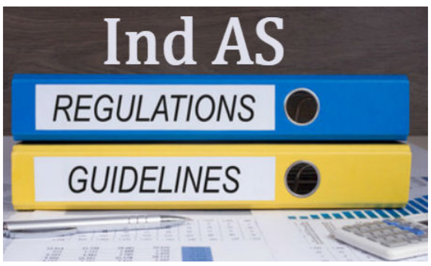
Business Model Ind AS 109

What's the Business Model for a Life Insurer's Bond Investment?

Ind AS 109: Financial Instruments bears the question of the link between a life insurer's business model and thereupon the accounting of bonds. The authors attempt to deduce the link.

Over the next few months, Indian insurers will implement for financial reporting the IFRS-adapted Ind AS accounting standards. The activity would continue over a few reporting quarters. Significant to the implementation, particularly with Indian life insurers, are two accounting standards: a) Ind AS 104: Insurance Contracts, and b) Ind AS 109: Financial Instruments.

In a vertically organised bond-investing life insurance industry where accounting standards are a horizontal, the accounting policy on investments will be closely watched. And at the time of this writing it is at an interpretative juncture. The accounting treatment of a life insurer's bond investments under Ind AS 109: Financial Instruments is the subject matter of this discussion.



A Historical Account

Readers may be aware that Ind AS 109: Financial Instruments is a veritable work-in-progress that has passed over from the already waning Ind AS 39: Financial Instruments, Recognition and Measurement. As IAS 39 (Ind AS 39 is an adaptation of IAS 39) was widely considered to be one of the most 'unfriendly' IFRSs due to its complexities and internal inconsistencies, the IASB significantly accelerated its project to replace the standard. Hence investment accounting under Ind AS 109 ought to be appreciated in this backdrop of discarding complexity.

The conceptual framework of IFRS (and by cue of Ind AS) was widely debated and eventually it was agreed that financial statements should faithfully represent the economic phenomena. The text of the accounting standards is long – rather very long, but it bends in principle toward representation of economic phenomena. And for that the principles-based depiction should have three characteristics namely, a) completeness, b) neutrality, and c) absence of error. Investment accounting in general and bond accounting in particular should resonate this credo.

Accounting options for bonds

Bond accounting – recognising income and carrying assets - was done on an amortised cost basis till now. Ind AS 109 eliminates 'held to maturity', 'available for sale' and 'loans and receivables' categories by requiring that on initial recognition, all financial assets are classified into one of just two measurement categories – amortised cost or fair value. While reporting periodically, Ind AS 109 frequents the question, "How is the asset held within the entity's business model?"

Figure 1: *Extract of Application Guidance to Ind AS 109 - Appendix B, clause B4.1.4C*

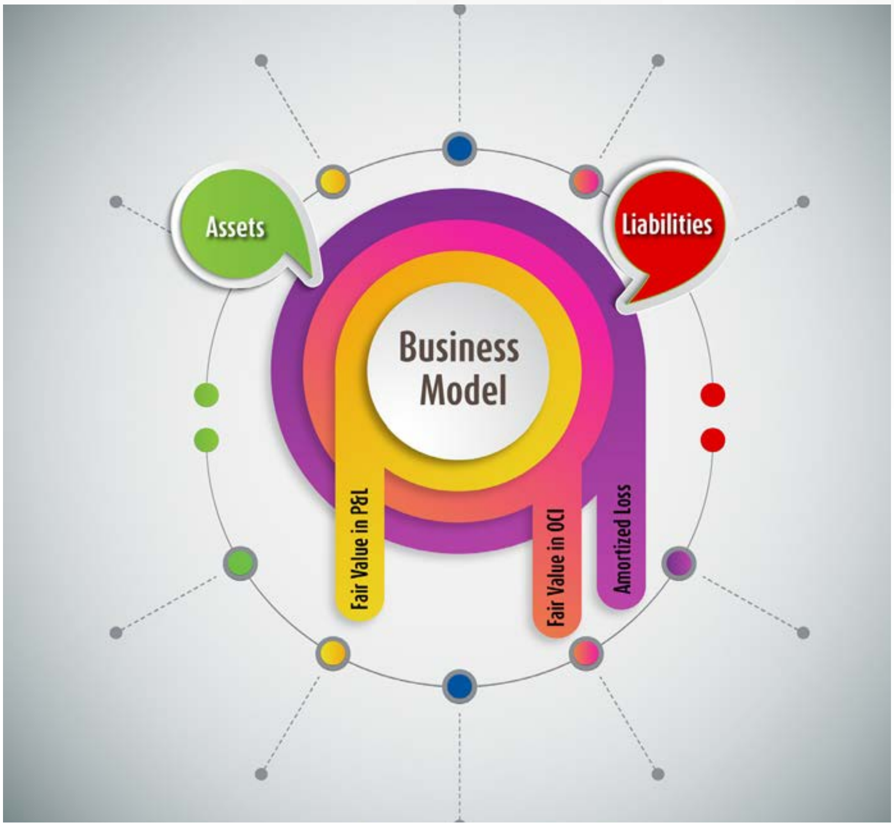
Example 7	**Analysis**
An insurer holds financial assets in order to fund insurance contract liabilities. The insurer uses the proceeds from the contractual cash flows on the financial assets to settle insurance contract liabilities as they come due. To ensure that the contractual cash flows from the financial assets are sufficient to settle those liabilities, the insurer undertakes significant buying and selling activity on a regular basis to rebalance its portfolio of assets and to meet cash flow needs as they arise.	The objective of the business model is to fund the insurance contract liabilities. To achieve this objective, the entity collects contractual cash flows as they come due and sells financial assets to maintain the desired profile of the asset portfolio. Thus both collecting contractual cash flows and selling financial assets are integral to achieving the business model's objective.

Ind AS 109 would re-visit and arguably change the existing practice from the amortised cost convention. Rather the application guidance steers a quick and dirty example for insurers. See Figure 1.

The example packs together both investment intentions i.e., collecting contractual cash flows and selling financial assets leading to 'amortised cost accounting' and 'fair value accounting' respectively. To suitably construe the underlying investment rationale and thereupon organise the accounting, needs a greater comprehension of the 'business model'.

Ind AS 109 identifies the 'business model' as the unique driver of investment accounting.

Business Model



Under Ind AS 109, insurers would have to define the business model as a guiding post to measurement and recognition of investment. In defining the business model, the layered sobriety of reason and accountability needs to prevail over immediate answers. As ordinarily understood, the business model does not allude to the life insurance business' product strategy or distribution philosophy. Business model here dwells on the organisation of groups of financial assets.

Application guidance B 4.1.2 instructs that business models are determined at a level that reflects how groups of financial assets are arranged together to achieve a particular business objective. Basis of conclusion BC 4.1 (C) states that a business model encompasses the way the entity arranges its financial assets to determine its measurement attribute, to provide relevant and useful information to users for their assessment of the amounts, timing and uncertainty of entity's future cash flows.

Clearly the arrangement of financial assets to achieve a stated business objective emphasises the business model – at least from the standpoint of Ind AS 109. Example, premium representing the investment fund under a single premium endowment assurance policy would likely be invested in a zero coupon bond of the same maturity to fully match the liability with an appropriate asset. Here the business objective is 'meeting the lump sum payout on policy maturity', and the business model 'buying a matching asset.'

Clause 4.1.2 of Ind AS 109 states, among others, that a financial asset shall be measured at amortised cost if the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows. The example of the single premium endowment assurance policy fits the narrative, and hence the asset which is held only to collect the single cash flow at the policy's maturity could be measured at amortised cost. However, if the collection of contractual cash flows of an asset is only incidental to achieving but not integrated with the business model's objective, the asset needs to be fair-valued (application guidance B 4.1.6 A).

'Re-balancing of bond portfolio' as the default

Life insurers organise assets mostly to match policy reserves. Broadly, bonds back non-participating reserves, underlying assets – either bonds or equities – in turn intertwine into unit reserves, and a combination overwhelmingly from bonds and partly from equities support participating reserves. Barring an outlier like a zero-coupon bond (if available) whose objective is to collect contractual cash flows and thus match the liabilities on single premium non-participating plans, a life insurer holds assets to dynamically hedge the liabilities using duration matching as its tool.

As interest rates vary over time, so does the portfolio's value i.e., volatility or modified duration-based. For a movement in the interest rate, not merely the bond's value, the modified duration also changes a bit – as measured by convexity. Changes in convexity, however are negligible due to the small effects beyond the second order. In principle, a small change in duration (i.e., positive convexity) requires some portfolio re-balancing (i.e., buying and selling of the bonds) even though the interest rate change is small.

Readers may recall the British actuary Frank Redington's immunisation theory's message "the default approach to managing a liability-matching bond portfolio would desire re-balancing."

The argument that most life insurance business segments hold assets not merely to collect contractual cash flows appeals to carry assets at fair value (clause 4.1.2 A). For example, unit linked policyholders can exercise an open option to partially withdraw from or surrender a policy, which will drive the insurer to sell assets.

Fair Value Accounting

If an asset is carried at fair value, Ind AS 109 provides the choice of recognising the gains / losses between two reporting periods either under the 'Statement of Other Comprehensive Income' (OCI) or 'Profit and Loss Account' (P&L). The default treatment directs the gains/ losses to OCI, however to achieve the matching of revenues with costs, the gains/ losses should be recognised in the P&L (clause 4.1.5).

Matching would be greatly dependent on reserving practices across life insurance business segments. And particularly in products with discretionary participating features, accounting for bonds will elicit deliberation. Surely the use of a particular valuation interest rate on a reporting date will have to be linked with the carrying value of assets backing the participating business' reserves.

Figure 2 records our views on plausible bond accounting treatment. Specific situations may warrant a treatment distinct from that tabulated.

First Time Implementation

With regard to accounting policy, we overestimate what new implementation can do in the short-run and underestimate what it can do in the long-run.

Hence care needs to be observed whilst implementing a new and maiden accounting policy. Accounting policy will have long-run implications on financial reporting, and with that, on investment policy, tax obligation, and regulatory solvency.

Figure 2: *Bond Accounting Treatment and Rationale*

Business segment	Objective of holding bond assets	Likely treatment	Ind AS 109 paragraph reference	Rationale
Unit Linked (UL) Fund	Fair Value of bond assets translate to unit reserves (UL liability)	Fair Value, P&L	Para 4.1.5 (Minimise Accounting mismatch)	As the fair value change in liability is classified under P&L, the corresponding change in UL assets should also be classified under P&L.
Non-participating, Traditional Fund	To match a guaranteed liability	Fair Value, either P&L or OCI	Para 4.1.5 (Minimise Accounting mismatch)	Debt would be classified through P&L to minimise the accounting mismatch – only if the valuation interest rate for policyholders' liabilities is market-orientated.
Participating Fund	To match a guaranteed liability and discretionary benefits	Fair Value, OCI	Para 4.1.2A, read with 4.1.5	Change in the financial liability unlikely to be mirrored by a change in assets, e.g., bonus smoothing. Fund for future appropriations (FFA) may not fully lift the liability. Case for classifying bond assets backing reserves in OCI as the practice would not violate Para 4.1.5 (i.e., no accounting mismatch).
Shareholders' Fund	No specific liability to match	Fair Value, OCI	Para 4.1.2A, read with 4.1.5	Bond investment may be deployed not merely to collect contractual cash flows, but also take interest rate risks.
Loan to Policyholders	To collect cash flows	Amortised cost	Para 4.1.2	Bond investment is likely deployed to collect cash flows, which comprise solely of principal and interest.

Accounting policy is not static to the first implementation. Indeed it must set rules for interpretation on: a) re-classification – a movement between OCI, P&L or amortised cost on change in the business model, b) measurement of fair value of investments that are not quoted or traded, c) subsequent measurements of investments that are initially recognised at fair value or amortised cost, d) measurement and recognition of interest income, and e) measurement and recognition on de-recognition/ sale of an investment.

Closing in

The IFRS implementation of the life insurance industry is at a point of inflection. Although, the effective date is 1st January 2018, some lobbying is ongoing to propose a deferral of IFRS 9 for insurers to align the effective dates between IFRS 9 (Ind AS 109 is an adaptation of IFRS 9) and the new insurance contracts standard IFRS 4 (Phase II) (Ind AS 104 is an adaptation of IFRS 4). The world's leading insurers have begun to evaluate the impact of adopting IFRS 9 on consolidated financial statements.

In India on the other hand, we have accelerated the Ind AS implementation and are staring at the first quarter of Ind AS reporting – metaphorically a semi-colon, a punctuation before the flow takes its onward course. It is almost always a greater pleasure to come across a semi-colon than a period. With the semi-colon there, you get a pleasant little feeling of expectancy; there's more to come; to read on; it will get clearer – as the first quarter of Ind AS reporting takes guard and fuses into the next.

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'THE ACTUARY INDIA' WISHES MANY MORE YEARS OF HEALTHY LIFE TO THE FELLOW MEMBERS
(Who have attained 60 years of age)
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