IFRS 9 for insurers

Are you good to go?

Application guidance

September 2021

Contents

Purpose of this document

What is *Good to go?*

IFRS 9 *Financial Instruments* changes the way insurers account for their financial instruments.

Many insurers have used the temporary exemption from applying IFRS 9 and have instead continued to apply the predecessor standard IAS 39 *Financial Instruments: Recognition and Measurement*. This exemption will no longer apply from periods beginning on or after 1 January 2023 when IFRS 17 *Insurance Contracts* becomes effective.

In the past, when major change to IFRS® Standards has led to large-scale implementation projects, management at companies – usually group financial controllers – have asked us 'How will I know when we're done?'

This guide helps to answer that question. It outlines key considerations that insurers need to focus on to get to the finish line so that you can discuss the issues and understand the main implications for your insurance company.

Following a discussion of the scope requirements of IFRS 9 (as amended by IFRS 17) compared to IAS 39, each chapter in this guide deals with a different issue and considers:

- new IFRS 9 requirements;
- how they differ from existing IAS 39 requirements; and
- application of the new IFRS 9 requirements.

Except where stated otherwise, this guide assumes that the insurer has taken advantage of the option to temporarily defer application of IFRS 9 and will initially apply IFRS 9 in the same period as IFRS 17. Therefore, it also includes changes to IFRS 9 introduced by IFRS 17. However, additional issues may arise depending on the specific facts and circumstances of each individual insurer.

One area where insurers may need to adapt their current plans is the presentation of comparative information. The International Accounting Standards Board (the Board) has proposed a new optional classification overlay approach which is discussed in Chapter 11. The Board plans to finalise any amendment by the end of 2021.

More information

Please see the back of this publication for further resources to help you apply IFRS 9's requirements.

Scope of IFRS 9

Scope

IFRS 9 largely carries forward the scope requirements and exceptions of IAS 39. However, there are some changes – including consequential changes that are effective when IFRS 17 is adopted – that need to be considered.

Scope exception for insurance contracts and interaction with IFRS 17

IFRS 9.2.1(e)

Like IAS 39, IFRS 9 generally excludes from its scope contracts meeting the definition of an insurance contract. Following adoption of IFRS 9 and IFRS 17, the determination of what is an insurance contract will be based on the relevant guidance in IFRS 17 rather than IFRS 4 *Insurance Contracts* – although that guidance is very similar.

Scope amendments that could change the population of items accounted for under IFRS 9 compared to IAS 39 include the following.

IFRS 9.2.1(e)(ii), (iv), 17.7(h)

IFRS 9.2.1(e)(i), 4.3, B4.3.8(h), IFRS 17.B10

Item	Description
Investment components that are separated from contracts in the scope of IFRS 17	IFRS 4 allows (and sometimes requires) an insurer to unbundle a deposit component from an insurance contract and account for it separately under IAS 39 if it can measure the deposit component separately. IFRS 17 does not provide an option to separate a financial instrument component from an insurance contract. Instead, it requires an investment component to be separately accounted for under IFRS 9 if it is 'distinct' and is not an investment contract with discretionary participation features. The entity attributes cash flows to a distinct investment component on a stand-alone basis – i.e. it measures the investment component as if it had issued the item as a separate contract. If separation is not required because a component is not distinct, then separation is prohibited under IFRS 17.
Embedded derivatives	Both IAS 39 and IFRS 9 require a derivative embedded in an insurance contract to be accounted for separately as a derivative under the financial instruments standards if its economic characteristics and risks are not closely related to the host contract and the embedded derivative would not be an insurance contract if it were a stand-alone instrument. An embedded derivative is closely related to a host insurance contract if they are so interdependent that an entity cannot measure the embedded derivative separately (i.e. without considering the host contract). IFRS 4 contained an exemption from separation for a policyholder's option to surrender an insurance contract for a fixed amount. This exception has not been carried forward to IFRS 17. Given that the value of a typical fixed-price surrender option

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	and the host insurance contract are likely to be interdependent, this change will probably have little impact in practice. Under IFRS 17, unlike IFRS 4, an entity cannot have a policy of separating embedded derivatives that do not meet the criteria for mandatory separation under IFRS 9. Conversely, under IFRS 17 an entity can no longer avoid separation by having a policy of accounting for the whole of an insurance contract at fair value through profit or loss (FVTPL).
IFRS 9.2.1.(e)(v), 17.8A **Contracts that limit compensation to the policyholder's obligation**	Following adoption of IFRS 17, an insurer can elect to apply IFRS 9, rather than insurance contract accounting, to financial instruments arising from insurance contracts that an insurer issues that limit the compensation for insured events to the amount otherwise required to settle the policyholder's obligation created by the contract. A possible example is a loan with a death waiver. The election to apply IFRS 9 or IFRS 17 is made for each portfolio of insurance contracts and is irrevocable.
IFRS 9.2.1(e)(ii), (iv), 17.7(h) **Credit cards and similar contracts that meet the definition of an insurance contract**	Following adoption of IFRS 17, an entity's rights and obligations that are financial instruments arising under credit card contracts (or similar contracts that provide credit or payment arrangements) issued by the entity are accounted for under IFRS 9 if the entity does not reflect an assessment of the insurance risk associated with an individual customer in setting the price of the contract with that customer. However, if the insurance coverage is a contractual term of the financial instrument, then the entity separates the insurance coverage component and applies IFRS 17 to that component only. This new exemption for certain credit cards and similar credit and payment arrangements may be relevant for some financial services groups whose business is primarily insurance.

Application of IFRS 9 requirements

IFRS 17.A, B

Definition of an insurance contract

The definition of an insurance contract does not change significantly between IFRS 4 and IFRS 17. IFRS 17 does clarify that a present value basis is used to assess whether insurance risk is significant (including considering whether there is a possibility of loss for the issuer) and the discount rates to use. This was not specified in IFRS 4 and, therefore, may result in changes to an entity's assessment of whether a contract is in the scope of the insurance standard or the financial instruments standards.

Insurers will evaluate this question as part of their IFRS 17 analysis of affected insurance contracts but need to consider how IFRS 9 might apply to affected financial instruments.

A similar approach will likely apply in considering whether and how to separate financial instrument components from insurance contracts under the new requirements in IFRS 17.

Contracts that limit compensation to policyholder's obligation

Insurers also need to consider whether they issue insurance contracts that limit the compensation to settlement of the policyholder's obligation under the contract. Possible examples might include advancing lifetime mortgages or purchasing catastrophe bonds under which payments are reduced significantly if the specified triggering event includes a condition that the issuer of the bonds suffers a loss. If so, the insurer may evaluate whether it wishes to apply IFRS 9 or IFRS 17 for financial assets that meet the criteria for possible exemption from IFRS 17. The significant insurance risk included in the contractual cash flows of these assets suggests that they would fail the 'solely payments of principal and interest' (SPPI) test in IFRS 9 and would be accounted for at FVTPL if IFRS 9 is applied (see Section 2).

Investment contracts with discretionary participation features

Before the adoption of IFRS 9 and IFRS 17, an entity that issues investment contracts with discretionary participation features accounts for them under IFRS 4 rather than IAS 39. These instruments are scoped out of the measurement requirements of IAS 39, but they are subject to the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures* and some of the presentation requirements of IAS 32 *Financial Instruments: Presentation*.

IFRS 7.3(d), 9.2.1(e), 17.3(c), IAS 32.4(d)

Following adoption of IFRS 9 and IFRS 17, IFRS 17 will apply to these contracts only if the entity also issues insurance contracts. If the contracts are in the scope of IFRS 17, then they will be excluded altogether from the requirements of IFRS 7, IFRS 9 and IAS 32. Conversely, investment contracts with discretionary participation features issued by entities that do not issue insurance contracts will be in the scope of IFRS 9, IFRS 7 and IAS 32.

Thus, the scope amendments for investment contracts with discretionary participation features will have a limited impact for entities that write insurance contracts.

Financial guarantee contracts

IFRS 17.7(e)

Although issued insurance contracts are generally accounted for under IFRS 17, IFRS 9 and IFRS 17 carry forward the requirement from IAS 39 and IFRS 4 that an entity accounts for financial guarantee contracts that it issues under the financial instruments standards rather than the insurance standard unless it has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting that is applicable to insurance contracts. If this is the case, then the issuer may choose to apply either IFRS 17 or the financial instruments standards to those issued financial guarantee contracts. The entity may make that choice contract by contract but the choice for each contract is irrevocable.

Application of IFRS 9 requirements

The contract-by-contract election to account for financial guarantee contracts under the financial instruments standards or the insurance contracts standard (if the issuer has previously asserted explicitly that it regards them as insurance contracts and accounted for them as such) is essentially unchanged. However, an insurer might wish to consider whether it would be more useful to apply the IFRS 9 or the IFRS 17 model going forward for its financial guarantees issued. Although such an election is usually irrevocable, it appears that the election under IFRS 17 is available on transition to IFRS 17 for financial guarantee contracts to which IFRS 4 was applied previously. Therefore, we believe that when an entity first applies IFRS 17 it may irrevocably elect to apply IFRS 17 or the financial instruments standards on a contract-by-contract basis for those existing contracts.

Own securities held as underlying items

IFRS 9.3.3.5, IAS 32.33A

IFRS 17 amends IFRS 9 and IAS 32 for cases in which own financial liabilities and shares are held in investment funds operated by the entity and provide their investors with benefits determined by the fund's units or are held as underlying items of issued direct participating contracts. Usually when an entity repurchases its own liability instruments, this is treated as a derecognition of the financial liability, whereas repurchases of an entity's own equity instruments are deducted from equity. However, IFRS 17 introduces the following new options.

– When an entity holds its own financial liabilities (e.g. issued bonds) as underlying items for a group of direct participating contracts or in investment funds that it operates, it may elect to continue to account for the instruments as financial liabilities and to account for the repurchased instruments as if they were financial assets and to measure them at FVTPL, instead of derecognising the liabilities.

– When an entity holds its own treasury shares as underlying items for a group of direct participating contracts or in such investment funds, it may elect to continue to account for them as equity and to account for the reacquired instruments as if they were financial assets and measure them at FVTPL.

The above choices are made on an instrument-by-instrument basis when the repurchase of each instrument is made and are irrevocable.

Application of IFRS 9 requirements

If an entity holds its own securities in investment funds that it operates or as underlying items for direct participating insurance contracts, then it should consider taking advantage of the option to account for those securities as financial assets at FVTPL. This may reduce accounting mismatches with how the entity accounts for its liabilities to fund investors and policyholders.

These requirements are discussed further in Chapters 7.1 and 8.1A in the 18th Edition 2021/22 of our publication Insights into IFRS.

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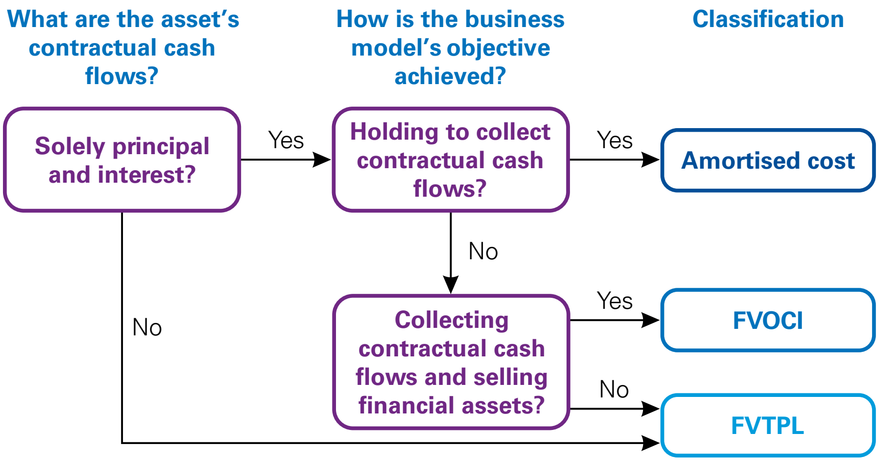
Introduction

On initial recognition, a financial asset is classified into one of the three primary measurement categories:

- amortised cost;
- fair value through other comprehensive income (FVOCI); or
- fair value through profit or loss (FVTPL). *IFRS 9.4.1.1*

IFRS 9.4.1.1–4.1.2A An insurer classifies financial assets based on the business model in which the financial asset is managed and whether the cash flows from the financial asset represent, on specified dates, solely payments of principal and interest (SPPI) on the principal amount outstanding.



IFRS 9.BC4.14 The order in which the business model and the cash flow characteristics assessments are performed does not impact the classification conclusion.

IFRS 9.4.1.5 On initial recognition, an insurer may choose to designate a financial asset that would otherwise qualify for amortised cost or FVOCI classification as at FVTPL. This is permitted if it eliminates or significantly reduces an accounting mismatch.

IFRS 9.5.7.5, B5.7.1 Investments in equity instruments are generally classified as at FVTPL. However, on initial recognition an insurer may elect to present fair value gains and losses on such an investment in other comprehensive income (OCI) rather than profit or loss if the investment is not held for trading.

IFRS 9.4.2.1 On initial recognition, financial liabilities are generally classified as subsequently measured at amortised cost, except for the following instruments:

- financial liabilities at FVTPL: these are liabilities held for trading or designated as at FVTPL on initial recognition;
- financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies: specific guidance on measurement is carried forward from IAS 39;
- financial guarantee contracts: subsequently measured at the higher of the amount initially recognised less any income recognised in accordance with the principles of IFRS 15 *Revenue from Contracts with Customers* and the amount of provision for expected credit losses (ECLs);

- commitments to provide a loan at a below-market interest rate: subsequently measured similar to financial guarantees; and
- contingent consideration issued in a business combination: subsequently measured at fair value.

IFRS 9.4.2.2, 4.3.5

An insurer may be permitted to designate a financial liability as at FVTPL if designation eliminates or reduces an accounting mismatch, the financial liability is managed on a fair value basis or the contract contains an embedded derivative that might otherwise need to be accounted for separately. For liabilities designated as at FVTPL, IFRS 9 introduces a new requirement to present gains and losses related to own credit risk in OCI.

IFRS 9 retains the requirements in IAS 39 for separating embedded derivatives when the host contract is a financial liability.

For further information, see 7.5.20 in the 18th Edition 2021/22 of our publication Insights into IFRS.

How does this approach differ from IAS 39 requirements?

The principles-based model for the classification of financial assets under IFRS 9 is different from the specific requirements in IAS 39. However, the changes for financial liabilities are more limited. This is discussed in more detail in the sections that follow.

The 'higher of' approach for issued financial guarantee contracts is similar to that in IAS 39, except that the provision for losses is based on the IFRS 9 ECL impairment model whereas IAS 39 referred to the guidance in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

An insurer currently applying the temporary exemption from IFRS 9 permitted under IFRS 4 is required under IFRS 4 to provide disclosures to help users of financial statements compare insurers applying the temporary exemption with those applying IFRS 9. These include disclosing the fair value at the reporting date and the amount of change in the fair value during the period separately for:

- financial assets with contractual terms that give rise on specified dates to cash flows that represent SPPI, except those that are held for trading or managed on a fair value basis; and
- all other financial assets.

Therefore, insurers applying the temporary exemption should already have developed some familiarity with some of the decisions required to apply the IFRS 9 classification model for financial assets. Insurers can leverage the analysis done for these disclosures in their IFRS 9 implementation projects (and vice versa) and should ensure that there is appropriate consistency between their pre-implementation disclosures under IFRS 4 and decisions made in their IFRS 9 implementation projects.

1 Business model criterion

1.1 Assessing the business model

Requirements of IFRS 9

IFRS 9.4.1.1–4.1.2A

The business model is assessed to determine whether a financial asset with SPPI cash flows should be classified as measured at amortised cost or FVOCI.

IFRS 9.B4.1.2A

The term 'business model' refers to how an insurer manages its financial assets to generate cash flows. That is, the insurer's business model determines whether cash flows result from collecting contractual cash flows, selling the financial assets or both.

IFRS 9.4.1.2–4.1.4

IFRS 9 provides additional guidance on how to assess the business model. The table below summarises the key features of each type of business model and the resulting measurement category.

Business model	Key features	Measurement category
Held-to-collect	– The objective is to hold financial assets to collect contractual cash flows – Sales of financial assets are incidental to the model's objective. Typically, sales of financial assets are low (in frequency and volume)	Amortised cost*
Both held to collect and for sale	– Both collecting contractual cash flows from and sales of financial assets are integral to achieving the business model's objective. Typically, more sales occur (in frequency and volume) than in the held-to-collect business model	FVOCI*

Business model	Key features	Measurement category
Other business models, including: – **trading** – **managing assets on a fair value basis** – **maximising cash flows through sale**	– Business model is neither held-to-collect nor held to collect and for sale – Collection of contractual cash flows is incidental to the objective of the model	FVTPL**

* Subject to meeting the SPPI criterion and not electing the fair value option. See Chapter 3 for more information on the option to designate financial assets as at FVTPL.

** SPPI criterion is irrelevant – all financial assets in all these business models are measured at FVTPL.

IFRS 9.B4.1.2C

Companies consider the frequency, volume and timing of sales in prior periods, the reasons for these sales and their expectations about future sales activity in assessing the business model. However, information about past and expected future sales activity is not considered in isolation, but as part of a holistic assessment of how the insurer's stated objective for managing the financial assets is achieved and how cash flows are realised.

IFRS 9.B4.1.3A–B4.1.3B, BC4.145

IFRS 9 gives the following examples of sales that may be consistent with a held-to-collect business model.

– The sales are due to an increase in the credit risk of a financial asset.

– The sales are infrequent (even if they are significant) or are insignificant individually and in aggregate (even if they are frequent).

– The sales take place close to the maturity of the financial asset and the proceeds from the sales approximate the collection of the remaining contractual cash flows.

These requirements are discussed further in 7.4.70 in the 18th Edition 2021/22 of our publication Insights into IFRS.

How does this approach differ from IAS 39 requirements?

New assessment of how financial assets are managed

Under IAS 39, an insurer considers the business model for managing financial assets in a more limited way and the impact of the assessment may be different. For example, IAS 39 requires an insurer to assess whether a financial asset is held for trading. Also, IAS 39 may allow amortised cost accounting for quoted bonds only if they are held to maturity.

IFRS 9.4.4.1, B4.1.2A, B4.4.1

IAS 39 does not generally require an assessment of past levels of sales but it does have a 'tainting' notion for the held-to-maturity measurement category. There is no similar notion under IFRS 9 – i.e. subsequent sales do not result in the reclassification of existing financial assets measured at amortised cost, as long as an insurer considered all relevant and objective information that was available when it assessed the business model. Reclassification of existing assets takes place under IFRS 9 only if senior management of the entity changes the objective of the entity's business model for managing those financial assets in a manner that is significant to its operations and demonstrable to external parties – this is expected to be very infrequent. However, changes in the way that assets are managed within the business model – e.g. an increased frequency of sales – may result in newly acquired assets being classified differently from existing assets.

Application of IFRS 9 requirements

Insurers identify and evaluate all available evidence when assigning a business model to financial assets

IFRS 9.B4.1.2, 2B, 2C

The business model is determined at a level that reflects the way groups of financial assets are managed together to achieve a particular business objective. An insurer's business model does not depend on management's intentions for an individual instrument. The assessment is not performed at the entity level and an insurer may have more than one business model for managing financial assets.

Although IFRS 9 states that an insurer'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.

All relevant and objective evidence available at the date of the assessment should be used to determine the business model for particular financial assets. The standard lists the following examples of 'relevant and objective evidence':

- how the performance of the business model and the financial assets held within that business model are evaluated and reported to the insurer's key management personnel;
- the risks that affect the performance of the business model (and the financial assets held within that business model) and the way those risks are managed; and
- 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.

IFRS 9 does not include 'bright lines' for assessing the impact of sales activity, but instead requires an insurer to consider:

- the significance and frequency of sales activity; and
- whether sales activity and the collection of contractual cash flows are each integral or incidental to the business model.

Example 1 – Business model for investment portfolio

Insurer G holds a portfolio of financial assets to fund its insurance contract liabilities. G uses the contractual cash flows from the financial assets to settle insurance contract liabilities as they become due. To ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities, G buys and sells a significant volume of the assets on a regular basis to rebalance the portfolio and to meet cash flow needs as they arise.

The objective of the business model is to fund the insurance contract liabilities. To achieve this objective, G collects contractual cash flows as they become due and sells financial assets to maintain the desired profile of the asset portfolio. Therefore, G's business model achieves this objective by both collecting contractual cash flows and selling financial assets.

Example 2 – Business model for investment portfolio

Insurer C invests excess cash in short- and long-term investments with investment-grade credit ratings.

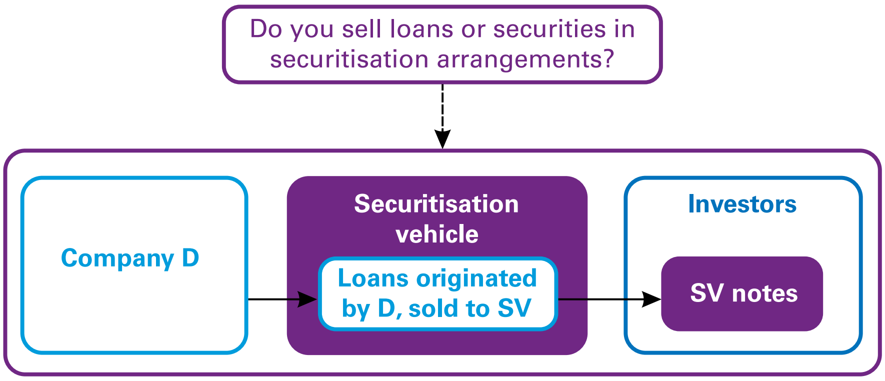
Investments are purchased to generate a return based on the effective yield at purchase. C monitors the credit quality of the financial assets and evaluates performance based on interest revenue earned and credit losses realised. C's investment policy states that investments may only be sold in a stress case scenario (i.e. if the insurer faces an unanticipated liquidity or solvency crisis) or when the credit quality of an investment declines to below investment grade. C does not otherwise make sales from the portfolio, although the fair values of the financial assets are monitored from a liquidity perspective.

C determines that its objective for the financial assets is to hold to collect the contractual cash flows. This conclusion is not affected by:

- sales due to an increase in the credit risk of an asset to minimise potential credit losses and that are integral to a held-to-collect business model; and
- the possibility that C might sell assets in a stress case scenario if C does not reasonably expect that such a stress scenario will occur.

1.2 Securitisation arrangements and repos

Securitisation arrangements commonly involve transferring financial assets or the rights to collect their cash flows between different entities. Similarly, an insurer might transfer financial assets to a third party and concurrently agree to buy them back at a future date (a 'repo'). Whether these transactions result in derecognition of the financial assets depends on the particular facts and circumstances. The business model assessment may not be straightforward and may require judgement.



For further discussion of these requirements, see 7.4.110 in the 18th Edition 2021/22 of our publication Insights into IFRS.

How does this approach differ from IAS 39 requirements?

Securitisations typically comprise loans or other receivables. As discussed in Section 1.1, assigning a financial asset to a business model is a new requirement under IFRS 9 that did not exist under IAS 39.

Under IAS 39, many loans and receivables are generally measured at amortised cost. However, financial assets that the insurer intends to sell immediately or in the near term are classified as held-for-trading.

Application of IFRS 9 requirements

Whether a financial asset is derecognised may influence the business model determination

A portfolio of financial assets acquired with the objective of selling to a securitisation vehicle may be consistent with a held-to-collect business model, depending on the circumstances. If selling the assets would result in their derecognition, then the objective would be inconsistent with the held-to-collect business model. However, if selling the assets would not result in derecognition, then further analysis may be required.

An insurer may hold a portfolio of financial assets with the objective of selling some of the financial assets to third parties in repo transactions. If the assets that are sold do not qualify for derecognition, then this might be considered consistent with a held-to-collect business model.

Example 3 – Impact of securitisation on the business model assessment

Securitisation Vehicle Z issues notes to investors. Z is consolidated by Insurer Y, which originates loans for the purpose of selling them to Z. Z receives the contractual cash flows on the loans and passes them on to investors in the notes.

Under IFRS 9, from the consolidated group's perspective, the loans are originated with the objective of holding them to collect contractual cash flows. The fact that the consolidated group entered into an arrangement to pass cash flows to external investors, and so does not retain cash flows from the loans, does not preclude a conclusion that the loans are held in a held-to-collect business model.

However, Y's objective is to realise cash flows on the loan portfolio by selling the loans to Z. Therefore, for its separate financial statements Y is not considered to be managing this portfolio to collect the contractual cash flows.

Example 4 – Financial assets sold under sale-and-repurchase agreements

Insurer M holds financial assets to collect the contractual cash flows through to maturity. However, M's objectives include selling some of those financial assets as part of sale-and-repurchase agreements (repos). Under these agreements, M agrees to repurchase the financial assets at a fixed price on a later date before their maturity. During the term of the repos, the transferee is required to immediately remit to M an amount equal to any payments that the transferee receives from the transferred assets. M does not derecognise the financial assets because it has retained substantially all of the risks and rewards of the financial assets.

This scenario is consistent with a held-to-collect business model, based on:

- M's continuing recognition of the financial assets for accounting purposes; and
- the requirements to pass on interest received and to return the assets back to M before their maturity.

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2 Assessing the SPPI criterion

2.1 Basic lending arrangement

Requirements of IFRS 9

IFRS 9.4.1.2(b), 4.1.2A(b), 4.1.3

If an asset is in a held-to-collect or held to collect and for sale business model, then an insurer assesses whether the cash flows from the financial asset meet the 'solely payments of principal and interest' (SPPI) criterion – i.e. whether the contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest.

– 'Principal' is the fair value of the financial asset on initial recognition. The principal may change over time (e.g. if there are repayments of principal).

– 'Interest' is consideration for the time value of money and credit risk. Interest can also include consideration for other basic lending risks and costs, and a profit margin.

IFRS 9.4.1.4–5, 5.7.5

A financial asset that does not meet the SPPI criterion is always measured at FVTPL, unless it is an equity instrument not held for trading and the insurer makes an irrevocable election to measure it at FVOCI.

IFRS 9.B4.1.8–B4.1.9

Contractual cash flows that meet the SPPI criterion are consistent with a basic lending arrangement. The SPPI assessment is made with reference to the currency in which the financial asset is denominated, and therefore multi-currency features may cause failure of the SPPI criterion. Fixed and floating rates are generally consistent with SPPI as long as they meet the definition of interest. Leverage increases the variability of the contractual cash flows such that they do not have the economic characteristics of interest – e.g. stand-alone options, forward contracts and swap contracts.

IFRS 9.B4.1.7A, 18

Contractual features that introduce exposure to risks or volatility unrelated to a basic lending arrangement do not meet the SPPI criterion. The following features are disregarded when analysing SPPI:

– features that could have only a de minimis effect;

– non-genuine features, i.e. those that affect the financial asset's contractual cash flows only on the occurrence of an extremely rare, highly abnormal and very unlikely event; and

– statutory or regulatory terms that are not part of the financial asset's contractual terms.

IFRS 9.4.3.2

Under IFRS 9, embedded derivatives in a hybrid contract with a host that is a financial asset are not separated from the host contract but are included in the classification assessment – i.e. assessing whether the cash flows of the hybrid contract meet the SPPI criterion.

For further discussion of these requirements, see 7.4.150 in the 18th Edition 2021/22 of our publication Insights into IFRS.

How does this approach differ from IAS 39 requirements?

Criteria for the classification of financial assets differ

IFRS 9 contains three principal classification categories for financial assets – i.e. amortised cost, FVOCI and FVTPL. The existing IAS 39 categories of held-to-maturity, loans and receivables and available-for-sale (AFS) have been removed. Although the permissible measurement categories for financial assets are similar to those under IAS 39, the criteria for classification into the appropriate measurement category differ significantly.

Unlike IAS 39, derivatives embedded in financial assets that are in the scope of IFRS 9 are never separated. Instead, the whole hybrid instrument is assessed for classification.

Application of IFRS 9 requirements

Assessment is performed on the overall instrument

Assessing the SPPI criterion may require judgement to ensure that financial assets are classified into the appropriate measurement category. Entities may need to undertake a comprehensive review of loan documentation and the terms of securities.

IFRS 9's approach to assessing SPPI focuses on an overall assessment of what the insurer is being compensated for and whether there is a basic lending arrangement, rather than on how much the insurer receives for a particular element. In addition, the concept of a *de minimis* contractual feature is introduced under the new standard.

Under IAS 39, an embedded derivative is always separated from a host debt instrument if its economic characteristics are not closely related to those of the host. In many of these cases, the embedded derivative, and therefore the hybrid contract in its entirety, would probably contain cash flows that are not payments of principal and interest, and so would not meet the SPPI criterion. Accordingly, although the separated host contract in these cases may have been eligible for measurement at amortised cost under IAS 39, under IFRS 9 the entire hybrid contract is measured at FVTPL.

Example 5 – Investment in a convertible bond

Insurer B has an investment in a convertible bond. Under the terms of the bond, the holder has the option to convert it into a fixed number of equity shares of the issuer. The convertible bond is analysed for classification in its entirety.

The conversion option causes the instrument to fail the SPPI criterion. This is because the embedded feature cannot be separated, and the contractual terms of the convertible bond as a whole do not give rise solely to payments of principal and interest on the principal amount outstanding on the bond. The return on the bond is not only consideration for the time value of money and credit risk, but also reflects the value of the issuer's equity.

Therefore, the convertible bond in its entirety is classified as at FVTPL.

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2.2 Prepayment features

Requirements of IFRS 9

IFRS 9.B4.1.11

The contractual cash flows of some financial assets may change over the life of the asset – e.g. in many cases an asset can be prepaid. A prepayment feature results in contractual cash flows that are SPPI if:

– it permits the issuer (i.e. the debtor) to prepay a debt instrument or permits the holder (i.e. the creditor) to put the debt instrument back to the issuer before maturity; and

– the prepayment amount substantially represents unpaid amounts of principal and interest on the principal amount outstanding – which may include reasonable compensation for the early termination of the contract.

IFRS 9.B4.1.11(b)

Principal and interest here have their usual meaning under the SPPI guidance (see Section 2.1) and are therefore based on the fair value of the financial asset on initial recognition. This means that the principal amount and accrued interest on that principal may differ from the contractual par amount and contractual accrual of coupons, particularly if the financial asset was acquired in a secondary market or in a business combination.

IFRS 9.B4.1.12

If a financial asset would otherwise meet the SPPI criterion but fails to do so only as a result of a prepayment feature, then it may still be eligible for measurement at amortised cost or FVOCI (depending on its business model) if the following exception applies.

Exception applies if all of these conditions are met:

1 **Asset is originated or acquired at a discount or premium to contractual par amount.**
Discount or premium

2 **Prepayment amount = contractual par + accrued interest, which may include reasonable compensation for early termination.**
Prepayment at par + interest

3 **When the financial asset is originally recognised, the fair value of the prepayment feature is insignificant.**
FV prepayment feature insignificant

For further discussion of these requirements, see 7.4.210 and 220 in the 18th Edition 2021/22 of our publication Insights into IFRS.

IFRS 9.B4.1.7A, BC4.232

Application of IFRS 9 requirements

Judgement applies when analysing prepayment features

An insurer needs to evaluate the nature of the prepayment feature at initial recognition. It also needs to consider what the prepayment amount would be at each date on which the prepayment feature is exercisable, to determine for all cases whether the prepayment amount substantially represents 'unpaid amounts of principal and interest'. This requires an insurer to consider the economic characteristics of the contract and may require judgement.

Further, IFRS 9 does not define 'reasonable compensation' and an insurer will need to apply judgement when determining whether any penalty for early termination is reasonable compensation. In doing this, it appears that an insurer may consider:

- which party can exercise the early repayment option (i.e. borrower or lender) or whether it is triggered by an event outside the control of both parties;
- what the compensation is designed to compensate for, which would involve an assessment of the nature and amount of the compensation; and
- whether the compensation includes any exposure to non-SPPI risks: i.e. for the compensation to comply with the SPPI criterion, any variability should be based solely on the time value of money, credit risk, other basic lending risks and costs, and the lender's profit margin. For example, if the compensation is indexed to equity prices or commodity prices or if it includes foreign currency risk that differs from the currency in which the financial asset is denominated, then it appears that it is not reasonable compensation.

Also, there may be different considerations depending on whether the penalty is fixed or variable. In particular, for fixed penalties it appears that if the amount is insignificant relative to the outstanding principal and interest amounts, then it would generally be regarded as compliant with the SPPI criterion. This is because the prepayment amount would substantially represent the unpaid principal (or par amount) and accrued interest. In other cases, the insurer needs to assess what the fixed penalty is designed to compensate for (e.g. administrative costs) and whether it is reasonable compensation for the early termination of the contract.

For variable penalties, an insurer needs to understand how the penalty is calculated and what the penalty is designed to compensate for. It appears that variable penalties may be seen as reasonable compensation if they are designed to compensate for:

- the impact of changes in market benchmark interest rates;
- the impact of other changes in market interest rates (e.g. credit or other relevant spreads); or
- other economic gains/losses (e.g. break costs in terminating a plain vanilla interest rate swap on prepayment of the loan that do not include non-SPPI risks, such as foreign exchange rate risk or equity price risk).

With some prepayment features, a party that chooses to terminate the contract early may receive, rather than pay, compensation for doing so – e.g. a lender may receive less than the unpaid principal and accrued interest to effectively compensate the borrower for the borrower's early termination of the contract. In some cases, a lender might receive a prepayment penalty even though it was the lender who terminated the contract by exercising a prepayment put option – i.e. negative compensation. However, the fact that the compensation may be negative, in itself, would not fail the SPPI criterion if the compensation were considered reasonable.

As shown above, an exception for prepayment features at par is available, which may allow measurement at amortised cost or FVOCI. For example, this might apply to:

– purchased, credit-impaired assets acquired at a deep discount to par; or

– financial assets issued at below-market rates: e.g. a loan provided to a customer as a marketing incentive such that the loan's fair value on initial recognition is significantly below its contractual par amount.

In these cases, the borrower may have the contractual ability to prepay at par, but the contractual prepayment feature would have an insignificant fair value because it is very unlikely that prepayment will occur.

– In the first example above, prepayment is very unlikely because the financial asset is impaired and so the borrower is unlikely to have funds to prepay the asset.

– In the second example above, it is very unlikely that the customer will choose to prepay, because the interest rate is below-market and the financing is advantageous. Consequently, the amount at which the loan can be prepaid does not introduce variability that is inconsistent with a basic lending arrangement.

These examples deal with circumstances in which a financial asset is originated or purchased at a discount to the par amount. However, the exception is equally relevant for assets that are issued or purchased at a premium. Possible examples might include:

– a fixed-rate bond that is acquired at a substantial premium to par, but is redeemable at par only at the option of the holder; or

– a bond that is acquired at a substantial premium to par but is prepayable at par at the option of the issuer only in the event of a specified change in tax law, which is considered very unlikely to occur.

Example 6 – Investment in a corporate bond prepayable at par

Insurer B invests in a corporate bond with a par value of 100. It acquires the bond at a premium (115) due to a decline in market interest rates since its original issue. The corporate bond is prepayable at the option of the issuer only in the event of a specified change in tax law. It can be prepaid at the contractual par amount plus accrued but unpaid interest.

B considers the fair value of the prepayment feature to be insignificant because it is unlikely that the specified change in tax law will occur. To support this, B determines the fair value of the prepayment option by comparing the fair value of an otherwise identical bond without the prepayment option with the fair value of the corporate bond.

For further examples, see 7.4.210 and 220 in the 18th Edition 2021/22 of our publication Insights into IFRS.

2.3 Other contractual features

Requirements of IFRS 9

There may be other contractual provisions that could change the contractual cash flows. An SPPI assessment considers all contractual features of the financial asset.

IFRS 9.B4.1.9B, B4.1.11–B4.1.10, B4.1.16–B4.1.17, B4.1.20–B4.1.26

In some cases, a financial asset may have contractual cash flows that are described as principal and interest but are not payments of principal and interest. This may be the case in the following circumstances.

- A creditor's claim is limited only to specified assets of the debtor or to the cash flows from specified assets (e.g. non-recourse loans).
- Contractually linked instruments create concentrations of credit risk (e.g. asset-backed securities) by prioritising payments to holders of different tranches in a securitisation-type structure.
- The relationship between the interest rate under the contract and the period for which it is set is imperfect (i.e. 'modified time value of money').
- The financial asset contains term extension features.
- The financial asset contains other contingent or discretionary features.

IFRS 9.B4.1.17

The fact that a financial asset is non-recourse does not in itself mean that it does not meet the SPPI criterion. In this case, the holder of the asset needs to assess ('look through to') the underlying assets or cash flows to determine whether the terms of the asset give rise to other cash flows or limit the cash flows so that they are inconsistent with the SPPI criterion.

IFRS 9.B4.1.20–B4.1.26

For contractually linked instruments, the right to payments of principal and interest on the principal amount outstanding on more junior tranches – i.e. those exposed to more credit risk – depends on whether the issuer generates sufficient cash flows to pay more senior tranches. For example, each tranche has a subordination ranking that specifies the order in which any cash flows generated by the issuer are allocated to the tranche. For these instruments, IFRS 9 includes detailed guidance on whether an investment in a tranche meets the SPPI criterion.

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IFRS 9.B4.1.9B

IFRS 9 introduces the concept of the 'modified time value of money' and provides the following examples:

– if the asset's interest rate is periodically reset but the frequency of that reset does not match the term of the interest rate (e.g. the interest rate resets every month to a one-year rate); or

– if the asset's interest rate is periodically reset to an average of particular short-term and long-term rates.

IFRS 9.B4.1.9C–B4.1.9D

When assessing whether a modified time value of money feature meets the SPPI criterion, an insurer determines how the undiscounted contractual cash flows could differ from the undiscounted cash flows that would arise if the time value of money element was not modified (the benchmark cash flows). If the difference could be significant, then the SPPI criterion is not met. An insurer considers the effect of the modified time value of money element in each reporting period and cumulatively over the life of the financial asset. However, an insurer considers only reasonably possible scenarios, instead of every possible scenario.

IFRS 9.B4.1.11

For assets with extension options – i.e. an option that permits the issuer or the holder to extend the contractual term of a debt instrument – an insurer determines whether the contractual cash flows that could arise over the life of the asset meet the SPPI criterion. A term extension feature meets the SPPI criterion if the contractual cash flows during the extension period are solely payments of principal and interest on the principal amount outstanding. The contractual cash flows may include reasonable compensation for the extension of the contract.

For further discussion of these requirements, see 7.4.180, 210, 310–320 and 340 in the 18th Edition 2021/22 of our publication Insights into IFRS.

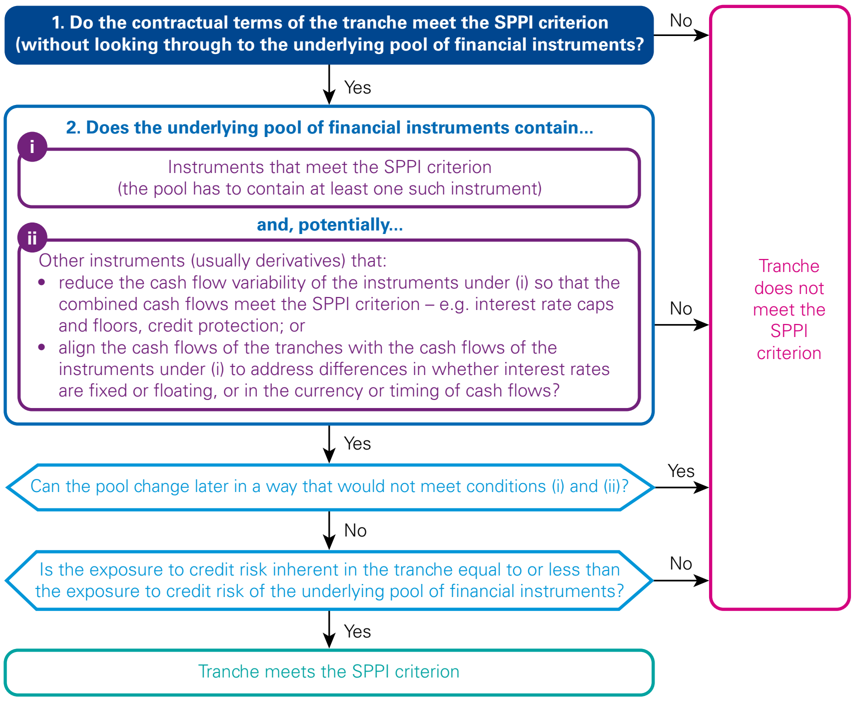
Application of IFRS 9 requirements

Non-recourse assets

Judgement is required when assessing whether a non-recourse asset meets the SPPI criterion. In our view, the underlying purpose of the assessment is to identify cases in which the financial asset is intended to provide the holder with a return based on the performance of specific assets or another variable that does not represent exposure to, and compensation for, a basic lending arrangement. These cases fail the SPPI criterion. In other cases, the borrower's obligation to pay cash represents specified amounts of principal and interest but the obligation in default is limited in a way that is in substance consistent with the exposure to credit risk of a basic lending arrangement.

Contractually linked instruments

Determining whether the guidance on contractually linked instruments applies requires an entity to consider the transaction structure and may require it to exercise judgement. The following flowchart illustrates how an investor determines whether a tranche meets the SPPI criterion. The approach drills down to the underlying pool of instruments that create the cash flows.



Modified time value of money

Assessing the modified time value of money requires judgement to:

- identify the characteristics of a benchmark instrument;
- identify reasonably possible scenarios; and
- determine whether the undiscounted contractual cash flows on the financial asset could (or could not) be significantly different from the undiscounted benchmark cash flows.

Extension features

Assessing extension features requires an insurer to assess the contractual cash flows that could arise both before and after the change in contractual cash flows.

Example 7 – Non-recourse loan

Insurer C provides funding to a non-consolidated structured entity holding an aircraft that is leased to an airline with a strong credit rating. The contractual payments on the loan include only stated principal and interest. In the case of default, C's recourse is limited to cash flows from the aircraft lease and the aircraft. Receipt of the minimum lease payments would be adequate to enable the structured entity to make all payments of principal and interest on the loan.

Looking through to the underlying assets, C concludes that the cash flows are consistent with payments representing principal and interest on the principal amount outstanding.

If the minimum lease payments were not adequate to service the loan or if the lease were to another structured entity, then further analysis would be required.

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Example 8 – Contractually linked instruments

Insurer V invests in contractually linked notes issued by a limited-purpose vehicle ('LPV 1'), whose only asset is an investment in contractually linked notes issued by another such vehicle ('LPV 2'). In this example, V looks through to the assets of LPV 2 in performing the assessment.

Example 9 – Contractually linked instruments and non-recourse loan

Insurer W invests in contractually linked notes issued by a limited-purpose vehicle ('LPV 1'), whose only asset is an investment in a non-recourse loan. The non-recourse loan is issued by another limited-purpose vehicle (LPV 2), whose only asset is a real estate property. In this example, W determines that the non-recourse loan meets the SPPI criterion – i.e. it does not give rise to any other cash flows or limit the cash flows in a manner inconsistent with payments representing principal and interest.

Because the non-recourse loan meets the SPPI criterion, W regards the non-recourse loan as the underlying pool of instruments that create the cash flows. The fact that the non-recourse loan meets the SPPI criterion means that it is not simply passing through the original cash flows from the property held by LPV 2. If the non-recourse loan did not meet the SPPI criterion, then W's investment would not meet the SPPI criterion either.

Example 10 – Extension features

Insurer D places an extendable deposit with Bank B by paying the principal amount to B. B is required to repay this principal amount at maturity. The terms of the extendable deposit include an initial five-year term and a fixed coupon rate, agreed at inception. At the end of five years, B has the unconditional option to extend the deposit at the same fixed coupon rate for an additional five years. B would probably choose to exercise the extension option only if the then-current market interest rate for five-year deposits is greater than the rate fixed in the contract.

In this example, D concludes that the contractual cash flows during the extension period are solely payments of principal and interest on the principal amount outstanding. This is because the coupon rate is fixed at inception of the deposit and is not leveraged. Furthermore, the contractual terms require payment at inception and repayment at maturity of the principal amount; they contain no other cash flow requirements or contingent features.

3 Fair value option for financial assets

Requirements of IFRS 9

IFRS 9.4.1.5

On initial recognition, an insurer may choose to designate as at FVTPL a financial asset that would otherwise qualify for amortised cost or FVOCI classification. This optional designation is permitted only if it eliminates or significantly reduces a measurement or recognition inconsistency (an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities, or recognising gains or losses on them, on different bases. The designation of a financial asset as at FVTPL on this basis may be used only on initial recognition and is irrevocable.

How does this approach differ from IAS 39 requirements?

On initial recognition, the option to designate a financial asset as at FVTPL, if doing so eliminates or significantly reduces an accounting mismatch, is carried forward without change from IAS 39. However, the adoption of IFRS 9 and IFRS 17 may significantly change the circumstances in which the option is available and when an insurer might wish to take advantage of it.

IAS 39 also allowed an entity to designate a financial asset on initial recognition as at FVTPL if:

– it is managed and its performance is evaluated on a fair value basis; or

– it contains an embedded derivative that might otherwise require separation.

These additional options are no longer available under IFRS 9 for financial assets (although they remain for financial liabilities – see Chapter 5). This is because, under IFRS 9, financial assets that are managed on a fair value basis are mandatorily classified as at FVTPL and there is no requirement or ability to separate an embedded derivative from a financial asset.

Application of IFRS 9 requirements

Insurers typically invest premiums from insurance contracts into portfolios of financial assets and hold financial assets to back their insurance liabilities. They often aim to match the expected durations of their financial assets with those of the related insurance contracts. Many insurers issue participating contracts in which returns to policyholders are directly or indirectly linked to returns on financial assets held by the insurer as underlying items or to interest rate indices. These are examples of instances where insurers may aim to minimise accounting mismatches between insurance contract liabilities and the financial assets that back them.

Under IFRS 17, all insurance contracts – except some with no significant financing component – will be remeasured based on current market interest rates. The effects of changes in discount rates and other financial risks on the measurement of insurance contracts will be presented as insurance finance income or expense (IFIE). An insurer has a policy choice under IFRS 17 for each portfolio of insurance contracts either to recognise all IFIE for the period in profit or loss or to disaggregate IFIE between profit or loss and OCI. When an insurer applies this OCI option under IFRS 17, the IFIE that is recognised in profit or loss depends on whether it relates to a group of direct participating contracts for which the insurer holds the underlying items. If it does not, then it will depend on whether changes in financial risk assumptions would have a substantial effect on the amounts paid to policyholders.

Insurers will want to consider how the policy choices available under IFRS 17 will interact with the expected classification outcomes and designation options under IFRS 9 in the context of their specific portfolios. Designating financial assets as at FVTPL may be attractive when they are used to cover insurance contracts for which IFIE is presented immediately in profit or loss.

Financial assets are designated as at FVPTL individually. There is no requirement for consistency in the use of the FVTPL designation for financial assets, meaning that an insurer can choose which, if any, of its eligible financial assets it designates into this category on initial recognition.

Portfolios of insurance contracts and related financial assets are generally dynamic and may vary in size and duration over time. To be designated as at FVTPL, the designation of an individual financial asset needs to actually reduce an accounting mismatch that would otherwise exist (or be expected to arise in the very near future). In making this designation, an insurer also needs to consider the overall size and risks of the related assets and liabilities, how they are managed and previous designations of financial assets.

Example 11 – Fair value designation

An insurer has dynamic portfolios of financial assets of 60 and related liabilities of 70. These financial assets and related liabilities would individually give rise to accounting mismatches proportionate with their values (if the financial assets were not measured at FVTPL); all of the financial assets are designated as at FVTPL. If the insurer acquires similar additional new financial assets of 40, which in the absence of designation would not be measured at FVTPL, then we believe that it could generally designate only up to 10 of the financial assets. This is because designation of the other 30 of new financial assets would not reduce an accounting mismatch.

4 Investments in equity instruments

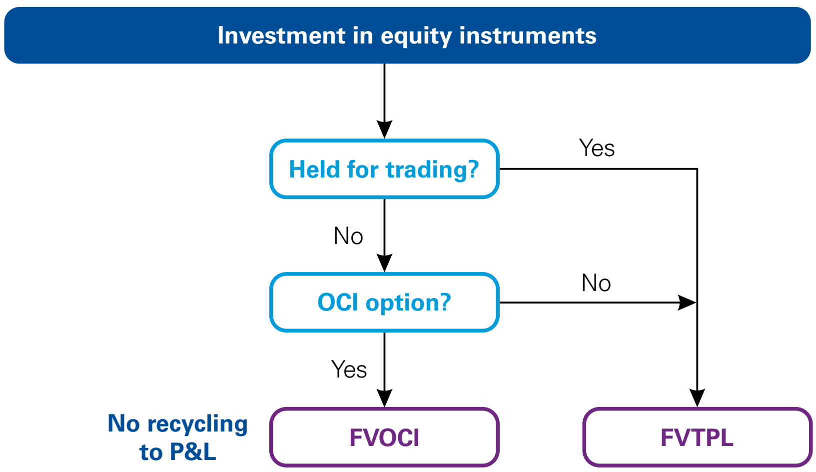
Requirements of IFRS 9

Under IFRS 9, investments in equity instruments are generally measured at FVTPL. However, on initial recognition an insurer may make an irrevocable election to present in OCI subsequent changes in the fair value of an investment in an equity instrument that is neither held for trading nor contingent consideration recognised by an acquirer in a business combination under IFRS 3 *Business Combinations*. Equity instruments are defined in accordance with IAS 32.

This election is irrevocable and can be made on an instrument-by-instrument (e.g. an individual share) basis on initial recognition.

IFRS 9.5.7.5, B5.7.1

Dividends are generally recognised in profit or loss unless they clearly represent a recovery of part of the cost of the investment.



These requirements are discussed further in 7.4.420 in the 18th Edition 2021/22 of our publication Insights into IFRS.

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How does this approach differ from IAS 39 requirements?

Different accounting for equity investments

Under IAS 39, equity instruments are generally classified as AFS financial assets and measured at fair value. However, an exemption for AFS financial assets whose fair value cannot be measured reliably is available so that they can be measured at cost.

This exemption applies only to unquoted equity instruments when:

- there is significant variability in the range of reasonable fair value estimates; and
- the probabilities of the various estimates within the range cannot be assessed reasonably.

Under IAS 39, fair value changes of AFS assets are recognised in OCI. When the asset is derecognised, on either sale or other disposal, or is impaired, the cumulative fair value changes recognised in OCI are reclassified from equity to profit or loss as a reclassification adjustment.

Under IFRS 9, measurement at cost is no longer permitted and FVTPL accounting applies unless the FVOCI election is made. The accounting for equity instruments under the new FVOCI election differs from that under IAS 39 because:

- the impairment requirements do not apply; and
- fair value gains and losses recognised in OCI are never reclassified to profit or loss.

Application of IFRS 9 requirements

FVOCI option is permitted only for instruments that meet the equity instrument definition under IAS 32

The FVOCI election is generally available for all investments in equity instruments in the scope of IFRS 9 that are not held for trading. However, it is not available under this standard for:

- investments in subsidiaries held by investment entities that are accounted for at FVTPL; and
- investments in associates and joint ventures held by venture capital organisations or mutual funds that are measured at FVTPL.

Under IFRS 9, equity instruments are defined in the same way as in IAS 32. This means that a holder of an investment assesses whether the instrument meets the definition of equity from the perspective of the issuer. IAS 32 both defines an equity instrument and provides guidance on what other instruments are classified as equity. However, the FVOCI option refers only to equity instruments defined as such by IAS 32; it does not apply to instruments defined as financial liabilities but classified as equity by the issuer – e.g. puttable instruments classified as equity by the issuer.

5 Financial liabilities designated as at FVTPL

Requirements of IFRS 9

IFRS 9.4.2.2, 4.3.5

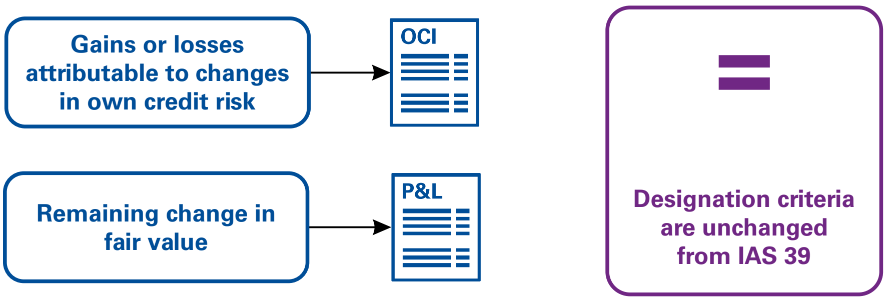
IFRS 9 retains the option in IAS 39 to designate, irrevocably on initial recognition, a financial liability at FVTPL, subject to meeting one of the following eligibility criteria.

- The designation would eliminate or significantly reduce a measurement or recognition inconsistency that would otherwise arise from measuring assets or liabilities, or from recognising the gains and losses on them, using different bases.
- A group of financial liabilities, or a group of financial assets and financial liabilities, is managed, and its performance evaluated, on a fair value basis in accordance with a documented risk management or investment strategy. Information about the group is provided internally on that basis to the entity's key management personnel.
- If a contract contains one or more embedded derivatives and the host is not a financial asset in the scope of IFRS 9, then an insurer may designate the entire hybrid (combined) contract at FVTPL. However, this does not apply if the embedded derivative is insignificant, or if it is obvious that separation of the embedded derivative would be prohibited.

IFRS 9.5.7.7

Under IFRS 9, fair value changes are generally presented as follows:

- the change in fair value that is attributable to changes in the credit risk of the liability is presented in OCI; and
- the remaining change in fair value is presented in profit or loss.



Amounts presented in OCI are never reclassified to profit or loss. This prohibition applies even if a gain or loss is realised by settling or repurchasing the liability at fair value.

These requirements are discussed further in 7.5.40 and 7.7.180 in the 18th Edition 2021/22 of our publication Insights into IFRS.

How does this approach differ from IAS 39 requirements?

New rules for presenting gains or losses attributable to own credit risk

Under IAS 39, all fair value changes on liabilities designated under the fair value option are recognised in profit or loss.

Since the fair value option for financial liabilities was introduced by IAS 39, many observers have expressed concern about a company recognising gains in profit or loss when its credit standing deteriorates (or losses when its credit standing improves). This result is widely seen as counterintuitive. IFRS 9 addresses this issue by generally requiring those changes to be recognised in OCI.

Application of IFRS 9 requirements

Meaning of credit risk for a financial liability

'Credit risk' is the risk that the issuer will cause a loss to the counterparty by failing to discharge its obligation. There is a difference between this and asset-specific performance risk relating to a financial liability. The latter arises when the liability transfers the risk of one or more assets performing poorly – e.g. a unit-linked liability that is based on the performance of specified assets. The effect of asset-specific performance risk is included in profit or loss.

Exceptions to split presentation exist and should be evaluated

IFRS 9.5.7.7–5.7.9, B5.7.6–8

There are two exceptions to the split presentation between profit or loss and OCI for financial liabilities designated as at FVTPL:

- if split presentation would create or enlarge an accounting mismatch in profit or loss; or
- if the financial liability is a loan commitment or a financial guarantee contract.

In these cases, all gains and losses are presented in profit or loss.

To determine whether split presentation would create or enlarge an accounting mismatch in profit or loss, an issuer assesses whether it expects the changes in the financial liability's credit risk to be offset in profit or loss by a change in the fair value of another financial instrument measured at FVTPL. The determination is based on an economic relationship between the characteristics of the financial liability and the characteristics of the other financial instrument.

The issuer makes this determination on initial recognition and does not reassess it.

6 Modification or exchange of financial instruments

Requirements of IFRS 9

IFRS 9.5.4.3, A, B5.4.6, BC4.253

In practice, modifications or exchanges of financial assets and financial liabilities that do not result in derecognition are common. Under IFRS 9, unless the financial instrument is measured at FVPTL the insurer recalculates the gross carrying amount (i.e. the amortised cost before adjusting for impairment) of the modified financial asset or the amortised cost of the modified financial liability by discounting the modified contractual cash flows using the original effective interest rate (EIR). It then recognises any adjustment to the gross carrying amount or amortised cost in profit or loss.

IFRS 9.5.4.3

When an instrument is modified but not derecognised, any fees and costs incurred are recognised as an adjustment to the carrying amount of the instrument and are amortised over the remaining term of the modified instrument.

If the insurer changes its accounting policy for these modifications or exchanges as a result of the initial application of IFRS 9, then it applies IFRS 9's transition requirements. These require retrospective application, subject to particular reliefs specified in IFRS 9.

These requirements are discussed further in 7.6.95 and 370, as well as 7.7.340 and 365, in the 18th Edition 2021/22 of our publication Insights into IFRS.

How does this approach differ from IAS 39 requirements?

Recognising a gain or loss at the date of modification

Insurers that have modified fixed-rate financial instruments may face a significant change in the accounting for a non-substantial modification. When accounting for a non-substantial modification under IAS 39 – i.e. one that does not result in derecognition – an entity often recalculates the EIR at the date of the modification to reflect the revised contractual cash flows and recognises no gain or loss. (This would not be the case for forbearance or impairment of a financial asset.)

Under IFRS 9, there is no change to the accounting for costs and fees when a modification of a financial liability occurs. For a non-substantial modification any fees and costs incurred are recognised as an adjustment to the carrying amount and are amortised over the remaining term.

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Modifications of floating-rate instruments

Insurers may need to consider how to apply the guidance in IFRS 9 to a modification of a floating-rate instrument. Paragraph B5.4.5 of IFRS 9 applies to floating-rate instruments and requires changing the EIR to reflect re-estimation of cash flows due to changes in market interest rates.

7 Scope of impairment requirements

Requirements of IFRS 9

IFRS 9.2, 5.5.1

The following table shows which instruments are in the scope and outside the scope of IFRS 9's impairment requirements.

In scope	Out of scope
– Financial assets that are debt instruments measured at amortised cost or at FVOCI – these may include loans, trade receivables and debt securities – Loan commitments issued that are not measured at FVTPL – Financial guarantee contracts issued that are in the scope of IFRS 9 and are not measured at FVTPL – Lease receivables in the scope of IFRS 16 *Leases* – Contract assets in the scope of IFRS 15	– Investments in equity instruments – Loan commitments issued that are measured at FVTPL – Other financial instruments measured at FVTPL – Receivables or commitments arising under contracts in the scope of IFRS 17

IFRS 9.5.5.15–5.5.16

IFRS 9 has a single ECL impairment model that applies to all financial instruments in the model's scope. However, it does include simplifications for trade receivables and contract assets[1] arising from transactions in the scope of IFRS 15 and lease receivables.

These requirements are discussed further in 7.8.10 in the 18th Edition 2021/22 of our publication Insights into IFRS.

1. IFRS 15 defines a 'contract asset' as an entity's right to consideration in exchange for goods or services that the entity has transferred to a customer when that right is conditional on something other than the passage of time – e.g. the entity's future performance.

How does this approach differ from IAS 39 requirements?

Different scope

The population of financial instruments in the scope of IFRS 9's impairment requirements differs from that under IAS 39.

Equity investments are no longer tested for impairment. Contract assets in the scope of IFRS 15 are now subject to impairment. The ECL impairment model may also affect insurers that apply IFRS 9 to issued financial guarantee contracts or loan commitments.

8 Application of impairment requirements

8.1 The expected credit loss concept

Requirements of IFRS 9

Under IFRS 9, an ECL model applies. It differs from the IAS 39 incurred loss model in that a loss event need not occur before an impairment loss is recognised. Consequently, all financial assets in the scope of the impairment model generally carry a loss allowance – even those that are newly originated or acquired.

IFRS 9.5.5.3, 5.5.5

IFRS 9 establishes a *general* approach for measuring impairment and a *simplified* approach for certain financial assets. Under the *general* approach, impairment is generally measured as either:

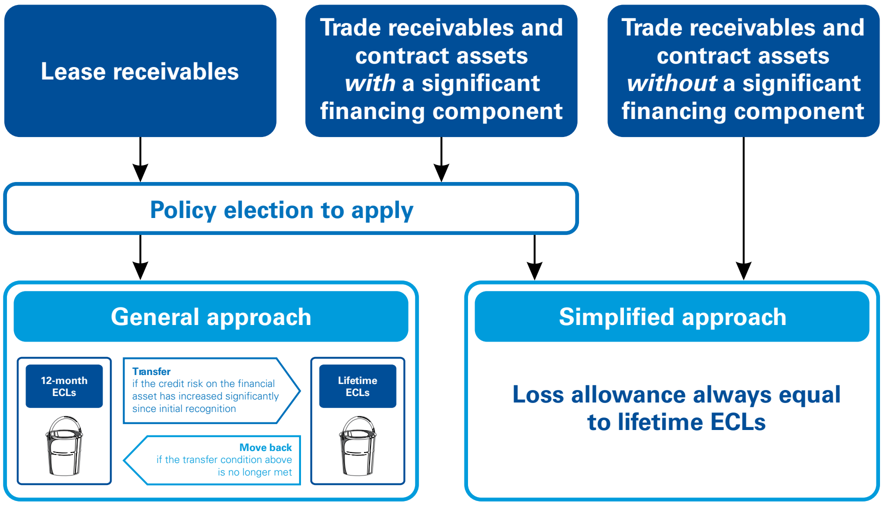
- *12-month ECLs*: defined in IFRS 9 as the 'portion of lifetime expected credit losses that represents the expected credit losses that result from default events on the financial instrument that are possible within the 12 months after the reporting date'; or
- *lifetime ECLs*: defined in IFRS 9 as the 'expected credit losses that result from all possible default events over the expected life of the financial instrument'.

IFRS 9.5.5.3, 5.5.5

Under the *general* approach, the measurement basis depends on whether there has been a significant increase in credit risk since initial recognition. ECLs are measured as lifetime ECLs if, at the reporting date, the credit risk on the financial instrument has increased significantly since its initial recognition.

IFRS 9.5.5.15–5.5.16

However, IFRS 9 allows a *simplified* approach for trade receivables or contract assets that result from transactions in the scope of IFRS 15, and lease receivables that result from transactions in the scope of IFRS 16. Under the *simplified* approach, the loss allowance is always equal to lifetime ECLs. The diagram below explains when the *simplified* approach may or needs to be applied.



IFRS 9.5.5.17(b), B5.5.44–B5.5.48

The estimate of ECLs has to reflect the time value of money – i.e. ECLs are discounted to the reporting date.

IFRS 9.5.4.1, 9.5.5.13–14, A

Special requirements apply for purchased or originated credit-impaired (POCI) financial assets – i.e. financial assets that are credit-impaired on initial recognition. A financial asset is credit-impaired if one or more events have occurred that have a detrimental impact on the estimated future cash flows of the asset (e.g. significant financial difficulty of the borrower). A POCI asset is measured using a credit-adjusted effective interest rate that reflects the estimated credit losses at initial recognition and a loss allowance is recognised to reflect the change in lifetime ECLs since initial recognition. These special requirements continue to apply to a POCI asset throughout its remaining life.

These requirements are discussed further in 7.8.30, 390 and 340 in the 18th Edition 2021/22 of our publication Insights into IFRS.

How does this approach differ from IAS 39 requirements?

Expected credit loss model

IAS 39's incurred loss model is replaced by an ECL approach under IFRS 9, which is based on a probability-weighted estimate of credit losses. A simplified approach is allowed for certain trade and lease receivables and contract assets.

Under IAS 39, an insurer might estimate an impairment loss as either a single amount or a range of possible amounts and, in the latter case, uses its best estimate within that range. Under the ECL approach, insurers will probably have larger and more volatile provisions for impairment losses.

Application of IFRS 9 requirements

Simplified approach

The simplified approach for trade receivables may not be applied to receivables purchased from third parties. It applies only to trade receivables that result from transactions that are in the scope of IFRS 15 from the perspective of the reporting entity.

Day one loss

The IFRS 9 impairment model generally requires entities to recognise ECLs in profit or loss for all financial assets – even those that are newly originated or acquired. Although the loss allowance need not be recognised until the end of the reporting period in which the asset is initially recognised, the effect is akin to recognising a day one loss.

8.2 Assessing significant increase in credit risk

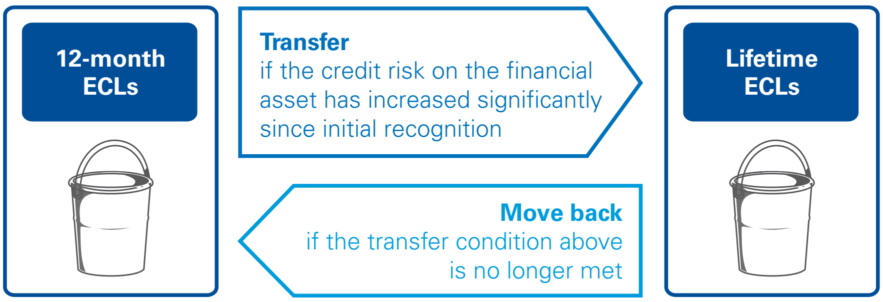
Requirements of IFRS 9

IFRS 9.5.5.9

Under IFRS 9's general approach, at each reporting date an insurer assesses whether the credit risk on a financial instrument has increased significantly since initial recognition.

IFRS 9.5.5.7

The impairment model is symmetrical and assets can move into and out of the lifetime ECLs category, as illustrated below.



IFRS 9.5.5.9

When assessing whether there is a significant increase in credit risk (SICR), an insurer uses the change in the risk of default occurring over the expected life of the financial instrument, rather than changes in the size of the loss if the default were to occur.

Changes in loss given default (LGD) are not considered when assessing whether there is a SICR, although they are incorporated into the resulting measurement of ECLs.

To determine whether the risk of default of a financial instrument has increased significantly since initial recognition, an insurer compares the current risk of default at the reporting date with the risk of default on initial recognition. IFRS 9 allows an insurer to apply various approaches when assessing whether there has been a SICR – including using different approaches for different financial instruments.

IFRS 9.B5.5.12

Any approach used considers:

– the change in the risk of default occurring since initial recognition;

– the expected life of the financial instrument; and

– reasonable and supportable information, including forward-looking information, that is available without undue cost or effort that may affect credit risk.

IFRS 9.B5.5.18

In some cases, the qualitative and non-statistical quantitative information available may be sufficient for the assessment. In other cases, a statistical model or credit ratings process may be used. Alternatively, an insurer may base the assessment on both of the following types of information, if both are relevant:

– a specific internal-rating category; and

– qualitative factors that are not captured through the internal credit ratings process.

IFRS 9.5.5.4, 5.5.11, B5.5.3

For some instruments, a significant increase in credit risk may not be evident on an individual instrument basis before the financial instrument becomes past due. For example, this could be the case for a receivable from a customer when there is little or no updated information that is routinely obtained and monitored on an individual instrument until a customer breaches the contractual terms. In these cases, if more forward-looking information is available on a collective basis, then an insurer makes the assessment on a collective basis.

IFRS 9.5.5.10, BC5.183–BC5.184

As an exception to the general requirements, an insurer may assume that the criterion for recognising lifetime ECLs is not met if the credit risk on the financial instrument is low at the reporting date. An insurer can choose to apply this simplification on an instrument-by-instrument basis.

IFRS 9.B5.5.22

IFRS 9 states that the credit risk is low if:

– the instrument has a low risk of default;

– the borrower has a strong capacity to meet its contractual cash flow obligations in the near term; and

– adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the borrower's ability to fulfil its obligations.

IFRS 9.B5.5.23

A financial instrument with an external rating of 'investment grade' is an example of an instrument that may be considered to have low credit risk. However, a financial instrument does not have to be externally rated for the exception to apply. When an internal grading is used to determine whether the credit risk of an instrument is low, the internal assessment of low credit risk is required to be consistent with a globally understood definition of low credit risk for the type of financial instrument being assessed. The assessment is required to consider the perspective of a market participant and all of the terms and conditions of the financial instrument.

IFRS 9.IE27

To conclude that an instrument with an external rating equivalent to investment grade has low credit risk, the insurer similarly needs to consider whether the external rating is determined using methodologies that are consistent with a globally understood definition of low credit risk and whether there is evidence of an increase in credit risk that is not yet reflected in the rating.

IFRS 9.B5.5.22

A financial instrument is not considered to have low credit risk simply because:

- the value of collateral results in a low risk of loss (this is because collateral usually affects the magnitude of the loss, rather than the risk of default);
- it has a lower risk of default than the insurer's other financial instruments; or
- it has a lower risk of default relative to the credit risk of the jurisdiction in which the insurer operates (e.g. it is a government exposure that has a lower risk of default than exposures to private sector borrowers in the same country).

IFRS 9.B5.5.24

The low credit risk exception does not mean that there is a bright line threshold for the recognition of lifetime ECLs when an instrument's credit risk ceases to be low. Instead, when an instrument no longer has low credit risk, the general requirements for assessing whether there has been a significant increase in credit risk apply.

IFRS 9.5.5.11, B5.5.2

IFRS 9 contains a rebuttable presumption that the condition for recognising lifetime ECLs is met when payments are more than 30 days past due. However, it also clarifies that delinquency is a lagging indicator, and that a significant increase in credit risk typically occurs before an asset is past due. Therefore, when more forward-looking information (compared with that about past-due payments) is available without undue cost or effort, it is considered when determining whether there has been a SICR and an insurer cannot rely solely on past-due data. For example, this information could be available at a portfolio level.

IFRS 9.B5.5.19

This rebuttable presumption is not an absolute indicator but is presumed to be the latest point at which lifetime ECLs should be recognised, even when using forward-looking information.

These requirements are discussed further in 7.8.60, 120 and 150 in the 18th Edition 2021/22 of our publication Insights into IFRS.

How does this approach differ from IAS 39 requirements?

SICR concept not in IAS 39

There is no requirement under IAS 39 to assess for a SICR since initial recognition because an incurred loss model applies. An insurer's approach under IFRS 9 will depend on the criteria that it uses to identify a SICR, which may include quantitative and qualitative factors.

Application of IFRS 9 requirements

Determining whether a SICR has occurred is a critical and difficult judgement

IFRS 9 does not define the term 'significant increase'. Insurers need to decide how to define this key term for their instruments.

Purpose of this document
Scope of IFRS 9
Classification and measurement
IMPAIRMENT
Hedge accounting
Other requirements
Further resources

Assessing SICR requires an insurer to identify the date on which it initially recognised a financial instrument. This is because any increase in credit risk is measured from that date at each reporting date. This assessment is made relative to expectations on initial recognition, irrespective of whether the financial instrument has been repriced to reflect an increase in credit risk after initial recognition. For loan commitments and financial guarantee contracts, the date of initial recognition is considered to be the date on which the insurer becomes a party to the irrevocable commitment. Loans drawn down under loan commitments (other than those measured at FVTPL) are treated as a continuation of the loan commitment.

To be 'significant', a larger absolute increase in the risk of default is required for an asset with a higher risk of default on initial recognition than for an asset with a low risk of default on initial recognition. For example, an absolute change of two percent in the probability of default occurring (PD) is more significant for an asset with an initial PD of five percent than for an asset with an initial PD of 20 percent. A larger absolute increase in the risk of default is also required for a longer-term financial asset than for a shorter-term financial asset.

The method that an insurer employs considers the characteristics of the financial instrument and the historical default patterns for comparable financial instruments.

To assess SICR, an insurer will need to ensure that its systems and controls are designed to capture, process and analyse up-to-date relevant information, including forward-looking information, about the lifetime risks of default of its financial assets. This might include:

- regular credit reviews of exposures;
- assignment of internal ratings and monitoring and review of external credit ratings;
- monitoring regulatory announcements and other public information about issuers and information about economic and business conditions impacting issuers;
- tracking changes in credit spreads on quoted investments; and
- recalculating lifetime PDs relative to expectations on initial recognition, considering up-to-date borrower-specific information and changes in macro-economic conditions.

IFRS 9.B5.5.27

Chapter 9 includes further discussion on the information used in determining ECLs. If there is evidence that there is no longer a SICR since initial recognition, then the loss allowance on the instrument returns to being measured as 12-month ECLs. Some qualitative indicators of an increase in credit risk (e.g. delinquency or forbearance) may be indicative of an increased risk of default that persists after the indicator itself has ceased to exist. In these cases, it may be necessary for the insurer to determine a probation period during which the financial asset is required to demonstrate good behaviour to provide evidence that its credit risk has declined sufficiently. For example, a history of missed or incomplete payments would not typically be erased by simply making one payment on time. When appropriate, an insurer determines a policy for setting probation periods that is monitored to reflect changes in how qualitative indicators impact credit risk and is applied consistently.

Example 12 – SICR: A relative concept

Insurer W uses an internal credit rating system of 1 to 10, with 1 denoting the lowest credit risk and 10 denoting the highest credit risk.

W considers an increase of two rating grades to represent a significant increase in credit risk. It considers Grades 3 and lower to be a low credit risk.

At the reporting date, W holds two bonds issued by Company X, as follows.

	Grade on initial recognition	Grade at reporting date
Bond A	2	5
Bond B	4	5

W assesses whether there has been a SICR for each of the bonds and reaches the following conclusions.

	SICR?	Recognise allowance equal to
Bond A	Yes	Lifetime ECLs
Bond B	No	12-month ECLs

The loss allowance for each bond is measured on a different basis because only the credit risk of Bond A has increased significantly since initial recognition. The measurement basis for the loss allowance differs irrespective of the fact that both bonds have the same grade at the reporting date.

8.3 Definition of default

Requirements of IFRS 9

IFRS 9.B5.5.37, BC5.248

IFRS 9 does not define the term 'default', but instead requires each entity to do so. The definition should be consistent with that used for internal credit risk management purposes for the relevant financial instrument and should consider qualitative indicators – e.g. breaches of covenants – when appropriate. An insurer can use a regulatory definition of default if it is consistent with the insurer's credit risk management practices and considers qualitative indicators.

IFRS 9.B5.5.37

IFRS 9 contains a rebuttable presumption that default does not occur later than 90 days past due, unless an insurer has reasonable and supportable information to corroborate a more lagging default criterion. The definition of default is applied consistently in the context of specific types of assets, unless information that becomes available indicates that another default definition is more appropriate for a particular financial instrument.

These requirements are discussed further in 7.8.50 in the 18th Edition 2021/22 of our publication Insights into IFRS.

How does this approach differ from IAS 39 requirements?

IAS 39 does not require insurers to define default

IAS 39 does not require insurers to define default to assess and measure impairment. However, it does include indicators of objective evidence of impairment, which also refer to contractual default. This includes the unlikelihood of payment by the debtor.

Under IFRS 9, the objective of the definition of default is similar. This means that an insurer might define default using indicators that are similar to the indicators of objective evidence of impairment in IAS 39.

Application of IFRS 9 requirements

Default includes qualitative and quantitative factors

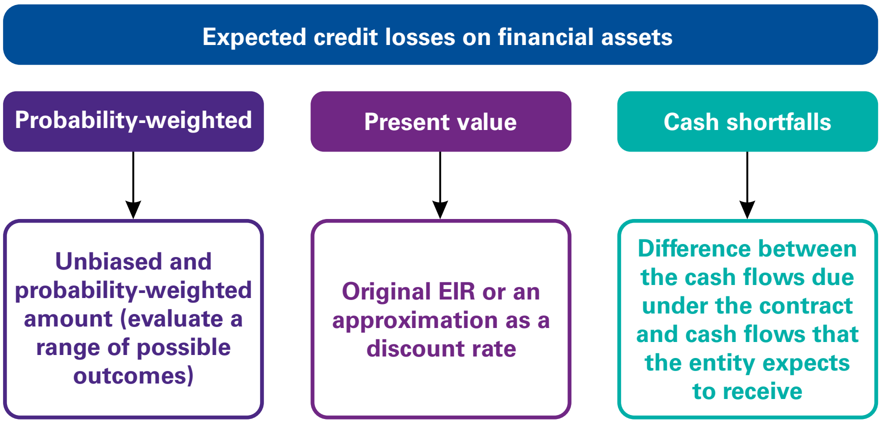
Insurers will need to define the term 'default' for each of their specific types of assets, and in a way that is consistent with their credit risk management practices.

9 Measuring impairment

Requirements of IFRS 9

IFRS 9.A, B5.5.28, B5.5.33

ECLs are a probability-weighted estimate of credit losses. 'Credit losses' are the present value of expected cash shortfalls. As discussed in Section 8.1, if there is a significant increase in credit risk (or the simplified model applies), an insurer recognises an impairment allowance equal to lifetime ECLs – i.e. based on the probabilities of all possible default events over the expected life of the financial instrument. If there is not a significant increase in credit risk (and the simplified model does not apply), an insurer recognises an impairment allowance equal to 12-month ECLs – i.e. the portion of lifetime ECLs that result from possible default events during the next 12 months.



IFRS 9.5.5.17

An estimate of ECLs is determined by evaluating a range of possible outcomes, rather than being based on a best- or worst-case scenario. The measurement of ECLs reflects:

– an unbiased and probability-weighted amount;

– the time value of money; and

– reasonable and supportable information that is available without undue cost or effort at the reporting date.

IFRS 9.5.5.17, B5.5.12, B5.5.49–B5.5.52

IFRS 9 does not prescribe a single method to measure ECLs. Rather, it acknowledges that the methods used to measure them may vary based on the type of financial instrument and the information available. The estimate of ECLs includes information about past events and current conditions, and forecasts of future economic conditions. An insurer uses an approach that is consistent with the measurement objective, and that can evolve over time as it obtains more experience in applying IFRS 9. This does not imply that an insurer needs to perform a full review of each financial instrument at the reporting date; rather, procedures, processes and systems need to be in place to provide relevant information required for assessing ECLs for the purposes of financial reporting.

IFRS 9.5.5.17(a), 5.5.18, B5.5.41

When assessing ECLs, an insurer is not required to identify every possible scenario, but the estimate always reflects at least two scenarios:

– the probability that a credit loss will occur, even if this probability is very low; and

– the probability that no credit loss will occur.

IFRS 9.5.5.8

The impairment loss (or reversal) recognised in profit or loss is the amount required to adjust the loss allowance at the reporting date to the amount that is required to be recognised under IFRS 9.

For detailed discussion of the requirements, see 7.8.160 in the 18th Edition 2021/22 our publication Insights into IFRS.

How does this approach differ from IAS 39 requirements?

Judgements required under IFRS 9 may be wider and significantly more complex

IFRS 9 does not retain the practical expedient available in IAS 39 to measure impairment on the basis of an instrument's fair value using an observable market price. However, it does require an insurer to consider observable market information about credit risk as part of considering all reasonable and supportable information when measuring ECLs.

Under IAS 39's incurred loss model, the expected cash flows from an asset are estimated only once an impairment trigger is reached. At this point, the borrower is often in financial difficulties and the analysis then focuses on the amount that can be recovered from any available assets that the borrower may have.

Under IFRS 9's ECL model, ECLs are needed for all financial instruments in its scope. For financial instruments maturing in the medium and longer term, these estimates may involve making assumptions about changes in economic conditions relatively far into the future. At any given time, there may be a number of conflicting and credible views about future economic conditions. Therefore, insurers will need to develop robust methodologies to ensure that their conclusions are reasonable and supportable, and that judgement is applied consistently.

Application of IFRS 9 requirements

IFRS 9 acknowledges that the degree of judgement required to estimate cash shortfalls depends on the availability of detailed information. As the forecast horizon increases – i.e. as the period for which an insurer needs to make its estimate becomes longer – the availability of detailed information decreases, and the judgement required to estimate ECLs increases.

An insurer is not required to forecast future conditions over the entire expected life of the instrument. For periods far in the future, it could develop projections by extrapolating the information that is available for earlier periods. The maximum period over which ECLs are measured is the contractual period – including any extension options held by the borrower – over which there is exposure to credit risk on the financial instrument. This maximum contractual period is determined in accordance with the substantive contractual terms. IFRS 9 requires ECL estimates to reflect reasonable and supportable information that is available without undue cost or effort – including information about past events and current conditions, and forecasts of future economic conditions.

Historical information is an important base from which to measure ECLs. This base is adjusted for current observable data reflecting current conditions and an insurer's forecast of future conditions during the life of the instrument. However, in some cases the best reasonable and supportable information could be the unadjusted historical information, depending on the nature of this information and when it was calculated, compared with circumstances at the reporting date.

ECLs reflect an insurer's own expectations of credit losses. Entities that have no, or insufficient, sources of entity-specific data are permitted to use peer group experience for comparable financial instruments (or groups of financial instruments). This may be particularly relevant for insurers with little internal historical data about defaults for the types of financial assets held.

The estimate of ECLs reflects the cash flows expected from collateral and other credit enhancements that are part of the instrument's contractual terms. These collateral and other credit enhancements are not recognised separately from the financial instrument being assessed for impairment.

The estimate of ECLs has to reflect the time value of money. ECLs are discounted to the reporting date, not to the expected default date or another date. For financial assets other than lease receivables, the discount rate used to reflect the time value of money is generally the EIR determined at the date of initial recognition or an approximation thereof (the current EIR for floating-rate financial assets). For lease receivables, the discount rate is the discount rate used in measuring the lease receivable under IFRS 16.

Insurers will need to implement new systems and controls to capture and process the data needed to calculate ECLs in accordance with the new requirements, including assessing that it is reasonable and supportable. This may include determining appropriate estimates of lifetime and 12-month PDs and LGDs, including the impact of changes in forward-looking information.

Example 13 – Measurement of ECLs

Insurer X invests in a corporate bond with a 10-year term for 1,000,000. The bond's coupon and EIR are 5% and the interest is paid annually.

Scenario 1 – Assume recognition of 12-month ECLs

Using the most relevant information available, X makes the following estimates:

– the bond has a 12-month PD of 0.5%; and

– the LGD (which is an estimate of the amount of loss if the bond were to default) is 25% and would occur in 12 months' time if the bond were to default.

The 12-month ECL allowance is 1,250 (1,050,000 ÷ 1.05 x 0.5% × 25%) – i.e. the amount of cash flows receivable (1,050,000) multiplied by the PD (0.5%) and by the LGD (25%), and discounting the resulting amount using the EIR for one year (5%).

Scenario 2 – Assume recognition of lifetime ECLs

Using the most relevant information available, X makes the following estimates:

- the bond has a lifetime PD of 20%; and
- the LGD is 25% and would occur on average in 24 months' time if the bond were to default.

The lifetime ECL allowance is 47,619 – i.e. 1,050,000* x 20% × 25% ÷ 1.05^2.

Summary

The difference between calculating 12-month ECLs and lifetime ECLs in this example comprises:

- the different PD applied (either the 12-month PD or the lifetime PD); and
- the timing of the losses occurring.

Other potential sources of differences could include:

- different LGDs; and
- different exposures at default (EADs).

Notes

* Includes the amount of principal and interest receivable in 24 months' time, assuming that the interest for Year 1 is paid in full.

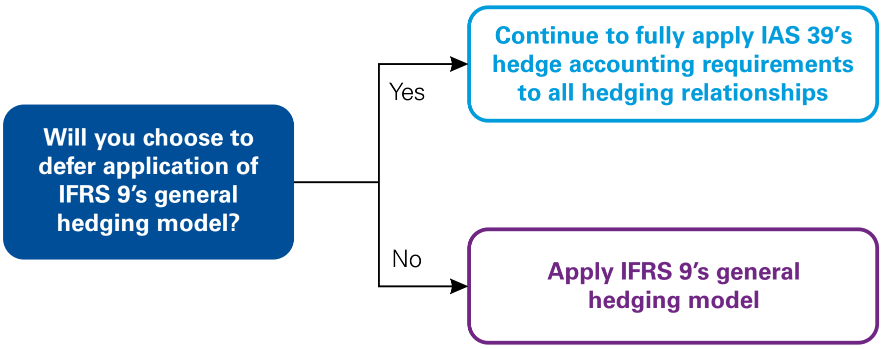
10 Hedge accounting

Requirements of IFRS 9

Accounting policy for hedge accounting

IFRS 9.7.2.21, BC6.102–BC6.104

When an insurer adopts IFRS 9, it may choose as its accounting policy to defer applying the IFRS 9 general hedging model until the standard resulting from the International Accounting Standards Board (the Board)'s project on dynamic risk management is completed.[2] Insurers making this accounting policy choice continue to apply IAS 39 hedge accounting requirements in their entirety to all of their hedging relationships.



IFRS 9.6.1.3, BC6.88, BC6.91, BC6.92(c)

In addition, if an insurer chooses as its accounting policy to apply the IFRS 9 general hedging model, then it may continue to apply IAS 39's requirements for a fair value hedge of the interest rate exposure of a portfolio of financial assets or financial liabilities.

These requirements are discussed further in 7.9.60–80 in the 18th Edition 2021/22 of our publication Insights into IFRS.

Application of IFRS 9 requirements

An insurer that chooses to continue to apply IAS 39's hedge accounting requirements in their entirety until the Board's project on accounting for dynamic risk management is completed also applies IFRIC 16 *Hedges of a Net Investment in a Foreign Operation*, without IFRS 9's consequential amendments. Regardless of whether an insurer applies the IAS 39 or IFRS 9 hedge accounting model, the new hedge accounting disclosure requirements in IFRS 7 may not be deferred.

Aligning hedge accounting with risk management

IFRS 9.6.1.1, 6.5.2

The IFRS 9 general hedging model is similar to that in IAS 39. This is because it maintains the same categories of hedging relationships (i.e. cash flow hedges, fair value hedges and net investment hedges), requirements for hedge documentation and effectiveness and broadly similar hedge accounting mechanics. It also requires that hedged risks should generally be ones that could affect profit or loss.

2. For further information, see the Board's work plan web page.

Purpose of this document
Scope of IFRS 9
Classification and measurement
Impairment
HEDGE ACCOUNTING
Other requirements
Further resources

IFRS 9.6.1.1, 6.4.1, B6.5.15, B6.5.24

However, there are many detailed changes and IFRS 9 introduces a new hedge accounting objective – i.e. to reflect the effect of an entity's risk management activities in its financial statements. IFRS 9 requires an insurer's hedge accounting to be more closely aligned with its actual risk management objectives and to be consistent with this new objective. To qualify for hedge accounting, an insurer is required to document its risk management objective and strategy for undertaking the hedge. Hedge documentation needs to demonstrate how the hedging relationship is aligned with the actual risk management objective and include an analysis of the sources of ineffectiveness and how the insurer determines the hedge ratio.

How does this approach differ from IAS 39 requirements?

IAS 39 does not establish an explicit principle for applying hedge accounting. Instead, hedge accounting is an exception to the normal recognition, measurement and presentation requirements in IFRS Standards. Under IAS 39, an insurer may voluntarily designate and discontinue a hedge accounting relationship. Under IFRS 9, although starting a hedge accounting relationship remains voluntary, an insurer does not have a free choice to discontinue an existing hedging relationship. However, discontinuation is required if the insurer changes its risk management objective such that the hedging relationship would no longer reflect its risk management objective.

Application of IFRS 9 requirements

Insurers would need to revisit and amend hedge documentation. IFRS 9 requires an insurer's hedge accounting to be more closely aligned with its actual risk management objectives.

IFRS 9 goes beyond IAS 39's requirement to formally document 'the entity's risk management objective and strategy for undertaking the hedge' to qualify for hedge accounting. An insurer's application of hedge accounting will now also have to be consistent with the new objective of hedge accounting – i.e. to reflect the effect of an insurer's risk management activities in the financial statements.

In instances where designations do not exactly represent the actual risk management approach, 'proxy hedging' may be applied. Examples of proxy hedging include using a designation of the gross amount of an exposure when risks are actually managed on a net position basis.

An insurer will need to apply judgement to assess how closely a hedge accounting designation needs to align with its risk management objectives to qualify for hedge accounting.

In addition, an insurer may need to rebalance its hedging relationships to maintain alignment with risk management and is prohibited from voluntarily de-designating a hedge accounting relationship that remains consistent with its risk management objectives.

These requirements are discussed further in 7.9.20, 820 and 830 in the 18th Edition 2021/22 of our publication Insights into IFRS.

Hedging instruments

IFRS 9.6.2.2

Under IFRS 9, an insurer may designate non-derivative financial assets or financial liabilities – as well as derivatives – as a hedging instrument in a hedge of any risk, provided that the instrument is measured at FVTPL. However, this does not apply to financial liabilities designated as at FVTPL for which changes in fair value attributable to changes in own credit risk are presented in OCI. An insurer may also designate the foreign currency risk component of any non-derivative financial asset or liability (unless it is an investment in equity instruments measured at FVOCI) as the hedging instrument in a hedge of foreign currency risk.

IFRS 9.6.2.1, 6.2.6, B6.2.4

Like IAS 39, IFRS 9 does not allow designation of a written option as a hedging instrument unless it is designated as an offset to a purchased option. However, IFRS 9 allows a stand-alone written option to be jointly designated with other instruments in other cases as long as in combination the instruments do not result in a net written option.

How does this approach differ from IAS 39 requirements?

IAS 39 does not allow a non-derivative to be designated as a hedging instrument except for hedges of foreign currency risk. IAS 39 also does not allow a stand-alone written option to be designated jointly with other instruments.

Managing credit risk using credit derivatives

IFRS 9.6.7.1, BC6.543–BC6.544

IFRS 9 introduces a new fair value option for certain credit exposures as a substitute for hedge accounting. If an insurer uses a credit derivative that is measured at FVTPL to manage the credit risk of a financial instrument, then it may designate that credit exposure at FVTPL.

How does this approach differ from IAS 39 requirements?

IAS 39 does not include this option.

Costs of hedging

IFRS 9 contains new requirements for accounting for certain 'costs of hedging' – i.e. the time value of purchased options, the forward element of forward contracts and foreign currency basis spreads.

IFRS 9.6.2.4

An insurer may separate the intrinsic value and the time value of a purchased option contract (including a zero-cost collar) and designate as the hedging instrument only the change in intrinsic value with the time value accounted for as a cost of hedging.

IFRS 9.6.5.15

For a time period-related hedged item, an insurer is required to account for the cost of hedging under an amortisation approach over the period during which the hedge adjustment for the option's intrinsic value could affect profit or loss. For transaction-related hedged items, the cost of hedging is deferred until the hedged transaction impacts profit or loss.

IFRS 9.6.2.4, 6.5.16

An insurer may also separate the forward element and the spot element of a forward contract and designate as the hedging instrument only the change in the value of the spot element. Similarly, foreign currency basis spreads may be separated and excluded from the designation of a financial instrument as the hedging instrument. In these situations, an insurer may (but is not required to) account for the undesignated forward element or foreign currency basis spread under an amortisation or a deferral approach, similar to the approaches used for purchased options.

How does this approach differ from IAS 39 requirements?

The costs of hedging concept is not included in IAS 39.

These requirements are discussed further in 7.9.650–770 in the 18th Edition 2021/22 of our publication Insights into IFRS.

Risk components

IFRS 9.6.3.7, B6.3.8

Under IFRS 9, separately identifiable and reliably measurable components of both financial and non-financial items may be hedged items.

IFRS 9.B6.3.10, B6.3.13–B6.3.15

A 'separately identifiable risk component' could be contractually specified (i.e. the risk component is explicit in the contract) or non-contractually specified (i.e. the risk component is determined in the context of the particular market structure). A non-contractually specified inflation component may qualify as a hedged item. However, the standard contains a rebuttable presumption that unless inflation is contractually specified it is not separately identifiable and reliably measurable.

IFRS 9.B6.3.10

When concluding whether a component is reliably measurable, an entity may consider whether sufficient observable forward transactions exist for that component.

IFRS 9.BC6.182–BC6.189

Like IAS 39, IFRS 9 has no requirement for the hedged risk component to be the main or largest component, or for the fair value movement in the hedged risk component to be in the same direction as that for the value of the entire item.

How does this approach differ from IAS 39 requirements?

IAS 39 treats financial and non-financial items differently for risk components that may be designated as hedged items. Under IAS 39, financial items may be hedged for risks that are separately identifiable and reliably measurable; however, non-financial items may only be hedged in their entirety for all risks or for foreign exchange risk.

These requirements are discussed further in 7.9.310 in the 18th Edition 2021/22 of our publication Insights into IFRS.

Hedged items

IFRS 9.6.3.4, B6.3.3

Under IFRS 9, there are a number of other additional exposures that may qualify as hedged items. These include aggregated exposures, groups of items (including net positions), components of nominal amounts and equity instruments at FVOCI as follows.

– *Aggregated exposures*: Combinations of derivative and non-derivative exposures that are managed together for risk management purposes may be designated as the hedged item in a hedging relationship. The components that make up the aggregated exposure do not need to be designated in a separate hedging relationship. Instead, insurers are allowed to hedge these exposures as one, even though they include a derivative.

How does this approach differ from IAS 39 requirements?

Under IAS 39, in almost all cases derivatives can be designated only as hedging instruments and not as hedged items. Consequently, aggregated exposures also cannot qualify as a hedged item.

IFRS 9.6.6.1

– *Groups of items (including net positions)*: For groups of items, including net positions, to be an eligible hedged item for fair value and cash flow hedges, the position would need to consist of items (including components of items) that would individually be eligible hedged items, and the items in the group would need to be managed together on a group basis for risk management purposes. Furthermore, specific requirements apply for a cash flow hedge of a group of items whose cash flows are not expected to vary in proportion to the overall variability in cash flows of the group. In this case, an offsetting risk position arises and the net position is an eligible hedged item only if it is a hedge of foreign currency risk and the designation specifies the reporting period in which the forecast transactions are expected to affect profit or loss, as well as their nature and volume.

How does this approach differ from IAS 39 requirements?

IAS 39 requires additional criteria to be met for a group of items to qualify for hedge accounting. In particular:

– the individual items within the group are required to have similar risk characteristics; and

– the changes in the fair value attributable to the hedged risk for each individual item in the group need to be approximately proportional to the overall change in the fair value of the group for the hedged risk.

In addition, net positions are prohibited from being designated as the hedged item. Instead, a gross position approach is generally applied. For example, an insurer may identify the excess of financial assets over financial liabilities and designate assets equal to the excess position as the hedged items.

IFRS 9.6.3.7(c), 6.6.2–3, B6.3.16–B6.3.20

– *Components of nominal amounts*: There are two types of components of nominal amounts that can be designated as the hedged item in a hedging relationship: a component that is a proportion of an entire item (or eligible group of items), or a layer component. An example of a component that is a

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proportion of an entire item is designating 50 percent of the payments on a fixed-rate bond as the hedged item in a fair value hedging relationship. A layer component may be specified from a defined, but open, population, or from a defined nominal amount – e.g. the bottom layer of 20 of a 100 fixed-rate bond. For a fair value hedge, the layer needs to be specified from a defined nominal amount that can be identified and tracked. Similarly, for a hedge of a layer component of a group of existing items, the entity needs to be able to identify and track the overall group. In a hedge of a layer component of a group of items, the items in the group also need to be exposed to the same hedged risk. A layer component that includes a prepayment option whose fair value is affected by changes in the hedged risk will be eligible as a hedged item in a fair value hedge only if the effect of the option is included in determining the fair value of the hedged item.

How does this approach differ from IAS 39 requirements?

Under the general model in IAS 39, insurers cannot designate a layer component, which is specified from a defined nominal amount, as the hedged item in a fair value hedging relationship.

IFRS 9.5.7.5, BC6.105–BC6.116

– *Equity investments at FVOCI:* Under IFRS 9, an insurer may, on initial recognition, make an irrevocable election to present subsequent changes in the fair value of an investment in equity instruments in OCI if the investment is not held for trading (see Chapter 4). An insurer can designate such an investment as a hedged item in a fair value hedge as an exception to the general requirement that a hedged exposure must relate to a risk that could affect profit or loss.

How does this approach differ from IAS 39 requirements?

IAS 39 does not contain this exception. As a result, hedge accounting cannot be applied under IAS 39's requirements to instruments where gains and losses on the hedged exposure are presented in OCI without reclassification to profit or loss.

These requirements are discussed further in 7.9.370, 390 and 420 in the 18th Edition 2021/22 of our publication Insights into IFRS.

Hedge effectiveness requirements and ineffectiveness

IFRS 9.B6.4.1–B6.4.2

Under IFRS 9, hedge effectiveness is the extent to which changes in the fair value or cash flows of the hedging instrument offset changes in the fair value or cash flows of the hedged item for the hedged risk. When designating a hedging relationship, and on an ongoing basis, insurers analyse the sources of ineffectiveness that are expected to affect the hedging relationship during its term.

IFRS 9.6.4.1(c)

A hedging relationship meets the effectiveness requirements if:

– there is an economic relationship between the hedged item and the hedging instrument;

– the effect of credit risk does not dominate the value changes that result from that economic relationship; and

– the hedge ratio is the same as that resulting from actual quantities of hedged items and hedging instruments used for risk management.

IFRS 9.B6.4.12

An insurer assesses hedge effectiveness at inception of the hedging relationship and on an ongoing basis. As a minimum, this is at each reporting date or on a significant change in the circumstances affecting the hedge effectiveness requirements, whichever comes first. This assessment relates to expectations about hedge effectiveness and, therefore, is only forward-looking or prospective.

IFRS 9.6.5.8, 6.5.11, B6.5.4

IFRS 9 also includes additional guidance on measuring hedge ineffectiveness. Except for hedges of FVOCI equity investments (see 'Hedged items' above) for which ineffectiveness is reported in OCI, IFRS 9, like IAS 39, requires actual ineffectiveness to be recognised in profit or loss. It is clear that the measurement of ineffectiveness should consider the time value of money – i.e. the change in value of the hedged item is determined on a present value basis.

How does this approach differ from IAS 39 requirements?

IAS 39 requires prospective and retrospective hedge effectiveness assessments to demonstrate that a hedge is highly effective. For a hedge to be regarded as highly effective retrospectively, under IAS 39 there is a bright line requirement for the actual results of the hedge to be within the range of 80–125 percent.

These requirements are discussed further in 7.9.780 in the 18th Edition 2021/22 of our publication Insights into IFRS.

Application of IFRS 9 requirements

Which hedge model can an insurer apply? IFRS 9 model vs IAS 39 model

An insurer will need to decide whether to apply the general IFRS 9 hedge accounting model when it initially applies IFRS 9 or instead continue to apply the IAS 39 hedge accounting model in its entirety to all of its hedging relationships. If an insurer initially decides not to switch to the IFRS 9 general model when it adopts IFRS 9, then it can elect to do so from the beginning of a subsequent reporting period.

To the extent relevant, each insurer needs to consider the various differences between the general IFRS 9 and IAS 39 models outlined above. This should be done in the context of its own actual and planned risk management activities and hedging strategies to determine which model may be more advantageous. This will probably include:

– identifying the different risk management activities;

– identifying what risks are being hedged and how;

– determining how the effects of those risks are recognised and presented in profit or loss or OCI for both hedging instruments and hedged items without hedge accounting;

- determining whether this gives rise to accounting mismatches;
- determining whether it may be possible to mitigate those mismatches through hedge accounting or alternative designations or policy choices under IFRS 9 or IFRS 17; and
- considering the costs and operational challenges associated with implementing different approaches.

In our experience, many banks have opted to remain with the IAS 39 model for the time being. This is because they viewed the IFRS 9 general model as offering insufficient incremental benefits in the context of their own hedging strategies, which are focused on hedging financial instruments. Therefore, they chose to avoid the cost and potential disruption that would accompany a change to the IFRS 9 general model. However, the cost-benefit calculus may work differently for some insurers, many of whom will have made little or no use of hedge accounting previously.

Even if an insurer chooses to adopt the IFRS 9 general hedging model, it is still permitted to apply the special requirements in IAS 39 for a fair value hedge of interest rate risk associated with a portfolio of financial assets or financial liabilities ('macro fair value hedging'). These special requirements are more accommodating to dynamic or open portfolios.

In our experience, insurers have not designated insurance contracts as hedged items under IAS 39. Some may be considering whether hedge accounting for risk management activities related to insurance contracts would be feasible following adoption of IFRS 17. This may focus on derivatives or other financial instruments at FVTPL used to manage interest rate duration mismatches between investments and insurance contracts. In some cases, it may be possible to designate hedging relationships in respect of actual or highly probable future investments.

For direct participating insurance contracts under the variable fee approach in IFRS 17, the risk mitigation option in IFRS 17 will be helpful. Also, hedge accounting will have little purpose for insurance portfolios for which the effects of changes in financial risk are reflected immediately in profit or loss.

For insurance contracts under the general measurement model in IFRS 17 and for which the effects of financial risk are disaggregated between profit or loss and OCI, insurers might be exploring whether macro fair value hedging would be possible (given that insurance contracts are generally financial liabilities, albeit outside the scope of IFRS 9). This would be permissible only if:

- it could be determined that interest rate risk was a separately identifiable and reliably measurable component of those insurance contracts; and
- other conditions necessary for hedge accounting were met.

This would be challenging and implementation of hedge accounting in conjunction with IFRS 17 would involve considerable operational complexities as well as the monitoring and recognition of hedge ineffectiveness.

11 Transition requirements

Requirements of IFRS 9

Comparative information

IFRS 9.7.2.2

The general principle in IFRS 9 is for retrospective application in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. The transition requirements refer to the date of initial application (DIA), which is the beginning of the reporting period in which an insurer first applies IFRS 9.

IFRS 9 contains certain exemptions from full retrospective application. These include an exemption from the requirement to restate comparative information about classification and measurement, including impairment. If an insurer does not restate prior periods, then opening retained earnings (or other components of equity, as appropriate) for the annual reporting period that includes the DIA is adjusted for any difference between the carrying amounts of financial instruments before adoption of IFRS 9 and the new carrying amounts. Insurers are allowed to restate comparatives if, and only if, this is possible without the use of hindsight. If an insurer restates prior periods, then the restated financial information reflects all of IFRS 9's requirements.

IFRS 9's hedge accounting requirements are generally applied prospectively, with limited exceptions. In particular, comparative information may need to be restated for the costs of hedging, which are applied retrospectively.

IFRS 9.7.2.1, 7.2.15, 7.2.26, IAS 8.19, 22

IFRS 9 is not applied to items that have already been derecognised at the DIA.

Application of IFRS 9 requirements

Comparative information for financial assets and financial liabilities

IFRS 17 requires comparative information for the annual period immediately preceding the date of initial application of IFRS 17 to be restated.

Many insurers will initially apply IFRS 9 in 2023 at the same time as they initially apply IFRS 17. Except as noted above for costs of hedging, IFRS 9 does not require comparative financial information for the period before the DIA to be restated. However if comparative financial information is restated for IFRS 9, IFRS 9 is not applied to financial assets that are derecognised before the DIA.

This may lead to accounting mismatches in the comparative information for insurers who do not plan to restate their comparative information under IFRS 9 or who do plan to restate their comparative information for IFRS 9 but have derecognised financial assets in the comparative period. For example, under IFRS 17, insurance contract liabilities would be measured using current information whereas any related financial assets that are classified at amortised cost under IAS 39 would be measured using historical effective interest rates. Accounting mismatches might also arise between retained earnings and accumulated OCI.

The accounting mismatches in the comparative information would probably be greater if the insurer does not restate comparative information under IFRS 9. However, some may still exist if comparative information is restated under IFRS 9 to the extent that financial assets are derecognised during the comparative period – i.e. IAS 39, rather than IFRS 9, must be applied for these assets and this also presents operational challenges.

Insurers will need to consider the various costs and benefits of restating their financial information under IFRS 9, including whether this is possible without the use of hindsight.

Insurers should also consider the reduction in comparability between reporting periods, and how they will communicate changes in their financial position and performance to their stakeholders if they do not restate comparative information.

Comparative information for financial assets – Potential new transition option for IFRS 17

To alleviate the accounting mismatches and operational challenges described above, the Board has proposed in Exposure Draft 2021/8 *Initial Application of IFRS 17 and IFRS 9 – Comparative Information* a narrow-scope amendment to IFRS 17 to introduce a new optional classification overlay approach.

The optional classification overlay would:

- apply to financial assets that are related to insurance contract liabilities and to which IFRS 9 has not been applied in the comparative periods;
- allow an insurer to classify and measure these financial assets (i.e. as amortised cost, FVTPL or FVOCI) in the comparative periods based on its expectations, using reasonable and supportable information available at the transition date, of how these assets would be classified on initial application of IFRS 9. Although the measurement requirements of IFRS 9 would generally apply based on the expected classification, the insurer would not be required to apply the IFRS 9 expected credit losses impairment model to these financial assets in the comparative periods;
- apply to comparative periods that have been restated for IFRS 17 (i.e. from the date of transition to the date of initial application of IFRS 17); and
- apply on an instrument-by-instrument basis.

The comment period for the exposure draft expires on 27 September 2021 and the Board plans to finalise an amendment by the end of 2021. For further discussion on the Board's deliberations and the exposure draft, see our insurance contracts hot topics page.

Insurers will need to monitor the status of this project and consider how it impacts their plans for reporting comparative information on financial assets for 2022. Many insurers will wish to restate for IFRS 9 or apply the classification overlay approach to reduce accounting mismatches in the comparative information and to present comparative information that is more aligned with that reported for 2023 and subsequent years. The classification overlay approach may be particularly attractive compared to restatement under IFRS 9 as it would reduce the complexities associated with applying different accounting policies to financial assets that are derecognised in the comparative period, can be focused on financial assets for which accounting mismatches might otherwise arise and does not require IFRS 9's ECL model to be applied before the DIA of IFRS 9.

Insurers will need to perform their own analyses to determine which approach to present comparative information works best for them and their stakeholders based on their own facts and circumstances. They will also need to identify the operational steps necessary to apply their preferred approach – in particular, making any necessary system changes before 2022 to ensure that restatement or the classification overlay approach may be applied for 2022 without the use of hindsight.

Specific transition requirements

Business model assessment

IFRS 9.7.2.3

On adopting IFRS 9, an insurer assesses the nature of the business models in which its financial assets are held. As an exception to retrospective application, the assessment is based on facts and circumstances at the DIA. An insurer is not required to consider business models that may have applied in previous periods. The resulting classification is applied retrospectively, irrespective of the insurer's business model in prior reporting periods.

Fair value designations

IFRS 9.7.2.8–7.2.10

The option to designate financial assets and financial liabilities as at FVTPL is re-opened, based on facts and circumstances at the DIA.

The following tables show the transition requirements for the fair value option for financial assets and financial liabilities at the DIA.

<table>
<tr><th colspan="2" rowspan="2">Financial assets</th><th colspan="2">On transition to IFRS 9</th></tr>
<tr><th colspan="2">Qualifying criterion for fair value option based on reducing an accounting mismatch …</th></tr>
<tr><th rowspan="5">IAS 39</th><th>Fair value option under IAS 39</th><th>… is met at the DIA</th><th>… is not met at the DIA</th></tr>
<tr><td>Not designated</td><td>Designation is permitted</td><td>Designation is not possible</td></tr>
<tr><td>Designation based on reducing an accounting mismatch</td><td>Previous designation may be revoked</td><td>Previous designation has to be revoked</td></tr>
<tr><td>Designation based on the criterion that a group of financial assets were managed on a fair value basis</td><td rowspan="2">Previous designation may be revoked</td><td rowspan="2">Previous designation has to be revoked
New designation is not permitted – i.e. classify based on the general criteria in IFRS 9 and the business model at the DIA</td></tr>
<tr><td>Designation based on the criterion that a financial asset contained an embedded derivative</td></tr>
</table>

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Financial liabilities		**On transition to IFRS 9**		
		Qualifying criterion for fair value option based on reducing an accounting mismatch …		**Liabilities managed on a fair value basis or containing an embedded derivative**
IAS 39	**Fair value option under IAS 39**	***… is met at the DIA***	***… is not met at the DIA***	
IAS 39	**Not designated**	Designation is permitted	Designation is not possible	Designation is not possible
IAS 39	**Designation based on reducing an accounting mismatch**	Previous designation may be revoked	Previous designation has to be revoked	Designation is not possible
IAS 39	**Designation based on the criterion that a group of financial liabilities were managed on a fair value basis**	Not permitted to revoke previous designation		
IAS 39	**Designation based on the criterion that a financial liability contained an embedded derivative**			

Application of the IFRS 9 requirements

Applying the fair value option on transition

Key focus areas for many insurers will include determining whether:

– revocations of fair value option designations are required; and/or

– new or continuing fair value option designations are permitted, and, if so, whether they are desirable.

Changes to the classification of financial assets under IFRS 9 and to the accounting for insurance contracts on transition to IFRS 17 may reduce or eliminate some previous accounting mismatches between these items or generate new ones (see Chapter 3).

Investments in equity instruments

IFRS 9.7.2.8(b)

At the DIA, an insurer may elect to present changes in the fair value of an investment in an equity instrument in OCI if it is not held for trading at that date.

IFRS 9.7.2.12–7.2.13

If an investment in equity instruments (or related derivative) was previously measured at cost under IAS 39, then it needs to be measured at fair value from the DIA.

Effective interest method

IFRS 9.7.2.11, IAS 8.5

It may be impracticable to apply the effective interest method retrospectively to certain financial instruments. In these cases, the fair value of a financial instrument at the DIA is treated as its new gross carrying amount (if it is an asset) or amortised cost (if it is a liability) at that date. If an insurer has restated comparative periods under IFRS 9, then the fair value at the end of each comparative period is similarly treated as the gross carrying amount or amortised cost at those dates.

Impairment

IFRS 9.7.2.19

When determining whether there has been a SICR since initial recognition, an insurer may apply:

- the low credit risk exception; and
- the rebuttable presumption for contractual payments that are more than 30 days past due if the insurer identifies a SICR based on past-due information.

IFRS 9.7.2.20

If determining at the DIA whether there has been a SICR since initial recognition of a financial instrument would require undue cost or effort, then the loss allowance or provision is generally measured as lifetime ECLs at each reporting date until that financial instrument is derecognised. However, if the credit risk of a financial instrument is low, then an insurer may assume that the credit risk on that asset has not increased significantly since initial recognition and may recognise a loss allowance equal to 12 months' ECLs.

Hedge accounting

IFRS 9.7.2.24, 7.2.25(b)

Hedging relationships that qualify for hedge accounting under IAS 39 and that also qualify under IFRS 9's general hedge accounting model (after considering any rebalancing on transition) will be regarded as continuing hedging relationships. When applicable, an insurer is required to use the hedge ratio under IAS 39 as the starting point for rebalancing the hedge ratio of a continuing hedging relationship.

IFRS 9.7.2.22, 7.2.26

All hedge accounting requirements will be applied prospectively, with the following limited exceptions.

- Retrospective application of the accounting for the time value of purchased options as a cost of hedging is *required* for all hedging relationships in which the hedging instrument was designated under IAS 39 as the intrinsic value of an option.
- Retrospective application of the accounting for the forward element of forward contracts as a cost of hedging is *permitted* for hedging relationships in which the hedging instrument was designated under IAS 39 as the spot element of a forward contract. This is the case only if this election is applied consistently to all hedging relationships that qualify for this election.
- Retrospective application of the accounting for foreign currency basis spreads as a cost of hedging is *permitted*.

For further information on the transition requirements, see Chapter 7.11 in the 18th Edition 2021/22 of our publication Insights into IFRS.

Application of IFRS 9 requirements

Insurers will need to be ready to adopt the standard at the DIA. This includes making relevant accounting assessments and elections.

Classification and measurement

To comply with IFRS 9's classification and measurement requirements, insurers need to, based on facts and circumstances at the DIA:

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- assess the objective of the business model within which financial assets are held;
- make any election to designate an investment in an equity instrument that is not held for trading as at FVOCI;
- designate, or revoke designations of, financial assets or financial liabilities as at FVTPL; and
- assess whether presenting the effects of changes in a financial liability's credit risk in OCI would create or enlarge an accounting mismatch in profit or loss for the purposes of applying the fair value option.

Modifications of financial assets and financial liabilities

IFRS 9 introduces new guidance on measuring financial assets and financial liabilities that are renegotiated or otherwise modified and the renegotiation or modification does not result in derecognition (see Chapter 6 above). Under this guidance, the gross carrying amount of the financial asset or amortised cost of the financial liability is recalculated as the present value of the modified contractual cash flows discounted at the instrument's original effective interest rate. The difference is recognised in profit or loss.

Except for modifications of financial assets because of financial difficulties of the borrower and guidance on the treatment of fees and costs when a financial liability is modified, IAS 39 is silent on how to account for modifications of financial assets and financial liabilities that do not result in derecognition. When impairment is not applicable, companies commonly recognise the difference in contractual cash flows arising from the modification over the remaining life of the instrument. They do this by adjusting the effective interest rate prospectively, rather than adjusting the carrying amount and recognising the difference immediately in profit or loss.

Because IFRS 9 requires retrospective application, it appears that companies that previously adjusted the effective interest rate prospectively should assess what the gross carrying amount or amortised cost would have been had the modification been accounted for in accordance with the IFRS 9 requirements. If comparative information for prior periods is not restated, then we believe that the difference in the gross carrying amount or amortised cost at the DIA should be recorded in opening retained earnings of the annual period that includes the date of initial application.

Previously reclassified financial assets

An insurer may have previously reclassified a financial asset from held-for-trading or available-for-sale to amortised cost measurement under IAS 39. In this case, the insurer would have determined the effective interest rate based on the fair value and expected future cash flows at the date of reclassification. Similar to the analysis for modification or exchange of financial instruments (see Chapter 6), because IFRS 9 is applied retrospectively, if the asset is measured at amortised cost or FVOCI under IFRS 9, then the gross carrying amount is recalculated as if the asset had always been classified that way, rather than by carrying forward the IAS 39 measurement.

Hedge accounting

Insurers need to choose whether to defer application of the IFRS 9 general hedging model. If the new financial instruments standard's model is applied, then all qualifying criteria for hedge accounting need to be met at the DIA to apply hedge accounting from that date, including updating hedge documentation to comply with the new standard. Hedge relationships may need to be rebalanced on transition to the new financial instruments standard. Further, an insurer needs to determine whether costs of hedging accounting will be applied retrospectively.

Example 14 – Modifications of financial assets

On 1 January 2022, Insurer D agrees to modify the terms of a financial asset by changing the interest rate charged. Under IAS 39 and IFRS 9, the modification does not result in derecognition of the financial asset, which is measured at amortised cost. Under IAS 39, D recognises the difference in contractual cash flows arising from the modification over the remaining life of the bond by adjusting the effective interest rate prospectively.

D initially applies IFRS 9 on 1 January 2023 without restating comparative information. D assesses what the gross carrying amount would have been had the modification been accounted for in accordance with IFRS 9. D recognises the difference in the gross carrying amount at 1 January 2023 in opening retained earnings at 1 January 2023.

Insurers that apply IFRS 9 before IFRS 17 – Re-designation of financial assets

Insurers applying IFRS 9 before IFRS 17 are permitted – and in some cases are required – to change their previously applied classification and designation of financial assets when they initially apply IFRS 17. These re-designations are based on facts and circumstances that exist at the DIA of IFRS 17 and are applied retrospectively using IFRS 9's transition requirements. In this case, when applying the IFRS 9 transition requirements the DIA is considered to be the date of initial application of IFRS 17. For discussion of these requirements and choices, see our publication First Impressions: IFRS 17 Insurance Contracts 2020 edition.

12 Presentation and disclosure requirements

Requirements of IFRS 9

IFRS 9.5.4.1, IAS 1.82

IFRS 9 amends IAS 1 *Presentation of Financial Statements* to require separate presentation in profit or loss of interest revenue calculated using the effective interest method (as well as of impairment losses, gains and losses on derecognition of financial assets measured at amortised cost and gains and losses on reclassifications of financial assets). The requirement for separation presentation of interest revenue calculated using the effective interest method applies only to financial assets measured at amortised cost or FVOCI. Such interest revenue is generally calculated by applying the effective interest rate to the gross carrying amount of the financial asset if the financial asset is not credit-impaired or to its amortised cost if the financial asset is credit-impaired.

IFRS 7.1

IFRS 9 introduces substantial amendments to the disclosure requirements of IFRS 7. The objective of the disclosure requirements is for an insurer to disclose information to enable users of financial statements to evaluate:

- the significance of financial instruments for the insurer's financial position and performance;
- the nature and extent of risks arising from those financial instruments, both during the period and at the reporting date; and
- how the insurer manages those risks.

To meet the disclosure objective, IFRS 9 introduces additional disclosure requirements in the following areas:

- investments in equity instruments designated as at FVOCI;
- impairment:
  - credit risk management practices;
  - quantitative and qualitative information about amounts arising from ECLs; and
  - credit risk exposure; and
- hedge accounting.

IFRS 7.44Z, 9.BC6.104

For hedge accounting, the extensive new disclosure requirements have to be applied even if the insurer chooses to continue to apply the hedge accounting requirements of IAS 39.

IFRS 7.21A

IFRS 9 requires an insurer to explain its risk management strategy for each category of risk exposures that it decides to hedge – e.g. interest rate risk, foreign exchange risk, commodity price risk – and to which it applies hedge accounting.

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On initial application

Specific disclosures are required on initial application of IFRS 9. This section highlights some of these key disclosures (but not all).

IFRS 7.42L On adoption of IFRS 9, an insurer discloses, in the reporting period that includes the DIA:

- the original measurement category and carrying amount determined under IAS 39; and
- the new measurement category and carrying amount determined under IFRS 9 for each class of financial assets and financial liabilities.

IFRS 7.42L In addition, an insurer explains how it has applied the classification requirements of IFRS 9 and the reasons for any designations or de-designations of financial assets and financial liabilities at FVTPL. The insurer also discloses the amount of any financial assets and financial liabilities that were previously designated as at FVTPL but are no longer so designated, distinguishing between mandatory and elective de-designations.

IFRS 7.42L An insurer discloses the changes in the classifications of financial assets and financial liabilities at the DIA, showing separately:

- the changes in the carrying amounts on the basis of their measurement categories under IAS 39; and
- the changes in the carrying amounts arising from a change in measurement attribute on transition to the IFRS 9.

IFRS 7.42P On the DIA of IFRS 9's impairment requirements, an insurer discloses reconciliations between:

- the closing balances for impairment allowances under IAS 39 and provisions under IAS 37; and
- the opening balances for loss allowances under IFRS 9.

For financial assets, an insurer provides this disclosure by measurement category in accordance with IAS 39 and IFRS 9, showing separately the effect of changes in measurement category on the loss allowance as at the DIA.

For further information on the presentation and disclosure requirements, see Chapter 7.10 in the 18th Edition 2021/22 of our publication Insights into IFRS.

How does this approach differ from IAS 39 requirements?

New presentation requirements

The requirements for separate presentation in profit or loss are new and insurers may need to revisit how they present affected amounts.

Disclosures are significantly expanded under IFRS 9

IFRS 7 previously included fewer specific disclosure requirements for credit risk exposures and hedge accounting. In comparison, IFRS 9 introduces extensive disclosure requirements that are intended to help users better understand the effect of credit risk on the amount, timing and uncertainty of future cash flows, as well as the insurer's risk management strategy and the effect that hedge accounting has had on the insurer's financial statements.

IFRS 9 introduces disclosure requirements for investments in equity instruments designated as at FVOCI, with specific disclosures required for those investments derecognised during the reporting period.

Application of IFRS 9 requirements

Significant changes to data-gathering processes may be necessary

Insurers will need to assess the additional disclosure requirements fully.

Insurers should assess whether their current systems and processes are capable of capturing, tracking, aggregating and reporting information to meet the new disclosure requirements. For many, this may require significant changes to existing data-gathering processes, IT systems and internal controls.

Further resources for application

In-depth analysis	
Insights into IFRS | Chapter 7 Financial instruments: IFRS 9	Guides to financial statements
Sector-specific material	
Insights into IFRS | Chapter 8 Insurance	Guide to annual financial statements | Illustrative disclosures for insurers
First Impressions | Insurance contracts 2020 edition	Web article | Insurers – Further guidance for audit committees on applying IFRS 17
Web article | Progress in new transition option for IFRS 17	Web article | Potential new transition option for IFRS 17
Web article | Interim reporting choices	Talkbook | Interim reporting choices under IFRS 17
Web article | Revised IFRS 17 Insurance Contracts	Web article | IFRS 17 – Background to the standard
Web article | Final amendments are out now	Web article | IFRS 4 amendments
Web article | IFRS 17 – April 2019 TRG meeting summary	Web article | IFRS 17 – September 2018 TRG meeting summary
Web article | IFRS 17 – May 2018 TRG meeting summary	Web article | IFRS 17 – February 2018 TRG meeting summary

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Better communication in financial reporting

Sustainability reporting

Handbooks

Earnings per share

Fair value measurement

IFRS compared to US GAAP

Leases

Revenue

Share-based payments

More guidance and insight

Business combinations and consolidation

Combined and/or carve-out financial statements

Insurance contracts

IBOR reform

Financial instruments

Banks

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Purpose of this document
Scope of IFRS 9
Classification and measurement
Impairment
Hedge accounting
Other requirements
FURTHER RESOURCES

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