Institute and Faculty of Actuaries

Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts

Proposed amendments to IFRS 4

IFoA response to the International Accounting Standards Board

8 February 2016

About the Institute and Faculty of Actuaries

The Institute and Faculty of Actuaries is the chartered professional body for actuaries in the United Kingdom. A rigorous examination system is supported by a programme of continuous professional development and a professional code of conduct supports high standards, reflecting the significant role of the Profession in society.

Actuaries' training is founded on mathematical and statistical techniques used in insurance, pension fund management and investment and then builds the management skills associated with the application of these techniques. The training includes the derivation and application of 'mortality tables' used to assess probabilities of death or survival. It also includes the financial mathematics of interest and risk associated with different investment vehicles – from simple deposits through to complex stock market derivatives.

Actuaries provide commercial, financial and prudential advice on the management of a business' assets and liabilities, especially where long term management and planning are critical to the success of any business venture. A majority of actuaries work for insurance companies or pension funds – either as their direct employees or in firms which undertake work on a consultancy basis – but they also advise individuals and offer comment on social and public interest issues. Members of the profession have a statutory role in the supervision of pension funds and life insurance companies as well as a statutory role to provide actuarial opinions for managing agents at Lloyd's.

Institute and Faculty of Actuaries

Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
London
EC4M 6HX

8 February 2016

Dear Mr Hoogervorst

Exposure Draft ED/2015/11: Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts

1. The Institute and Faculty of Actuaries (IFoA) welcomes the opportunity to comment on the Exposure Draft ED/2015/11: Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts (2015 ED). We recognise and welcome the objectives of the International Accounting Standards Board (IASB) in producing this 2015 ED and the desirability of developing global standards in the accounting approach for the assets and liabilities held by insurance companies.

2. The IFoA is the chartered professional body for UK actuaries, with members working in the insurance industry in the UK and abroad, for employers that operate both in the UK and globally. The adoption of any standard in this area will directly affect the day-to-day work of many of our members. As such, the IFoA is committed to working with the IASB to ensure that the standard that emerges from this consultation provides a global standard that faithfully represents the economics of insurance business and, at the same time, is practical to implement.

Addressing the concerns raised

3. The effective date for IFRS 9 Financial Instruments, which will determine the measurement approach for most insurance company assets, is 1 January 2018. The effective date for the new Insurance Contracts Standard ("IFRS 4 Phase II") is not expected to be earlier than 1 January 2020. This misalignment of effective dates will result in two significant sets of changes to the financial reporting of insurance companies over a relatively short period of time.

4. The interaction between asset and liability cash flows is a fundamental feature of insurance business. Asset liability management plays a vital role in risk mitigation, capital management, pricing, business planning and performance reporting for insurance business. Furthermore, for participating business (e.g. with-profits business) and for unit-linked business, policyholder benefits are determined by direct reference to the underlying assets. To reflect these dynamics, it is important that assets and liabilities are measured and presented in the financial statements in a consistent manner. Consequently, it is not desirable from a reporting or business management perspective to have a two-step process, whereby changes to the approach for measuring assets are introduced separately from changes to the approach for the measurement of liabilities. There is also a risk that accounting mismatches may be introduced (depending on the circumstances of particular insurers) which would result in financial statements that are likely to be less relevant to the users of them. We support a temporary solution in the current IFRS 4 Insurance Contracts to address these concerns until the effective date of IFRS 4 Phase II.

The ‘Overlay Approach’

5. IFRS 9 will lead to a new Fair Value measure for some assets, through Profit or Loss. The IASB’s proposed Overlay Approach would allow this change to be reflected in Other Comprehensive Income (not Profit or Loss) for assets relating to contracts within the scope of IFRS 4.

6. The impact of the Overlay Approach will be to remove certain accounting mismatches from Profit or Loss. While we recognise the Overlay Approach as a step in the right direction to address the identified concerns, it does not resolve the underlying misalignment in timeline and potential mismatches that would remain in shareholder equity. We remain concerned about the inconsistent measurement of assets and liabilities in the balance sheet and shareholder equity, which are essential components in the assessment of an insurance company’s financial position. This will be a very significant issue for insurers that have operations in Europe and North America and, as mentioned above, will impact the work of actuaries employed by such organisations.

7. The insurance industry, together with users of its financial reports, will be experiencing a number of significant changes to financial and capital reporting over the coming years. These include the implementation and embedding of Solvency II in Europe, forthcoming global capital standards and the implementation of IFRS 9 and IFRS 4 Phase II. As such, we view it as unhelpful to have the added complexity of separate timelines for the accounting of assets and liabilities which would still exist in the Overlay Approach. We believe that this issue is best resolved by the Temporary Exemption from applying IFRS 9 although we acknowledge that the Overlay Approach may be useful in some circumstances.

‘Temporary Exemption’ from applying IFRS 9

8. The IASB has also proposed in the 2015 ED a ‘Temporary Exemption’ whereby entities whose predominant activity is issuing insurance contracts within the scope of IFRS 4 can qualify for a temporary exemption from applying IFRS 9.

9. We support the principle of the Temporary Exemption as it will address the concerns described above for qualifying insurance entities. However, we understand that only a small population of insurers will qualify for the Temporary Exemption, being those entities where liabilities under the scope of IFRS 4 comprise more than 75% of the total liabilities of the insurer. For example, insurers who write significant volumes of unit-linked contracts may not qualify for the Temporary Exemption. Such contracts are classified as insurance business for solvency purposes but investment contracts under IFRS (either due to there being no significant insurance risk or because the unbundling provisions if IFRS 4 paragraphs 10 to 12 are adopted).

10. It is important that the Temporary Exemption should be applicable to the insurance industry as a whole to ensure comparability and consistency of application. We recognise that further work is required on the definition of the scope of the Temporary Exemption. In particular, it is important to recognise that the assets backing unit-linked investment contracts would be measured at “Fair Value through Profit and Loss” under both IAS 39 and IFRS9. It is inappropriate that the existence of such assets, that would be unaffected by the Temporary Exemption, should affect the accounting for an insurer’s other assets. Furthermore, eligibility criteria based on IFRS 4 liabilities do not take account of the existence of derivative liabilities and external funding liabilities relating to insurance activities.

11. The Temporary Exemption may make it easier to ensure that the gains/losses treated using the Overlay Approach are dealt with properly when IFRS4 Phase II and IFRS 9 are introduced. However, if there was a significant delay in the introduction of IFRS4 Phase II then the Temporary

Exemption could become less justifiable, and there may be a case for setting a clear end date for its application.

Review and assessment of the proposals

12. Given the complexity of the IFRS 4 Phase II proposals, it is essential that the proposals are subject to detailed review and assessment before being finalised to ensure that they are internally consistent and workable when taken together with IFRS 9. Any such review and assessment should consider the balance sheet as a whole, including both assets and liabilities, as well as the income statement. Such a process is important to ensure that the proposals in their entirety, taking account of the interactions between the different components of IFRS 4 Phase II, provide meaningful performance reporting, consistent with how insurance business is managed.

13. We have included in the appendix our responses to the questions raised in the 2015 ED.

14. We trust that these comments will be useful to the IASB in further developing this standard. We reiterate the strong commitment of the IFoA to assist the IASB in this process and during any post-implementation review period. If you have any further questions or would like to meet to discuss the points raised in this response, please contact Matthew Levine, Policy Manager, in the first instance at Matthew.Levine@actuaries.org.uk or 0207 632 1489.

Yours sincerely,

Kamran Foroughi
Chairman, Financial Reporting Group, Institute and Faculty of Actuaries

Appendix – Response to questions raised in the 2015 ED

Question 1 — Addressing the concerns raised

Paragraphs BC9–BC21 describe the following concerns raised by some interested parties about the different effective dates of IFRS 9 and the new insurance contracts Standard:

- **(a) Users of financial statements may find it difficult to understand the additional accounting mismatches and temporary volatility that could arise in profit or loss if IFRS 9 is applied before the new insurance contracts Standard (paragraphs BC10–BC16).**

- **(b) Some entities that issue contracts within the scope of IFRS 4 have expressed concerns about having to apply the classification and measurement requirements in IFRS 9 before the effects of the new insurance contracts Standard can be fully evaluated (paragraph BC17–BC18).**

- **(c) Two sets of major accounting changes in a short period of time could result in significant cost and effort for both preparers and users of financial statements (paragraphs BC19–BC21).**

The proposals in this Exposure Draft are designed to address these concerns.

Do you agree that the IASB should seek to address these concerns? Why or why not?

We agree that the IASB should seek to address these concerns.

The interaction between asset and liability cash flows is a fundamental feature of insurance business. Asset liability management plays a vital role in risk mitigation, capital management, pricing, business planning and performance reporting for insurance business. Furthermore, for participating business (e.g. with-profits business) and for unit-linked business, policyholder benefits are determined by direct reference to the underlying assets. To reflect these dynamics, it is important that assets and liabilities are measured and presented in the financial statements in a consistent manner. Consequently, it is not desirable from a reporting or business management perspective to have a two-step process whereby changes to the approach for measuring assets are introduced separately from changes to the approach for the measurement of liabilities. There is also a risk that accounting mismatches may be introduced (depending on the circumstances of particular insurers) which would result in financial statements that are likely to be less relevant to the users of them. We support a temporary solution in the current IFRS 4 Insurance Contracts to address these concerns until the effective date of IFRS 4 Phase II.

Question 2 — Proposing both an overlay approach and a temporary exemption from applying IFRS 9

The IASB proposes to address the concerns described in paragraphs BC9–BC21 by amending IFRS 4:

(a) to permit entities that issue contracts within the scope of IFRS 4 to reclassify from profit or loss to other comprehensive income some of the income or expenses arising from designated financial assets that:

(i) are measured at fair value through profit or loss in their entirety applying IFRS 9 but

(ii) would not have been so measured applying IAS 39 (the 'overlay approach') (see paragraphs BC24–BC25);

(b) to provide an optional temporary exemption from applying IFRS 9 for entities whose predominant activity is issuing contracts within the scope of IFRS 4 (the 'temporary exemption from applying IFRS 9') (see paragraphs BC26–BC31).

Do you agree that there should be both an overlay approach and a temporary exemption from applying IFRS 9? Why or why not?

If you consider that only one of the proposed amendments is needed, please explain which and why.

While we understand that an Overlay Approach may be beneficial for some organisations, we believe that the Temporary Exemption is preferable for entities whose predominant activity is insurance. Consequently, we agree that there should be both an Overlay Approach and a Temporary Exemption from applying IFRS 9.

Question 3 — The overlay approach

Paragraphs 35A–35F and BC32–BC53 describe the proposed overlay approach.

(a) Paragraphs 35B and BC35–BC43 describe the assets to which the overlay approach can be applied. Do you agree that the assets described (and only those assets) should be eligible for the overlay approach? Why or why not? If not, what do you propose instead and why?

(b) Paragraphs 35C and BC48–BC50 discuss presentation of amounts reclassified from profit or loss to other comprehensive income applying the overlay approach. Do you agree with the proposed approach to presentation? Why or why not? If not, what do you propose instead and why?

(c) Do you have any further comments on the overlay approach?

The impact of the Overlay Approach will be to remove certain accounting mismatches from Profit or Loss. While we recognise the Overlay Approach as a step in the right direction to address the identified concerns, it does not resolve the underlying misalignment in timeline and potential mismatches that would remain in shareholder equity. We remain concerned about the inconsistent measurement of assets and liabilities in the balance sheet and shareholder equity, which are essential components in the assessment of an insurance company's financial position. This will be a very significant issue for insurers that have operations in Europe and North America and will impact the work of actuaries employed by such organisations.

The insurance industry, together with users of its financial reports, will be experiencing a number of significant changes to financial and capital reporting over the coming years with the implementation and embedding of Solvency II in Europe, forthcoming global capital standards and the implementation of IFRS 9 and IFRS 4 Phase II. As such, we view it as unhelpful to have the added complexity of separate timelines for the accounting of assets and liabilities which would still exist in the Overlay Approach. We believe that this issue is best resolved by the Temporary Exemption from applying IFRS 9 although we acknowledge that the Overlay Approach may be useful in some circumstances.

Question 4 — The temporary exemption from applying IFRS 9

As described in paragraphs 20A and BC58–BC60 the Exposure Draft proposes that only entities whose predominant activity is issuing contracts within the scope of IFRS 4 can qualify for the temporary exemption from applying IFRS 9.

(a) Do you agree that eligibility for the temporary exemption from applying IFRS 9 should be based on whether the entity's predominant activity is issuing contracts within the scope of IFRS 4? Why or why not? If not, what do you propose instead and why?

As described in paragraphs 20C and BC62–BC66, the Exposure Draft proposes that an entity would determine whether its predominant activity is issuing contracts within the scope of IFRS 4 by comparing the carrying amount of its liabilities arising from contracts within the scope of IFRS 4 with the total carrying amount of its liabilities (including liabilities arising from contracts within the scope of IFRS 4).

(b) Do you agree that an entity should assess its predominant activity in this way? Why or why not? If you believe predominance should be assessed differently, please describe the approach you would propose and why.

Paragraphs BC55–BC57 explain the IASB's proposal that an entity would assess the predominant activity of the reporting entity as a whole (i.e. assessment at the reporting entity level).

(c) Do you agree with the proposal that an entity would assess its predominant activity at the reporting entity level? Why or why not? If not, what do you propose instead and why?

We support the principle of the Temporary Exemption as it will address the concerns described above for qualifying insurance entities. However, we understand that only a small population of insurers will qualify for the Temporary Exemption, being those entities where liabilities under the scope of IFRS 4 comprise more than 75% of the total liabilities of the insurer. For example, insurers who write significant volumes of unit-linked contracts may not qualify for the Temporary Exemption. Such contracts are classified as insurance business for solvency purposes but investment contracts under IFRS (either due to there being no significant insurance risk or because the unbundling provisions if IFRS 4 paragraphs 10 to 12 are adopted).

It is important that the Temporary Exemption should be applicable to the insurance industry as a whole to ensure comparability and consistency of application. We recognise that further work is required on the definition of the scope of the Temporary Exemption. In particular, it is important to recognise that the assets backing unit-linked investment contracts would be measured at "Fair Value through Profit and Loss" under both IAS 39 and IFRS9. It is inappropriate that the existence of such assets, that would be unaffected by the Temporary Exemption, should affect the accounting for an insurer's other assets. Furthermore, eligibility criteria based on IFRS 4 liabilities do not take account of the existence of derivative liabilities and external funding liabilities relating to insurance activities.

The Temporary Exemption may make it easier to ensure that the gains/losses treated using the Overlay Approach are dealt with properly when IFRS4 Phase II and IFRS 9 are introduced. However, if there was a significant delay in the introduction of IFRS4 Phase II then the Temporary Exemption could become less justifiable, and there may be a case for setting a clear end date for its application.

Question 5 — Should the overlay approach and the temporary exemption from applying IFRS 9 be optional?

As explained in paragraphs BC78–BC81, the Exposure Draft proposes that both the overlay approach and the temporary exemption from applying IFRS 9 would be optional for entities that qualify. Consistently with this approach, paragraphs BC45 and BC76 explain that an entity would be permitted to stop applying those approaches before the new insurance contracts Standard is applied.

(a) Do you agree with the proposal that the overlay approach and the temporary exemption from applying IFRS 9 should be optional? Why or why not?

(b) Do you agree with the proposal to allow entities to stop applying the overlay approach or the temporary exemption from applying IFRS 9 from the beginning of any annual reporting period before the new insurance contracts Standards is applied? Why or why not?

(a) We agree with the proposal that the overlay approach and the temporary exemption from applying IFRS 9 should be optional as entities should always be able to adopt a new Standard early if it believes that this will result in improved performance reporting.

(b) We agree with the proposal to allow entities to stop applying the overlay approach or the temporary exemption from applying IFRS 9 from the beginning of any annual reporting period before the new insurance contracts Standards is applied.

Question 6 — Expiry date for the temporary exemption from applying IFRS 9

Paragraphs 20A and BC77 propose that the temporary exemption from applying IFRS 9 should expire at the start of annual reporting periods beginning on or after 1 January 2021.

Do you agree that the temporary exemption should have an expiry date? Why or why not?

Do you agree with the proposed expiry date of annual reporting periods beginning on or after 1 January 2021? If not, what expiry date would you propose and why?

Given the complexity of the IFRS 4 Phase II proposals, it is essential that the proposals are subject to detailed review and assessment before being finalised to ensure that they are internally consistent and workable when taken together with IFRS 9. Any such review and assessment should consider the balance sheet as a whole, including both assets and liabilities, as well as the income statement. Such a process is important to ensure that the proposals in their entirety, taking account of the interactions between the different components of IFRS 4 Phase II, provide meaningful performance reporting, consistent with how insurance business is managed.

We believe that the Temporary Exemption should not expire before this review and assessment is complete and the new Insurance Contracts Standard is finalised.