurance contract accounting practices, it's important to begin the transition process of IFRS 9 as soon as possible.

The challenge, then, is to keep as close an eye as possible on what IFRS 4 will look like as you put IFRS 9 into practice to help

reduce rework and make the final transition as smooth as possible. Along with understanding exactly what must be done, companies need to be sure they have the information to do it at hand. New requirements are different and substantial, and many existing systems will not be set up to deliver the data required. If this is the case, it adds extra layers to the problem and means you'll need more than the CFO—investment managers and actuaries, for example—to be more deeply involved in the process.

With the entire business potentially affected, insurers need to start thinking now about IFRS 9 and what it means. This paper outlines some of the most important areas to consider in terms putting IFRS 9 into practice today, while taking potential future impacts and requirements into account. There are three relevant areas of change to consider—classification and measurement; impairment; and hedge accounting—the first two of which will be covered here, while the third will be the topic of a separate paper.

IFRS 9 addresses accounting for financial instruments, which is made more complicated for insurers due to the industry's use of asset/liability matching in their business models.



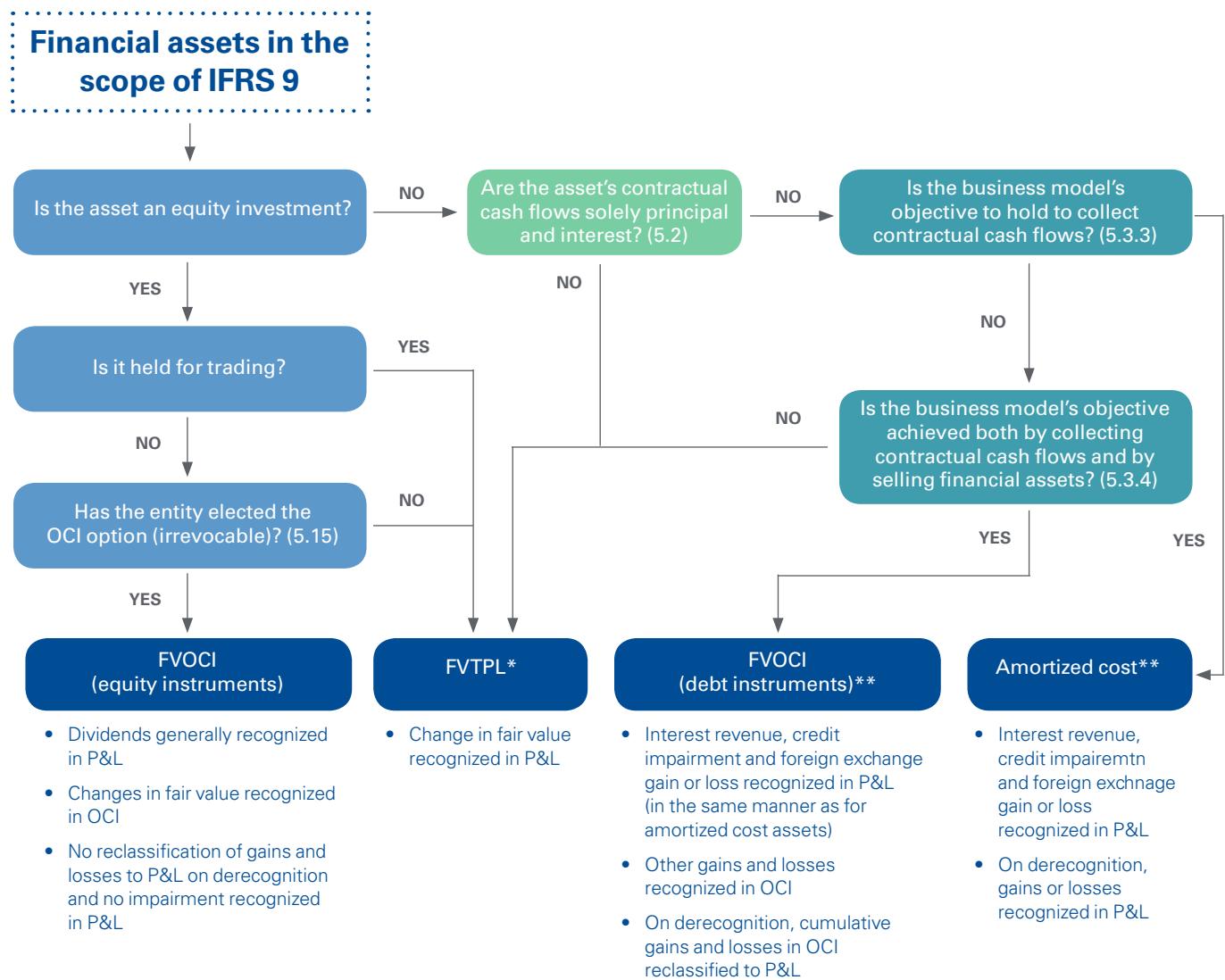
Classification and measurement

On a first glance, classification and measurement under IFRS 9 may not seem much different than current standards. A closer look, however, shows that while your conclusions might end up being similar the process of getting there, the information required and the prescribed method of reporting are quite different. Insurers are used to using the IAS 39 standard, which classifies financial assets into four measurement categories: fair value through profit and loss (FVTPL), available for sale (AFS), held to maturity or loans and receivables (both measured at amortized cost). While these measurement categories under IFRS 9 are similar—FVTPL,

fair value through OCI, and amortized cost—companies will need to apply a business model approach to specific investments. In essence, all financial assets will have to be assessed based on their cash flow characteristics and/or the business model in which they are held. Although the categories are similar, the “journey” of classification is very different.

Impact of classification and measurement

Given the need to account for a wide variety of product offerings and often multiple, varied investment portfolios, it's easy to see why the impending standard changes will not be simple. The



* Certain credit exposures can also be designated as at FVTPL if a credit derivative that is measured at FVTPL is used to manage the credit risk of all, or a part, of the exposure.

** Subject to an entity's irrevocable option to designate such a financial asset as at FVTPL on initial recognition if, and only if, such designation eliminates or significantly reduces a measurement or recognition inconsistency.



business decisions underpinning each product offering could be different, as could the business reasons for holding each investment. How might these classification and measurement standards specifically affect an insurance company with respect to various types of financial assets?

Bonds

Investments in bonds generally fall into two categories: the amount being used to back policy liabilities (the majority of the investment) and the amount being used to back surplus (the amount remaining after investment assets having been matched with policy liabilities/potential claim payouts). Regardless of the category, insurance companies need to look at whether their investments are backing policy liabilities or whether they're backing surplus. This concept is already done by most life insurers, however the added complexity under IFRS 9 is looking at the business purpose of the investment for each of the product types.

Equity

Equity is initially considered similarly to bonds—what is the business purpose of the investment and is it supporting insurance contract liabilities or surplus. For those backing surplus—today classified as “available for sale”—the issue becomes more complicated. If the investment is not held for trading, it may be classified as FVOCI, a situation that many companies won’t want to happen. Once designated as FVOCI any gains (even when realized) are locked into accumulated other comprehensive income—an irrevocable decision—they will never go through Profit & Loss Statement (P&L). As a result, most companies will look for ways to class these investments using the FVTPL model, where all gains and losses flow through the income statement.

Loans and receivables

Today, loans and receivables are carried as amortized cost. With IFRS 9 (where current contract accounting is still in place pending the revised IFRS 4) this is expected to continue. However, there is the possibility that the new contract accounting standard may change the classification to FVTPL if the regulator relaxes current restrictions that prohibit doing so. This may, in fact, happen as certain changes in IFRS 9 may lead to asset-liability mismatches under amortized cost, but not under FVTPL. Quite logically then, most companies believe that the FVTPL model will be preferable for classifying loans and receivables so that their numbers are balanced. This may or may not be easy to achieve. They will have to look very carefully at their investments to make sure they meet the specific requirements of their desired classification; while the same results may be reached as under IAS 39, the requirements to get there are quite different. In other words, to get the same result under the business model classification approach, you may have to do a lot more initial work.

It should be clear that you’ll need to go outside of accounting and get more people involved from different areas of the organization in order to effectively implement IFRS 9 and the business model classification approach. Your business people will need to answer a number of questions: why, exactly, are you holding a particular investment? What are the terms of your contracts? Was an investment purchase driven by an embedded derivative on which you expected to make your return? Only investment personnel will be able to answer these types of questions, many of which are not currently asked on a security-by-security basis. Similarly, accounting should get actuaries involved when considering the liability side of IFRS 9. The actuarial side of the business needs to understand FVTPL and how various financial assets are accounted for because it may change the way they consider impairments in their models.

KPMG's Global Credit Loss Accounting Solution ("gCLAS") is a full service impairment accounting solution that functions as a modular add-on to existing accounting systems and processes. Our multi-phase delivery process provides for effective integration of the system within your business.

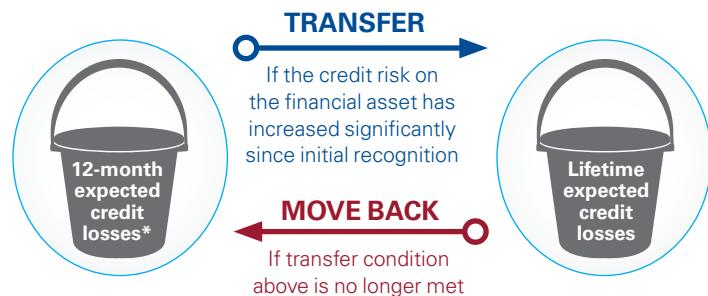
Impairment

For investments classified as FVTPL, impairment is never an issue, but it can figure in a big way for investments classified under FVOCI or amortized cost—which is why getting to an FVTPL classification where possible, and removing as much complication as you can, is a good idea.

Currently, impairment is assessed using a "what has happened" approach, but IFRS 9, attempting to address concerns over "too little too late" provisioning for loan losses, will move to an "expected loss" model. Impairment decisions will be based on what loss is expected rather than just actual losses considered in retrospect, which is quite a different approach and will alter where these calculations fall on the final statement as well as who is doing them; calculations become more granular and you begin looking for a more holistic view of the entire portfolio. Looking at both incurred and expected losses, the new model requires an impairment provision to be set up on Day 1. You're no longer waiting for something to happen, but creating an anticipatory model. You may buy something at \$100, but may record it at \$90 because that's your fair value after accounting for expected loss. This really is a different concept because something you buy today may literally not be worth what you bought it for.

Currently embedded within insurance contract liabilities is an asset default risk margin for investments supporting the liability. In this case, if those investments are classified as FVOCI, then the change becomes a geography issue. For investments backing surplus, there is no current asset default risk, so this isn't just an income statement "geography" issue—it's a measurement issue critical to the extremely difficult task of estimating impairment, which is as much art as it is science. The new impairment model involves difficult judgments about whether loans will be paid as due—and, if not, how much will be recovered and when. The new model, which widens the scope of these judgments, relies on companies being able to make robust estimates of both expected credit losses and the point at which there is a significant increase in credit risk.

In general, the expected credit loss model uses a dual measurement approach.



* 12-month expected credit losses are defined as the expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the reporting date.

For example, your Day 1 provision might look at what could potentially happen in the next 12 months. As things progress, however, you could potentially look at the second bucket, which considers all possible losses over the entire life of the instrument, which is a bigger number. You need to track all shifts back and forth between 12-month and lifetime expectations, and that can be a very confusing process.

Here, as mentioned earlier, your investment and actuarial people come into the equation because these impairment calculations are complex and require information that might not be readily available today. And again you must ask: how can we be certain we can access and aggregate the information we need to do these calculations using our current systems? Most companies' existing systems will not be able to track the necessary information—the general ledger won't be set up do it on an appropriately granular level, and because this is a management estimate, the service organization, like investment custodians, won't be able to source it. Do you really want to reintroduce the old complexities of manual spreadsheets? You will need, at the very least, cross-organizational involvement to get the information you need and make appropriate, justifiable impairment decisions.

Cutting out the cookie cutter

IFRS 9 was designed to take the cookie cutter out of the insurance kitchen. Regulators want insurers' investment groups to exercise judgment and decide what makes sense for the individual organization, and auditors in turn will have to exercise their judgment on top of that. It really is a new approach, but because some conclusions may be the same, the danger of underestimating both broader implications and nuanced differences are real. As insurers move forward with IFRS 9 adoption, it's important to start understanding and addressing the issues now. Waiting for IFRS 4 is not an option, but taking a measured, forward-looking approach to IFRS 9 should make the long-term adoption prognosis much more positive.



How we can help

KPMG's Insurance practice

KPMG's insurance practice is a network of professionals, offering skills, insights and knowledge based on substantial experience. KPMG can identify the issues early and can share leading practices to help avoid the many pitfalls of such projects.

For those affected by the new financial instrument requirements, our network of professionals can advise you on your transition to the new standards, including designing an approach to implementation that incorporates fast-approaching regulatory changes. Our practice brings leading program management skills to deliver successful accounting changes in your business. The following are just a few examples of how our cross-functional team of experts can help you with the accounting and operational challenges, subject to independence limitations.

- Performing a thorough review of financial assets to help ensure that they are appropriately classified and measured.
- Developing impairment methodologies and controls to help ensure that judgement is exercised consistently and supported by appropriate evidence.
- Identifying system and process changes necessary to collect new data and perform new calculations, taking into consideration regulatory requirements and internal controls over financial and regulatory reporting.
- Evaluating the impact of accounting change on management compensation metrics, performance targets and KPIs.
- Developing a communication plan that strives to minimize surprises for stakeholders.



- Developing and executing training plans for employees across functions and locations.
- Setting up a project team with representatives from risk management, accounting, tax, regulatory and IT teams, with an appropriate governance structure, realistic timescales and clear accountabilities.

Starting now will allow you to assess the impact and design an appropriate implementation plan that helps allow time for unanticipated complexity.

Contact us

**Neil Parkinson**

Partner, Audit and National Leader,
Insurance Sector

T: 416-777-3906

E: nparkinson@kpmg.ca

**Luzita Kennedy**

Partner
Accounting Advisory Services

T: 416-777-3782

E: l kennedy@kpmg.ca

**Robert Lefrancois**

Partner
Accounting Advisory Services

T: 514-840-2176

E: rlefrancois@kpmg.ca

**Dilshad Hassen**

Partner, Advisory

T: 416-777-8978

E: dhassen@kpmg.ca

**Stephen Smith**

Senior Manager
Audit Financial Services

T: 416-777-3194

E: stephensmith@kpmg.ca

kpmg.ca

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavor to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2015 KPMG LLP, a Canadian limited liability partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved. 8947

The KPMG name, logo and "cutting through complexity" are registered trademarks or trademarks of KPMG International.