

Aligning IFRS 9 with IFRS 17

May 8, 2019





IFRS 9 represents significant change for financial instrument accounting. How can policy choices be made to align IFRS 9 and IFRS 17 to achieve optimal results?

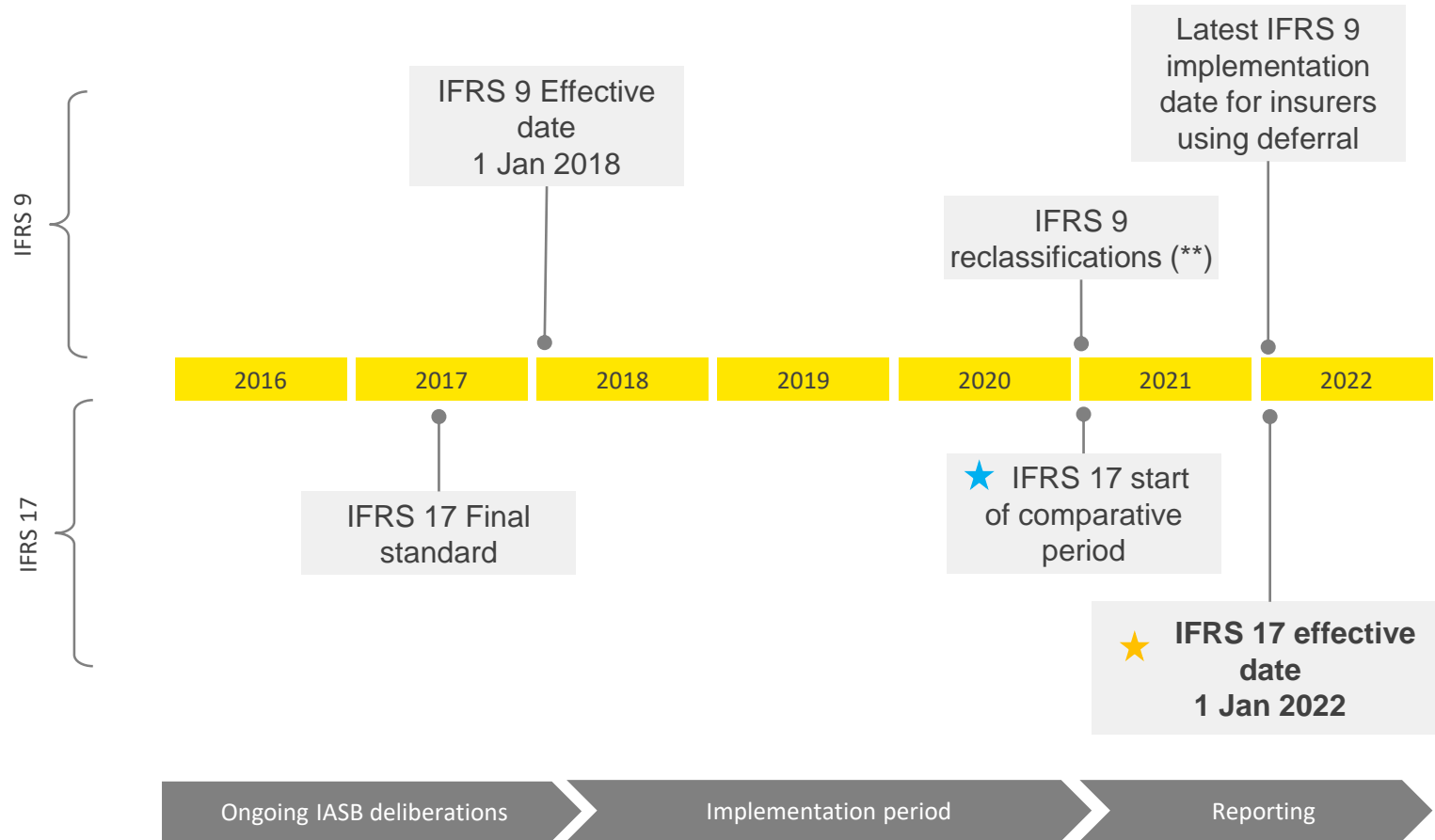


The better the question. The better the answer.
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What can be learned from IFRS 9 implementations at the Canadian Banks?



Timeline



(*) This timeline reflects one-year deferral of the effective date proposed by IASB

(**) Reclassification is a policy election under IFRS 9 for comparative period

Refresher on IFRS 9

- ▶ In July 2014, the IASB issued the final version of IFRS 9 *Financial Instruments* to replace IAS 39 *Financial Instruments: Recognition and Measurement*, which brings together the three aspects:
 - ▶ Classification and measurement
 - ▶ Impairment of financial assets (expected credit loss model)
 - ▶ Hedge accounting
- ▶ IFRS 9 is effective for annual periods beginning on or after 1 January 2018
- ▶ Insurance Companies adopting IFRS 17 can elect to defer IFRS 9 until the adoption of IFRS 17 in 2022.

Lessons learned from IFRS 9

- ▶ Underestimation of the effort associated with controls design and execution
- ▶ Underestimation of resources required to perform BAU activities;
- ▶ Underestimation of effort required to document methodologies, accounting whitepapers
- ▶ Need for greater emphasis on quantitative skills required to perform analytics (model decomposition, sensitivities, etc.)
- ▶ Need for a greater emphasis on streamlining finance and risk functions to comply with IFRS 9 requirements
- ▶ Lack of proper project budgeting/cost and resourcing overall effort required to get to BAU state
- ▶ Lack of understanding interdependencies between Risk/Finance/IT

Lessons learned from IFRS 9 – IT Implementation

Program Governance

A lack of full program governance paired with extremely tight timelines and program complexity increased the likelihood of missed milestones, a solution that does not meet requirements, and the risk of non-compliance with the standard.

Program Management

It is critical for implementation programs to have a fully-costed business case, integrated, detailed program plan with critical path, dependencies, task ownership, and key milestones identifies. Lack of doing so resulted in a higher likelihood of missing overall timelines, cost overruns, and missed scope.

Scope Definition

Program scopes were not explicitly identified, tied back to an overall IFRS 9 methodology, and documented in detailed requirements. An improperly defined scope resulted in a higher likelihood of missing overall timelines, and cost overruns.

Solution

Proposed end to end solutions were not been explicitly aligned with the banks' IT strategy and related principles. In some instances the proposed approach did not provide sufficient segregation of duties regarding the program requirements, design, development and testing, and potential IT implementation and production support.

Testing

A work stream dedicated to testing lead reporting into the program, overall test strategy, and specific test phase plans were neglected in the implementation plans. Without a test work stream with dedicated lead and strategy identified, a program with the complexity of IFRS 9 has a significant risk of delivering a solution that does not meet requirements.

Classification and Measurement – Interaction of IFRS 17 with IFRS 9



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Classification and measurement

Financial instruments in the scope of IFRS 9

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graph TD; A[Financial instruments in the scope of IFRS 9] --> B[Financial assets]; A --> C[Financial liabilities]; B --- D[New classification criteria]; B --- E[New categories that use OCI]; C --- F["New presentation: 'own credit' related FV changes in OCI (for liabilities under the FVO)"]
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Financial assets

New classification criteria

New categories that use OCI

Financial liabilities

New presentation: 'own credit' related FV changes in OCI (for liabilities under the FVO)

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Classification of financial assets: Overview of the model

		Contractual cash flow characteristics Solely payments of principal and interest (SPPI)	
		Yes	No
Business model	Business model whose objective is to hold financial assets in order to collect contractual cash flows	Amortised cost	FVPL
	Business model whose objective is achieved by both collecting contractual cash flows and selling financial assets	FVOCI	FVPL
	Financial assets which are neither held at amortised cost nor at fair value through other comprehensive income (FVOCI)	FVPL	FVPL

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Classification of financial assets: Summary

Equity investments	Debt instruments	Loan to a parent company
<p>Fail the SPPI test as cash flows do not represent SPPI.</p> <p>Measure at fair value through P&L, or OCI where elected.</p>	<p><u>Careful</u> assessment of SPPI test required.</p> <p>Examples: Prepayment options, indexed interest features, term extension features.</p>	<p>May or may not be interest bearing.</p> <p>Consider the existence of prepayment options.</p> <p><u>Careful</u> assessment of SPPI test required.</p>
Trade receivables	Cash and cash equivalents	Derivatives
<p>Generally represent a single cash flow.</p> <p>May or may not be interest bearing.</p> <p><u>Generally</u> will pass the SPPI test</p>	<p>Similar analysis to trade receivables.</p> <p>Will pass the SPPI test.</p>	<p>Derivatives fail the SPPI test.</p> <p>Derivatives (options, forwards, swaps) include <u>leverage</u> which is considered a non-SPPI feature.</p>

Overview of IFRS 9 as it applies to insurance industry assets/liabilities



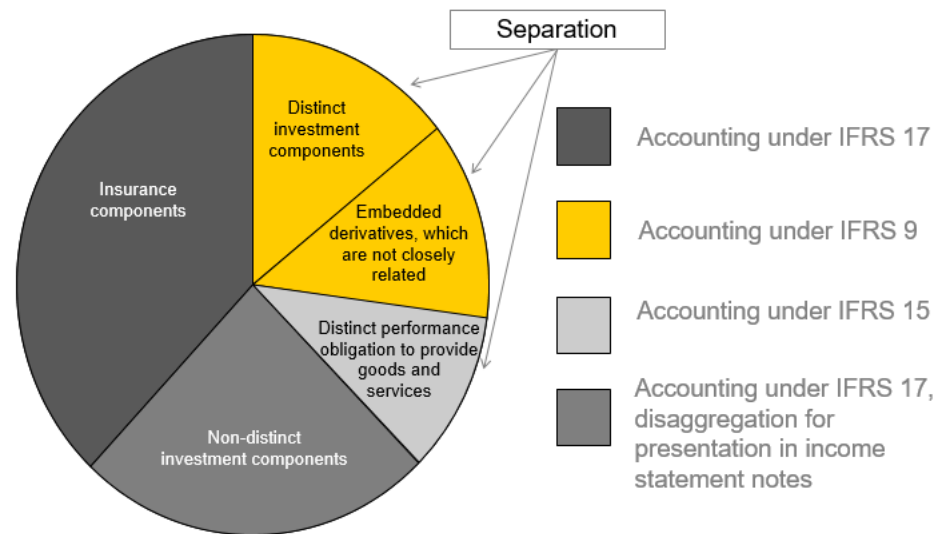
What is changing from IFRS 4?

- ▶ Canadian Asset Liability Method (CALM) implicitly considered the insurer's asset returns in valuing liabilities
- ▶ CALM set the insurance reserve equal to the assets backing those reserves – considering reinvestment assumptions
- ▶ The General Model considers a market rate of return and entity specific instruments and ALM strategy are not reflected in calculating the reserve

- ▶ **IFRS 17 decouples the insurer's assets from setting the level of required insurance reserve – a significant change from today's practice**
- ▶ Note: LICAT has provisions to prevent entities from not following an investment strategy where asset-liability matching is considered – through market risk

Separating Components from Insurance Contracts

- ▶ Currently, many insurers have a rebuttable presumption that IFRS 17 requires an insurer to identify and separate distinct components in certain circumstances. When separated, those components are accounted for under the relevant IFRS (i.e., not under IFRS 17) :
 - ▶ Contain embedded derivatives that, if bifurcated, would be within the scope of IFRS 9
 - ▶ Include investment components that, if provided under separate contracts, would be within the scope of IFRS 9



Discount rates – significant policy choices and IFRS 9

Insurers need to be aware of how IFRS 9 and IFRS 17 policy choices interact:

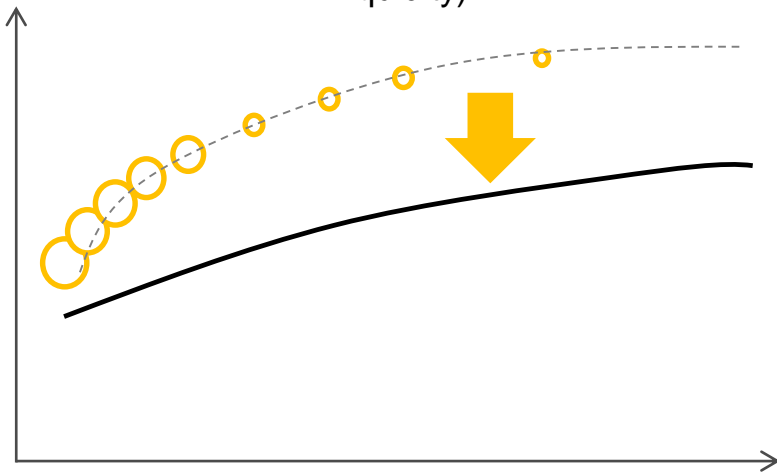
- ▶ **Major IFRS 17 policy choice is whether changes in discount rate go through P&L or OCI each year (Para 88)**
- ▶ To avoid an accounting mismatch, both asset and liability policy elections around P&L or OCI for returns and discount rates respectively should be aligned as much as possible – this will therefore, require IFRS 9 and IFRS 17 to be considered together
- ▶ IFRS 9 has an election where any asset can be recorded at FVTPL if it would eliminate an accounting mismatch
- ▶ For example, if changes in financial variables go through P&L for IFRS 17, it may make sense to record assets backing liabilities at FVTPL, to have changes in both sides through P&L

Related IFRS 17 guidance on discounting

Top-down approach
Current market rates of returns:
either of own asset portfolio or a
reference portfolio

Adjust for **risks that are not relevant to the insurance contract**, e.g., default risk, market risk

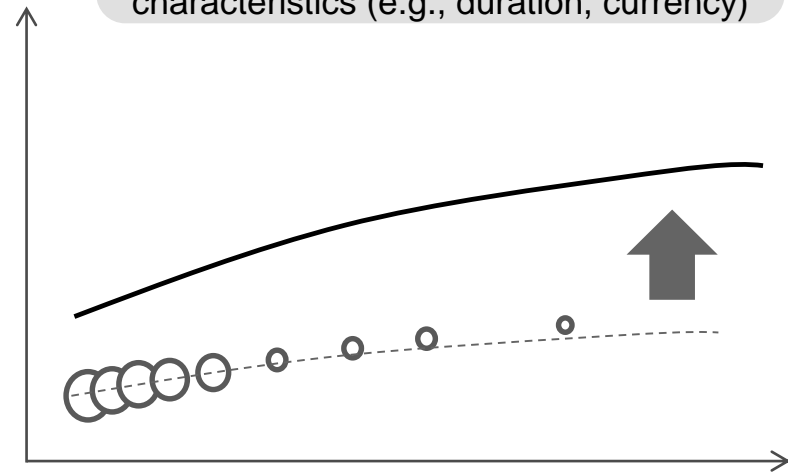
Adjust for **duration differences** if necessary
(No need to adjust for the difference due to liquidity)



Adjust for **other characteristics** of the insurance contracts if necessary

Illiquidity premium: Adjust for liquidity characteristics of the insurance contracts

Bottom-up approach
Risk-free yield curve with similar characteristics (e.g., duration, currency)



Investment income (Finance income)

- ▶ Investment income will come from the insurer's assets
- ▶ Determinations under IFRS 9 will drive income being recognised in the P&L versus OCI
- ▶ For example – if SPPI which requires FVOCI treatment, mismatch may arise if insurer does not elect OCI policy choice for changes in the discount rate as discussed on next slide
- ▶ In that example, if the insurer elected changes in discount rate related to the insurance contract liability through P&L – if the insurer elected FVPL for otherwise FVOCI fixed income assets, the FVPL election would be allowable to remove accounting mismatch (IFRS 9). The finance income and expense will be offset in the P&L to the extent asset returns equal market rate returns using bottom up or top down approach for insurance liability

IFRS 17 and IFRS 9 alignment

- ▶ Consider how your company defines its portfolios
 - ▶ Are portfolios being set to manage portfolios of insurance contracts, one type of products or a sub-component of a product? Different accounting conclusions are driven by how different portfolios are managed. There may be changes that can be made to asset management that result in favourable accounting outcomes under IFRS 9.
- ▶ Consider which portfolios back which liabilities/ surplus
 - ▶ For assets backing surplus, less FVTPL assets in those portfolios may reduce volatility (asset changes not offset by liability changes for surplus)

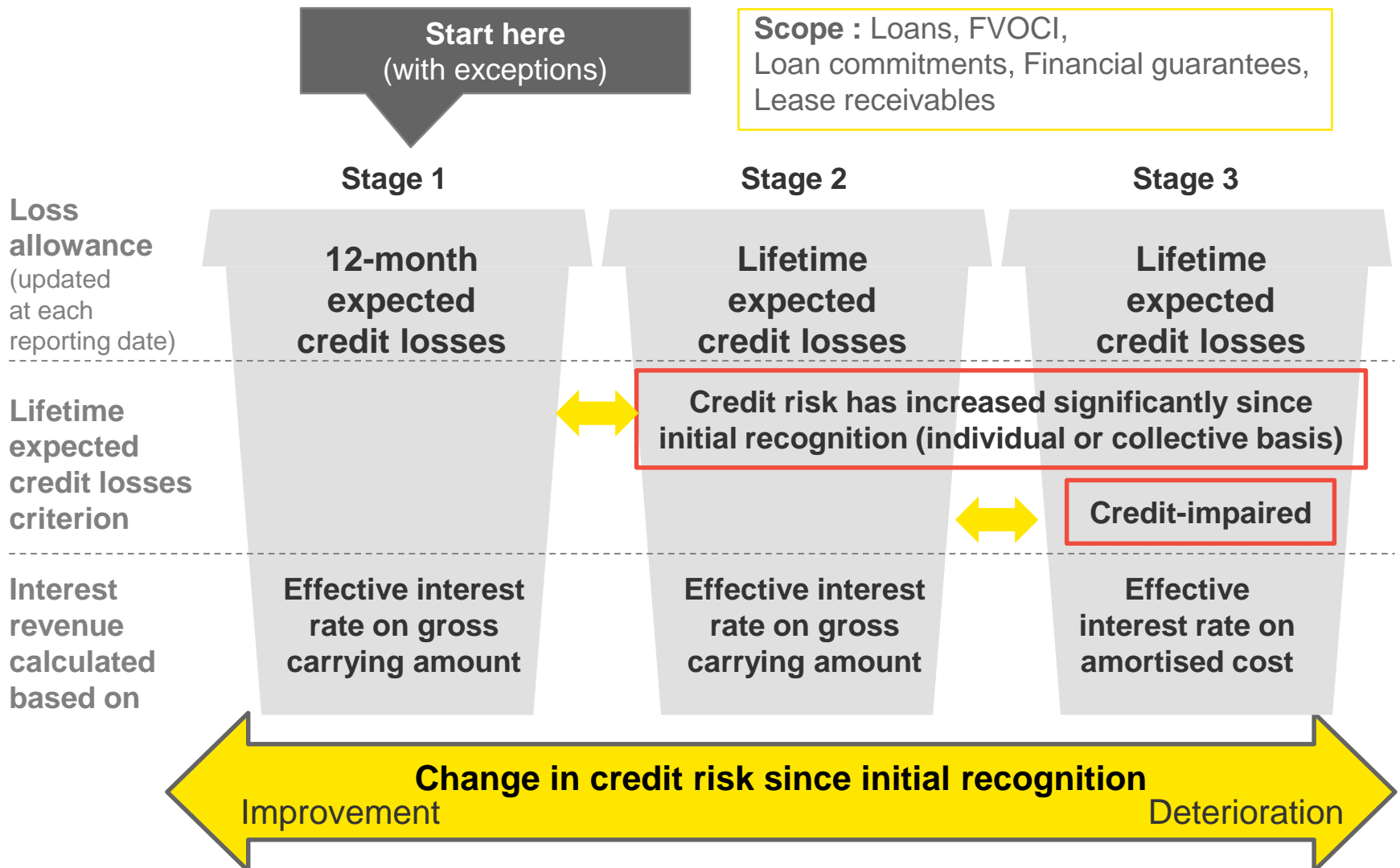
Emerging thoughts

- ▶ Currently, many insurers have a rebuttable presumption that IFRS 17 financial variables will go through P&L
 - ▶ Will mortgages and other fixed income assets not currently recorded at FV (i.e. amortized cost) that back liabilities now be recorded at FVTPL?
 - ▶ If surplus is backed by equities and other instruments at FVTPL, will it subject the income statement to volatility?
 - ▶ If some portfolios are SPPI but with some selling resulting in FVOCI, without the election for FVTPL, will there be accounting mismatch in the P&L? For example, bonds backing insurance liabilities.

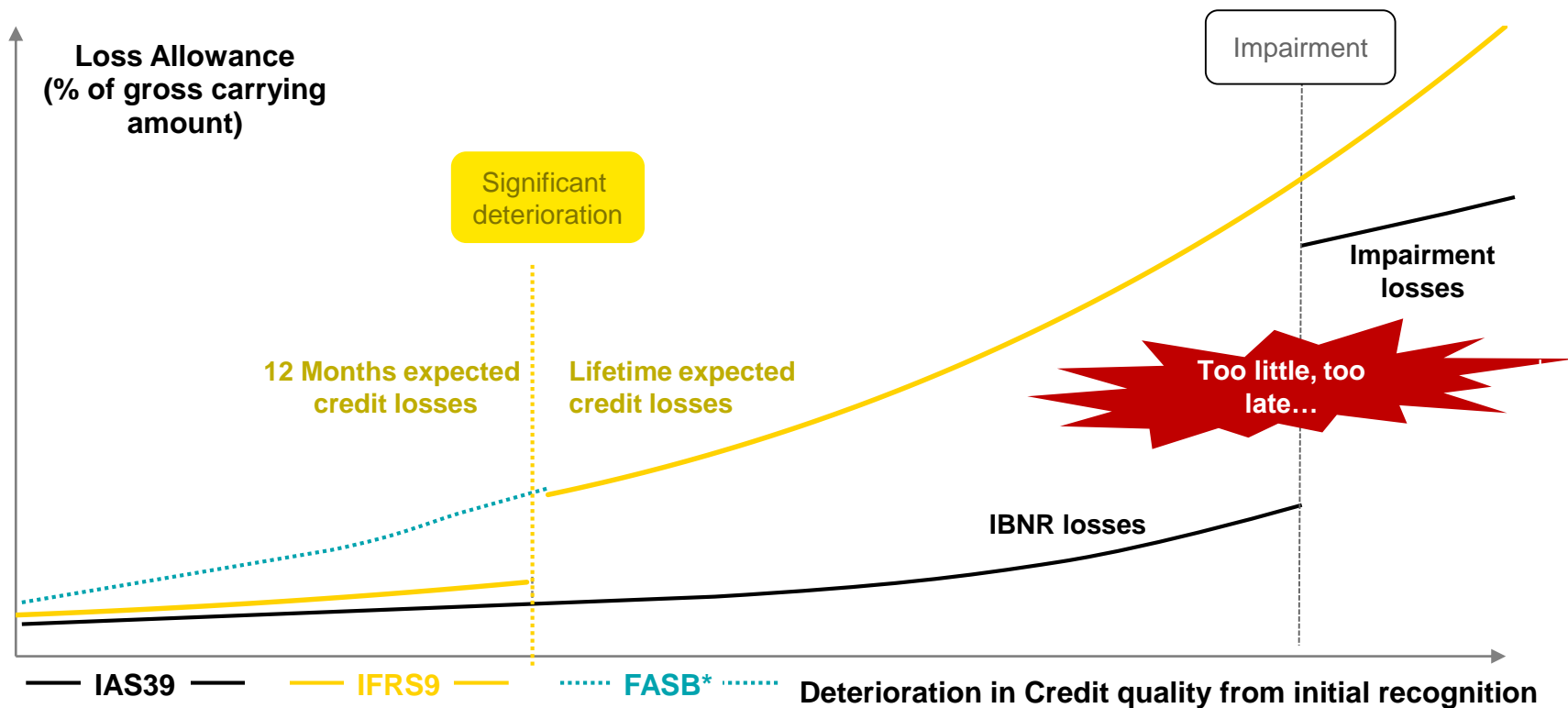
IFRS 9 impairment model



Overview of the new impairment model

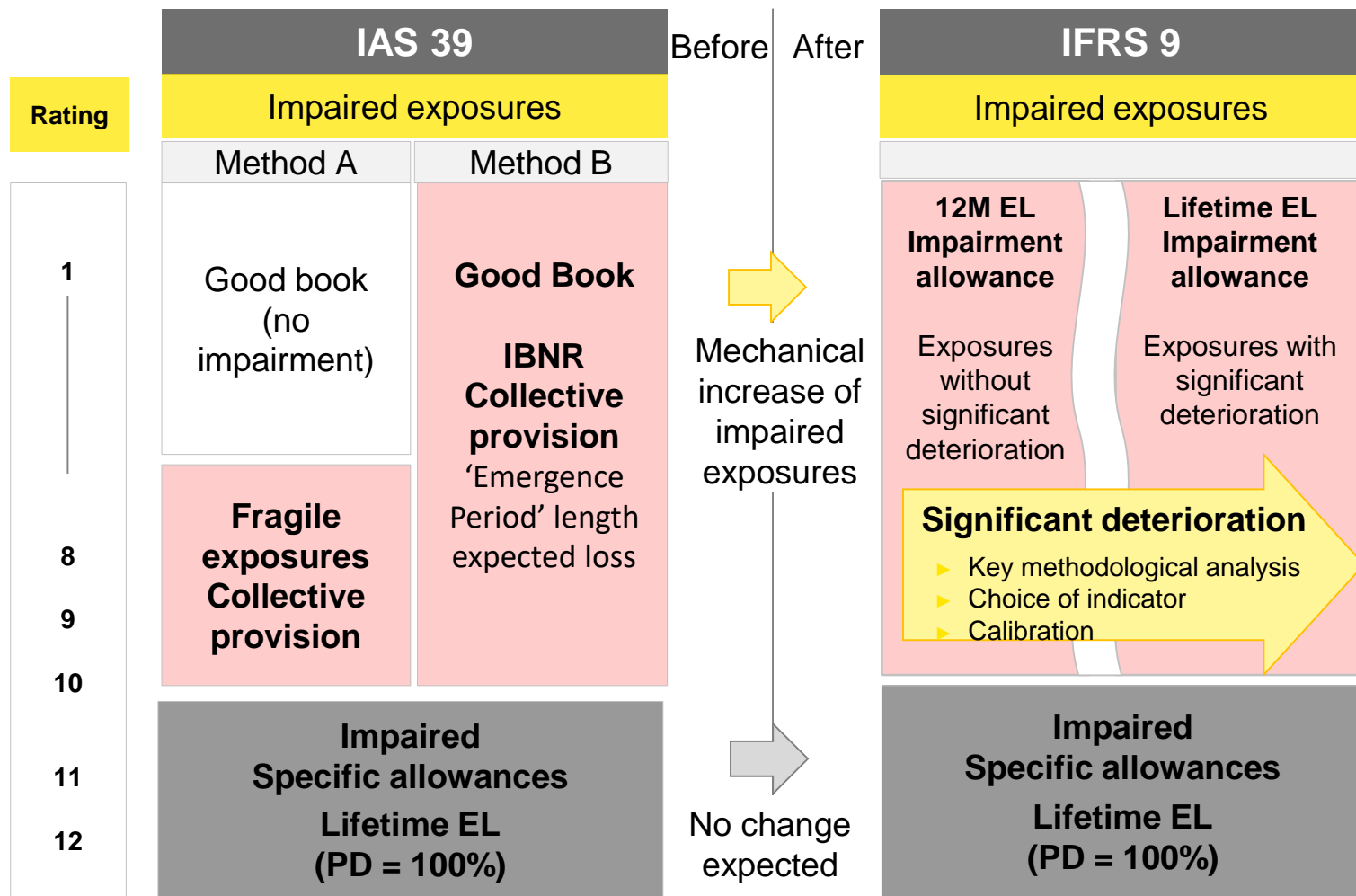


Overview of the new impairment model



Key change from IAS 39 requirements

► Example:



Key Principles

Definition of 12-month and lifetime ECL

Expected credit losses

Present value of all cash shortfalls over the remaining life, discounted at the original effective interest rate (EIR)

- **Probability-weighted outcomes:** possibility that a credit loss occurs, no matter how low the possibility

Lifetime expected credit losses

*Expected credit losses that result from **all possible default events** over the expected life of a financial instrument.*

= [Exposure at Default x Probability of Default x Loss Given Default]

12-month expected credit losses

*The **portion** of lifetime expected credit losses that result from **default events** on a financial instrument that are **possible within the 12 months** after the reporting date.*

'Default'

*Default must be **consistent with risk management***

It shall take into account qualitative indicators (for example, financial covenants)

*There is a **90 days past due rebuttable presumption**.*

Key insights for insurers

- ▶ Only required for assets not measured at FVTPL. If majority of assets back liabilities are at FVTPL from the election to reduce accounting mismatch with IFRS 17 policy choices, establishing an ECL model may only be needed for assets backing surplus not at FVTPL
- ▶ Investment grade bonds may have immaterial ECLs given low probability of default within 12 months
 - ▶ Practical expedient to use movement from investment grade to non-investment grade as a trigger to stage two – reduces burden to staging
- ▶ If mortgages are at FVTPL, it may reduce challenges on implementing ECL models.

Key insights for insurers

- ▶ IFRS 17 excludes financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts. If so, the issuer may elect to apply either:
 - ▶ IFRS 17 or IAS 32 Financial Instruments: Presentation, IFRS 7 Financial instruments: Disclosures and IFRS 9 to the financial guarantee contracts.
 - ▶ The issuer may make election on a contract by contract basis.
 - ▶ The choice for each contract is irrevocable.
 - ▶ This accounting policy election is the same as it was in IFRS 4.

IFRS 9 hedging



Hedge accounting: background and objective

- ▶ IAS 39 hedge accounting was criticised for being complex, rules based and not aligned with risk management activities.
- ▶ Objective of new hedge accounting model in IFRS is to represent in the financial statements the effect of an entity's risk management activities:
 - ▶ More economic hedging strategies should qualify for hedge accounting
 - ▶ Easier for users of financial statements to understand hedging activities and the accounting consequences
- ▶ The new model does not change the types of hedges and the main mechanics of hedge accounting.

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Hedge accounting

Requirement	IAS 39	IFRS 9
Risk component as eligible hedged item	Financial Items	All Items
Hedging of aggregated exposures	X	✓
80%-125% test	✓	X
Retrospective effectiveness testing	✓	X
Quantitative effectiveness test	✓	Depends
Qualitative effectiveness test	X	Depends
Rebalancing of hedge ratio	X	✓
Accounting for 'costs of hedging'	X	✓
Dedesignation (risk management objective unchanged)	✓	X
Fair value option for own use contracts	✓*	✓

*via consequential amendment to IAS 39

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Hedge accounting: Effectiveness assessment

Hedge effectiveness test



1) Economic relationship

- ▶ Between hedged item and hedging instrument
- ▶ Systematic change (opposite direction) in response to same or economically related underlyings



2) Credit risk does not dominate

- ▶ Credit risk does not frustrate economic relationship
- ▶ Credit risk can arise from hedging instrument and hedged item



3) Hedge ratio

- ▶ Consistent with actual ratio used by entity
- ▶ Different ratio only if accounting outcome would be inconsistent with purpose of hedge accounting

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Hedge accounting: Risk components

- ▶ **Criteria for designation of risk components**
 - ▶ Component must be separately identifiable
 - ▶ Component must be reliably measureable
- ▶ **Types of risk components**
 - ▶ Contractually specified components
 - ▶ Some non-contractually specified components
- ▶ **Market structure is relevant for:**
 - ▶ Analysis whether a non-contractually specified component is separately identifiable
 - ▶ The measurement of the risk component

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Hedge accounting: Summary of implementation considerations

- ▶ Quantitative testing may still be required
 - ▶ Challenges with of economic relationship (qualitative and/or quantitative)
 - ▶ Accounting for 'costs of hedging'
- ▶ Relationship between risk components and the total cash flows of an item
- ▶ Costs / benefits of implementation

Thank you

