MOODY'S ANALYTICS

## Article

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# Where standards intersect

## Eve Pastor reports on the interaction between IFRS 17 and IFRS 9, and its implications for asset liability management, valuation and financial reporting.

Insurers will see a new era of financial reporting ushered in on 1 January 2022. As of then, International Financial Reporting Standard (IFRS) 17 for insurance contracts, and IFRS 9 for financial instruments, will be effective for insurers and reinsurers. As insurers and reinsurers are preparing for these changes, it is worth considering the interaction between the two standards. Asset liability management (ALM), valuation and financial reporting implications could create unintended consequences in financial statements for years to come, so it is important to take a holistic view of the possible financial statement impacts, rather than making decisions in isolation.

In April 2019, the International Accounting Standards Board (IASB) approved proceeding with an Exposure Draft of Amendments to IFRS 17. The IASB also confirmed that it has not seen any early adopters of the standard. The announcement was a pivotal moment in the IFRS 17 and IFRS 9 journey; many insurers had been waiting to see how delayed the effective date for IFRS 17 would be, and how many changes would be made to the standard. The IASB also made the tentative decision to extend the temporary deferral of IFRS 9 for insurers so that both IFRS 9 and IFRS 17 can be applied at the same time. The Exposure Draft brings much more clarity on these points, and it is now time for insurers to move ahead with implementation.

## A collaborative journey

On a practical level, implementation of IFRS 17 and IFRS 9 often resides in silos – one for IFRS 17, involving actuarial, accounting and IT participation; the other for IFRS 9, involving accounting, asset management, IT and sometimes limited actuarial participation. Siloed implementation can impede good outcomes, particularly when decisions are made in isolation and sequentially, rather than together and holistically. There is plenty of interaction between IFRS 17 and IFRS 9. Navigating that interaction, and making the best choices, requires objectives to be established and outcomes prioritised.

There are choices within the implementation of IFRS 17 and IFRS 9 that allow insurers to potentially reduce accounting mismatches, reduce volatility in their income statements and, in certain jurisdictions, affect the amount they pay in taxes. Insurers need to consider the purpose and audience for their IFRS financial statements: are the statements prepared for shareholders, insurance regulators, tax authorities or all of the above? Sometimes what is operationally easiest does not result in the most decision-useful financial statement or optimal cash effect. A

cost-benefit trade off should be considered. For example, if insurers approach fair value options as a practical expedient, while assets that are fair valued do not need to then be addressed by the impairment requirements, this approach could lead to increased volatility and cash impacts on a taxation basis.

## Interaction and implications

Some of the implications from the interaction between IFRS 17 and IFRS 9 come from the requirements of the standards themselves and are first-order effects. Other implications are second or even third-order effects. For example, the decision to fair value assets (a first-order effect) could result in more prominent volatility on the financial statements, and a decision to change the investment allocation (a second-order effect). This, in turn, could lead to regulatory scrutiny (a third-order effect). Investment allocation and regulatory scrutiny involve meaningful economic consequences, affecting the risks insurers take. During implementation of IFRS 17 and IFRS 9, then, it is important for insurers not just to work out the decisions for first-order effects, but to consider various outcomes on second and third-order levels. This will help mitigate risk and serve policyholders.

## Leveraging knowledge

IFRS 17 and IFRS 9 implementation offers insurers a significant opportunity to gain an end-to-end understanding of the financial reporting process and to enhance the usefulness of their financial statements. This will facilitate better business decisions. Rather than operating in silos, where inputs are received as if on a factory assembly line, technology offers collaborative platforms that allow teams to share their expertise in order to meet the challenges of new requirements. In these collaborative platforms, actuaries can see their work's impact on the financial statements, and accountants can see the underlying calculations and data that drive the results.

Actuarial expertise has always been a key driver of an insurer's success. The implementation of IFRS 17 and IFRS 9 is an important time for actuaries to be involved across the enterprise. Actuarial involvement in IFRS 9 implementation is important because even if the first-order impacts are not their responsibility, actuaries will be coping with the second and third-order impacts. Their expertise and recommendations therefore need to be incorporated into IFRS 9 projects.

Under IFRS 17, some of the most impactful decisions to be made are around the level of aggregation and insurance contract groupings for both measurement and presentation; the change in discount rate through profit and loss (P&L) versus other comprehensive income (OCI); the choice of methodology for the discount rate; the risk mitigation option; and transition methods. IFRS 9 provides for changes in classification and measurement, impairment and hedging, as well as the most immediately impactful decision: which assets to fair value.

## The ALM perspective

Even though IFRS 17 and IFRS 9 provide financial statement users with a more current view of the underlying economics of an insurer, there will still be differences between economic and financial statement results. ALM strategies will need to be evaluated on how they impact economic results, as well as how financial statements will appear as of 2022. ALM implications from the interaction of IFRS 17 and IFRS 9 include:

- Grouping of insurance contracts and the equivalent grouping of assets to back those liabilities
- Mismatches that can be caused by fair valuing assets when the related liabilities are not fair valued
- Changes to the investment allocation and/or hedging programme
- Possibilities that assets will be impaired through the expected credit losses process of IFRS 9 and need to be reconsidered for their ALM effectiveness
- The liability discount rate is now meant to reflect the characteristics of the liabilities and not the assets that back the liabilities, creating a disconnect that might need to be addressed when the financial statement results are explained.

## Valuation viewpoint

Valuation implications from the interaction of IFRS 17 and IFRS 9 vary. A few areas that are likely top of mind for insurers include:

- Decisions such as whether changes in the discount rate go through P&L or OCI with the opportunities to reduce accounting mismatches – or exacerbate them
- IFRS 17 decisions around defining portfolios and how that then relates to IFRS 9 regarding which assets back which liabilities. This is also an example of where valuation and ALM intersect
- Comparison of transition approaches under IFRS 17 and IFRS 9 to see how aligned those should or can be
- Which components of the insurance contract can be unbundled under IFRS 17 and then accounted for under IFRS 9 – these are the distinct investment components and embedded derivatives, which are not closely related IFRS 9 decisions around the possibility of electing fair value through profit or loss for assets
- Economic assumptions used across the enterprise for both IFRS 17 and IFRS 9. For example, are the actuaries and the asset managers taking the same view of the long end of the curve and of the macro-economic environment?

## Implications for financial reporting

There are several financial reporting implications from the interaction of IFRS 17 and IFRS 9. Management and investors are often concerned by volatility, even if well mitigated through risk management programmes. As such, making valuation decisions that could increase the volatility of the results may lead to negative market perceptions.

Another interaction that is intriguing because it cannot be predicted in advance is how the economic environment in 2022 – the year IFRS 17 takes effect – will interact with transition methods and potentially create long-lasting effects on balance sheets. The counterargument is often simply that all insurers will be facing the same economic environment on the same transition date. Of course, that oversimplifies the reality, which is that insurers operate in different jurisdictions with different economic environments, have different product mixes, and will make different implementation choices regarding accounting policy and actuarial methodology. As a result, not all will be equally impacted.

Historically, insurers have operated with handoffs of data between departments; however, the interaction of IFRS 17 and IFRS 9 calls for an end-to-end understanding by all functions involved. One of the greatest benefits of IFRS 17 and IFRS 9 is the opportunity to foster collaboration across teams to achieve a winning outcome for all. Actuarial expertise is essential to the ongoing success of insurers. It is important for actuaries to be involved not only in their own actuarial decisions that have first-order actuarial effects, but to participate across the enterprise to help the team achieve the best second-order and third-order effects. Collaborative platforms that make actuarial calculations transparent to the finance function and the financial statement impacts of such calculations transparent to the actuarial function are already becoming the new normal.

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