STAFF PAPER

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Project	Insurance contracts		
Paper topic	Use of IFRS 4 *Insurance Contracts* to address the consequences of applying IFRS 9 *Financial Instruments* before the new insurance contracts Standard		

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This paper has been prepared for discussion at a public meeting of the IASB and does not represent the views of the IASB or any individual member of the IASB. Comments on the application of IFRSs do not purport to set out acceptable or unacceptable application of IFRSs. Technical decisions are made in public and reported in IASB *Update*.

Purpose of this paper

1. This paper considers how entities would apply IFRS 9 *Financial Instruments* in conjunction with existing IFRS 4 *Insurance Contracts*. This paper is for information only. It focuses on the accounting implication and does not discuss the staff's view on whether the IASB should modify IFRS 4.

2. This paper first describes the interaction between existing IFRS 4 and IAS 39 *Financial Instruments: Recognition and Measurement*. It considers the potential accounting mismatches that could arise because of differences in the measurement bases of financial assets under IAS 39 and insurance liabilities under existing IFRS 4 (paragraphs 5-6).

3. This paper then considers:

   (a) The effect of the application of IFRS 9 in conjunction with existing IFRS 4 (paragraphs 7-9);

   (b) The effect of application of the new insurance contracts Standard in conjunction with IFRS 9 and, in particular, the implications of the variable fee approach (paragraphs 10-14).

4. Finally, this paper:

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(a) describes the methods for reducing accounting mismatches that are available in existing IFRS 4 (paragraphs 15-24).

(b) outlines potential amendments to IFRS 4 that could be considered to address the consequences of the effective date of IFRS 9 being before the effective date of the new insurance contracts Standard (paragraphs 25-30).

Potential mismatches arising under existing IFRS 4 and IAS 39

5. Existing IFRS 4 allows a wide range of accounting policies for insurance contract liabilities. The financial assets that an entity holds to back insurance contracts liabilities are accounted for in accordance with IAS 39. The staff understand that many entities measure insurance liabilities on a cost basis, and such entities measure most financial assets that back those liabilities using the amortised cost or available-for-sale (AFS) categories in IAS 39. However, these entities also have financial assets measured using the fair value through profit or loss (FVPL) category in IAS 39, for example derivatives.

6. As a result, under existing accounting requirements, accounting mismatches could arise between insurance contract liabilities measured on a cost basis and the financial assets the entity holds to back those insurance contract liabilities as follows:

   (a) if the assets are measured at amortised cost, there would be little accounting mismatch in profit or loss or equity because both the insurance contract liability and the assets would be measured on a cost-basis.

   (b) if the assets are classified as AFS, there would be little accounting mismatch in profit or loss because the liability would be measured on a cost basis and the entity would report all changes in the fair values of the assets (other than those attributable to impairment) in other comprehensive income (OCI). However, there would be an accounting mismatch in equity because changes in fair value of the assets would be reported in OCI[1].

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[1] Accounting mismatches can arise in profit or loss when gains or losses on financial assets classified as AFS or measured at amortised cost are realised and recognised in profit or loss (unless there is a corresponding effect on the measurement of insurance contracts liabilities).

(c) if the assets are measured at FVPL, there would be an accounting mismatches in profit or loss because the liability would be measured on a cost basis and the entity would report all changes in the fair value of the assets in profit or loss. There would also be an accounting mismatch in equity.

Application of IFRS 9

7. The staff note that application of IFRS 9 does not affect the *type* of accounting mismatch that could arise compared to IAS 39. This is because both IAS 39 and IFRS 9 are mixed measurement attribute models. The methods available in IFRS 4 to reduce those mismatches (discussed in paragraphs 15-24) would continue to be available and relevant after IFRS 9 is applied. However, the application of IFRS 9 could change the extent to which such mismatches arise, and therefore the extent of remaining mismatches compared to those under IAS 39 and IFRS 4.

8. Some stakeholders have expressed particular concerns about the effect of the following changes:

   (a) Some debt instruments that are classified as AFS under IAS 39 would not qualify for measurement at fair value through other comprehensive income (FVOCI) under IFRS 9 because they would not meet the contractual cash flow characteristics test.

   (b) An entity may find it unattractive to classify equity investments classified as AFS under IAS 39 at FVOCI in accordance with IFRS 9, because gains and losses on those equity investments would not be recycled to profit or loss. Accordingly the entity might choose to classify such equity investments at FVPL under IFRS 9.

9. The staff note that while stakeholders are primarily concerned about potential increases in mismatches arising from the classification of assets at FVPL that were not previously classified at FVPL, there are also situations in which accounting mismatches could be reduced when IFRS 9 is applied, for example:

(a) Some bonds that would have previously been classified as AFS because they are traded in active markets could qualify for amortised cost measurement under IFRS 9; or

(b) An entity could revoke the fair value option on initial application of IFRS 9, which would reduce the number of financial assets measured at FVPL.

Application of the new insurance contracts Standard

10. On application of the new insurance contracts Standard, insurance contract liabilities would be measured on the basis of current market assumptions. The Board is yet to decide whether entities should be permitted to choose an accounting policy, in respect of contracts with participation features, that presents all changes in the value of an insurance contract in profit or loss, or to disaggregate those changes into an amount included in OCI and an amount included in profit or loss.

11. If the Board decides to give entities such a choice, the application of the new insurance contracts Standard would reduce accounting mismatches in profit or loss and in equity that would otherwise arise between insurance contract liabilities measured on a cost basis, and assets that are measured at FVPL or FVOCI.

Implications of the variable fee approach described in paper 2B

12. In Agenda Paper 2B *Variable fee approach for direct participation contracts*, the staff recommends that, for direct participation contracts, an entity should recognise changes in the variable fee that is equivalent to the entity's share of underlying items as an adjustment to the contractual service margin.

13. When an entity holds underlying items classified at FVPL, an entity applying both IFRS 9 and the proposed variable fee approach would recognise:

    (a) changes in the fair value of the underlying items in profit or loss; and

    (b) a corresponding change to the liability in profit and loss for both the policyholders' and the entity's share of those underlying items.

14. Some stakeholders are concerned about the temporary volatility from the entity's share of underlying items that may arise in profit or loss if IFRS 9 is applied before

the new insurance contracts Standard, and the application of IFRS 9 results in a change in classification of assets from AFS or amortised cost to FVPL. Applying IAS 39, changes in the value of the entity's share of underlying items is reported in OCI (if AFS) or not remeasured (if amortised cost). When the new insurance contracts Standard is applied, such volatility would be recognised as an adjustment to the contractual service margin on application of the variable fee approach, if required by the new insurance contracts Standard.

Methods available in existing IFRS 4 for reducing accounting mismatches

15. Insurers have the ability to reduce accounting mismatches described in paragraph 6, using one or both of the following options available in existing IFRS 4:

    (a) shadow accounting (see paragraphs 17-21); or

    (b) use of current market interest rates (see paragraphs 22-24).

16. In addition, the staff note that IFRS 4 permits an entity to change its accounting policies for insurance contracts if the change makes the financial statements more relevant to the economic decision-making needs of users. This means that an entity applying IFRS 4 could already change its accounting policies to reduce accounting mismatches, including ways that would be consistent with the application of the new insurance contracts Standard. However, some question whether entities have the practical ability to apply the new insurance contracts Standard early, or consider that a significant change in accounting policy that would be consistent with, but not the same as, the new Standard, would impose costs that would not be justified for benefits that would apply for only a few years until the new Standard is effective.

Shadow accounting

17. Shadow accounting is a way of adjusting aggregate insurance liabilities to reduce accounting mismatches that can arise when unrealised gains and losses on assets held by the entity are recognised in the financial statements but corresponding changes in the measurement of the insurance contract liabilities are not.

18. Paragraph 30 of IFRS 4 permits the use of a form of shadow accounting[2] as follows:

> **Shadow accounting**
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> In some accounting models, realised gains or losses on an insurer's assets have a direct effect on the measurement of some or all of (a) its insurance liabilities, (b) related deferred acquisition costs and (c) related intangible assets, such as those described in paragraphs 31 and 32[3]. An insurer is permitted, but not required, to change its accounting policies so that a recognised but unrealised gain or loss on an asset affects those measurements in the same way that a realised gain or loss does. The related adjustment to the insurance liability (or deferred acquisition costs or intangible assets) shall be recognised in other comprehensive income if, and only if, the unrealised gains or losses are recognised in other comprehensive income. This practice is sometimes described as 'shadow accounting'.

19. Recognised unrealised gains and losses on financial assets appear to be the most significant cause of shadow adjustments, although other timing differences can also lead to these adjustments, eg, gains and losses on investment properties measured at fair value, differences in the impairment of assets, etc. Further details about shadow accounting, including an example of how shadow accounting could be used to reduce an accounting mismatch, are set out in Appendix A.

20. IFRS 4 limits shadow accounting so that it applies only when there is a direct relationship between the realisation of gains and losses on an insurer's assets and the measurement of its insurance liabilities and related assets. Therefore shadow accounting would not apply:

    (a) for life contracts without participation features or non-life contracts or contracts with participation features where there is an indirect relationship between realised gains and losses on specified assets and the measurement of insurance liabilities. The staff understand that practice may vary amongst insurers, and that judgement is required, when assessing whether

[2] Shadow accounting was originally developed by the FASB and SEC staffs to answer questions about the application of FASB Statement 115.

[3] Paragraphs 31 and 32 of IFRS 4 refer to an expanded presentation that splits the fair value of insurance contracts acquired in a business combination or portfolio transfer into (a) a liability measured in accordance with the insurer's accounting policies and; (b) an intangible asset representing the difference between the fair value of the contracts acquired and (a).

the relationship between specified asset returns and liability measurement is sufficiently direct. For example, some question whether there is a direct relationship in contracts where there are specified underlying assets but there is significant discretion over the proportion of realised gains passed on to policyholders.

(b) for the shareholder’s share of unrealised gains and losses. Furthermore, the staff understand that practice varies on how to quantify the policyholder share of unrealised gains and losses. For example, some entities limit their estimate of the policyholder’s share to a minimum amount based on contractual or legal requirements whereas others include amounts in excess of the minimum to reflect their best estimates of the amounts they expect to pay.

21. Furthermore, limitations on the use of shadow accounting adjustments to offset unrealised gains and losses arise in practice for the following reasons:

(a) Limitations on the extent to which shadow accounting is applied to unrealised losses. In principle, shadow accounting would apply equally to unrealised losses on the entity’s assets, resulting in the recognition of a deferred policyholder asset that the entity expects to be able to recover by reducing amounts to be paid to policyholders. However, the staff understand that practice varies in the recognition of deferred policyholder assets where there is uncertainty about the extent to which insurers can recover unrealised losses from policyholders.

(b) in some situations, there may be regulatory restrictions on the form of shadow accounting used.

Use of current market interest rates

22. Paragraph 24 of IFRS 4 permits insurers to introduce the use of current market interest rates in the measurement of insurance liabilities.

An insurer is permitted, but not required, to change its accounting policies so that it remeasures designated insurance liabilities[4] to reflect current market interest rates and recognises changes in those liabilities in profit or loss. At that time, it may also introduce accounting policies that require other current estimates and assumptions for the designated liabilities. The election in this paragraph permits an insurer to change its accounting policies for designated liabilities, without applying those policies consistently to all similar liabilities as IAS 8 would otherwise require. If an insurer designates liabilities for this election, it shall continue to apply current market interest rates (and, if applicable, the other current estimates and assumptions) consistently in all periods to all liabilities until they are extinguished.

23. The introduction of current market interest rates in the measurement of part or all insurance liabilities (and deferred acquisition costs and intangible assets) may make the resulting liabilities more responsive to changes in market conditions that also affect the fair value of the insurer's assets. As a result, the use of current interest rates may reduce accounting mismatches in equity when assets are classified as AFS (but would create mismatches in profit or loss), and reduce accounting mismatches in equity and in profit or loss when assets are measured at FVPL, for example if the entity uses the fair value option in IAS 39.

24. However, measuring a portfolio of insurance contracts using current interest rates would not fully eliminate accounting mismatches when the assets the entity holds are measured using a mix of FVPL, FVOCI and amortised cost. Such accounting mismatches could be reduced if entities were to apply the fair value option for financial assets in IFRS 9. The staff note that entities would later be able to revoke such uses of the fair value option when the new insurance contracts Standard is applied if they are no longer needed to address accounting mismatches.

[4] Insurance liabilities in this context include related deferred acquisition costs and related intangible assets.

Potential amendments to IFRS 4

25. The staff think it likely that most entities would be willing to accept and explain accounting mismatches that arise in equity, given that such accounting mismatches already occur today. However, entities express concerns about increases in accounting mismatches that would arise in profit or loss after IFRS 9 is applied and before the new insurance contracts Standard is applied. Furthermore, some entities are concerned that, when IFRS 9 is applied before the insurance contracts Standard is applied, the entity's interest in financial assets held in respect of direct participating contracts would be recognised in profit or loss (rather than in OCI or not remeasured as is the case today or in the contractual service margin if the variable fee approach is applied under the new insurance contracts Standard), as described in paragraph 14.

26. The staff observe that the methods described in paragraphs 15-24 to address accounting mismatches that are already available in IFRS 4 could equally be applied to the additional accounting mismatches that arise after IFRS 9 is applied and before the application of the new insurance contracts Standard.

27. However the staff note that:

    (a) There are limitations on the contracts to which shadow accounting could apply (see paragraph 20);

    (b) Many entities would prefer not to use current interest rates to measure insurance contracts, particularly if doing so would not fully eliminate accounting mismatches when the assets are measured using a mix of FVPL, FVOCI and amortised cost; and

    (c) Such methods would not address the volatility that would arise from the entity's share of underlying items in profit or loss before the application of the new insurance contracts Standard, as described in paragraph 14, which is not attributable to accounting mismatch.

28. The IASB could seek to reduce these remaining accounting mismatches and other sources of volatility by one or both of the following amendments to existing IFRS 4:

    (a) Allow an adjustment similar to that in shadow accounting that would result in the recognition of gains and losses on insurance contract liabilities that would offset any unrealised gains and losses on the assets when:

(i) there is no direct relationship in the contract with the assets, for example in non-life insurance contracts, life insurance contracts without participation features, or indirect participation contracts. The staff note that some would argue that the unrealised gains and losses on assets in this situation represent economic gains and losses, rather than an accounting mismatch because there is no direct link between realisation of assets and measurement of insurance liabilities.

(ii) those gains and losses arise in contracts for which there is a direct link between the realisation of assets and measurement of insurance liabilities, but the gains and losses would be attributable to the entity, and not the policyholder. Such an approach would take the profit or loss recognition pattern closer to the variable fee approach recommended in Agenda Paper 2B.

(b) Permit entities to recognise a liability adjustment to reflect the differences between the change in value of the assets under IAS 39, and the change in their fair value under IFRS 9 to the extent that those changes are recognised in profit or loss. This approach would, in effect, result in the deferral of the effects of application of IFRS 9 prior to applying the new insurance contracts Standard while not deferring IFRS 9 itself. One advantage of this approach is that it would ensure comparability in accounting for financial instruments across all companies.

29. Under both these approaches, the IASB would need to consider how to define the assets that would give rise to these adjustments or whether to allow entities to designate the assets to which the adjustments would apply.

30. The staff note that applying these modifications may require that an entity implements systems and other changes that some might consider unjustified in the light of the relatively short period between the application of IFRS 9 and the new insurance contracts Standard. However, consistently with the methods for reducing accounting mismatch already in IFRS 4, if this approach were to be pursued, the IASB could make any modifications to IFRS 4 optional so that any unwanted effect on entities arising from changes to IFRS 4 could be minimised. The staff also note that any

change to IFRS 4 would be subject to the IASB’s usual due process including public consultation.

Appendix: shadow accounting

A1. This appendix provides further details about the application of shadow accounting in existing practice. The examples in this appendix illustrate shadow account but are not exhaustive.

A2. Common examples of shadow accounting in accordance with IFRS 4 include the following:

(a) Deferred participation in unrealised gains and losses; and

(b) Adjustments to the amortisation of deferred acquisition costs and related intangible assets

Deferred participation in unrealised gains and losses

A3. In some cases, insurance contracts give policyholders a right to receive a proportion of investment income received and realised gains less losses arising from the assets in which their premiums have been invested ('underlying assets'). Policyholder rights may be determined on the basis of accounting for assets on an amortised cost basis subject to minimum guaranteed returns plus the entity's discretion to pay more than the minimum amount. Policyholders do not have a right to payments based on unrealised gains (less losses). Liabilities are typically measured on a cost basis for these contracts under existing IFRS 4. This leads to a mismatch in profit or loss, if the underlying items are measured at FVPL, and in total comprehensive income if underlying items are measured at AFS.

A4. The following example shows how shadow accounting would reduce such an accounting mismatch:

Example of shadow accounting for deferred policyholder liabilities.

Assumptions:

a) Policyholders have a right to receive 90% of income and realised gains from a specified pool of financial assets

b) Financial assets are classified as AFS

c) Unrealised gains arise on the financial assets of CU100

d) Relevant tax rate is 30%

Without shadow accounting

Dr assets	100	
Cr OCI – unrealised gains		70
Cr OCI – deferred tax liability		30

Shadow accounting could correct a misconception that the equity of the entity has increased by CU70 when policyholders would have a right to most of the gains if they were realised.

With shadow accounting

Dr assets	100	
Cr deferred policyholder liability		90
Cr OCI – unrealised gains		7
Cr OCI – deferred tax liability		3

Shadow accounting entries in the income statement would be split between profit or loss and OCI if the underlying items were a mix of FVPL and AFS.

A5. In the example above there is a residual amount of unrealised gain in OCI that is not offset by shadow accounting, ie, the CU7 that represents the entity's interest in unrealised gains arising from underlying assets.

Adjustments to the amortisation of deferred acquisition costs (DAC) and related intangible assets

A6. In US GAAP, the amortisation of deferred acquisition costs (DAC) is based (for some contracts) on the gross profits expected to be earned over the life of a book of contracts. One element of gross profits is the total investment return from assets notionally held to back the policyholder liabilities. Realisation of an investment gain has the effect of accelerating some of that return from future periods to the

current period and, as a result, accelerating amortisation of deferred acquisition costs. A realised investment loss may have the opposite effect, recapturing costs previously amortised. An unrealised gain or loss, in the rationale of shadow accounting, should produce the same result.

A7. Based on recent outreach by the staff, it seems that (a) adjustments to the amortisation of DAC tend to be applied by entities applying IFRS that base their insurance contract accounting on US GAAP; and (b) the mitigation of accounting mismatches through adjustment to the amortisation of DAC and related intangible assets is less significant than shadow adjustments for deferred policyholder liabilities. The staff would expect DAC amortisation adjustments to have a less significant effect on the financial statements than deferred policyholder liabilities because it is a consequential effect of unrealised gains and losses.