Amundi
ASSET MANAGEMENT

New accounting standard: more complex implementation and more volatile results

IFRS 9

The application of IFRS 9 starting in 2018 will complicate the processing of some financial instruments and increase the volatility of profit and loss.

Although some insurers may defer application of IFRS 9 to coincide with the application of IFRS 17 on their liabilities, corporations, banks and a large number of bancassurers will apply the new standard to financial assets in 2018.

IFRS 9 changes the classification of financial instruments, applicable impairment rules, and the approach to hedge accounting.

The European Union's approval process has been finalised.

IFRS 9 was adopted by the European Commission in November 2016 through Commission Regulation (EC) No. 2016/2067.

Unlike European Directives, which must be enacted in each country, Regulations are applied directly.

Although the business model is still a critical factor in determining the classification of a financial asset, the characteristics of the instrument held, especially the contractual provisions that define the cash flows it generates, have become essential to this classification.

Classification of debt securities

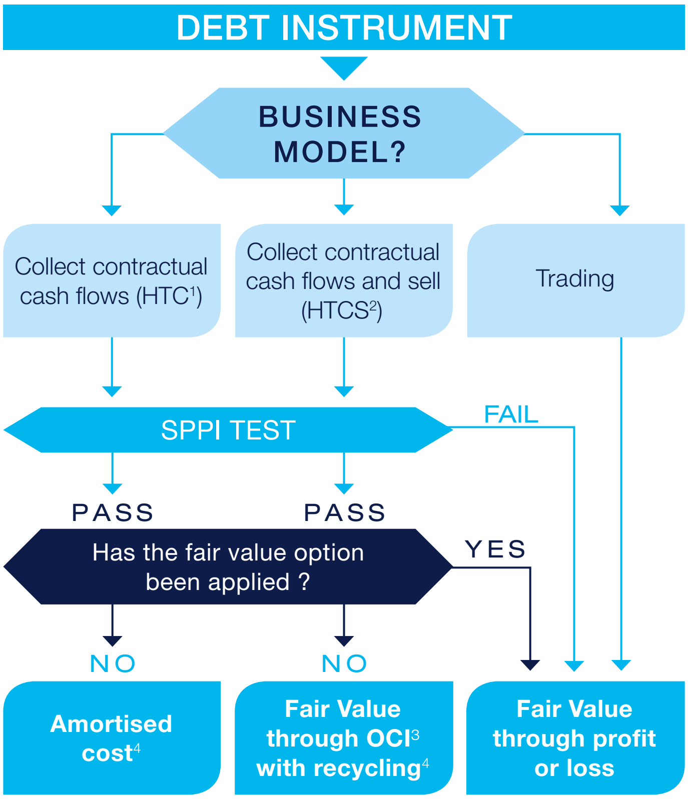
Debt instruments may be held under one of the following three business models:

- with the objective of collecting contractual cash flows,
- with the objective of collecting contractual cash flows and selling financial assets,
- with the objective of selling financial assets (by default)

However, classification also depends on whether the securities are categorised as SPPI (solely payments of principal and interest) or non-SPPI.

A security is categorised as SPPI if its contractual cash flows are solely payments of principal and interest on the principal that is still owed.

The IFRS 9 standard proposes three classifications for debt instruments:



The entity may choose to measure assets at fair value through profit or loss if doing so allows it to eliminate or significantly reduce accounting mismatches.

1. Hold-to-collect - 2. Hold-to-collect and sell - 3. Other Comprehensive Income - 4. Impairment considerations apply

The SPPI test

Interest must compensate for the time value of money, credit risk and other “incidental” items such as liquidity risk, administrative costs and profit margins.

If the financial product contractually includes clauses modifying payment dates for cash flows or the amount of said flows, an in-depth analysis must be carried out.

Examples of non-SPPI securities are convertible bonds and bonds with coupons that are inversely correlated with interest rates. Meanwhile, examples of SPPI securities include bonds with coupons indexed to inflation, or floating rate bonds, whose coupons are indexed to an x-month interbank benchmark rate corresponding to the issue currency even with a cap.

Under IFRS 9, debt instruments that include options are treated as a whole. There are no longer any rules separating such instruments into a “standard” debt component whose income is linked to the cost of money and a derivative component that was necessarily recognised at fair value whose changes will impact profit or loss.

A new impairment model based on expected credit losses starting at the purchase date

In contrast to the rules of IAS 39, which take an approach that reacts to an event once it has occurred, the IFRS 9 impairment model is based on a forward-looking approach.

The new general model[5] distinguishes three stages with different calculation methods depending on the stage. This system is therefore much more complicated to implement. It requires models and parameters to identify when an investment moves from one stage to the next and to estimate provisions in accordance with the new principles.

Initially, the entity recognises losses due to a possible default event in the following 12 months **(stage 1)**. If credit quality deteriorates significantly, the purchased security or loan commitment is considered to have entered **stage 2**, and we must then take into account losses on expected cash flows in the event of a default throughout the lifetime of the security or loan.

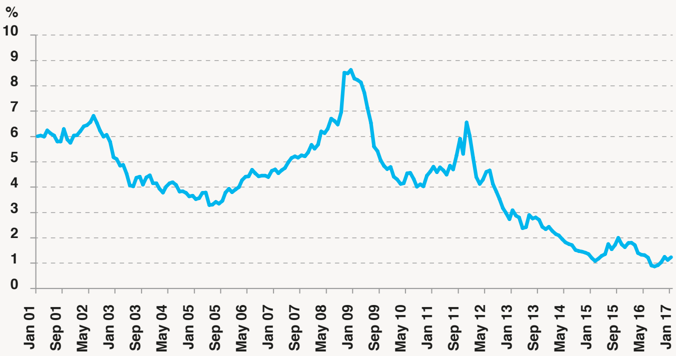
If a bond position has been built up over several purchases, the significant deterioration might only be recognised on a portion of the position. As a matter of fact, the change is calculated for each of the purchases, however, the issuer’s credit quality may have changed between the different purchase dates.

Stage 3 is triggered by the occurrence of a default event. Credit losses to maturity are always taken into account, but the basis for calculation is reduced as the effective interest rate is then applied to the value after impairment.

IFRS 9 implementation will take place in a few months, while interest rates are at historic lows.

Changes in corporate bond yields

(Yield to maturity of Barclays Euro Aggregate Corporate Baa bond index)



Source: Barclays Risk Analytics and Index Solutions ltd ("BRAIS") as of January 2017

The transition of an investment into stage 2 results in a substantial increase in provisions due to the need to take into account losses over the lifetime of the security. If the economic environment deteriorates, a significant percentage of bonds in an insurance portfolio may transition from stage 1 to stage 2, triggering a decline in profit. In the opposite, after a period of recovery, the securities would once again be categorised as stage 1.

Investments in equity instruments

Investments in securities deemed to be equity instruments from the perspective of the issuer (based on criteria set out in IAS 32) are recognised at fair value. Apart from stocks, some subordinated securities meet this criterion, such as perpetual subordinated bonds whose coupon payments may be suspended for an unlimited period.

If the business model is not a “trading” model, the entity may choose to record changes in fair value through Other Comprehensive Income (OCI), however, unlike the current treatment of securities categorised as “available-for-sale assets”, gains or losses recorded in OCI cannot be reclassified to profit or loss once the securities are sold.

The concept of Provision for Permanent Impairment existing in IAS 39 is eliminated. The new standard also eliminates the ability to measure unquoted equity instruments at cost, if the measurement of such securities is deemed unreliable.

5. A simplified approach is permitted for trade receivables, for example, and specific guidance is applied to assets purchased when they are already impaired.

Investments in UCITS[6] : only one possible accounting treatment

IFRS 9 leads to the classification of mutual funds at fair value through profit or loss.

This classification increases the appeal of products whose management aims to reduce volatility. For example, "MinVar" funds, funds that include partial hedging strategies or that implement a type of portfolio insurance may be of heightened interest.

Hedge accounting

The new microhedging principles aim at providing a better link with the company's risk management.

As such, the scope of eligible instruments is changing. For example cap+floor combinations are accepted under IFRS 9.

Quantitative effectiveness criteria have also been eased, and the quantitative 80%-125% bright line thresholds have been eliminated. The new standard promotes taking the risk management policy into account. The hedging relationship must be documented right from the start (and must be updated if the method changes).

Macro hedging is the subject of a specific project, and therefore the provisions of IAS 39 will continue to be applied to some types of hedges.

The option offered to insurers to defer application of IFRS 9 was set out by an amendment to IFRS 4 (the standard for insurance contracts).

The amendment makes it possible to make the implementation of IFRS 9 coincide with that of IFRS 17 on insurance contracts, which is to be applied starting in 2021.

A temporary exemption from applying IFRS 9 is an option for legal entities whose predominant activity is insurance. Eligibility criteria for this exemption take into account the calculated ratio of an entity's insurance liabilities relative to the book value of its total liabilities. If this ratio is greater than 90%, the entity is eligible. If it is between 80% and 90%, the entity is eligible if it does not engage in another activity that generates significant revenue or expenses.

Another approach is permitted in order to reduce the volatility in profit or loss for entities that issue insurance contracts. This involves allowing entities to reclassify to other comprehensive income (OCI) the amount of any gains or losses resulting from the difference in the price of instruments held as part of the insurance activity, classified as FVPL[7] under IFRS 9, while IAS 39 allows a different treatment.

The amendment also defines additional requirements in terms of financial disclosures when these specific provisions are implemented.

6. Except for dedicated consolidated UCITS. The "hold-to-collect and selling" model may be used for securities in such consolidated entities and categorisation as SPPI or non-SPPI should be studied for each of the debt securities.

7. Fair value through profit or loss

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Design: Amundi's Communication Department - 02/2017.