STAFF PAPER

October 2015

REG IASB Meeting

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| **Project** | **Insurance Contracts** |
| Paper topic | Classification and measurement of financial assets on transition to the new insurance contracts Standard |

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## Purpose of the paper

1. In September 2015, the IASB tentatively decided to propose amendments to IFRS 4 *Insurance Contracts* to permit particular entities to apply the Overlay Approach or the Deferral Approach when those entities initially apply or would otherwise be required to initially apply IFRS 9 *Financial Instruments.* Accordingly, the following scenarios could arise on transition to the new insurance contracts Standard:

   (a) An entity initially applies IFRS 9, with or without the Overlay Approach, **before** it initially applies the new insurance contracts Standard, and

   (b) An entity initially applies IFRS 9 and the new insurance contracts Standard **at the same time**; eg the entity applies the Deferral Approach and continues to apply IAS 39 *Financial Instruments: Recognition and Measurement* before it initially applies the new insurance contracts Standard.

2. This paper discusses classification and measurement of financial assets **on transition** to the new insurance contracts Standard for entities that initially apply IFRS 9, with or without the Overlay Approach, **before** they initially apply the new insurance contracts Standard (ie the scenario described in paragraph 1(a)).

3. This paper does not discuss:

(a) Classification and measurement of financial assets on transition to the new insurance contracts Standard for entities that initially apply IFRS 9 and the new insurance contracts Standard at the same time. In that case, transition provisions in IFRS 9 would apply in the usual way.

(b) Presentation of comparative information about financial instruments on transition to the new insurance contracts Standard either for entities that initially apply IFRS 9 before they apply the new insurance contracts Standard or for entities that initially apply those Standards at the same time. Presentation of comparative information in those scenarios is discussed in Agenda Paper 2B for this meeting.

(c) Transition out of the Overlay Approach and out of the Deferral Approach, including presentation of comparative information, **before transition** to the new insurance contracts Standard. Transition requirements in those scenarios were addressed at the September 2015 IASB meeting. Appendix A describes the relevant decisions made at that meeting.

## Structure of the paper

4. This paper is structured as follows:

   (a) Summary of staff recommendations (paragraph 5),

   (b) Overview of the IASB's tentative decisions to date (paragraphs 6-14):

      (i) Designation and de-designation of financial assets under the fair value option (FVO) and the other comprehensive income (OCI) presentation election for investments in equity instruments on transition to the new insurance contracts Standard (paragraphs 6-9), and

      (ii) Reassessment of the business model for managing financial assets on transition to the new insurance contracts Standard (paragraphs 10-14),

   (c) Scope of the reassessment of the business model for managing financial assets (paragraphs 15-24),

(d) Optional or mandatory reassessment of the business model for managing financial assets (paragraphs 25-29),

(e) Application of the reliefs for classification and measurement of financial assets on transition to the new insurance contracts Standard (paragraphs 30-35),

(f) Disclosure requirements for changes in classification and measurement of financial assets on transition to the new insurance contracts Standard (paragraphs 36-39).

## Summary of staff recommendations

5. For entities that initially apply IFRS 9, with or without the Overlay Approach, **before** they initially apply the new insurance contracts Standard, the staff recommend that:

   (a) an entity should be permitted to reassess the business model for managing financial assets on transition to the new insurance contracts Standard,

   (b) the reassessment of business model should apply to financial assets that the entity designates as related to contracts that are within the scope of IFRS 4 or the new insurance contracts Standard consistent with the designation approach under the Overlay Approach set out in paragraphs 10-16 of September 2015 Agenda Paper 14B (and tentatively agreed by the IASB at that meeting),

   (c) on transition to the new insurance contracts Standard, the reassessment of the business model for managing financial assets and the designation and de-designation of financial assets under the FVO and the OCI presentation election for investments in equity instruments should be based on the facts and circumstances that exist on initial application of that Standard—that is, the beginning of the latest period presented,

   (d) the resulting classification of financial assets should be applied retrospectively (ie as if the financial assets had always been so classified),

(e) the cumulative effect of any changes in classification and measurement of financial assets as a result of applying the transition reliefs in the new insurance contracts Standard should be recognised in the opening balance of retained earnings or accumulated OCI,

(f) an entity that applies the transition relief for the reassessment of the business model for managing financial assets should be required to disclose its policy for designating financial assets to which that transition relief is applied,

(g) when the classification and measurement of financial assets changes as a result of applying the transition provisions in the new insurance contracts Standard (ie as a result of the reassessment of the business model for managing financial assets or designation/de-designation of financial assets under the FVO or the OCI presentation election for investments in equity instruments), an entity should be required to disclose for those financial assets by class:

   (i) the measurement category and carrying amount immediately before the initial application of the new insurance contracts Standard,

   (ii) the new measurement category and carrying amount determined as a result of applying the transition provisions in the new insurance contracts Standard,

   (iii) the amount of any financial assets in the statement of financial position that were previously designated under the FVO but are no longer so designated, distinguishing between those that an entity was required to de-designate and those that an entity elected to de-designate,

   (iv) qualitative information that would enable users of financial statements to understand how an entity applied the transition provisions in the new insurance contracts Standard to those financial assets whose classification has changed as a result of initially applying that Standard, including:

      1. the reasons for any designation or de-designation of financial assets under the FVO, and

2. an explanation of why the entity came to a different conclusion in reassessing its business model.

## Overview of the IASB's tentative decisions to date

### *Designation and de-designation of financial assets on transition to the new insurance contracts Standard*

6. In January 2015, the IASB tentatively decided to confirm the transition provisions proposed in the 2013 Exposure Draft *Insurance Contracts* (the 2013 ED) for entities that initially apply IFRS 9 **before** they initially apply the new insurance contracts Standard. Specifically:

    (i) an entity is permitted to designate financial assets under the FVO if doing so eliminates or significantly reduces an accounting mismatch that would otherwise arise from measuring assets or liabilities or recognising the gains or losses on them on different bases;

    (ii) an entity is required to revoke previous designations of financial assets under the FVO option if the accounting mismatch that led to the previous designation is eliminated by initial application of the new insurance contracts Standard; and

    (iii) an entity is permitted to designate an investment in an equity instrument under the OCI presentation election and is permitted to revoke previous designations.

7. Under the proposals in the 2013 ED, on transition to the new insurance contracts Standard, an entity would be required to:

    (a) designate and de-designate financial assets under the FVO and the OCI presentation election for investments in equity instruments based on the facts and circumstances at the beginning of the earliest period presented,

    (b) restate comparative periods presented, and

(c) recognise the cumulative effect of those changes at the beginning of the earliest period presented as an adjustment to the opening retained earnings or accumulated OCI.

8. The transition provisions for designation and de-designation of financial assets under the FVO and the OCI presentation election for investments in equity instruments were aligned with the overall transition requirements proposed for the new insurance contracts Standard. That is, the 2013 ED proposed that, unless otherwise specified, that Standard would be applied retrospectively and require restatement of comparative information. Application of the transition reliefs for classification and measurement of financial assets is further discussed in paragraphs 30-35.

9. The 2013 ED did not propose any disclosure requirements to accompany the designation and de-designation of financial assets under the FVO and the OCI presentation elections for investments in equity instruments on transition to the new insurance contracts Standard. Disclosure requirements for changes in classification of financial assets on transition to that Standard are discussed in paragraphs 36-39.

### *Reassessment of the business model for managing financial assets on transition to the new insurance contracts Standard*

10. In January 2015, the IASB tentatively decided to consider providing further transition relief for entities that apply IFRS 9 before they apply the new insurance contracts Standard. The IASB tentatively decided that, subject to further discussion, that relief would either permit or require an entity to reassess the business model for managing financial assets at the date of initial application of the new insurance contracts Standard based on the facts and circumstances that exist at that date; that is, at the beginning of the latest period presented.

11. In making that tentative decision, the IASB noted that it would need to consider the following detailed application questions:

    (a) the financial assets to which the transition relief should apply, and

    (b) when classification and measurement of financial assets changes as a result of applying the transition relief:

(i) whether such a change should be applied prospectively or retrospectively and how any resulting gains or losses should be treated, and

(ii) what information should be disclosed.

12. The scope of the reassessment of the business model is discussed in paragraphs 15-24. Paragraphs 25-29 discuss whether the reassessment should be permitted or required.

13. Application of the transition reliefs for classification and measurement of financial assets is discussed in paragraphs 30-35. Disclosure requirements are discussed in paragraphs 36-39.

14. Restatement of comparative information about financial instruments on transition to the new insurance contracts Standard is discussed in Agenda Paper 2B for this meeting.

## Scope of the reassessment of the business model for managing financial assets

15. As noted in Agenda Paper 14C for the September 2015 IASB meeting, all approaches to addressing concerns about the interaction between the effective dates of IFRS 9 and the new insurance contracts Standard on the financial asset side of that interaction have a common scope objective. That is, they all target financial assets that relate to insurance activities. As discussed in that paper, absent a direct link between financial assets and insurance contracts[1], those financial assets are difficult to identify. That paper also noted that while the need to identify financial assets that relate to insurance activities exists under all of those approaches, the appropriate scope for different approaches could be different because of their different information content, or the different length of time over which those approaches apply.

16. In September 2015, the IASB developed two approaches to identifying financial assets that relate to insurance activities:

[1] The scopes of both IFRS 4 and the new insurance contracts Standard are broader than just insurance contracts (ie contracts with insurance risk). However, in this paper the staff may refer to contracts in the scope of those Standards as 'insurance contracts' for brevity.

(a) Predominance assessment proposed under the Deferral Approach, and

(b) Designation of financial assets proposed under the Overlay Approach.

17. The staff think that the IASB should first consider whether one of those approaches would be appropriate for identifying financial assets to which the transition relief for the reassessment of the business model would apply. This is because unnecessarily introducing another approach for identifying financial assets that relate to insurance activities would increase the complexity of financial reporting for both preparers and users of financial statements.

18. The staff think that the scope of the reassessment of the business model for managing financial assets does not need to be as strict as the scope of the Deferral Approach. This is because the reassessment of the business model applies at a point in time, ie on transition to the new insurance contracts Standard, rather than over a period of time. In addition, the staff think that reassessing the business model for managing financial assets would not result in a loss of information as would the case under the Deferral Approach. Rather, the reassessment of the business model would allow an entity to fully reflect the current facts and circumstances on initial application of the new insurance contracts Standard.

19. In contrast, the staff think that the designation approach to identifying financial assets that relate to insurance contracts proposed under the Overlay Approach and set out in paragraphs 10-16 of September 2015 Agenda Paper 14B would be appropriate for the purposes of the reassessment of business model for managing financial assets. On one hand, that designation approach would provide an entity with a degree of flexibility in determining financial assets that relate to insurance activities. On the other hand, the designation approach would exclude financial assets that are clearly unrelated to insurance activities. The staff think that such an approach would be appropriate for a provision that is intended to provide transition relief, applies at a single point in time, does not result in a loss of information and would allow an entity to reflect current facts and circumstances.

20. In addition, the staff think that having a consistent scope for the Overlay Approach and the reassessment of the business model for managing financial assets would reduce operational costs for an entity that chooses to apply IFRS 9 with the Overlay Approach before it initially applies the new insurance contracts

Standard. That is, an entity would be able to develop a consistent approach to identifying financial assets that relate to insurance activities that serves both purposes, ie the Overlay Approach and the reassessment of the business model.

21. Finally, the staff note the designation approach to the reassessment of the business model for managing financial assets is consistent with the feedback received by the IASB at the March 2015 meeting of the Accounting Standards Advisory Forum (ASAF). At that meeting, most ASAF members believed that applying that relief to all financial assets of the entity would be too wide. Most ASAF members also believed that applying that relief only to financial assets that are contractually linked to insurance contracts would be too narrow. Many ASAF members preferred that an entity should identify financial assets related to its insurance activities and apply the transition relief to those identified assets.

22. Accordingly, consistent with the approach to identifying financial assets that relate to insurance activities under the Overlay Approach, the staff recommend that the reassessment of the business model for managing financial assets on transition to the new insurance contracts Standard should apply to financial assets that an entity designates as related to insurance activities. For the purposes of this reassessment, insurance activities are understood as issuing contracts that are in the scope of IFRS 4 *or* the new insurance contracts Standard (this is because the reassessment of the business model for managing financial assets takes place on the transition between those Standards).

23. Consistent with the designation under the Overlay Approach, the designation of financial assets for the purposes of the reassessment of the business model would apply to both:

    (a) financial assets that the entity holds to fund the settlement of liabilities arising from expected levels of insurance claims and expenses; and

    (b) additional (or surplus) assets an entity needs to hold in case insured events are more frequent, more severe, or require settlement sooner than expected.

24. However, consistent with the designation under the Overlay Approach, the designation for the purposes of the reassessment of the business model would not apply to financial assets that are clearly held in respect of activities other than

issuing contracts within the scope of IFRS 4 or the new insurance contracts Standard. For example, the designation would not apply to:

(a) financial assets of a group held by a banking subsidiary that does not issue contracts in the scope of those Standards; or

(b) financial assets held in funds clearly ear-marked as relating to investment contracts that are outside of the scope of those Standards.

| **Question 1 for the IASB** |
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| Does the IASB agree with the staff recommendation in paragraphs 22-24 that the reassessment of the business model for managing financial assets on transition to the new insurance contracts Standard would apply to financial assets that an entity designates as related to contracts within the scope of IFRS 4 or within the scope of the new insurance contracts Standard, consistent with the designation approach set out for the Overlay Approach in paragraphs 10-16 of September 2015 Agenda Paper 14B? |

## Optional or mandatory reassessment of the business model for managing financial assets

25. The staff note that the objective of providing relief for the reassessment of the business model for managing financial assets is to address the fact that, for some entities, the assessment of the business model based on facts and circumstances that exist when the new insurance contracts Standard is initially applied could be different compared to the assessment based on facts and circumstances that existed when IFRS 9 was initially applied. However, that would not be the case for all entities that issue insurance contracts. The staff therefore think that entities that do not face such an issue should not be forced to perform the reassessment of the business model.

26. In addition, the staff note that the reassessment of the business model is intended to provide a **relief**. The staff think that relief by its very nature lends itself to being optional rather than required. The staff also think that the proposed scope of the reassessment, ie the designation approach, also lends itself to an optional rather than a required reassessment.

27. The staff note that, as discussed in Agenda Paper 14A for the September 2015 meeting, users of financial statements tend to favour mandatory rather than optional approaches. However, the staff think that the lack of comparability that could arise if the reassessment of business model for managing financial assets were permitted rather than required could be mitigated by requiring disclosures that are discussed further in this paper. In addition, the staff note that the reassessment of the business model has a limited effect on comparability as it is applied at a point in time (ie on transition to the new insurance contracts Standard) when comparability will be already disrupted due to the change in accounting policy for insurance contracts.

28. Finally, the staff note that the other proposals that the IASB has developed to date to address the concerns about different effective dates of IFRS 9 and the new insurance contracts Standard have also been optional rather that mandatory.

29. Accordingly, for the reasons stated in paragraphs 25-28, the staff recommend that the reassessment of the business model for managing financial assets on transition to the new insurance contracts Standard should be permitted rather than required.

| **Question 2 for the IASB** |
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| Does the IASB agree with the staff recommendation in paragraph 29 to permit rather than require entities to reassess the business model for managing financial assets on transition to the new insurance contracts Standard? |

## Application of the reliefs for classification and measurement of financial assets on transition to the new insurance contracts Standard

30. As discussed in paragraph 7, under the proposals in the 2013 ED, the designation and de-designation of financial assets under the FVO and the OCI presentation election for investments in equity instruments on transition to the new insurance contracts Standard would be performed based on the conditions at the beginning of the **earliest** period presented, with the cumulative effect of those changes recognised as an adjustment to the opening retained earnings or accumulated OCI—and comparative information would be restated.

31. However, as discussed in paragraph 10, the IASB tentatively decided at the January 2015 meeting that the reassessment of the business model for managing financial assets would be based on the facts and circumstances that exist on initial application of the new insurance contracts Standard, ie the beginning of the **latest** period presented.

32. The staff think that, on transition to the new insurance contracts Standard, the reassessment of the business model for managing financial assets and the designation and de-designation of financial assets under the FVO and the OCI presentation election for investments in equity instruments should be aligned so that they are done as of the **same date**. That is, either both the reassessment of the business model and designation and de-designation of financial assets under the FVO and the OCI presentation election should be based on the facts and circumstances that exist at the beginning of the earliest period presented, or both should be based on the facts and circumstances that exist at the beginning of the latest period presented.

33. Consistent with the IASB's deliberations about the business model assessment in the IFRS 9 project and the Basis for Conclusions on IFRS 9, the staff think that it would be difficult, if not impossible, for an entity to assess the business model for managing financial assets based on facts and circumstances that existed in the past, particularly without the use of hindsight. Moreover, the staff think that it would be more appropriate to perform the reassessment of the business model on the basis of the current (rather than past) facts and circumstances so that an entity can most accurately reflect its business model for managing financial assets when it initially applies the new insurance contracts Standard.

34. Accordingly, the staff recommend that, on transition to the new insurance contracts Standard, the reassessment of the business model for managing financial assets and the designation and de-designation of financial assets under the FVO and the OCI presentation election for investments in equity instruments should be based on the facts and circumstances that exist on initial application of that Standard; that is, the beginning of the latest period presented. The staff note that such treatment would be consistent with the transition requirements in IFRS 9 (ie that assessment and designation/de-designation are performed at the date of initial

application of IFRS 9 on the basis of the facts and circumstances that exist at that date).

35. Also consistent with the transition requirements in IFRS 9, the resulting classifications should be applied retrospectively (ie as if the financial assets had always been so classified) and the cumulative effect of any changes in classification and measurement of financial assets as a result of applying those transition reliefs should be recognised in the opening balance of retained earnings or accumulated OCI.

**Question 3 for the IASB**

Does the IASB agree with the staff recommendation in paragraphs 34-35 that:

1. on transition to the new insurance contracts Standard, the reassessment of the business model for managing financial assets and designation and de-designation of financial assets under the FVO and the OCI presentation election for investments in equity instruments should be based on the facts and circumstances that exist on initial application of that Standard; that is, the beginning of the latest period presented, and
2. the resulting classifications should be applied retrospectively (ie as if the financial assets had always been so classified) and the cumulative effect of any changes in classification and measurement of financial assets as a result of applying those transition reliefs should be recognised in the opening balance of retained earnings or accumulated OCI?

## Disclosure requirements for changes in classification and measurement of financial assets on transition to the new insurance contracts Standard

36. In September 2015, the IASB tentatively decided that an entity that chooses to apply the Overlay Approach should be required to disclose the entity's policy for determining the financial assets for which an overlay adjustment is made. The staff think that the same disclosure requirement should apply to an entity that chooses to apply the transition relief for the reassessment of the business model for managing financial assets. This is because both the Overlay Approach and the

reassessment of the business model apply to financial assets designated by the entity.

37. In addition, the staff think that entities should be required to provide both quantitative and qualitative information about changes in the classification and measurement of financial assets as a result of applying the transition provisions in the new insurance contracts Standard. That information would enable users of financial statements to understand and evaluate the effects of transition to the new insurance contracts Standard on the classification and measurement of financial assets.

38. The staff note that the IASB has already developed and issued disclosure requirements for changes in classification and measurement of financial assets as a result of applying different versions of IFRS 9; eg if an entity initially applies IFRS 9 (2009) and subsequently applies IFRS 9 (2014). The staff think that those disclosure requirements would equally provide useful information for changes in the classification and measurement of financial assets on transition to the new insurance contracts Standard.

39. Accordingly, the staff recommend that for any changes in classification and measurement of financial assets as a result of applying the transition provisions in the new insurance contracts Standard (ie as a result of the reassessment of the business model for managing financial assets or designation and de-designation of financial assets under the FVO or the OCI presentation election for investments in equity instruments), an entity should be required to disclose, by class of financial assets:

(a) the measurement category and carrying amount immediately before the initial application of the new insurance contracts Standard,

(b) the new measurement category and carrying amount determined as a result of applying transition provisions in the new insurance contracts Standard,

(c) the amount of any financial assets in the statement of financial position that were previously designated under the FVO but are no longer so designated, distinguishing between those that an entity was required to de-designate and those that an entity elected to de-designate,

(d) qualitative information that would enable users of financial statements to understand how an entity applied the transition provisions in the new insurance contracts Standard to those financial assets whose classification has changed as a result of initially applying that Standard, including:

  (i) the reasons for any designation or de-designation of financial assets under the FVO, and

  (ii) an explanation of why the entity came to a different conclusion in reassessing its business model.

**Question 4 for the IASB**

Does the IASB agree with the staff recommendations for disclosure requirements for changes in classification and measurement of financial assets on transition to the new insurance contracts Standard set out in paragraph 35 and paragraph 38?

## Appendix A—September 2015 IASB tentative decisions on transition out of the Overlay Approach and out of the Deferral Approach before initial application of the new insurance contracts Standard

| | The Overlay Approach | The Deferral Approach—at the reporting entity level |
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| Transition out of the approach | An entity is permitted to stop applying the Overlay Approach from the beginning of any annual reporting period before initial application of the new insurance contracts Standard.<br><br>When an entity stops applying the Overlay Approach it shall reclassify any balance of prior periods' overlay adjustments accumulated in OCI to the opening balance of retained earnings as of the later of (a) the beginning of the earliest reporting period presented or (b) the beginning of the reporting period when the Overlay Approach was first applied. | An entity is permitted to stop applying the Deferral Approach (ie to stop applying IAS 39 and start applying IFRS 9) from the beginning of any annual reporting period before initial application of the new insurance contracts Standard.<br><br>In doing so, the entity applies the transition provisions in IFRS 9. |