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Project	**Insurance Contracts**		
Paper topic	Redesignation and Reclassification of Financial Assets		
CONTACT(S)	Yulia Feygina	yfeygina@ifrs.org	+44 (0)20 7332 2743
	Andrea Pryde	apryde@ifrs.org	+44 (0)20 7246 6491

Purpose of this paper[1]

1. The purpose of this paper is to ask the IASB whether upon the first application of the proposed insurance contracts standard insurers should be permitted to redesignate and/or reclassify[2] financial assets that had previously been designated or classified in accordance with IAS 39 *Financial Instruments: Recognition and Measurement* or IFRS 9 *Financial Instruments*.

2. As discussed in agenda paper 10E *Transition—effective date, comparative financial statements and early application*, if the effective dates of the proposed insurance contracts standard and IFRS 9 were the same, there would be no need to consider redesignation and/or reclassification of financial assets. However, as we expect that the effective dates of these standards will not be aligned, the staff believe the IASB should consider whether to permit insurers to redesignate and/or reclassify their financial assets upon first application adoption of the proposed insurance contracts standard. This paper does not address the effective date of the insurance contracts standard, which is discussed in agenda paper 10E. The staff

[1] This paper was adapted from FASB agenda paper 91 and some of the analysis in this paper is consistent with the analysis in that paper. However the IASB staff and FASB staff have reached differing conclusions, in part because of differences in the underlying financial instruments standards.

[2] IAS 39 and IFRS 9 include requirements for the *classification* of financial assets. IAS 39 and IFRS 9 also include fair value options for entities to *designate* financial assets as measured at fair value.

note that IFRS 9 is effective for annual periods beginning on or after 1 January 2015 and already permits early application.

3. If there are no special transition provisions, any redesignation and/or reclassification would need to be consistent with the financial instruments standard the insurer is applying at the date when it first applies the insurance contracts standard:

   (a) If the insurer applies the insurance contracts standard before it applies any version of IFRS 9, financial assets would be redesignated and/or reclassified in accordance with IAS 39.

   (b) If the insurer applies the insurance contracts standard after it applies a version of IFRS 9, financial assets would be redesignated and/or reclassified in accordance with that version of IFRS 9.

Staff recommendation

4. The staff recommend that an insurer should follow the *reclassification* guidance in the relevant financial instruments standard, except that an insurer:

   (a) would be permitted to designate eligible financial assets under the fair value option (FVO) where new accounting mismatches are created by the first application of the insurance contracts standard.

   (b) would be required to revoke previous designations under the FVO where an accounting mismatch no longer exists due to the application of the insurance contracts standards; and

   (c) following earlier application of IFRS 9, would be permitted to newly elect to use other comprehensive income for the presentation of changes in the fair value of some or all equity instruments that are not held for trading, or revoke a previous election.

Background

IASB Exposure Draft

5. Paragraph 102 of the IASB exposure draft (ED) stated the following, thus proposing that an insurer would be able to use what is commonly called the fair value option:

> At the beginning of the earliest period presented, when an insurer first applies this [draft] IFRS, it is permitted, but not required, to redesignate a financial asset as measured at fair value through profit or loss if doing so would eliminate or significantly reduce an inconsistency in measurement or recognition. The reclassification is a change in accounting policy and IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* applies. The insurer shall recognise the cumulative effect of that redesignation as an adjustment to opening retained earnings of the earliest period presented and remove any related balances from accumulated other comprehensive income.

6. In the Basis for Conclusions, paragraph BC253 states:

> On transition to IFRS 4, the Board permitted an insurer to redesignate its financial assets as available for sale to avoid an accounting mismatch that arises when the insurer's financial assets are measured at fair value and its insurance liabilities are measured on a cost basis (which IFRS 4 allows). The Board understands that insurers applying IFRS 9 (which removes the available for sale classification) before the new IFRS on insurance contracts may wish to reclassify some of their financial assets, where allowed, at amortised cost rather than at fair value through profit or loss in order to continue to avoid the accounting mismatch. However, because the draft IFRS would measure insurance liabilities at a current value with all remeasurements recognised in profit or loss, accounting mismatches would arise if an insurer continues to measure its financial assets at amortised cost. To avoid that

outcome, the Board proposes that on adoption of the draft IFRS an insurer would be permitted to use the fair value option to redesignate its financial assets by measuring them at fair value through profit or loss.

Comment letters

7. The January 2011 Agenda Paper 3E/55E *IASB Comment Letter Summary* provided feedback from comment letters. As noted in that paper (paragraph 137) some respondents suggested that the boards consider specific transition arrangements to ease the first-time application of the insurance contracts standard in the context of any new requirements arising in the financial instruments projects, as follows:

> "Some suggest specific arrangements to ease transition to the insurance contracts standard in the context of the new requirements in IFRS 9. These include:
>
> a) support for the proposal in the ED to align the effective date of the insurance contracts standard with IFRS 9, even if this were to mean delaying the effective date of IFRS 9 for, say, a year.
>
> b) permitting insurers to redesignate financial assets as measured at fair value or at amortised cost if those insurers are required to apply IFRS 9 before the effective date of the insurance contracts standard. Some note that the ED proposed that insurers would be permitted to redesignate financial assets as measured at fair value when they apply the insurance contracts standard for the first time, and believe that a similar option should be available for amortised cost."

Existing requirements – financial instruments classification & measurement

Classification

8. IAS 39 classifies financial assets into 4 categories:

   (a) Financial asset at fair value through profit or loss: a financial asset that either:

      (i) is classified as held for trading (i.e., if acquired or originated principally for the purpose of generating a profit from short-term fluctuations in price or dealer's margin or if it is part of a portfolio of identified instruments that are managed together and for which there is evidence of a recent actual pattern of short-term profit-taking or it is a derivative), or

      (ii) upon initial recognition is designated by the entity as at fair value through profit or loss (through use of the FVO).

   (b) Held-to-maturity financial investments: non-derivative financial assets with fixed or determinable payments and fixed maturity that an entity has the positive intention and ability to hold to maturity, other than:

      (i) those designated at fair value through profit or loss upon initial recognition

      (ii) those designated as available for sale and

      (iii) those that meet the definition of loans and receivables

   (c) Loans and receivables: non-derivative financial assets with fixed or determinable payments that are not quoted in an active market

   (d) Available-for-sale financial assets: non-derivative financial assets designated as available for sale or not classified in any other of the 3 above categories.

9. Paragraphs 4.1.1 - 4.1.5 of IFRS 9 requires entities to classify financial assets at either amortized cost or fair value through profit and loss on the basis of both:

   (a) The entity's business model for managing the financial assets and

   (b) The contractual cash flow characteristics of the financial asset.

10. Under IFRS 9:

    (a) a financial asset shall be measured at amortized cost if both of the following conditions are met:

        (i) The asset is held within a business model whose objective is to hold the assets in order to collect contractual cash flows.

        (ii) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

    (b) an entity shall measure a financial asset at fair value through profit or loss unless it measures the asset at amortized cost. However, an entity may, at initial recognition, irrevocably designate a financial asset as measured at fair value through profit or loss if doing so eliminates or minimizes an accounting mismatch that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases (the FVO).[3]

    (c) an entity may, at initial recognition (or on transition to IFRS 9), irrevocably designate an equity investment that is not held for trading as measured at fair value through other comprehensive income (FVOCI).

11. Paragraph 4.4.1 of IFRS 9 requires reclassification of financial assets “when and only when, an entity changes its business model for managing financial assets” and provides application guidance about what could be considered a change in business model.

Proposed requirements – Limited amendments to IFRS 9

Initial classification

12. In the project to consider limited amendments to the classification and measurement requirements of IFRS 9, the IASB tentatively decided to:

[3] IFRS 9 and the tentative IASB decisions on limited amendments to IFRS 9 provide an opportunity to reconsider fair value option elections on transition to IFRS 9.

(a) re-affirm the contractual cash flow characteristics assessment that already exists in IFRS 9, but to provide an amendment to the application guidance in IFRS 9 to clarify how the principle should be applied to particular instruments.

(b) re-affirm the business model assessment for amortised cost classification that already exists in IFRS 9, but to provide an amendment to clarify application guidance in IFRS 9.

(c) introduce a FVOCI measurement category in IFRS 9 for debt investments.

13. The IASB also tentatively decided to extend the current eligibility condition in IFRS 9 for designating financial assets under the "accounting mismatch" FVO (discussed in paragraph 10(b)) to debt investments that otherwise would be measured at FVOCI. Thus, these debt instruments may be measured at fair value through net income (FVNI) if doing so would eliminate or significantly reduce an accounting mismatch.

14. Thus, under proposed limited amendments to IFRS 9, financial assets would be classified as:

(a) Amortized Cost—Financial assets would qualify for amortized cost if the assets are held within a business model whose objective is to hold the assets in order to collect contractual cash flows.

(b) FVOCI—Financial assets would qualify for classification and measurement at FVOCI if they are managed within a business model that is both to hold the financial assets to collect contractual cash flows and to sell the financial assets.

(c) FVNI—Financial assets that fail the amortized cost and FVOCI business model assessment would be measured at FVNI. That is, FVNI is the residual category.

Staff analysis

15. The staff analysis discusses:

    (a) whether a change in accounting for insurance contracts could result in a **change in classification** of financial assets in accordance with the current and proposed limited amendments to IFRS 9.

    (b) what, if any, accounting mismatches could arise or cease to exist upon the first application of the new insurance contracts standard.

    (c) alternative solutions to the perceived issue.

Change in classification

16. Paragraphs 8-14 describes the criteria for how an entity would classify and measure its financial assets under current and proposed financial instruments standards, both on initial classification and on reclassification.

17. The staff note that there is a relatively high hurdle for reclassification. IFRS 9 does not permit subsequent redesignation under the FVO, nor redesignation of equity instruments that are not held for trading at FVOCI under IFRS 9, and IFRS 9 states that frequent assertions that an entity has changed its business model would be inconsistent with the IASB's view that 'an entity's business model does not relate to a choice (ie it is not a voluntary designation) but rather it is a matter of fact that can be observed by the way an entity is managed and information is provided to its management'.[4]

18. In the paragraphs that follow, the staff explores whether a change in the accounting for insurance contracts is, by itself, capable of resulting in reclassification of financial assets under the existing requirements in the financial instruments standards.

19. As previously noted, some instruments accounted for under IAS 39 are classified taking into consideration an entity's *intent*. Presumably, the ability to hold or sell

[4] Paragraph BC4.20 of the Basis for Conclusions on IFRS 9

a financial instrument would not be changed by the adoption of a new accounting standard. However, management's intent may change based on the impact of the accounting change on the entity's financial statements.

20. Under current IFRS 9 and the IASB's tentative decisions in the project to consider limited amendments to IFRS 9, debt instruments are classified based on (a) contractual cash flow characteristics of the financial asset and (b) the entity's business model for managing the financial assets. The cash flow characteristics are inherent in the instruments themselves and therefore will not change because of the first application of a new accounting standard. Some might argue, consistent with the IASB's intention, that a change in accounting standard by itself could not change the entity's business model. However, others might argue that management may change its business model due to asset-liability management considerations, in the same way that management may change its intent.

21. The staff support the view that a change in accounting policy caused by the application of the new insurance contracts standard would not, by itself, result in a change in either an insurer's intent or its business model. The staff acknowledge that, in some cases, application of the new standard might be one factor that causes an insurer to review whether its existing intent or business model is still appropriate. If that review leads to a change in intent or a change in the business model, the reclassification guidance in the financial instruments standard will determine whether that change results in a change in classification.

Sources of accounting mismatch

22. Under the IASB's tentative decisions, insurance liabilities will be measured at a current value. Changes in the insurance liability will be recognised and presented differently depending on their source:

(a) changes in discount rates are presented in other comprehensive income in the period they occur.[5]

(b) changes in estimates of future cash flows are offset in the residual margin (to the extent available) and recognised as the residual margin is released.

(c) All other changes in the insurance liability are recognised and presented in net income in the period they occur.

23. Financial assets will be measured at either FVNI, FVOCI, or amortized cost based on the criteria in the version of the financial instruments standards that the insurer applies.

24. Because of the different measurement bases and use of OCI for financial assets and insurance contract liabilities, some accounting mismatches will exist regardless of which of the three financial asset classifications is used. This paper does not address these mismatches. However, other accounting mismatches will be driven or avoided depending on the classification of the financial assets that the insurer holds. An insurer may choose to minimise those accounting mismatches as follows:

(a) If the changes in the discount rate are expected to be the main cause of mismatch (i.e., the non-financial assumptions are not expected to be very volatile), classifying financial assets as at FVOCI may be the best option to reduce accounting mismatches.

(b) If the contracts contain significant distinct investment components that would be unbundled and accounted for under the financial instruments standards, the liability measurement may be more akin to amortized cost (i.e., the amount payable on demand similar to a mutual fund). Classifying financial assets on the same measurement basis (i.e., amortized cost) would be the best option to reduce accounting mismatch.

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[5] Agenda paper 2F discusses how the presentation of changes in discount rate in OCI applies in the case of participating contracts.

(c) Similarly, the election of a fair value option (or desire to reverse previously elected options) for financial assets might reasonably be affected by the accounting for any liabilities the assets economically hedge.

Potential solution to mitigate accounting mismatch

25. As noted in paragraph 2, if an insurer adopts the IFRS 9 and the insurance contract standard on the same date, insurers would be able to assess the business model at that date taking into account the recognition and measurement of the insurance contracts that are managed together with specific portfolios of financial assets. Similarly, an election under the FVO for financial assets might be based on reducing accounting mismatches for the life of the assets and related insurance contract liabilities.

26. However, as we describe in agenda paper 10E, the effective dates of IFRS 9 and the insurance contracts standard are likely to differ and the mandatory effective date of IFRS 9 is likely to be before the new insurance contracts standard. As a result, absent special transition provisions, the reclassification guidance described in paragraph 11 would apply, rather than guidance that applies on initial classification. Therefore, absent special transition provisions, the insurer would, when making classification choices for financial assets, risk creating new mismatches in the period when they apply the financial instruments standard but not the insurance contracts standard.

27. The following paragraphs consider two alternatives:

    (a) Alternative 1: Permit insurers to classify financial assets at amortized cost, FVNI, or FVOCI, as if IFRS 9 had been initially applied at the same time that the insurance standard is applied.

    (b) Alternative 2: Limited reconsideration of the FVO and also permit an insurer to newly designate / revoke previous designation of equity investments that are not held for trading at FVOCI

28. In both alternative 1 and alternative 2, an insurer would be permitted to designate or de-designate financial assets under the FVO to eliminate new accounting

mismatches that arise when the insurer applies the new insurance contracts standard (and required to revoke previous designations under the FVO where the accounting mismatch no longer exists).

29. As previously noted in paragraphs 5 and 6, the IASB's ED proposed to permit insurers, on transition to the insurance contracts standard, to use the fair value option in IFRS 9 to redesignate its financial assets by measuring them at fair value through profit or loss. That would permit insurers to designate financial assets as measured at fair value through profit or loss if doing so would eliminate or significantly reduce an inconsistency in measurement or recognition.

30. The need to make fresh designations under the FVO remains. Accounting mismatches may be introduced when the insurance contracts standard is first applied, as a result of the board's tentative decisions to present changes in the discount rate in other comprehensive income, the requirement to offset changes in estimates of future cash flows in the residual margin, and from the unbundling of distinct investment components. Thus the staff thinks insurers should be *permitted* to eliminate any such new mismatches by permitting insurers to designate financial assets under the FVO when the insurer applies the new insurance contracts standard. The staff also thinks insurers should be *required* to de-designate financial assets previously measured using the FVO, if initial application of the insurance contracts standard removes the accounting mismatch that previously led the insurer to use the FVO and *required* to revoke previous designations under the FVO where the accounting mismatch no longer exists.

31. Alternatives 1 and 2 differ in that Alternative 1 would permit an insurer to use the *classification* criteria in the financial instruments standards (ie IAS 39 or IFRS 9 as applicable) to reclassify financial assets, whereas Alternative 2 would require an insurer to use the *reclassification* criteria in the financial instruments standards (ie IAS 39 or IFRS 9 as applicable) to reclassify financial assets.

Alternative 1 – Permit insurers to classify financial assets at amortized cost, FVNI, or FVOCI, as if IAS 39 or IFRS 9 had been initially applied at the same time that the insurance standard is applied

32. This alternative would permit insurers to classify their financial assets consistently with how they would be classified, if IAS 39 or IFRS 9 and the insurance

contracts standard had been initially applied at the same time. In other words, on first application of the insurance contracts standard, an insurer should have the same classification options as it would have had on first applying IAS 39 or IFRS 9. This would, in effect, **fully** remove the restrictions regarding reclassifications between different categories, including reconsidering classification options. The classification would thus be based on the criteria of IAS 39 or IFRS 9, as applicable.

Advantages of Alternative 1

33. Alternative 1 would permit an insurer to assess, as it was applying IAS 39 or IFRS 9 for the first time at the same time as the transition to the new insurance contracts standard:

(a) The FVO for accounting mismatches and the ability to designate an equity investment that is not held for trading at FVOCI. The insurer would be required to revoke previous designations under the FVO if the conditions are no longer met.

(b) Other classification decisions, particularly those that depend on the insurer's business model under IFRS 9. This alternative would state that the insurer may make the assessment of its business model in the light of circumstances that exist when it adopts the insurance contracts standard.

34. This alternative would allow insurers to better consider what classification decisions are most appropriate when they first apply IFRS 9, rather than being "distracted" by whether that will lock them into decisions that may be sub-optimal for subsequent application of the insurance contracts standard. Because this alternative involves a fresh-start classification both at the date of application of IFRS 9 and the date of application of the insurance contract standard, it arguably achieves a more relevant classification for both periods affected.

35. Some argue that the effects of application of the insurance contracts standard for an insurer could be transformational if viewed as a fundamental change in the measurement of virtually all an insurer's products and therefore could be one factor that might cause management to review whether its intent and/or its business model is still appropriate. Those who are of this view might argue that it

is appropriate to permit insurers to change the classification of their assets upon application of the new insurance contracts standard as if they also applied the applicable financial instruments standard at the same time.

Disadvantages of Alternative 1

36. This alternative will result in some additional cost if insurers were to assess and classify financial assets twice (i.e., both upon adoption of IFRS 9 and upon adoption of the insurance contracts standard).

37. Furthernore, some might observe that there is no basis to revisit the IASB's decisions to restrict reclassification and redesignation for entities applying the insurance contracts standard for the first time. Such an exception applicable to insurers could similarly be argued as beneficial for many other industries. However, with the exception of other financial institutions whose assets and liabilities would be both subject to the financial instruments standard, some believe that other industries would not have such a close linkage between financial assets and their liabilities and would not have as significant a change in accounting requirements.

Alternative 2 – Limited reconsideration of the FVO and ability to newly designate / revoke previous designation of equity investments that are not held for trading at FVOCI

38. Similarly to Alternative 1, Alternative 2 recognises the importance of asset-liability management in insurers' business. However, the proponents of Alternative 2 believe that the entity's business model is already reflected in the classification and *reclassification* requirements of IFRS 9. That is, an entity classifies its financial assets based on the relevant business model (and contractual cash flow characteristics of the financial assets) and must reclassify financial assets if the business model changes. If an insurer were to change its business model for managing financial assets when it applies the new insurance contracts standard, the insurer would be required to reflect that change in business model in accordance with the general requirements of IFRS 9 and reclassify the affected financial assets.

39. The proponents of this alternative recognise that the first application of the new requirements for accounting for insurance liabilities may change the accounting

mismatches as discussed in paragraph 23-25. However, they believe that this issue would already be addressed if the IASB were to decide that, upon the adoption of the new insurance contracts standard, an insurer:

(a) should be permitted to designate financial assets under the FVO where the first application of the insurance contracts standard creates a new accounting mismatch;

(b) should be required to revoke previous designations under the FVO where an accounting mismatch no longer exists due to the application of the insurance contracts standards; and

(c) should be permitted to newly designate an equity investment that is not held for trading at FVOCI, or to revoke such a designation. Even though this classification option is not driven by accounting mismatches, in practice entities may consider accounting mismatches when deciding whether to apply this classification option. Therefore, the proponents of this alternative believe that an insurer should be given an opportunity to re-consider this election upon the first application of the new accounting requirements for insurance contract liabilities. However, because the criteria for this classification option do not refer to accounting mismatches, the proponents of this alternative do not believe that the reconsideration should be limited to changes in accounting mismatches (unlike in the case with the FVO).

Staff recommendation

40. The staff recommend alternative 2, ie that insurers should **not** be afforded an exception to reclassify their financial assets upon adoption of the insurance contracts standard, except as described in paragraph 39. IFRS 9 is clear about the types of events could cause a change in business model. If an insurer changes its business model when it implements the insurance contracts standard, then reclassification could occur in accordance with the normal requirements. The staff note that, even if the board were to make an exception from the reclassification requirements in IFRS 9, there would be no effect unless insurers were to change the way they manage their financial assets.

Question for the IASB: Redesignation and Reclassification of Financial Assets

Does the IASB agree that an insurer should follow the *reclassification* guidance in the relevant financial instruments standard, except that an insurer should be:

(a) permitted to designate eligible financial assets under the FVO where new accounting mismatches are created by the first application of the insurance contracts standard

(b) required to revoke previous designations under the FVO where the accounting mismatch no longer exists due to the application of the insurance contracts standard; and

(c) following earlier application of IFRS 9, permitted to use other comprehensive income for the presentation of changes in the fair value of some or all equity instruments that are not held for trading, or revoke a previous election.