



cutting through complexity

Risk & Regulatory Series

**IFRS 9 Classification,
Measurement and Impairment
(Insurance Sector):
Initial Considerations**

Why is This Important?



- Although the permissible measurement bases for financial assets – amortized cost, FVOCI* and FVTPL* – are similar to IAS 39, the criteria for classification are significantly different and judgement will be needed.
- Evaluating contractual terms of financial assets and determining business models is likely to be a substantial project for most in financial sector.
- Identifying options and elections available under IFRS 9.

* FVTPL – Fair value through profit or loss
FVOCI – Fair value through other comprehensive income

In this section

1 Introduction

2 Classification and measurement

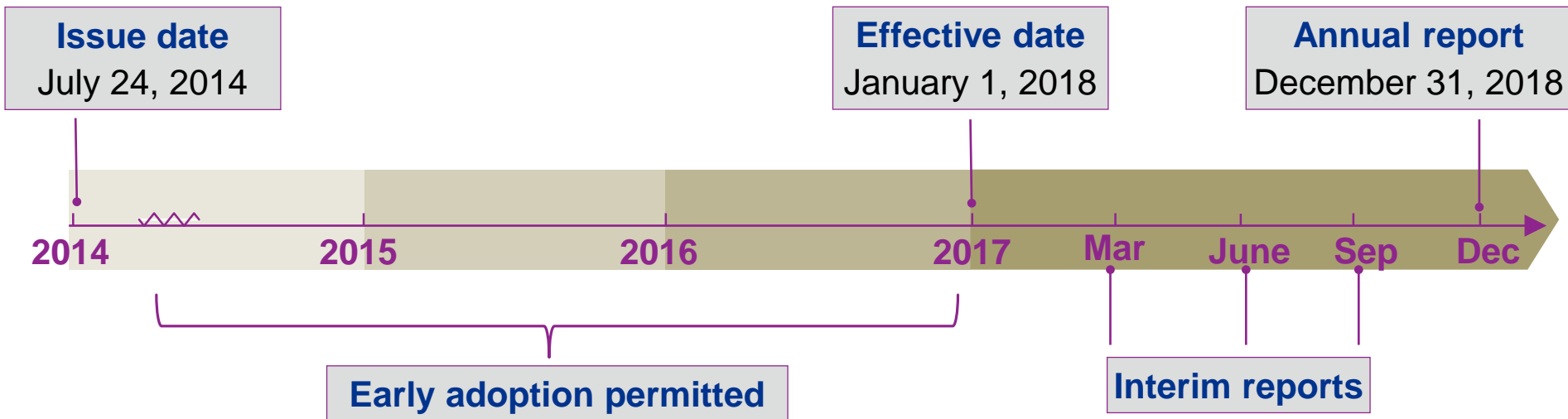
3 Impairment

4 gClas- practical impairment tool

5 Interaction between IFRS 9 and IFRS 4 Phase II

6 Preparing for transition

Effective Date



- Entities that initially apply a previous version of IFRS 9 by January 31, 2015 can continue to apply that version until January 1, 2018
- Permitted to early adopt 'own credit' requirements in isolation.

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Measurement categories

- Similar categories:

IFRS 9	IAS 39
FVTPL	FVTPL
Amortised cost	Loans and receivables/HTM*
FVOCI	AFS*

- Significant changes in criteria for classifying assets.

Derivatives embedded in a financial asset are not separated – the whole asset is assessed for classification.

* HTM – Held to maturity
AFS – Available for sale

Reclassifications

- Financial assets
 - Reclassification is required if the business model has changed.
 - Expected to be very infrequent as changes must be significant to the entity's operations and demonstrable to external parties.
- Financial liabilities
 - Reclassifications are not permitted.



Reclassify Financial
Assets



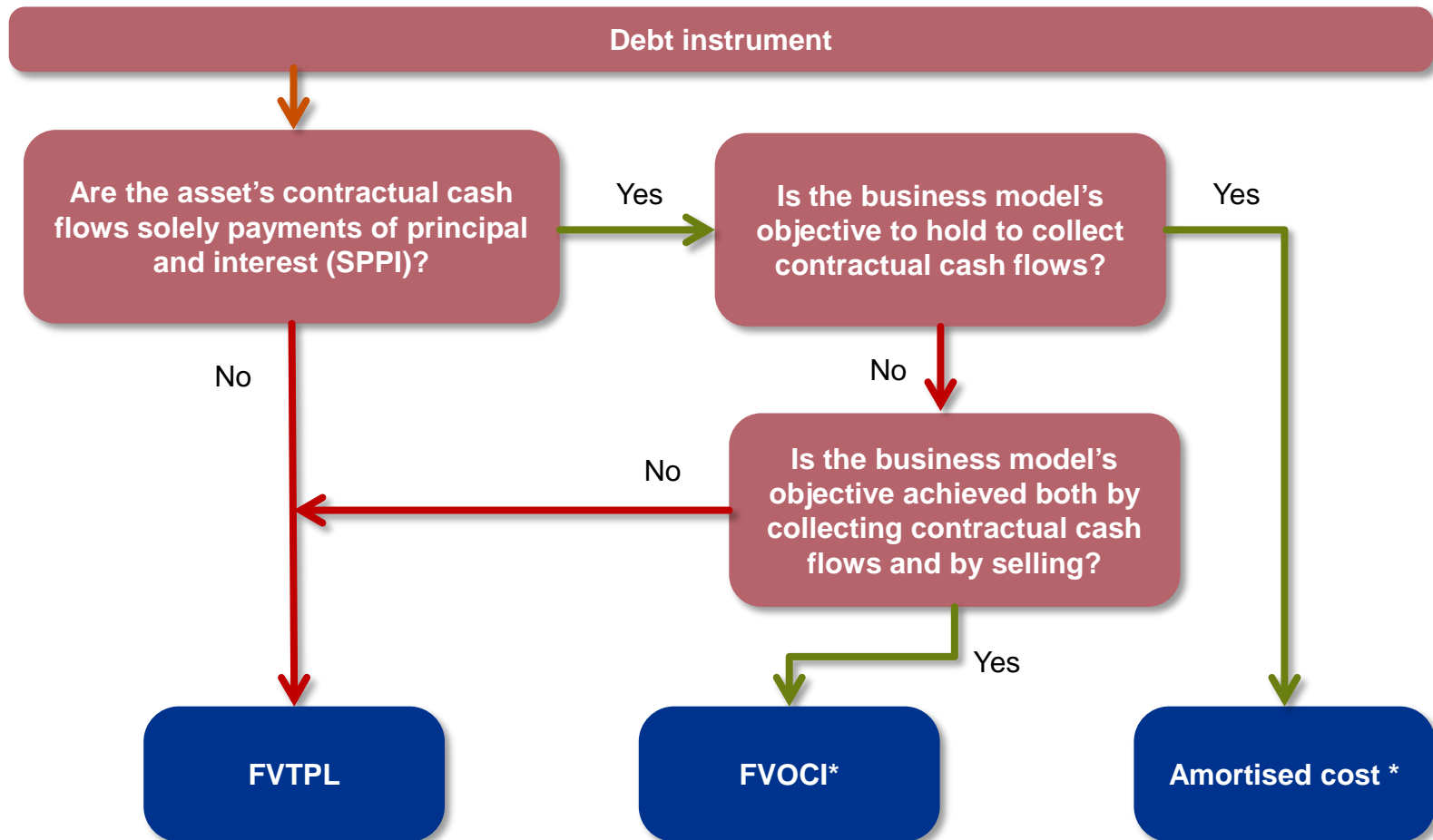
Reclassify Financial
Liabilities

Measurement categories

- Requirements from IAS 39 largely retained.
 - Classified as measured at amortised cost or FVTPL.
- Presentation in OCI* of gain or loss on a financial liability designated at FVTPL attributable to changes in own credit risk.

* OCI – other comprehensive income

Classification of Financial Assets – Debt Instruments



* Subject to FVTPL designation option - if it reduces accounting mismatch

Business Model Assessment

- Business model refers to how an entity manages its financial assets in order to generate cash flows.
- Business model is a matter of fact – typically observable through the activities undertaken.
- Does not depend on management's intention for an individual instrument.
- However, judgment is often needed.

Types of Business Models

Held-to-collect contractual cash flows

- Financial assets held to collect contractual cash flows over the life of the instrument.
- Need not hold all instruments until maturity.
- Selling assets is incidental to business model objective.

Held both to collect contractual cash flows and to sell

- Both collecting contractual cash flows and selling financial assets are integral to achieving objective of business model.
- Typically involves greater frequency and value of sales compared to held to collect model.

Other business models

- Models that do not meet the above criteria.

Business Model Assessment: Considerations

In assessing business models, consider:

How performance is evaluated and reported to key management personnel

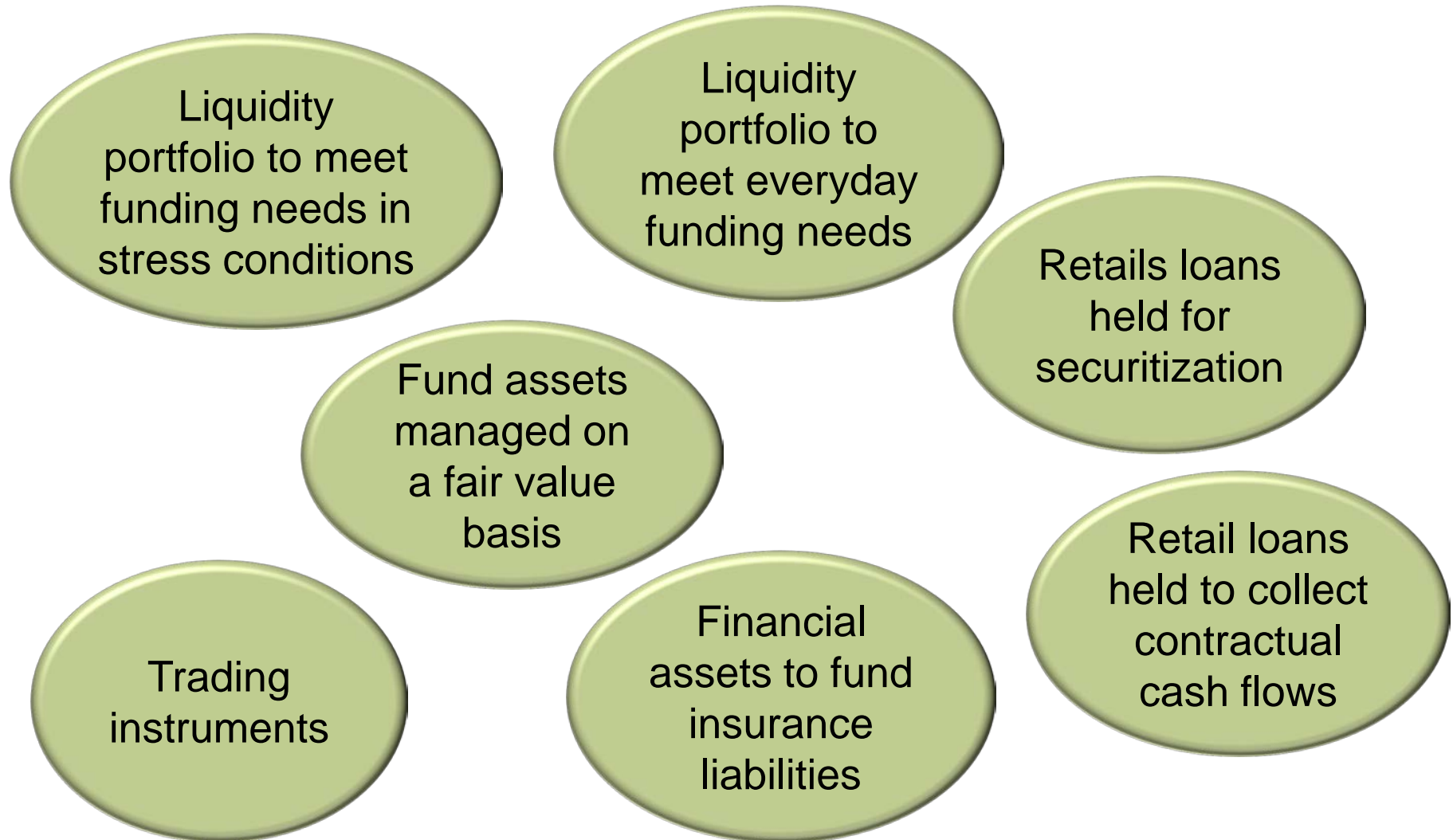
How managers are compensated

The level that financial assets are managed, e.g. portfolio

Risks affecting performance and how they are managed

Actual and expected frequency, value and timing of sales

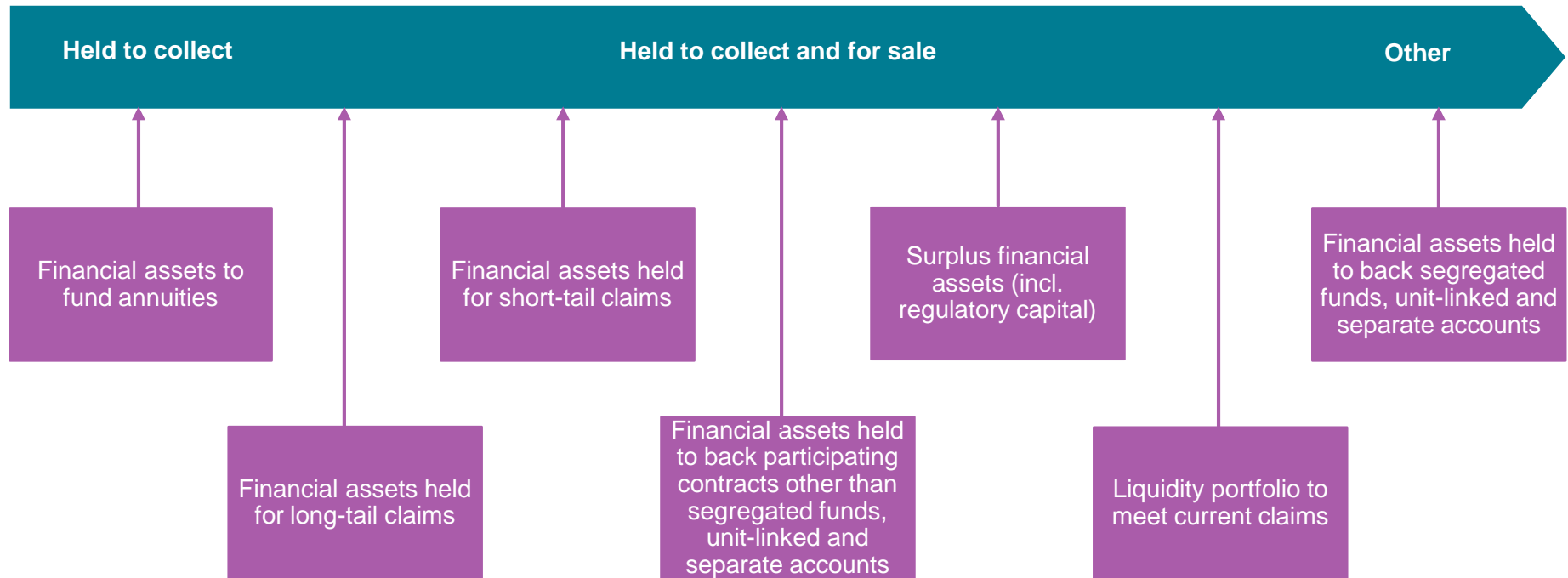
Examples of Business Models



Interaction between IFRS 9 and IFRS 4 Phase II

IFRS 9 business model objective

For each portfolio (and sub-portfolio) of financial assets, what is the business model's objective?



Although IFRS 9 states that an entity's business model for managing financial assets is a matter of fact, it also acknowledges that judgement is needed to assess the business model for managing particular financial assets. An entity considers information about sales activity as part of an holistic assessment of how the entity's stated objective for managing the financial assets is achieved and how cash flows are realised.

The SPPI Criterion

Do the cash flows consist only of principal and interest?

- Consistent with a basic lending arrangement.

	Definition
Principal	Fair value of asset on initial recognition.
Interest	Consideration for: time value of money; credit risk; other basic lending risks (such as liquidity risk); other associated costs (such as administrative costs); and a profit margin.

De Minimis, Not Genuine and Leverage

De minimis

- Ignored.
- De minimis means 'too trivial or minor to merit consideration.'

Not genuine

- Ignored.
- A contractual term is not genuine if it affects cash flows only on the occurrence of an event that is extremely rare, highly abnormal and very unlikely to occur.

Leverage

- Not consistent with SPPI.
- A contractual cash flow characteristic that increases variability of cash flows with result that they do not have the economic characteristics of interest.

Classification and measurement

The SPPI – Key factors

Interest (floating or fixed): is defined as consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin.

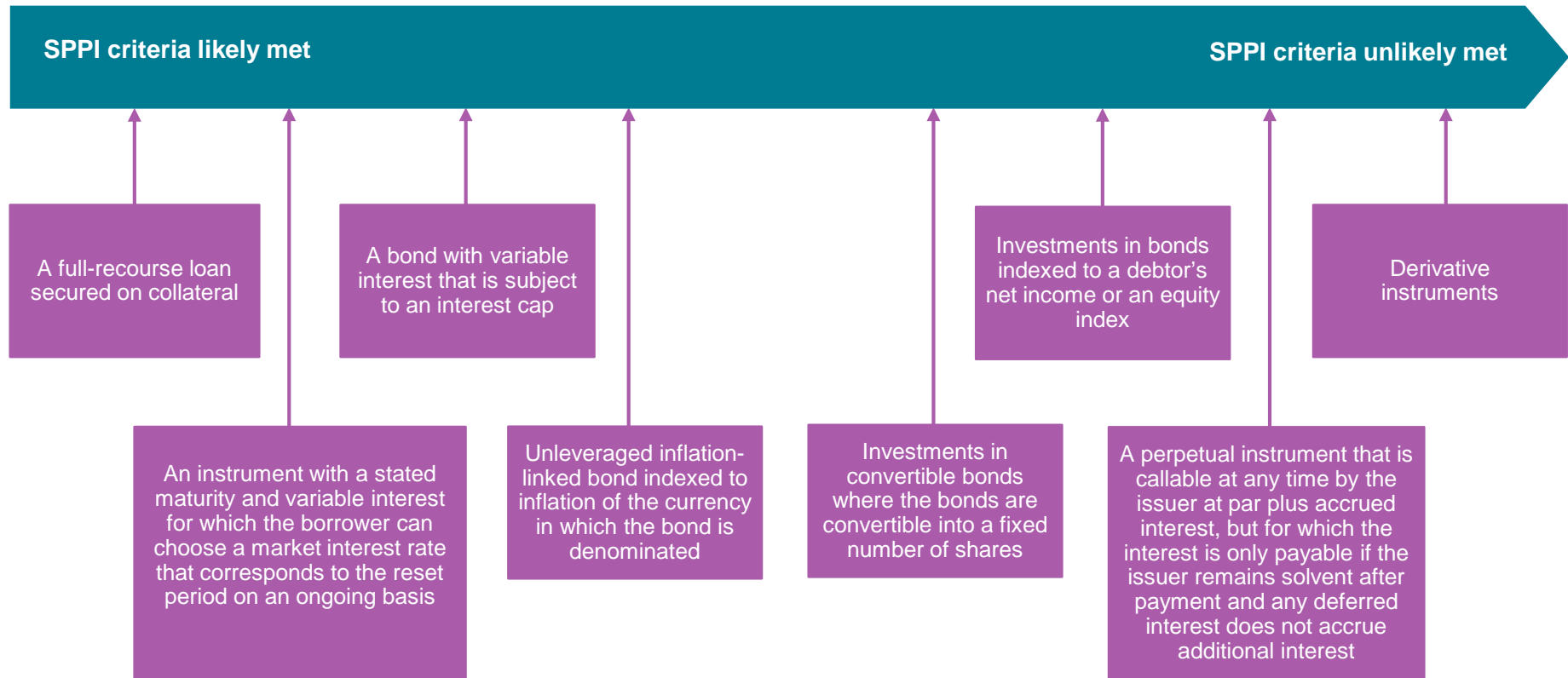
Indicators when the asset may need to be measured at *Fair Value through Profit or Loss*

Features	Description
Non-standard interest rate	Contractual terms that change the timing or amount of cash flows. Inverse floating rate, interest reset feature with a frequency that does not match the tenor of the interest rate, deferred interest without additional interest accrual are example of non-standard interest rate which are considered non-SPPI.
Leverage	Contractual term that increases variability of the contractual cash flows.
Prepayment options	Contractual terms that allow the issuer to prepay before maturity. Payment option do not preclude Amortised Cost category as long as these features are consistent with the SPPI concept.
Term extension options	Contractual terms that allow the issuer or the holder to extend the term of financial asset. Extension option do not preclude Amortised Cost category as long as these features are consistent with the SPPI concept.
Non-recourse loan	Contractual term in which a creditor's claims are limited to specified assets, which may be financial or non-financial assets.
Contractually linked instruments	The right to payment on more junior tranches (i.e. exposed to more credit risk) depends on the issuer's generation of sufficient cash flows to pay more senior tranches. A look-through approach is required to determine whether the SPPI criterion is met.
Hybrid instrument	Existence in the contract of an embedded derivative feature.
Modified TVM	Frequency of the reset does not match the tenor of the interest rate significantly, e.g. variable interest rate that is reset every month to a one-year interest rate (qualitative or quantitative test).

Interaction between IFRS 9 and IFRS 4 Phase II

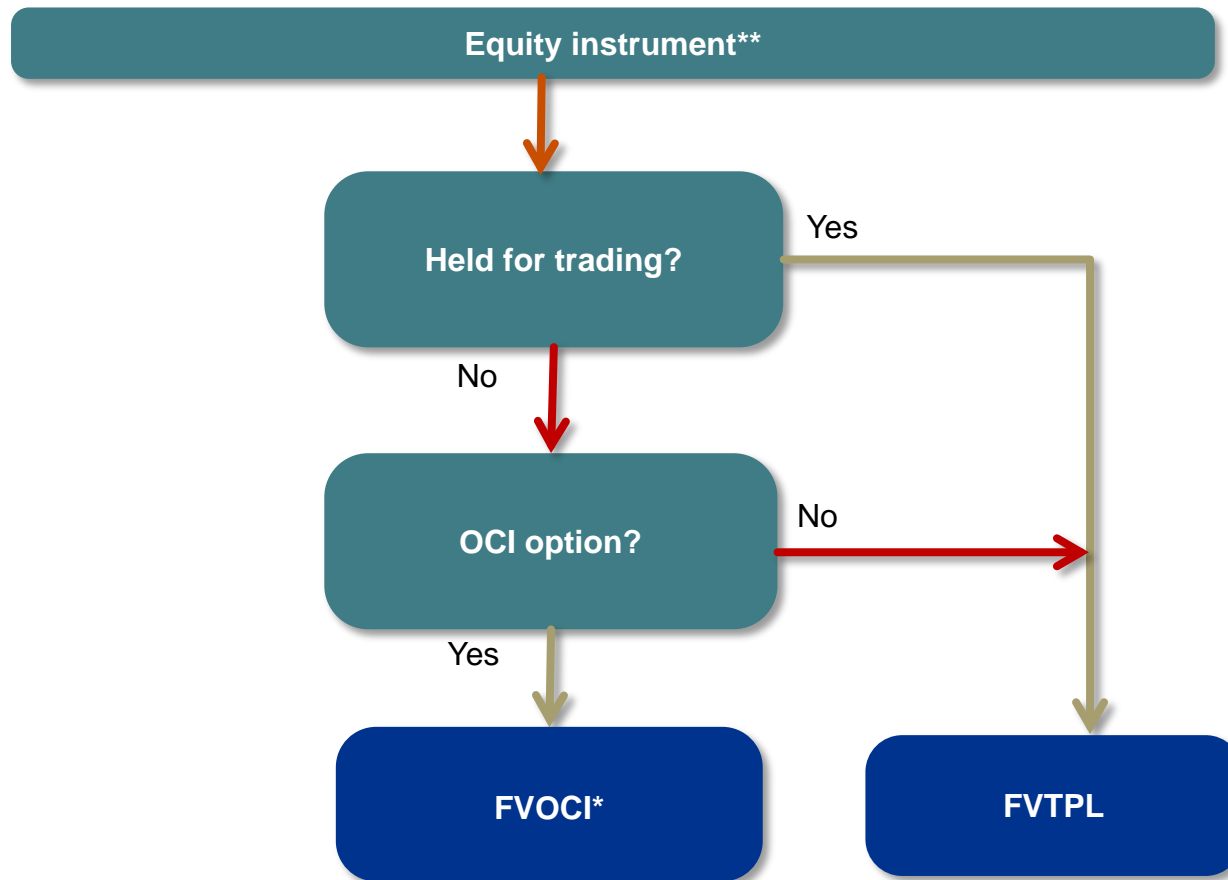
IFRS 9 SPPI criteria

For each financial asset in the scope of IFRS 9, are the asset's contractual cash flows solely principle and interest (SPPI)?



Deciding whether the SPPI criterion is met will require an assessment of contractual provisions that do or may change the timing or amount of contractual cash flows.

Classification of Equity Instruments

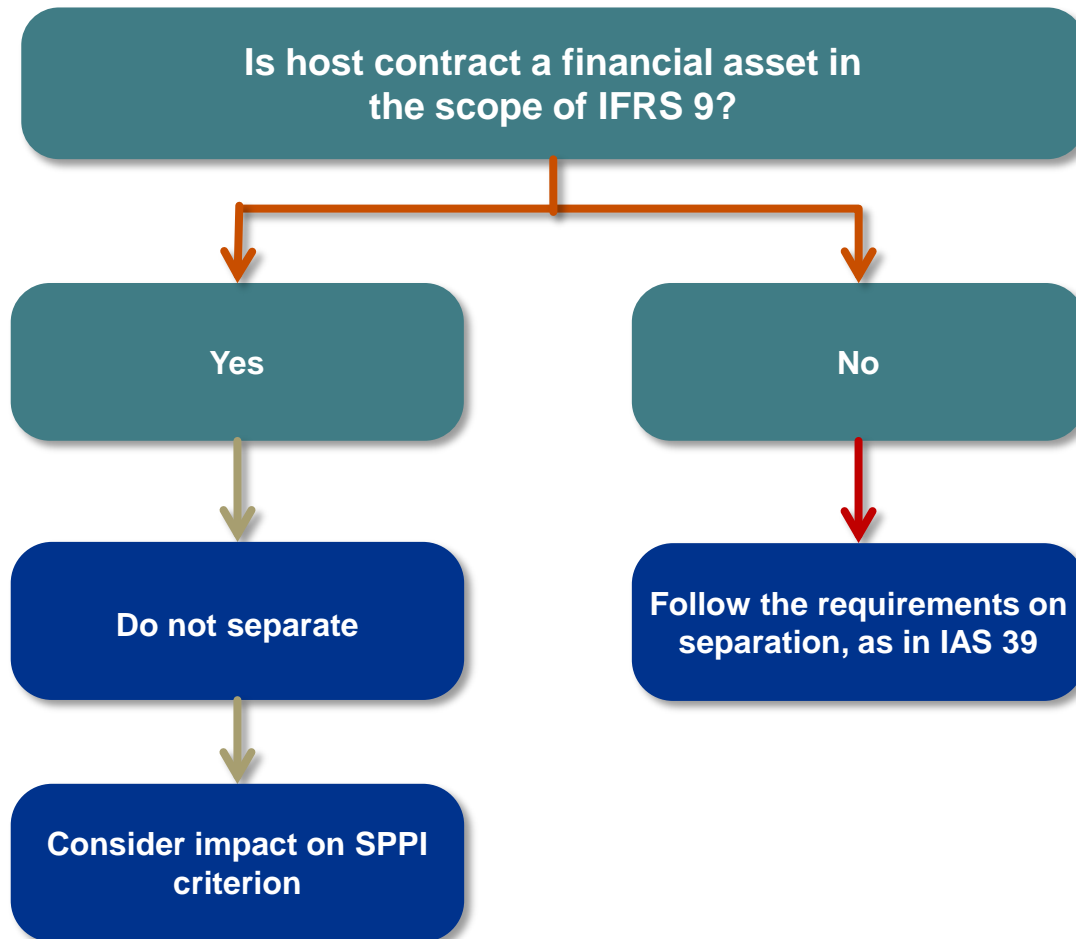


* Amounts recognised in OCI are not reclassified to profit or loss on derecognition and no impairment loss recognised in profit or loss.

** Equity instrument is as defined in IAS 32

Classification and measurement

Embedded Derivatives



Option to Designate at FVTPL

- Financial assets
 - May designate only if doing so eliminates or significantly reduces measurement or recognition inconsistency (accounting mismatch).
- Financial liabilities – no change from IAS 39
 - Additionally, a financial liability can be designated as at FVTPL if:
 - Managed on fair value basis or
 - Contains separable embedded derivative
- In addition, the following can be designated as at FVTPL if specific conditions are met:
 - Certain contracts to buy or sell a non-financial item.
 - Certain credit exposures.

Measurement of Financial Assets

Measurement category	P&L	OCI	Presentation of gains/losses same as under IAS 39?
Amortised cost	All gains and losses	-	✓
Debt investments at FVOCI	Interest, impairment losses, foreign exchange gains and losses, gain or loss on disposal	Other gains and losses	✓
Equity investments at FVOCI	Dividends (unless clearly represents recovery of part of cost of investment)	Fair value gains and losses	✗
FVTPL	All gains and losses	-	✓

Measurement of Financial Assets: Equity Investments

- Equity investments at FVOCI:
 - On derecognition, amounts recognised in OCI are not reclassified to profit or loss (different to debt investments at FVOCI).
 - No impairment loss recognised in profit or loss.
- No cost exemption for equity investments and derivatives linked to such investments.

Measurement of Financial Assets: Amortised Cost

- When contractual cash flows are renegotiated or otherwise modified but do not result in derecognition:
 - Recalculate gross carrying amount (GCA)* of the financial asset and recognise a modification gain or loss in profit or loss.
 - Costs or fees incurred adjust carrying amount of modified financial asset and are amortised over remaining term.

*GCA = PV of renegotiated or modified contractual cash flows discounted at original EIR.

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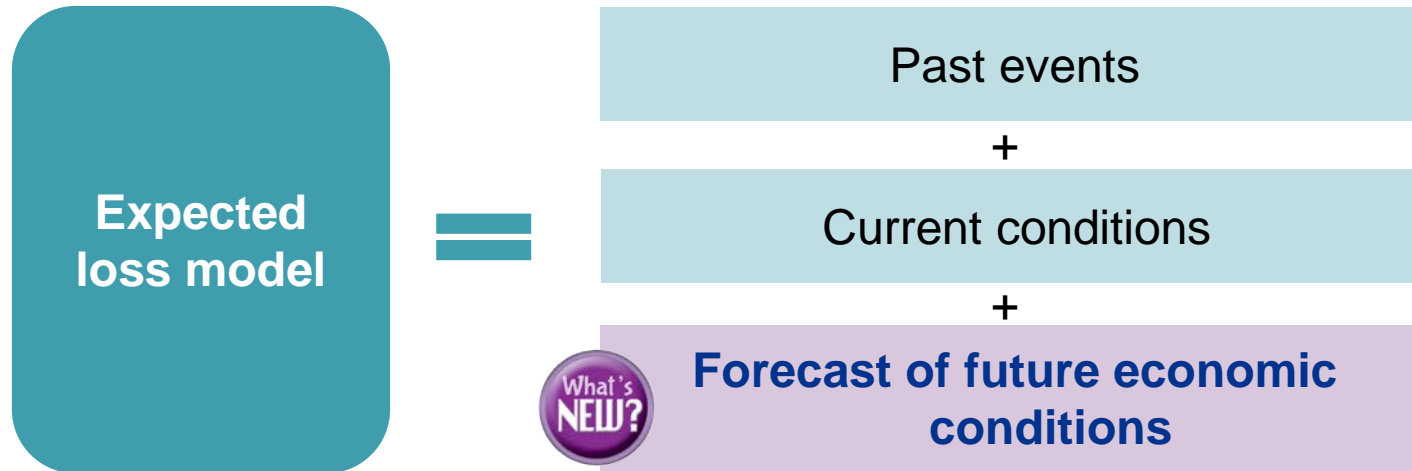
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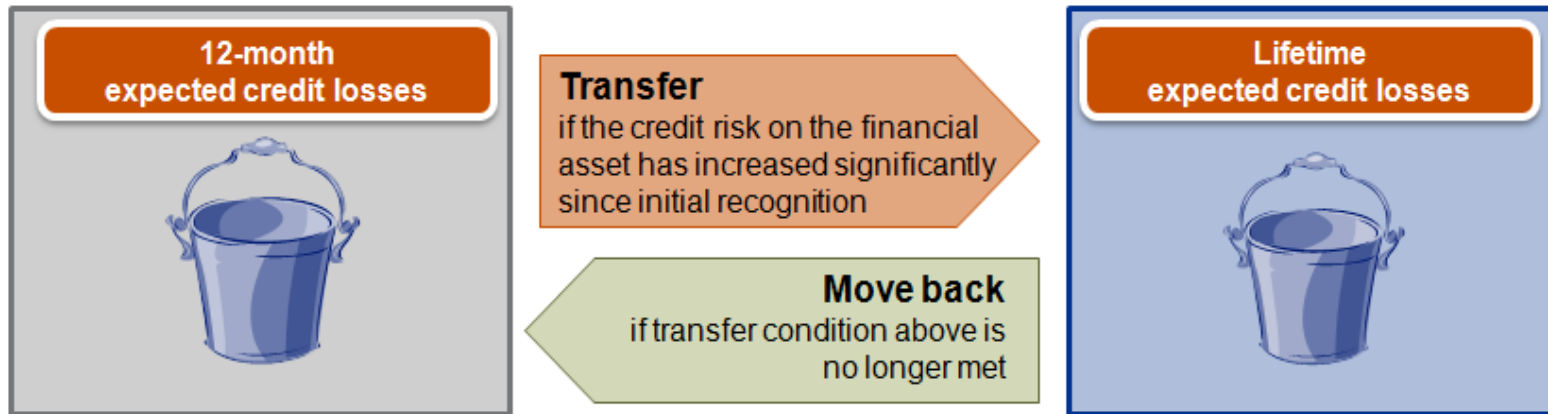
Impairment

The new model



- Generally, all financial assets carry a loss allowance.
 - No trigger is required for recognising impairment
- More judgement.
- One model for financial instruments in the scope of IFRS 9.

Dual Measurement Approach



- Under the general principle, one of two measurement bases applies:
 - 12-month expected credit losses; or
 - Lifetime expected credit losses.
- The measurement basis depends on whether there has been a significant increase in credit risk since initial recognition.

Dual Measurement Approach – Key Concepts

12-month expected credit losses

- Losses resulting from default events possible within 12 months after reporting date.

Lifetime expected credit losses

- Losses resulting from all possible default events over expected life of financial instrument.

Significant increase in credit risk

- Not defined.

Default

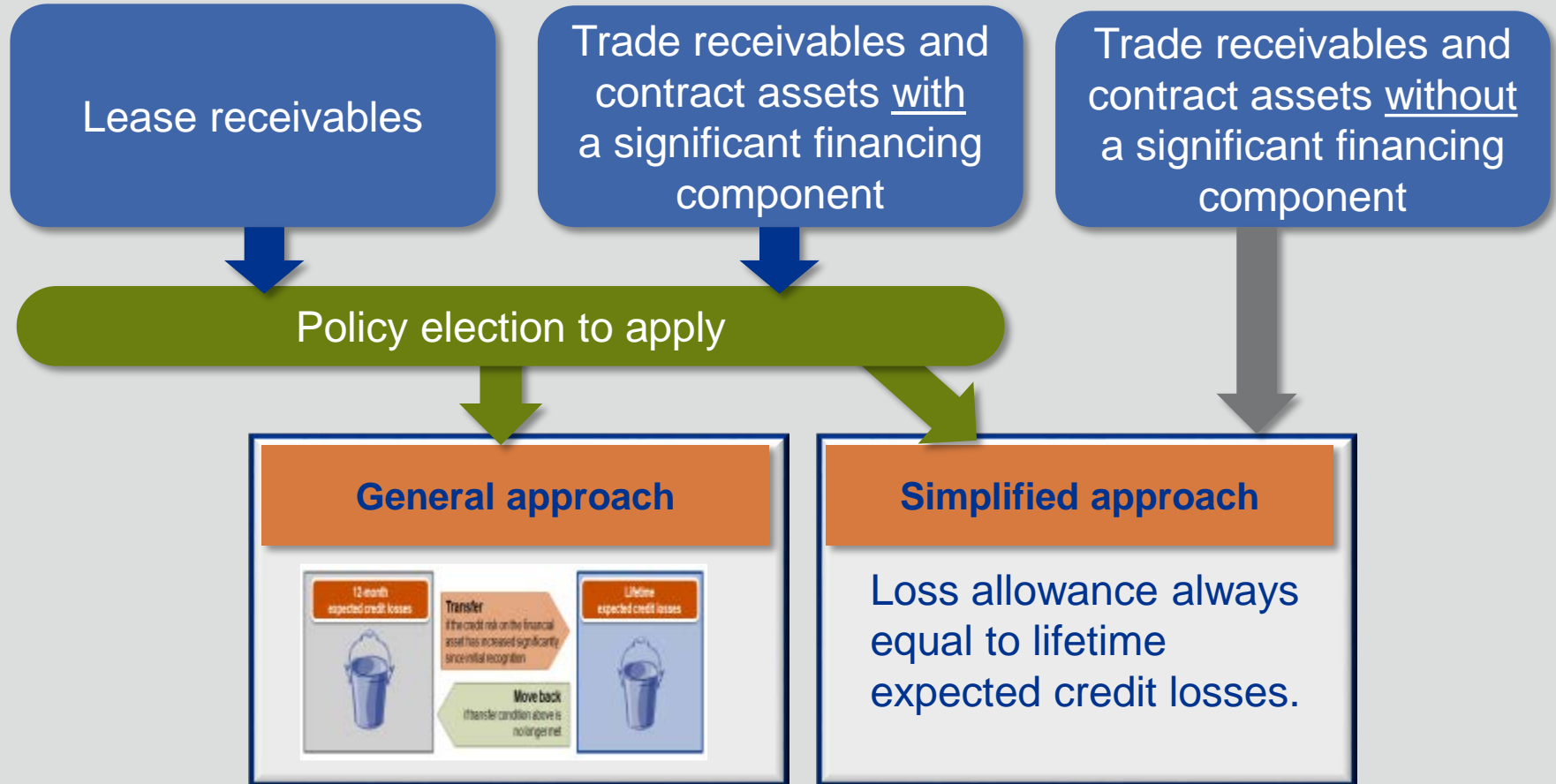
- Not defined.

Dual Measurement Approach – Applying a Definition of Default

- Consistent with definition used for internal credit risk management purposes for the relevant instrument.
- Consider qualitative indicators when appropriate, e.g. breach of covenants.
- May be the same as used for regulatory purposes but has to be consistent with the above two requirements.
- Should be applied consistently.

**Rebuttable presumption that default does not occur
later than 90 days past due**

Simplified Approach for Trade and Lease Receivables and Contract Assets



Practical expedient to calculate expected credit losses – provision matrix.

Assessment of Significant Increases in Credit Risk – A Relative Concept

- Assessment based on change in risk of default since initial recognition.
- Not based on change in amount of ECL.
- Based on all reasonable and supportable information, including forward-looking info, available without undue cost or effort such as:
 - Actual/expected internal/external credit rating changes.
 - Actual/forecast macroeconomic data.
 - Changes in price and market indicators of credit risk.
 - Actual/expected changes in operating results/environment of borrower.

Assessment of Significant Increases in Credit Risk – Risk of Default

- Cannot simply compare change in absolute risk of default.
 - Risk of default tends to reduce over time.
 - If risk of default has not reduced over time, this may indicate an increase in the credit risk.
 - However, this may not be the case if significant payment obligations only close to maturity.
- Change in 12-month risk of default may be reasonable proxy.

Measurement of Expected Credit Losses

Expected credit losses on financial assets

Probability weighted



Unbiased probability-weighted amount (evaluate range of possible outcomes and consider risk of credit loss even if probability is very low)

Present value



Generally calculated using original EIR or an approximation as discount rate

Cash shortfalls



Difference between cash flows due under the contract and cash flows that entity expects to receive

Expected Credit Losses

What does this mean for you.....?

Life Insurance

P&C Insurance

Disclosures

- Extensive new disclosures required, e.g.:

Explanation of how judgement is exercised

- How the entity determines if increase in credit risk is significant.
- Definition of 'Default' and reasons for selecting it.
- Inputs and assumptions used for impairment.

Quantitative disclosures

- Significant changes in gross carrying amounts of financial assets, information on collateral and modifications of financial assets.



Designing disclosures and sourcing data – key part of IFRS 9 implementation.

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What changes are brought on by IFRS 9 impairment?

Calculating expected credit losses especially over the remaining lifetime is the most significant change under the IFRS 9 impairment regulations

**Lifetime
Expected Credit
Losses**

Extensive disclosure requirements demand increased data models and merging of risk and accounting data, while accounting for defaulted assets becomes a complicated exercise

**Accounting &
Disclosures**

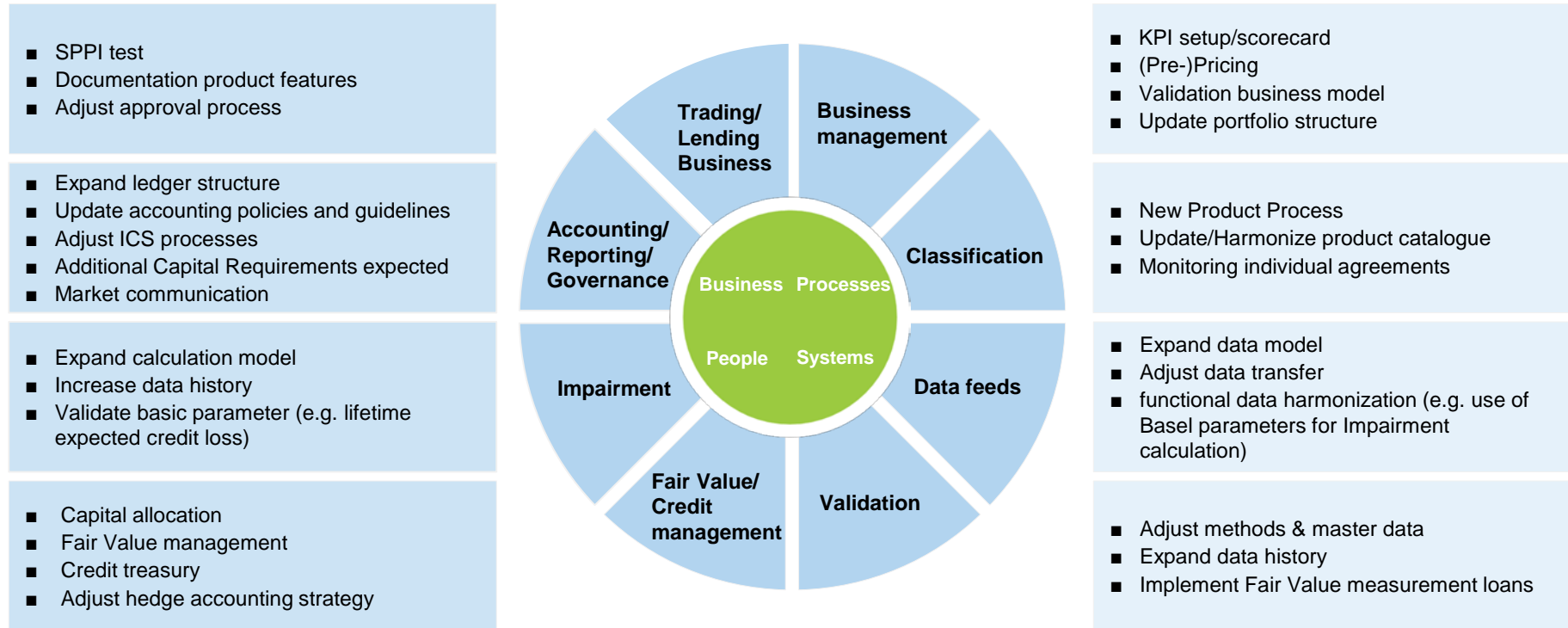
**IFRS 9 changes
and challenges**

Determining the correct level of reserves depends not only on the level of expected credit losses, but also an individual asset's credit deterioration over time, which must be monitored on an ongoing basis

Stage Allocation

The challenges of IFRS 9 impairment reach beyond accounting and require changes to systems and processes

IFRS 9 poses a strategic challenge that has far reaching implications beyond just accounting



The extensive impacts of IFRS 9 require a coordinated approach and proven solutions to minimize risks and maximize potential

gCLAS provides necessary accounting functions beyond the calculation of lifetime expected credit loss

Scope of Solution

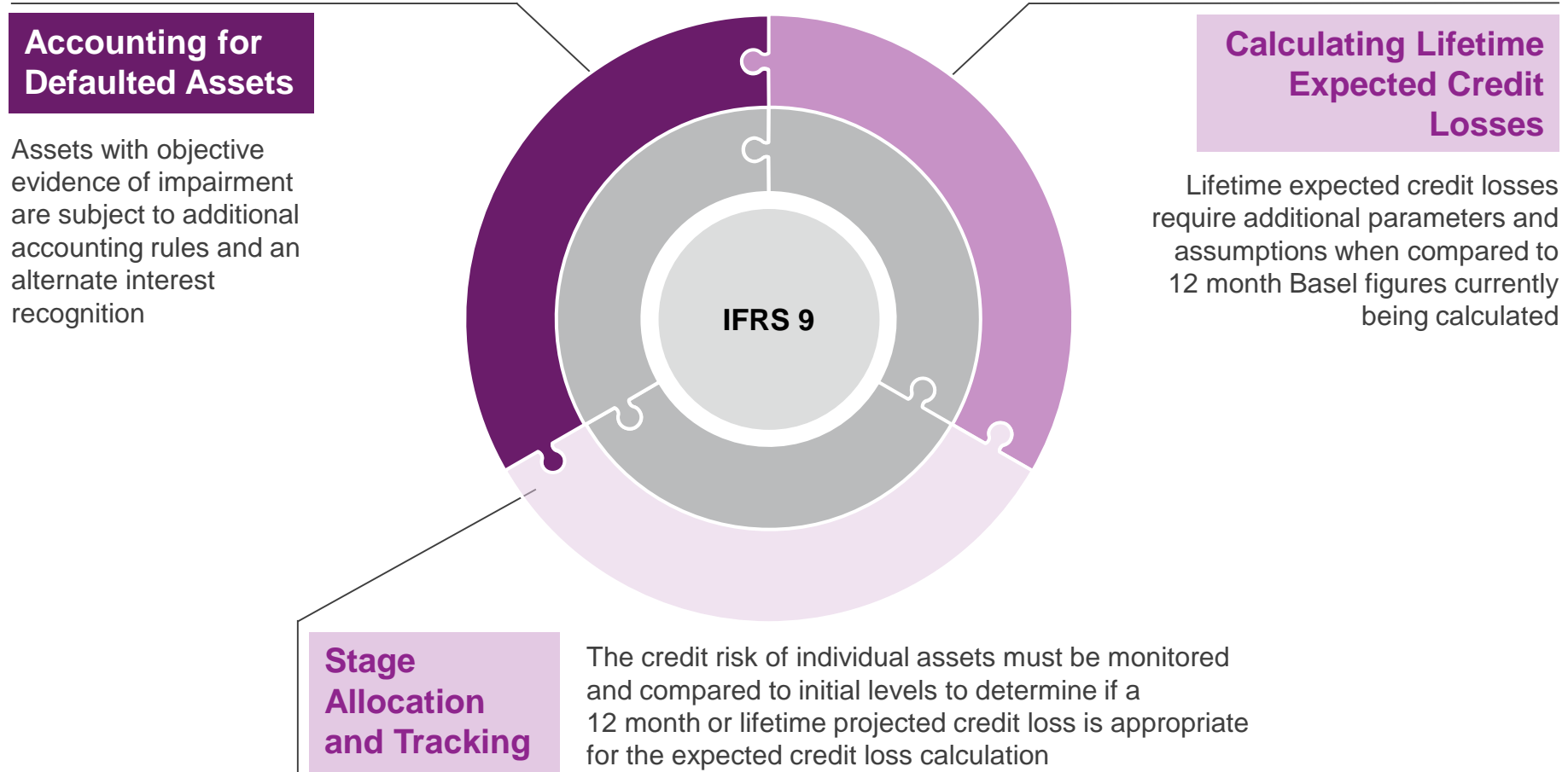
- Calculation of lifetime expected credit loss at transaction level
- Calculation of 12 month expected credit loss at transaction level
- Allocation to IFRS 9 stages 1 – 3 with manual override capability
- Accounting for impaired (stage 3) assets
- Generate journal entries and required financial statement disclosure reports
- Creation of transition matrices based on input data (either delinquency status, risk grade or other user defined metric)
- Import and use of additional risk parameters such as transition matrices (in addition to those calculated) or LGD curves/vectors
- Calculate (original) effective interest rates and spreads for fixed and variable interest rate assets
- Calculate adjusted EIR that isolates effects of credit from assumptions in prepayment speed

Added Value for Financial Institutions

- Efficient and transparent calculation of expected credit loss figures in compliance with IFRS and US GAAP
- Solution not only calculates provisioning amounts and credit impaired accretion income, but generates the appropriate journal entries for booking in the general ledger and required disclosure reports
- Offers a full service impairment solution to clients with limited data, while still offering sophisticated clients the flexibility to incorporate best available information
- Offers IFRS and US GAAP compliance to clients with reporting entities in multiple jurisdictions subject to multiple accounting standards
- The model can be extended during implementation to include client-specific requirements
- In addition to whole loans, model can be adapted to in scope debt securities subject to amortized cost impairment

Financial institutions benefit significantly from the extensive scope of gCLAS

IFRS 9 brings with it a new set of challenges that gCLAS is in a unique position to address



gCLAS adds value to the risk and accounting process by integrating these more closely

gCLAS provides an answer to challenges clients face when implementing IFRS 9

IFRS 9 Challenge

- Calculating 12 month and lifetime expected credit loss values for a broad scope of assets at a granular level, often in the face of limited data availability
- Allocating assets across stages and monitoring the status from period to period with corresponding effects for the balance sheet and P&L
- Extensive disclosure requirements requiring qualitative and quantitative analysis as well as expanded data models to track flags
- Changes in accounting requirements result higher and more volatile reserve levels, which require additional analysis and robust parameterization. This also includes definitions of 'low credit risk' and 'significant increase in credit risk'
- The scope of IFRS 9 is expanded to cover additional financial instruments, including off-balance sheet items

Solution in gCLAS

- gCLAS calculates ECLs based on cash flow amortization and available risk data, with delinquency status as a minimum parameter
- Stages are assigned using an algorithm/ manual input and stage transfers trigger changes in the ECL calculation as well as journal postings
- Reporting is structured around the disclosure requirements so that individual reports can be fed into the year-end processes as building blocks for the notes
- Parameters for stage allocation and calculating ECLs can be entered flexibly at portfolio level to enable differentiation across segments. These parameters can be stressed to understand past volatility and future risks

gCLAS provides a one-stop solution to many difficulties that financial institutions face when implementing IFRS 9

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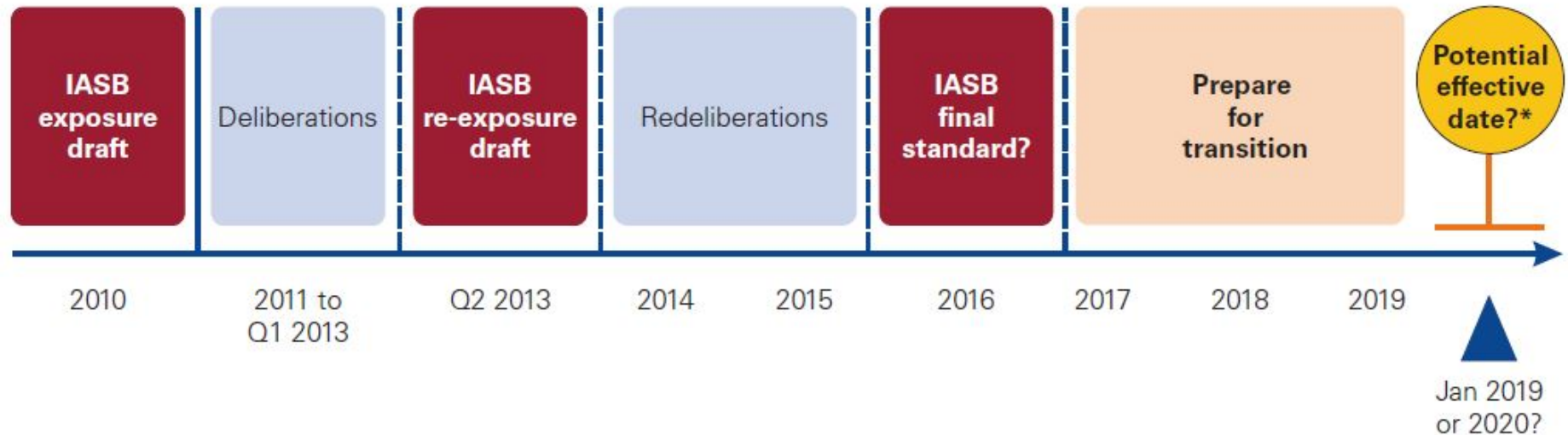
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IFRS 4 Phase II

Current timeline

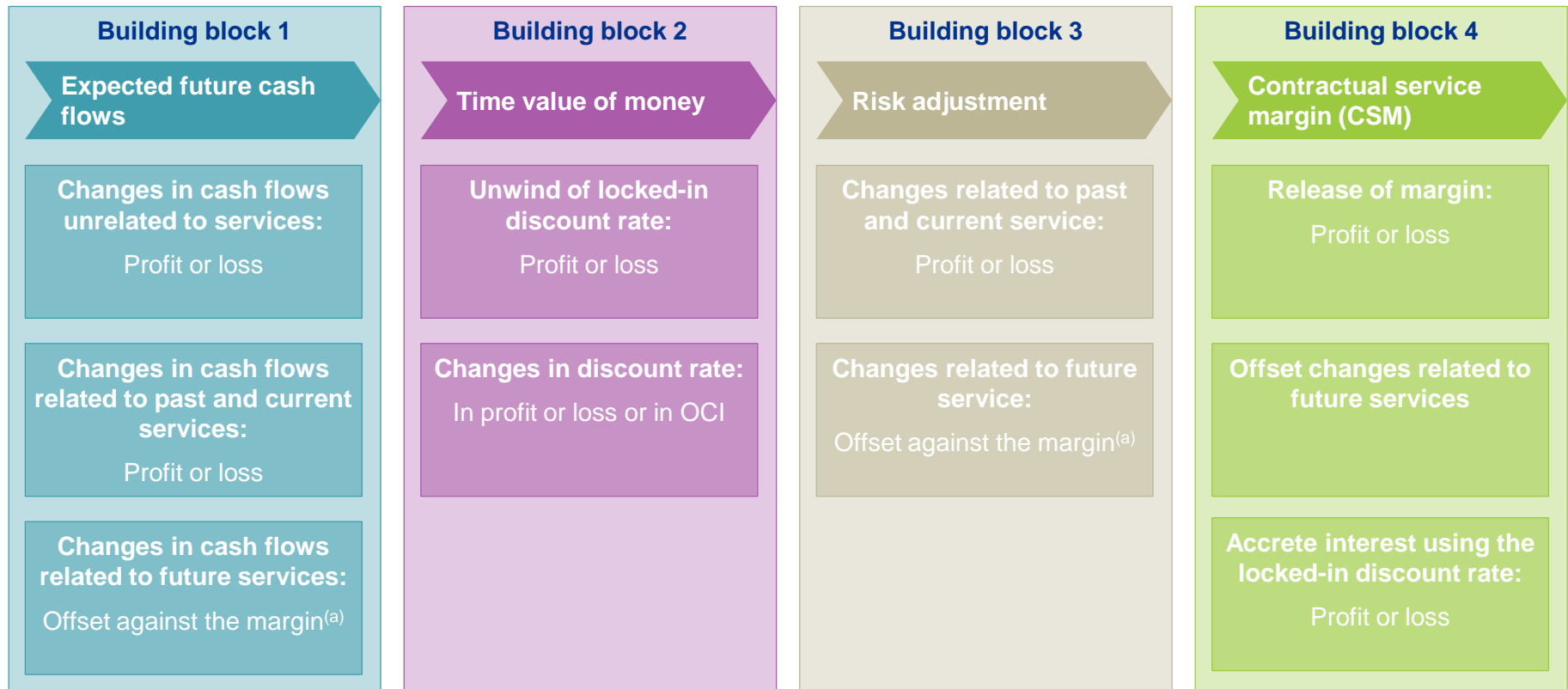
The IASB re-exposed its insurance contracts proposals and issued ED/2013/7 *Insurance Contracts* in June 2013. A final standard is no longer expected during 2015.



* The effective date of the final standard is expected to be approximately three years after the standard is issued. The IASB staff do not expect the final standard to be published before the end of 2015. The mandatory effective date will be considered after the redeliberations on the model for participating contracts have been completed.

IFRS 4 Phase II

Current timeline



Note: (a) Recognised in profit or loss if no contractual service margin or if rebuilding previously recognised losses.

IFRS 4 Phase II and IFRS 9

Summary of interactions

What are the issues for insurers?

The interaction of IFRS 9 with IFRS 4 Phase 2 on the measurement of liabilities could result in accounting mismatches and greater volatility in the financial statements.

The use of Fair Value through Other Comprehensive Income (FVOCI) will require the design and build of an impairment process and robust model.

If insurers use Fair Value through Profit and loss (FVTPL) for their classification, inputs/changes will be minimal.

Many Life insurers are expected to continue using Fair Value through Profit and loss (FVTPL), therefore the impact of IFRS 9 will be low.

Other insurers may choose to use Fair Value through Other Comprehensive Income (FVOCI) for both assets and liabilities leading to more challenges (financially and operationally)

Overlap with IFRS 4 Phase 2

IFRS 4 Phase 2 is not expected to go live until 1 January 2019 at the earliest;

Two major change programmes within close proximity, impacting resources, BAU, results, costs.

How should insurers account in the interim period?
Have they considered the impact on results?

Business decisions made for IFRS 9 accounting may require changes once IFRS 4 implications for the organisation are clearer

Sufficient flexibility needs to be built into IFRS 9 systems changes/to accommodate IFRS 4 Phase 2.

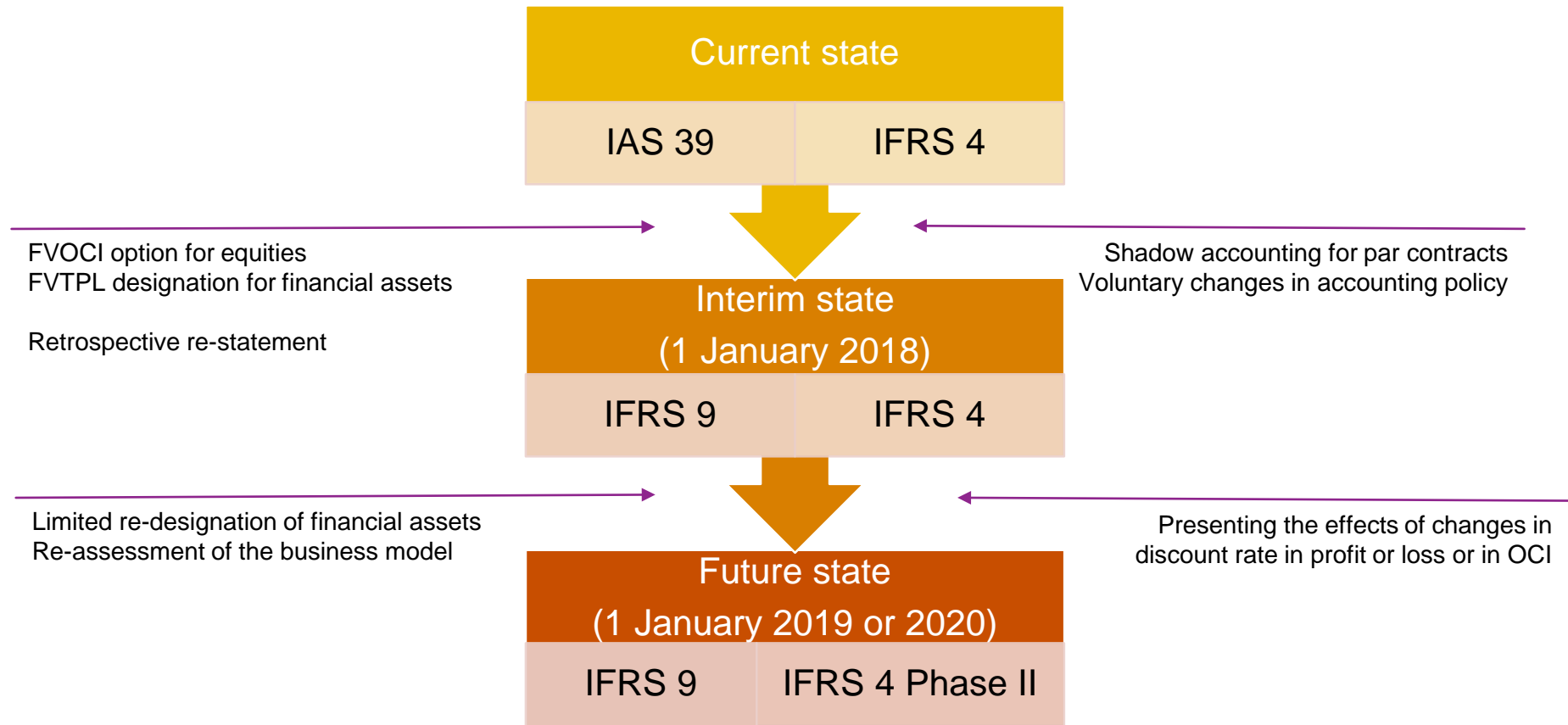
Questions for insurers

- Have insurers thought about their accounting model for both standards? The initial thinking will have a very significant impact on numbers and the work required to implement the standards.
- Have insurers using Fair value through OCI accounting evaluated the level of work required for the impairment process and the impact on their results?
- Given the potential gap between IFRS 9 being implemented and IFRS 4 Phase II, have insurers considered that they may need to make different accounting policy selections for their assets?

IFRS 4 Phase II and IFRS 9

A stepped process...




With options and elections are available each step of the way...



Even with effective use of options and elections available, insurers can expect increased volatility in profit or loss and equity

IFRS 4 Phase II and IFRS 9





Possible classifications for life insurers

Financial Asset	Current designation in CALM system	Designation under IFRS 9 – 2018	Designation under IFRS 9 – 2019 (IFRS 4)
Bonds backing insurance contracts	FVTPL (fair value through profit and loss)	FVTPL	FVTPL ³
Bonds backing surplus	AFS ¹ (available for sale)	FVOCI ¹ (fair value through OCI)	FVOCI ¹
Stocks backing insurance contracts	FVTPL	FVTPL	FVTPL
Stocks backing surplus	AFS ¹	 FVTPL	FVTPL
Loans and receivables	Amortized cost	Amortized cost	 FVTPL (for assets backing insurance contracts) ^{2,3}
Mortgages	Amortized cost	Amortized cost	 FVTPL (for assets backing insurance contracts) ^{2,3}

- 1 – AFS and FVOCI both reflect income on an amortized cost basis, and unrealized market value changes in other comprehensive income (OCI). However, FVOCI is unattractive for equities since realized gains are not recycled through income. Under IFRS 9, the amortized cost basis will reflect expected credit loss provisions.
- 2 – FVTPL available for loans, receivables and mortgages under IFRS, but need OSFI to change Guideline D-10 as is expected, for the new IFRS 4 or earlier for IFRS 9.
- 3 – Consideration is being given to using FVOCI or amortized cost assets for the Contractual Service Margin in policy liabilities, to improve matching,

IFRS 4 Phase II and IFRS 9

Possible classifications for P&C insurers

Asset	Current prevailing designation	Designation under IFRS 9 – 2018	Designation under IFRS 9 – 2019 (IFRS 4)
Bonds backing insurance contracts	AFS ¹ (available for sale), some use of FVTPL (fair value through P&L)	Likely unchanged, AFS assets continuing as FVOCI	 FVOCI if the OCI option is used, FVTPL ³ otherwise
Bonds backing surplus	AFS ¹ (available for sale)	FVOCI ¹ (fair value through OCI)	FVOCI ¹
Stocks backing insurance contracts	AFS or FVTPL (relatively uncommon)	 FVTPL	FVTPL
Stocks backing surplus	AFS ¹	FVTPL	FVTPL
Loans and receivables	Amortized cost	Amortized cost	 FVTPL (for assets backing insurance contracts)? ^{2,3}
Mortgages	Amortized cost	Amortized cost	 FVTPL (for assets backing insurance contracts)? ^{2,3}

- 1 – AFS and FVOCI both reflect income on an amortized cost basis, and unrealized market value changes in other comprehensive income (OCI). However, FVOCI is unattractive for equities since realized gains are not recycled through income. Under IFRS 9, the amortized cost basis will reflect expected credit loss provisions.
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Transition for Classification and Measurement

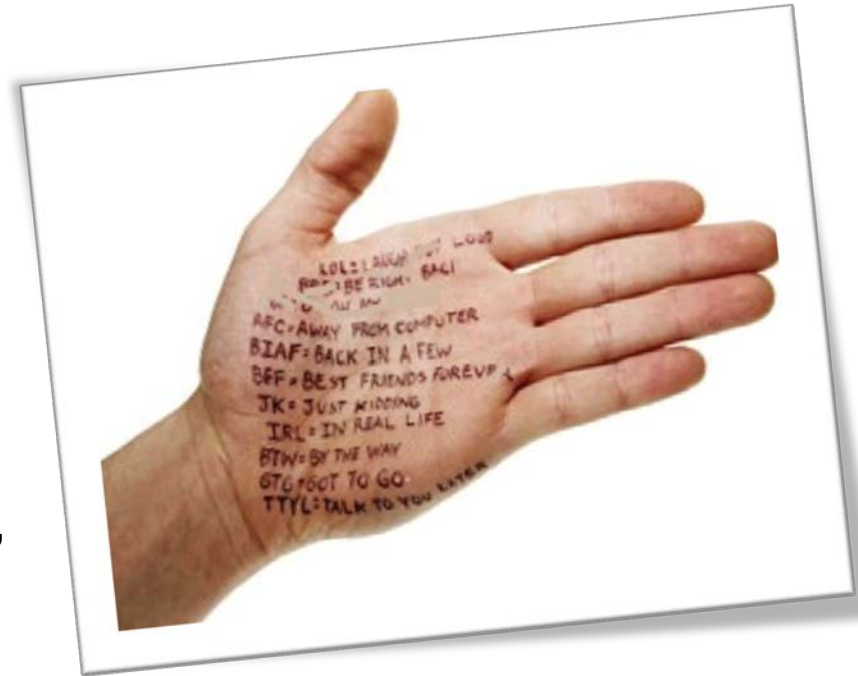
Retrospective
application, with some
exemptions

Comparatives need not
be restated (can be
restated if possible
without using hindsight)

Limited reopening of
the FV option

Key Points to Remember!

- Criteria for classification significantly different to IAS 39 (judgement required).
- Evaluating contractual terms and determining business model likely to be a substantial project for most in financial sector.
- Identifying options and elections available under IFRS 9.
- Impact on financial ratios, regulatory capital, new product approval process and business strategy.



Wide Impact

System and process implications

Resources

- What training of the existing staff is needed?
- Will on-boarding of skilled resources be needed?
- How much funding need to be secured?

Data

- Which new type of data will have to be collected?
- What will be the difficulty to obtain it?

Governance over process

- How quickly can volatility be forecasted and what information can be used to model this? How to back test the forecasts?

Systems

- Where will the data be held?
- Who will own and maintain the C&M model?
- What linkages will be needed with existing systems and models?
- What changes are required to the GL?
- How will the results be compared under old and new categories?
- What level of detail will need to be captured in source systems to support C&M and impairment, if applicable?
- What changes to key internal controls over financial reporting and to the way in which work is performed are needed?

Wide Impact

Other implications and program decisions

Strategy and strategic position

- Measurement basis used by competitors and its effect on P&L
- Measurement basis used by Group or other subsidiaries, (non-IFRS)

Communication

- What communication will have to be provided to staff, Business Units, Board, Group and financial statements users?
- How expected changes to financial statements and reporting metrics will be explained?

Budget

- What budget will be required for implementing the programme?

IFRS 4 implementation

- Will IFRS 9 and IFRS 4 implementation be integrated into one program, or will they be run separately?
- How will the budget and resources be split?
- How will be the timing aligned?

Programme plan

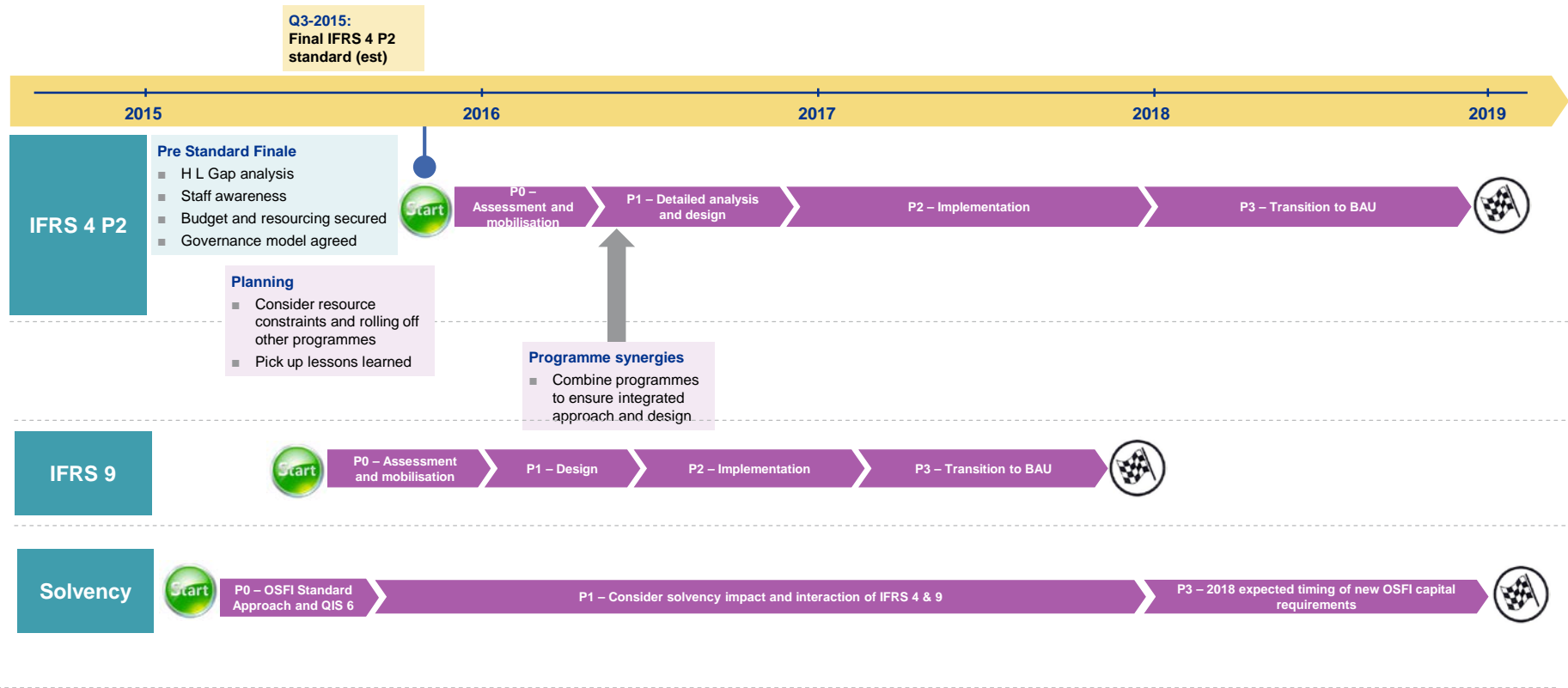
- Who will own the process?
- How long will be the program?

Timing

- Will you benefit from adopting IFRS 9 earlier than the effective date?
- How will you align your programme with final publication of IFRS 4 Phase II requirements?

Planning further steps

High level timeline including other programmes



Other Presentations

The other presentations that were presented as part of the Risk and Regulatory series are:

- Cyber Resiliency
- Market Conduct
- ORSA – Next Steps
- Regulatory Compliance Management

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