IFRS 9: Manageable Impact for Insurers

Working towards IFRS 17 Implementation Remains Key

Special Report

The International Accounting Standards Board (IASB) introduced IFRS 9: Financial Instruments in July 2014, with an effective date of 1 January 2018. The new standard replaces the previous standard, IAS 39: Financial Instruments, and introduces key changes in a shift towards measuring assets on a fair-value basis.

Manageable for Insurers: Fitch Ratings expects a moderate increase in volatility of investment income for insurers as more financial assets will be valued on a fair-value basis. However, we expect the overall impact on reported financial performance to be manageable as the bulk of insurers' investments remain in plain-vanilla, fixed-income-type securities held for the long term.

Life Insurers Likely More Affected: IFRS 9 implementation may have a bigger impact on the financial performance of life insurers than non-life ones due to life insurers' increasing holdings of non-fixed-income investment assets, and their long-term business model. The APAC insurance industry has several features that may accentuate this relative difference. The classification of financial assets under IFRS 9 should also be considered in tandem with the upcoming IFRS 17, and will be important for life insurers in minimising accounting mismatches.

Impact on Investment Portfolio: In general, the impact of the new standard is likely to be greater on insurers that previously held amortised-cost and available-for-sale (AFS) assets. Debt instruments that are plain-vanilla investments (based on a Solely Payments of Principal and Interests test) and substantially held over a long term basis (based on Business Model test) may be classified on an amortised cost or fair value through other comprehensive income (FVOCI) basis.

The new standard also replaces incurred-based credit losses with an expected credit-loss model. The latter is likely to increase credit loss volatility based on macroeconomic forecasting. This, coupled with increased fair value accounting, could increase overall earnings volatility.

Additional Consideration for Equities: Insurers will reassess business models in tandem with IFRS 17 considerations, and could separate a portion of equity currently reported as AFS to be classified on a fair value through profit and loss (FVPL) basis while keeping others on a FVOCI basis. They may also opt to classify strategic holdings under FVOCI. This election will have consequences for their financial performance.

Transitional Arrangements: The IASB has introduced transitional arrangements via the overlay or deferral approaches to help insurers cope with the difference in timeline, and the accounting mismatches that arise, between the implementation of IFRS 9 and IFRS 17, which relates to insurance contracts, in 2021. While the deferral approach is more commonly preferred by insurers, there are pros and cons to both options, as we discuss in the report.

Greater Challenge from IFRS 17: The new insurance accounting standard, which is due to be implemented in 2021, is likely to pose a greater challenge to insurers as it aims for consistent accounting for all companies' insurance contracts globally. Nevertheless, the interactions between IFRS 9 and IFRS 17, which mainly affect insurers' assets and liabilities on the balance sheet, respectively, will affect their financial reporting.

Related Research

IFRS 17: Insurance Accounting Overhaul (December 2017)

Analysts

Christopher Han
+65 6796 7224
christopher.han@fitchratings.com

Jeffrey Liew
+852 2263 9939
jeffrey.liew@fitchratings.com

Harish Gohil
+44 20 3530 1257
Harish.gohil@fitchratings.com

Kazim Razvi
+44 20 3530 1220
Kazim.razvi@fitchratings.com

IFRS 9: An Overview

A New Standard for Financial Instruments

The IASB introduced *IFRS 9: Financial Instruments* in July 2014, with an effective date of 1 January 2018. The new standard replaces the previous standard, *IAS 39: Financial Instruments*, and marks a shift towards measuring financial assets and liabilities using fair value – partly in response to perceived areas of deficiencies in the previous accounting that were exposed during the 2008 global financial crisis.

In APAC, most IFRS-compliant countries have implemented the new standard in accordance with the proposed effective date. A few countries however, have postponed the implementation by a year or two (see *Appendix*). Countries that report on a local GAAP basis remain largely unaffected by this.

Where insurers are concerned, there are three major changes that IFRS9 introduces:

- **Classification and measurement**: Three classification categories are prescribed.

Classifications under IFRS 9	Measurement Method
Fair Value through Profit and Loss (FVPL)	Asset is measured at fair value. Changes in fair value are recognised in profit and loss as they arise.
Fair Value through Other Comprehensive Income (FVOCI)	Asset is measured at fair value. Changes in fair value are recognised initially in other comprehensive income, and transferred to profit and loss upon de-recognition. Impairment loss and interest income (dividend income for equities) are recognised in profit and loss.
Amortised Cost	Asset is measured at amount recognised upon initial recognition, less principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount, adjusted for any loss allowance.

Source: Fitch

  Under the new standard, financial assets are now measured at fair value as a starting point, and gains or losses are treated as FVPL. The assets can only be recognised at amortised cost or FVOCI if the respective criteria are fulfilled (see *Appendix* for flow-chart and description on IFRS 9 Classification and Measurement):

  - Business Model Test: the business model is to hold financial assets to collect contractual cash flows (amortised cost), or to both collect contractual cash flows and to potentially sell the assets for profit (FVOCI);
  - Solely Payments of Principal and Interest (SPPI) Test: these cash flows represent solely payments of principal and interest (amortised cost)

- **Expected credit losses**: Entities are now required to recognise impairment of loans, receivables and debt instruments on an expected loss model, and any changes in impairment allowance will flow through to the income statement. The expected credit-loss model may create more volatility in earnings as it is based on macroeconomic forecasts. The previous standard was less forward-looking, as this was done on an incurred basis, and a loss is recognised only when a loss event happened, and there is objective evidence of impairment.

- **Impairment for equity instruments irrelevant**: Equity instruments are now measured at fair value, and therefore there is no longer a need for impairment, as any gain or loss will be taken straight to the income statement. Under the previous standard, fair value gains or losses held in equity may be "recycled" to the income statement upon impairment, thus

Related Criteria

Insurance Rating Criteria (November 2017)

allowing a company to delay recognition of asset impairments, and preserve profitability prior to the impairment year.

These changes better reflect the intrinsic fair values of financial assets at a particular point in time. However, they may also introduce greater volatility to the financial performance of companies as more gains and losses are being brought to the income statement. Insurers have a large proportion of their assets in financial instruments, and the FVPL classification would be the least favoured among the three.

Nevertheless, IFRS 9 also permits some exemptions for insurers, such as allowing a portion of financial assets that is required to be recognised at amortised cost to be recognised at fair value to avoid accounting mismatches.

Implications for Insurers

Different Accounting Principles, Similar Conclusion

The new accounting standard is likely to have the most impact on the investment portfolios of insurers. Based on the criteria for classification and measurement described above, this means that only plain–vanilla, fixed-income instruments are eligible for the amortised cost classification – all other financial assets will either fall under FVPL or FVOCI.

While the classification categories are similar to the classifications under IAS 39[1], the process and principle through which this is determined is different – under IFRS 9, the basis on which assets are measured determines their classification, whereas the reverse is true under the previous standard. Therefore, insurance companies will have to re-assess their business models through the lens of the new standard, to determine if there are any changes to treatment of their financial assets.

Fixed-Income Instruments

At the onset, we expect fixed-income securities, loans and other similar assets with fixed payments held by insurers to be eligible for classification as FVOCI or amortised cost, and therefore the accounting treatment would be similar to what it was under the previous standard.

Nevertheless, the treatment for these investments will depend on the purpose for which they are held (eg to back policy liabilities or capital surplus), and the investment strategies that underpin the business models (eg intention to switch bonds for yield pick-ups, buying and selling of bonds to manage duration). Specifically, the FVOCI classification permits sales of investments in more limited circumstances, such as credit concentration, whereas more frequent and opportunistic trading of instruments would likely warrant the FVPL classification.

The FVOCI classification under IFRS 9 is solely determined by the business model; whereas IAS 39's AFS classification was previously more liberally applied. As a result, some of these assets that were previously held as AFS, may not be eligible to be treated using amortised cost or FVOCI, and hence may have to be measured on an FVPL basis.

Equities

We expect a proportion of equities that was previously treated as AFS to now be classified as FVPL. Any changes to the fair value of these equity instruments will be reflected as a gain or loss in the income statement. This is unlike previously where any gain or loss was accounted for under Other Comprehensive Income (OCI).

This treatment for equities adds to the volatility of investment income; however, it is worth noting that since the gains and losses are brought 'onto' the income statement under IFRS 9,

[1] Previously under IAS 39, financial instruments were classified into held for trading (HFT), available for sale (AFS) or held to maturity (HTM) categories, generally according to their basis of classification by type of financial instrument

earnings will better reflect the underlying changes in value of the investment assets at the particular point in time, and provide a better representation of any fluctuations in economic value of the assets under such classification.

Some insurers may consider revising their investment strategy to mitigate this. For example, they may focus more on higher-yielding blue-chip equities with stable capital movements, or substitute equities with alternative financial instruments, such as unit trusts and exchange-traded funds, which offer diversification with comparably lower risks and volatility. Insurers that are generally more exposed to equities (eg some Chinese and Japanese life insurers) may have to manage this situation more closely.

Other Considerations

FVOCI Classification for Equities

Under IFRS 9, insurers may reassess business models together with IFRS 17 considerations, and could separate a portion of equity currently reported as AFS to remain classified under FVOCI. However, unlike the AFS classification of the previous standard, any changes in fair value may never be reclassified to profit and loss upon de-recognition once this election is made upon initial recognition of the asset.

This may also apply to insurers with strategic holdings of affiliated companies (for example, a life insurance company owning a controlling stake in a non-life subsidiary). Critically, this designation is also irrevocable and would have long-term implications on insurers' financial statements, so they would have to consider the strategic importance of such assets, including whether they intend to hold the investments for the long term or if a potential spin-off is a realistic possibility in the future.

Loss Provisioning for Loan Portfolio

In some countries, insurers also hold loan assets as part of their investment portfolios. Generally speaking, their loan portfolios have been historically well managed, with non-performing asset ratios and loan defaults at low levels. Notwithstanding this, the shift to an expected loss model from an incurred loss basis may result in some one-off consequences on insurers' financial performance in the form of higher loss provision allowances. However, given the low-risk books that most insurers maintain, we expect them to be able to take the effects in their stride, and absorb any negative pressure on investment income.

Assessing the Impact

Keeping the above in mind, we expect investment income to be more volatile in the future as the amount of financial assets that will be measured using FVPL will increase. However, as the bulk of insurers' investments remain in traditional fixed-income-type securities, we expect the impact on insurers' financials to be manageable. Fundamentally, nothing has changed in terms of the intrinsic value of the assets; rather it is the format and underlying principles of financial reporting that have evolved towards a more fair-value approach.

In addition, transition measures were introduced to the current accounting standard for insurance contracts (discussed below), and offer insurers the option to smooth out any accounting mismatches in the years to 2021 when IFRS 17 – the new accounting standard for insurance contracts – is implemented, and at the same time provide investors and users of financial reports alike a preview of what is to come in 2021 through additional disclosures.

Thinking ahead, potential accounting mismatches could arise as IFRS 9 and IFRS 17 adopt different basis for classification into profit and loss or OCI. The former is driven by the characteristics of the underlying investment, while the latter is driven by decisions made on a portfolio basis. Fitch recognises that this would result in potential accounting mismatches, and would look to account for this in our analysis, where possible.

Life Insurers versus Non-Life Insurers

The impact on the income statements of life insurers is likely to be greater, due to their higher exposure to non-fixed-income investments compared with non-life insurers. In APAC, life insurers in many developed markets continue to shift their portfolios towards equities and alternative investments in search of higher yields amid a low interest-rate environment, and the introduction of IFRS 9 is likely to exacerbate any investment income volatility in the future.

In addition, the long-term nature of their business models may also mean that life insurers are not able to hold all fixed-income assets to maturity, and consequently are forced to measure some bonds on an FVPL basis as well, which would add to the volatility. This is especially so in the developing markets of APAC, where longer-dated bonds are generally more limited in supply, and rolling over of bonds is common.

Under the upcoming IFRS 17, insurance companies will have to value their contract liabilities based on discount rates that are based on prevailing market yields. To this end, it will also be more challenging for life insurers, which underwrite longer term contracts compared with their non-life counterparts, to select accounting policies under both IFRS 17 and IFRS 9 in order to minimise accounting mismatches and volatility in financial reporting. From a ratings perspective however, the new standard will have no immediate impact on an insurer's credit profile as the economic substance of the insurer will not be directly affected by the changes, and hence is unlikely to trigger any immediate rating changes (see our *IFRS 17: Insurance Accounting Overhaul* report for a more detailed discussion).

Non-life insurers have simpler, lower-yielding and highly liquid investment portfolios in short-term instruments to match their short-tail liabilities. Therefore, the impact of IFRS 9 on their financial statements is likely to be minimal, as asset-liability management is less crucial.

Transitional Arrangement for Insurers

To the extent that insurers currently measure contract liabilities on an amortised cost basis, the increased fluctuation in asset values under IFRS 9 may lead to more severe accounting mismatches than under IAS 39 in the interim, because there is no corresponding change on the liabilities side. These mismatches would therefore reduce the comparability with financial statements from previous years.

To address this, IASB has allowed two approaches to address the effects on insurance entities that have chosen the option to delay the implementation of IFRS 9:

- **Overlay Approach:** differences in profits or losses arising from the introduction of IFRS 9, relative to IAS 39, may be recognised in Other Comprehensive Income, and therefore reduce any incremental volatility in the income statement.
- **Deferral Approach:** the application of IFRS 9 is deferred until 2021, i.e. the effective date of IFRS 17.

Pros and Cons: Deferral Approach the Preferred Option

While the overlay approach may provide temporary relief from the volatility in profit and loss and help transition towards full implementation, companies who choose to adopt this method would have to undergo two rounds of major accounting standard change, and abide by both IFRS 9 and IAS 39 simultaneously up to 2021.

The deferral approach is the more common approach adopted by insurers, and may be a more efficient option as all necessary transitions are done in 2021. However, the disclosure requirements are more onerous, and may put a strain on operational costs, especially if substantial efforts are required for the additional reporting and disclosure.

Notwithstanding the above, insurers that are part of a larger non-insurance group or conglomerate (i.e. activities that are not predominantly from insurance) are unlikely to benefit from this, and therefore have to start implementing IFRS 9 with effect from 2018.

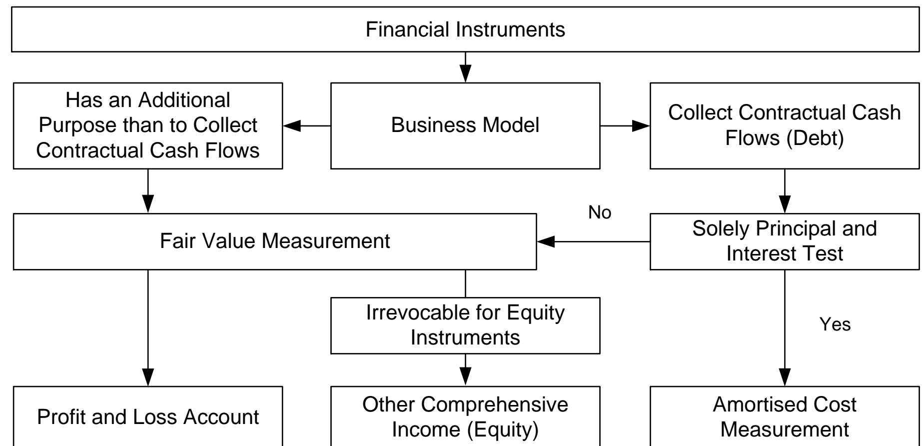
IFRS 17: Eye on the Greater Challenge

For insurers, the coming few years represent a significant challenge to transition to a new accounting era of increased transparency, granularity and comparability. In line with a concerted effort to better reflect the impact from changes in the economic environment on book values, IFRS 9 should be viewed in tandem with the imminent introduction of IFRS 17, which is expected to have a more significant impact on insurers, both operationally and financially.

Investment assets and insurance contract liabilities are often managed together in the business model of insurers. Consequently, the interactions of the two new reporting standards may potentially have effects on their financials, and insurance companies will have to consider carefully their implications.

Appendix

IFRS 9 - Classification and Measurement



Source: Fitch

Implementation Timeline

	2018	2019	2020	2021
IFRS 9	effective 1 Jan 2018 →			
IFRS 4 Amendment[a]	Concurrent with IFRS 9 effective date →			
IFRS 17				effective 1 Jan 2021

[a] Amendment made to the current accounting standard (IFRS 4) to provide insurers with transitional arrangements to address issues arising from the different implementation dates of IFRS 9 and IFRS 17, via the deferral approach or overlay approach
Source: IASB, Fitch

IFRS 9 Adoption Status by Selected APAC Countries

Status	Countries
Effective in 2018	Australia China Hong Kong India Malaysia New Zealand Philippines Singapore South Korea Sri Lanka Taiwan
Implementing in 2019	Thailand
Implementing in 2020	Indonesia
Not Adopting[a]	Japan Vietnam

[a] Japan and Vietnam both report on local GAAP
Source: Fitch

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: HTTPS://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2018 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001.