



Preparing for IFRS 9: Investment implications for insurers

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IN BRIEF

- As part of its reforms to the accounting treatment of financial instruments, the International Accounting Standards Board (IASB) finalized International Financial Reporting Standard 9 (IFRS 9) *Financial Instruments* in July 2014 to replace International Accounting Standard 39 (IAS 39) *Financial Instruments: Recognition and Measurement*.
- The migration from IAS 39 to IFRS 9 is expected to result in changes to the accounting treatment of different types of financial instruments. Some of these accounting changes will have implications for the level and volatility of reported profits, which may in turn drive changes in investment behavior.
- This paper discusses some potential effects of IFRS 9 on bond and equity investment¹ strategies and styles, focusing on three key areas:
 - *Fixed income investing*, and the introduction of expected credit losses calculation, which may encourage more detailed credit analysis and active management of bond portfolios.
 - *Equity investing*, and the potential attractiveness of high dividend strategies now that realized gains or losses are not booked into the profit or loss if an election to present fair value changes in Other Comprehensive Income has been made.
 - *Hedge accounting*, and the relative ease of qualification, which is likely to encourage the use of derivatives to manage certain portfolio risks.
- The new accounting standard will be effective from 1 January 2018. While the IASB has proposed a deferral approach for insurance companies until 2021, it is nonetheless imperative for insurers to fully understand this new accounting standard and its investment implications.

¹ This paper focuses on direct investments in bonds and equities, rather than indirect investments, for example via mutual funds.

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Executive summary

INTERNATIONAL FINANCIAL REPORTING STANDARDS are applied to the preparation of financial statements in many jurisdictions outside of the U.S.² As part of its reforms to the accounting treatment of financial instruments, the IASB finalized IFRS 9 *Financial Instruments* to replace IAS 39 *Financial Instruments: Recognition and Measurement* in 2014. The principles set out in IFRS 9 contain several changes to the rules provided by IAS 39, which focus on financial recognition and measurement, impairments and hedge accounting.

The new accounting standard will be effective from 1 January 2018, although the IASB has proposed a deferral approach for insurance companies until 2021. Nevertheless, given the potentially significant implications on investment and asset allocation decisions, it is crucial that insurers fully understand the new accounting standards to prepare for any changes in investment strategies driven by this migration. This is particularly important for insurers that are subsidiaries of larger financial services groups, as they may well be required to provide IFRS 9 information to their parent companies for consolidated accounting purposes from January 2018 onwards if insurance is not the dominant business of the parent.³

This paper focuses⁴ on the impact of IFRS 9 on bond and equity investments, which typically form the majority of a life insurance company's general asset allocation. We believe that investment behavior is likely to change as a result of the introduction of IFRS 9. Not least because of the way that IFRS 9 classifies bonds and equities, but also due to the methods used to measure the financial performance of these financial instruments, and by the location (on either the balance sheet or the P&L statement) where they are measured.

² Domestic U.S. companies whose securities trade in US public markets, must prepare accounts in line with the US Generally Accepted Accounting Principles (US-GAAP).

³ In December 2015, the IASB published an exposure draft containing proposed amendments to IFRS 4 Insurance Contracts that address concerns relating to the effective dates for IFRS 9 and the new Insurance Contracts standard. The IASB has acknowledged the potential accounting volatility that may arise if IFRS 9 were to be applied before the new Insurance Contracts standard. The IASB has proposed to amend IFRS 4 Insurance Contracts to give companies whose business model is predominantly to issue insurance contracts the option to defer the effective date until 2021 (the "deferral approach"). The IASB has also proposed to give insurers who implement IFRS 9 the option to remove from profit or loss some of the accounting mismatches and temporary volatility that could occur before the new Insurance Contracts standard is implemented (the "overlay approach").

⁴ Other areas, such as the challenges that may arise from the new documentation and disclosure requirements needed to comply with IFRS 9, are not within the scope of this paper.

Exhibit 1 provides a summary of the potential implications arising from the migration to IFRS 9.

EXHIBIT 1: IFRS 9 SUMMARY OF POTENTIAL INVESTMENT IMPLICATIONS

Rule change compared to IAS 39	Description	Potential investment implications
Fixed income investment: Accounting for expected credit losses	To accelerate the recognition of credit losses for bonds not classified as Fair Value through Profit or Loss (FVTPL), entities are required to allow for expected credit losses (ECL) as a forward looking indicator. The ECL calculation are expected to increase profit or loss (P&L) and balance sheet volatility, especially when the loss allowance basis switches between the 12-month ECL and the lifetime ECL pools.	To reduce any ECL- related volatility, initial and ongoing credit analysis and risk management is likely to become more important for bond portfolios, particularly when moving up the credit risk spectrum.
Fixed income investment: The concept of tainting will cease to exist	Under IAS 39, “tainting” refers to the loss of the right to classify any existing and new bonds as Held-to-Maturity (HTM) for two years after a significant amount of HTM bonds are sold or reclassified without meeting certain conditions. The removal of the “tainting” concept from IFRS 9 means there is more flexibility to sell a bond classified as Amortized Cost (which is a similar category to HTM under IAS 39) ⁵ without affecting the P&L statement and balance sheet.	A more active approach to bond and credit risk management is likely to be encouraged.
Equity investment: Changes in the accounting treatment of realized gains/losses	To avoid P&L volatility during the investment period, an entity can make an election to present fair value changes in Other Comprehensive Income (OCI) for equity investments not held for trading purposes. However, this option to achieve greater P&L stability comes with an opportunity cost, as any realized gains will not be recorded in the P&L statement.	Some investors may try to compensate for the opportunity cost by focusing on high dividend strategies. It is also possible that some investors may choose the alternative FVTPL classification if they want the opportunity to register any realized gains in the P&L statement.
Hedge accounting: The introduction of relatively more flexible hedge accounting rules	The removal of the 80%-125% effectiveness test as one of the hedge accounting criteria means that it will be relatively easier to apply for hedge accounting treatment under IFRS 9 in order to reduce P&L fluctuations that can otherwise be caused by certain derivatives.	The easier application of hedge accounting is likely to encourage the use of derivatives to manage certain risks of a portfolio—for example, currency risks.
More embedded derivatives may need to be marked-to-market	The introduction of the “Solely Payments of Principal and Interest” criteria under IFRS 9 may trigger the requirement to classify some structured notes as FVTPL, which may lead to P&L volatility due to changes in the value of the host contract and of the embedded derivatives.	The use of certain types of structured notes—for example, inverse floaters—may be discouraged as investors try to avoid potential P&L volatility.

Source: IAS 39, IFRS 9, J.P. Morgan Asset Management; as of February 2016

⁵ While Held-to-Maturity is comparable to Amortized Cost in terms of their accounting measurements, they are not identical due to the requirement to include an ECL calculation under IFRS 9 and the difference in impairment models between the two sets of accounting rules. In addition, their classification criteria also differ.

Fixed income investing

CLASSIFICATION FOR INVESTMENT IN BONDS

Under IFRS 9, bonds should be classified and measured based on an entity’s business model for managing the bonds and their contractual cash flow characteristics (**Exhibit 2**). The business model refers to how an entity manages bonds in order to generate cash flows—either by collecting contractual cash flows, selling the bonds or both. An entity is also required to determine whether the bond’s contractual cash flows are “Solely Payments of Principal and Interest” (SPPI) on the principal amount outstanding.

The entity must assess its business model by looking at several factors, including the expected frequency, volume and timing of asset sales, the measurement of financial asset performance, the management of investment risks, and whether the compensation of business managers is based on a fair value of the assets managed or on the contractual cash flows collected.

EXHIBIT 2: CLASSIFYING BOND INVESTMENTS USING IFRS 9

	Criteria I: Business model	Criteria II: Contractual Cash Flow Characteristics
Amortized Cost	Hold financial assets to collect contractual cash flows	Solely Payments of Principal and Interest on the principal amount outstanding
Fair Value through Other Comprehensive Income (FVOCI)	Hold financial assets to collect contractual cash flows and for sale	
Fair Value through Profit or Loss (FVTPL)	Effectively a residual category for bonds that cannot be classified as either Amortized Cost or FVOCI, but an entity can also make an irrevocable election to classify a bond as FVTPL to reduce accounting mismatches*	

Source: IFRS 9, J.P. Morgan Asset Management; as of February 2016. *Note that criteria I and II are not applicable to FVTPL.

The choice of accounting classification for bonds is likely to be based on many factors in addition to tolerance for balance sheet and P&L volatility. Insurance companies are also likely to consider the sensitivity of their assets and liabilities to changes in interest rates. Insurers whose liabilities are valued on a book value or smoothed basis are likely to have a relatively large proportion of bonds classified as Amortized Cost or FVOCI to reduce the sensitivity of their net assets to changes in interest rates.

Exhibit 3 presents the closest comparable accounting classifications for bonds in IAS 39 and IFRS 9.

EXHIBIT 3: ACCOUNTING CLASSIFICATIONS FOR BONDS—COMPARISONS BETWEEN IAS 39 AND IFRS 9

Financial Assets	IAS 39	IFRS 9
Bonds	Held-to-Maturity	Amortized Cost
	Available-for-Sale	FVOCI
	Held-for-Trading	FVTPL

Source: IAS 39, IFRS 9, J.P. Morgan Asset Management; as of February 2016.

While Held-to-Maturity is comparable to Amortized Cost and Available-for-Sale is comparable to FVOCI in terms of their accounting measurements, they are not identical due to the requirement to include an ECL calculation under IFRS 9 and the difference in impairment models between the two sets of accounting rules. In addition, their classification criteria also differ.

FIXED INCOME: ACCOUNTING FOR EXPECTED CREDIT LOSSES

The ability to delay the recognition of credit losses on loans until there is evidence of a trigger event has been identified as one of the weaknesses in the existing incurred loss model outlined in IAS 39. To tighten up the credit loss rules, a forward looking impairment model has been built into IFRS 9 that is applicable for bonds classified as Amortized Cost or FVOCI. Reporting entities are required to make ECL calculations for these bonds.

Generally the loss allowance shall be calculated at an amount equal to the 12-month ECL unless there has been a significant increase in credit risk since the purchase date of the bond, at which time the loss allowance will be measured at an amount equal to the lifetime ECL. Since the ECL calculation is designed to reflect the changes in ECL relative to the initial recognition of a bond, the same bond purchased at a different point in time may have a different ECL allowance. An entity shall recognize in the P&L statement, as an impairment gain or loss, changes in the amount of ECL. See Appendix I for a more detailed explanation of the ECL calculation.

Any change in an entity’s ECL calculation is likely to lead to significant balance sheet and P&L volatility, especially when the loss allowance calculation changes between the 12-month and the lifetime ECL pools. Insurers with less tolerance for accounting volatility may therefore want to perform much more detailed credit analysis, especially for volatile asset classes like high yield bonds, in order to fully assess the long-term creditworthiness of bond issuers before they make an investment decision.

Exhibit 4 and Exhibit 5 in the worked example to follow provide a simplified set of accounting entries to compare the differences in accounting entries under IAS 39 and IFRS 9 when accounting for debt instruments.

ACCOUNTING STANDARDS FOR DEBT INSTRUMENTS: IAS 39 VS. IFRS 9 CASE STUDY

The examples in this case study have been simplified and are intended only to illustrate how ECL calculations can affect accounting entries at the first reporting date after a bond purchase.

An entity purchases a bond at par for \$1,000 very shortly before its financial reporting date (we assume that there is no coupon payment between the purchase date and the first financial reporting date). On the reporting date, the market value of the bond decreases to \$950.

Exhibit 4 shows how the bond would be accounted for under IAS 39, while **Exhibit 5** shows the accounting treatment under IFRS 9. The main difference is that, under IFRS 9, the reporting entity is required to register an impairment gain or loss in its P&L statement equal to the changes in ECL since the last reporting date.

In this example, the entity determines that there has not been a significant increase in credit risk since the initial recognition of the bond and thus reports a loss allowance equals to the 12-month ECL, which amounts to \$30.

EXHIBIT 4: ACCOUNTING TREATMENT UNDER IAS 39

AT PURCHASE DATE

Held-to-Maturity, Available-for-Sale, Held-for-Trading		
	Debit	Credit
Bond	\$1,000	
Cash		\$1,000

AT REPORTING DATE

Held-to-Maturity*		
No accounting entries		

Available-for-Sale		
	Debit	Credit
Unrealized loss (in OCI)	\$50	
Bond		\$50

Held-for-Trading		
	Debit	Credit
Loss (in P&L)	\$50	
Bond		\$50

	Held-to-Maturity	Available-for-Sale	Held-for-Trading
Potential balance sheet volatility	X	✓	✓
Potential P&L volatility	X	X	✓

Source: IAS 39, IFRS 9, J.P. Morgan Asset Management; as of February 2016. For illustrative purposes only.

* Note: The Held-to-Maturity classification is similar to Loans and Receivables in respect to its effect on balance sheet and P&L volatility.

ACCOUNTING STANDARDS FOR DEBT INSTRUMENTS: IAS 39 VS. IFRS 9 CASE STUDY

EXHIBIT 5: ACCOUNTING TREATMENT UNDER IFRS 9

AT PURCHASE DATE

Amortized Cost, FVOCI, FVTPL		
	Debit	Credit
Bond	\$1,000	
Cash		\$1,000

AT REPORTING DATE

Amortized Cost		
	Debit	Credit
Impairment loss (in P&L)	\$30	
Bond		\$30

FVOCI		
	Debit	Credit
Unrealized loss (in OCI)	\$50	
Bond		\$50
Impairment loss (in P&L)	\$30	
Loss allowance (in OCI)		\$30

FVTPL		
	Debit	Credit
Loss (in P&L)	\$50	
Bond		\$50

	Amortized Cost	FVOCI	FVTPL
Potential balance sheet volatility	✓	✓	✓
Potential P&L volatility	✓	✓	✓

Source: IFRS 9, J.P. Morgan Asset Management; data as of February 2016. For illustrative purposes only.

THE IMPORTANCE OF CREDIT ANALYSIS AND ACTIVE BOND MANAGEMENT UNDER IFRS 9

The ECL requirement in IFRS 9 makes the initial selection of bonds much more important, as selecting bonds with good long-term credit health is key to reducing the risk of future P&L fluctuations caused by changes in ECL. This is especially important for insurers that would like to adopt a buy-and-maintain bond investment strategy.

In an ideal world, the best action is to sell the bond prior to the start of its credit quality decline. Such early action will avoid P&L volatility due to the subsequent increase in ECL. However, in practice, a bond may only come into focus after its credit quality has started to deteriorate, by which time the credit spread is likely to have already moved up and the price may have fallen significantly. At that point, trading out of the bond position will involve realizing a loss. Therefore, investors must accept a trade-off between suffering a current loss and the avoidance of a potentially larger P&L fluctuation in the future due to any ECL increase.

The potential impact of the introduction of an ECL calculation on investment strategy can be illustrated by looking at bonds issued by Petrobras, the Brazilian oil group. Take, for example, “PETBRA 5.75% 20 January 2020”—a USD 2.5 billion 10-year senior unsecured bond issued by Petrobras with a 5.75% coupon on 30 October 2009.

On 10 September 2015, Standard & Poor’s announced a double-notch downgrade for Petrobras, taking the company’s foreign currency long-term rating from BBB- to BB. This decision followed a downgrade to Brazil’s sovereign rating (Exhibit 6A). Following subsequent downgrades to Petrobras by Moody’s and Fitch, the company’s credit rating was deemed to be sub-investment grade by all three major rating agencies. As a result, the company’s bonds no longer qualified for certain investment grade bond indices.

Brazil spreads were 25-50 basis points wider after the country’s credit downgrade. However, Petrobras suffered more significant price falls and a greater widening in its yield spread following its downgrade (Exhibit 6B).

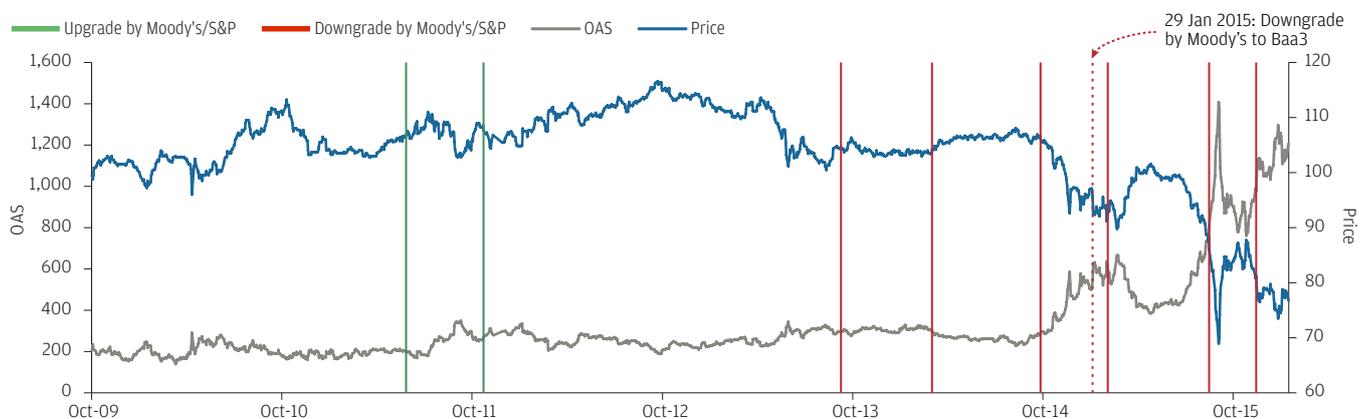
EXHIBIT 6A: RATING ACTIONS ON PETBRA 5.75% 20 JANUARY 2020 BY S&P AND MOODY’S

Date	Rating action by S&P	Rating
23-Oct-09	Initial Rating	BBB-
17-Nov-11	Upgrade	BBB
24-Mar-14	Downgrade	BBB-
10-Sep-15	Downgrade	BB

Date	Rating action by Moody’s	Rating
23-Oct-09	Initial Rating	Baa1
21-Jun-11	Upgrade	A3
3-Oct-13	Downgrade	Baa1
21-Oct-14	Downgrade	Baa2
29-Jan-15	Downgrade	Baa3
24-Feb-15	Downgrade	Ba2
9-Dec-15	Downgrade	Ba3

Source: Moody’s, Standard and Poor. Data as of 9 February 2016.

EXHIBIT 6B: OPTION-ADJUSTED SPREAD FOR PETBRA 5.75% 20 JANUARY 2020



Source: Barclays Live, Bloomberg, Moody’s, Standard and Poor’s, J.P. Morgan Asset Management. Data as of 9 February 2016. The green and red bars indicate an upgrade and a downgrade respectively by Standard & Poor’s and/or Moody’s.

The information in this case study is intended as an example only and should not be construed as advice, it may not be suitable for your particular circumstances and if you are unsure of the suitability of any investment you should seek financial advice. Past performance is not a guarantee of the future. The opinions and views expressed here are those held by the author as at date of this document, which are subject to change and are not to be taken as or construed as investment advice. J.P. Morgan Asset Management may or may not hold positions on behalf its clients in any or all of the aforementioned securities.

The downgrade by Moody's on 29 January 2015 represented a critical decision point for investors. At this point, the bond was trading at about \$95 per \$100 notional, which was below its issuance price. It was still rated as investment grade, hence investors may still choose to rely on the "low credit risk"⁶ definition under IFRS 9. In deciding whether to sell the bond, an investor would need to consider the trade off between the desire to avoid potential future P&L volatility caused by an increase in the ECL requirement, and the recognition of a realized loss on the immediate sale of the bond.

FIXED INCOME: ENDING THE CONCEPT OF "TAINTING"

Under IAS 39, insurers operating in jurisdictions where insurance liabilities are not measured at fair value have tended to classify some of their bonds as Held-to-Maturity (HTM). Under this classification, changes in the market value of a bond will generally have no impact on the insurer's accounts (unless the bond is impaired). Consequently, the stability provided to the valuation of both assets and liabilities translates into greater balance sheet and P&L stability.

However, bonds classified as HTM can only be sold or reclassified in limited circumstances under IAS 39. Unless the conditions are met, any significant sales or reclassification out of HTM investments will result in the reporting entity losing the right to classify any existing investments as HTM. The entity is also not allowed to classify any new investments in the following two years as HTM. This rule is sometimes referred to as the "tainting" penalty.

Under IFRS 9, the concept of "tainting" has been abolished. The classification of bonds is based instead on the entity's business model and the contractual cash flow characteristics of the entity's bond holdings. Sales of bonds in the Held-to-Collect business model are not as tightly restricted. For instance, sales driven by an increase in credit risk are not considered to be inconsistent with a Held-to-Collect model.

This more flexible approach encourages more active management of bond portfolio and credit risk controls, because insurers are no longer penalized for selling bonds as Amortized Cost under certain conditions.

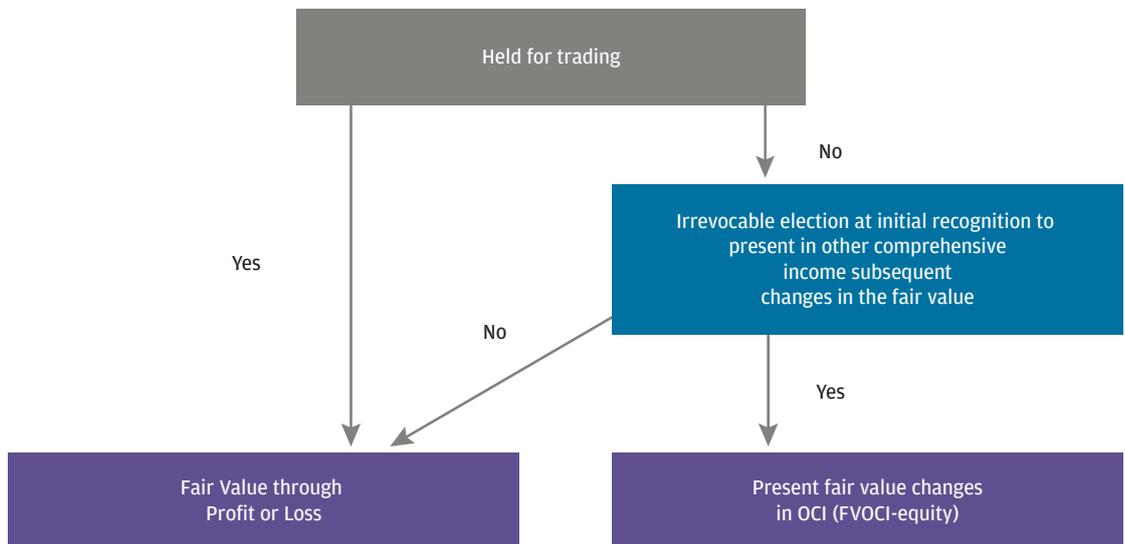
⁶ According to IFRS 9, an external rating of "investment grade" can be considered an attribute of low credit risk.

Equity investing

CLASSIFICATION FOR INVESTMENT IN EQUITIES

Under IFRS 9, equities held for trading are required to be classified as FVTPL. For other equities, entities can make an irrevocable election on initial recognition to present fair value changes in the OCI rather than the P&L statement (**Exhibit 7**).

EXHIBIT 7: CLASSIFYING EQUITY INVESTMENTS UNDER IFRS 9



Source: IFRS 9, J.P. Morgan Asset Management; as of February 2016.

Exhibit 8 presents the closest comparable accounting classifications for equities in IAS 39 and IFRS 9.

EXHIBIT 8: ACCOUNTING CLASSIFICATIONS FOR EQUITY—COMPARISONS BETWEEN IAS 39 AND IFRS 9

Financial Assets	IAS 39	IFRS 9
Equity	Available-for-Sale	Fair Value through Other Comprehensive Income - Equity
	Held-for-Trading	Fair Value through Profit or Loss

Source: IAS 39, IFRS 9, J.P. Morgan Asset Management; as of February 2016.

While Available-for-Sale is comparable to FVOCI-Equity, they are not identical, due to the difference in the location of financial statements in which any realized gain/loss on sales is registered.

EQUITY INVESTMENTS: ACCOUNTING FOR REALIZED GAINS/LOSSES

Similar to an Available-for-Sale classification under IAS 39, IFRS 9 allows an initial option to be made to present fair value changes in the OCI rather than the P&L statement. However, this “P&L stability” option comes with an opportunity cost under IFRS 9, as any realized gain (or loss) will not be recorded in the P&L statement.

Entities that have opted to present fair value changes in the OCI may want to compensate for this opportunity cost by focusing on higher dividend yielding stocks, as generally dividends will continue to be recorded in the P&L statement under IFRS 9. Dividend seeking investors may therefore focus on certain countries or industries after careful analyses of past and expected future dividend trends.

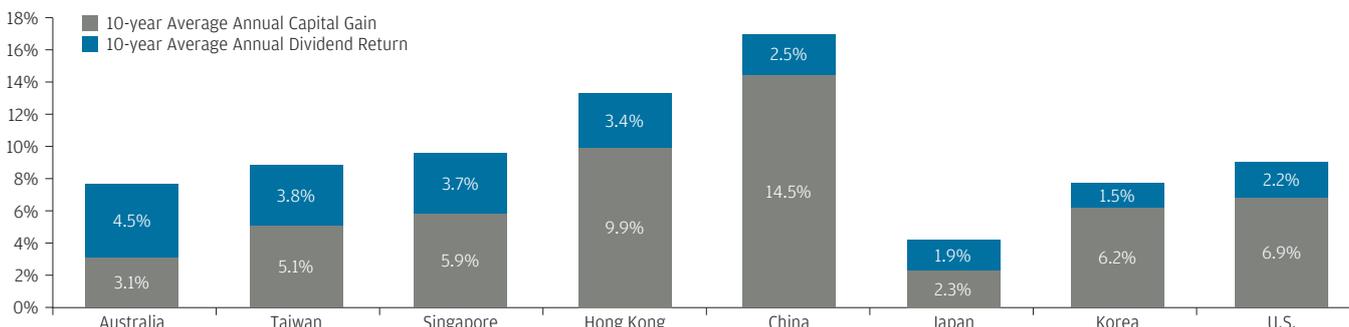
Exhibit 9A shows the 10-year historical average capital gain and dividend return for a number of Asian Pacific equity markets. This exhibit highlights that equity markets in Australia, Taiwan, Singapore and Hong Kong have historically

offered higher dividend returns compared with the other Asian Pacific countries.

Exhibit 9B shows the 10-year historical average capital gain and dividend return for the Taiwan market as a whole, and also by industry. This exhibit highlights that while some sectors, such as the telecoms and materials sectors, have historically produced relatively lower capital gains, they have produced considerably higher dividend returns. Please see **Appendix II** for sector analyses of the Australia, Singapore and Hong Kong markets.

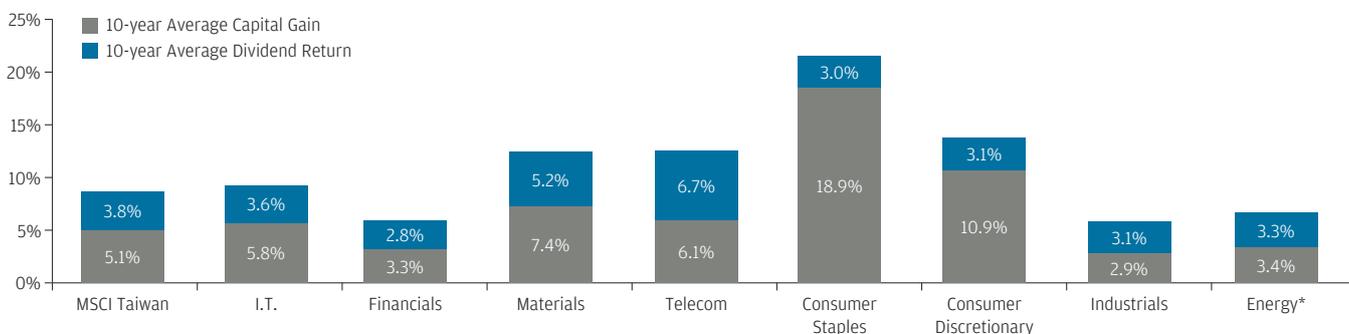
Other investors who do not want to suffer this opportunity cost may choose to classify an equity investment as FVTPL instead. It is possible that these investors may trade more frequently, as they may be tempted to sell their holdings as soon as they make a small gain in order to register a profit and to avoid potential future price volatility.

EXHIBIT 9A: HISTORICAL DIVIDEND RETURN VS. CAPITAL GAIN ACROSS SELECT ASIAN PACIFIC MARKETS



Source: Bloomberg, MSCI, J.P. Morgan Asset Management. Data as of 31 December 2015. Period covered from 31 December 2006 to 31 December 2015. For capital markets except U.S., MSCI indexes are used. S&P 500 is the proxy for U.S. equity market. Price return is the annual price return. For example, the price return for 2015 is the percentage change between the price index levels (Bloomberg field “PX_LAST”) on 12/31/2015 and 12/31/2014. 10-year average annual price return is the arithmetic average of the annual returns for 2006 to 2015. Annual dividend return is calculated as the net dividend per share received in the past year at year end (Bloomberg field “NET_12M_DPS_AGGTE”) divided by the price index level from 12 months ago. 10-year average annual dividend return is the arithmetic average of the annual returns for 2006 to 2015. Returns are in local currency terms.

EXHIBIT 9B: MSCI TAIWAN - HISTORICAL DIVIDEND RETURN VS. CAPITAL GAIN ACROSS SECTORS



Source: Bloomberg, MSCI, J.P. Morgan Asset Management. Data as of 31 December 2015. Period covered from 31 December 2006 to 31 December 2015. From the left of the horizontal axis, the sectors are sorted in a descending order according to the weightings in MSCI Taiwan. Price return is the annual price return. For example, the price return for 2015 is the percentage change between the price index levels (Bloomberg field “PX_LAST”) on 12/31/2015 and 12/31/2014. 10-year average annual price return is the arithmetic average of the annual returns for 2006 to 2015. Annual dividend return is calculated as the net dividend per share received in the past 12 months at year end (Bloomberg field “NET_12M_DPS_AGGTE”) divided by the price index level from 12 months ago. 10-year average annual dividend return is the arithmetic average of the annual returns for 2006 to 2015. Returns are in local currency terms. *MSCI Taiwan Energy Index is only available from 2006 onwards, therefore the returns of the energy sector are calculated as a nine-year average.

Hedge accounting

IN GENERAL, IT IS EASIER TO QUALIFY FOR HEDGE ACCOUNTING under IFRS 9, compared with IAS 39. As a result, hedging derivatives are likely to cause less net P&L volatility. Insurers may therefore be encouraged to use derivatives more actively to implement more effective risk management strategies.⁷

REMOVAL OF THE IAS 39 QUANTITATIVE EFFECTIVENESS TEST

Under IAS 39, the use of hedge accounting is only permitted if the reporting entity can prove that the hedging strategy meets a set of relatively strict criteria. One of the criteria is the requirement that the effectiveness ratio (the change in the fair value of the hedging instruments relative to the change in fair value of the hedged items) must fall between 80% and 125% on both a retrospective and a prospective bases. If the ratio falls outside of the 80-125% band, the hedge will be considered ineffective and any changes in the mark-to-market value of the derivatives will have an immediate impact on the P&L statement.

It can be argued that hedge accounting rules under IAS 39 are not very supportive of risk management activities as some hedging programs, while economically sensible, do not qualify for hedge accounting treatment currently.

Under IFRS 9, hedge accounting can be more closely aligned with risk management strategies and better reflect the objective of hedging activities. In general, the application of hedge accounting will become relatively easier due to the removal of the 80-125% quantitative effectiveness test requirement. In fact, prospective effectiveness test can be performed on a qualitative rather than quantitative basis in some cases.

We further examine the implications of these changes in the following examples:

⁷ IFRS 9's general hedge accounting rules do not address specific accounting requirements for open portfolios or macro hedging. Instead, the IASB is currently discussing proposals for these items and has published a Discussion Paper on the subject: "Accounting for Dynamic Risk Management: A Portfolio Revaluation Approach to Macro Hedging", Discussion Paper DP/2014/1, (IASB, IFRS, April 2014).

EXAMPLE 1: ACCOUNTING FOR THE TIME VALUE OF OPTIONS UNDER IFRS 9

Certain financial options are useful for insurers to hedge downside risks while maintaining upside potential. For example, receiver interest rate swaptions (options to enter into a receiver fixed interest rate swap in the future) can provide protection against the risk of a fall in interest rates while allowing an insurer to benefit from any interest rate rises.

Under IAS 39, changes in the time value of these options are likely to cause P&L volatility, unless there are eligible hedged items with the same type of “optionality.”

Under IFRS 9, the same option is likely to create less P&L volatility. For example, where the option is used to hedge a future transaction related to a financial item, any changes in the time value of the option can be accumulated in the OCI and be reclassified into the P&L statement when the financial transaction occurs. And in cases of a time-period hedge (where the option offers downside protection on an existing item over a period of time), only the amortization of the original time value of the swaption (the time value at the time of designation of the option) will need to be reflected in the P&L statement.

EXAMPLE 2: USE OF INTEREST RATE DERIVATIVES TO ENHANCE ASSET DURATION

Some insurers currently use long-dated bonds to serve two purposes—first, to provide yield; and second to manage liability duration matching. Under the current low yield environment, long-dated bonds with lower credit ratings may need to be used to meet a target level of yield. Price fluctuations can be largely isolated from the P&L statement if these bonds are classified as Held-to-Maturity or Available-for-Sale under IAS 39.

Under IFRS 9, the introduction of the ECL requirement for bonds classified as Amortized Cost or FVOCI may pose challenge to this investment model, as the potential ECL-related P&L volatility is likely to increase with longer duration and lower credit rating.

The new hedge accounting standard may encourage some insurers to separate their asset liability duration matching decisions from their yield seeking decisions. For instance, insurers operating in countries with liquid and long-dated interest rate swap markets may consider using interest rate derivatives to match liability duration, but search for yield from asset classes like higher yielding short-dated bonds that may create relatively less ECL volatility.

Embedded derivatives

MORE EMBEDDED DERIVATIVES WILL BE MARKED-TO-MARKET

Derivatives can be embedded into a host contract to transform the basic cash flows of the host contract. IAS 39 does not require certain derivatives embedded in a host contract to be bifurcated. Hence, any change in the market value of these embedded derivatives will not cause any P&L volatility. Thus, some insurers prefer to access the economics of certain derivatives (sometimes for the purpose of yield enhancement) via structured notes (i.e. host contracts plus embedded derivatives) rather than standalone derivatives.

To avoid embedded derivatives causing P&L volatility under IFRS 9, structured notes will need to be classified as either Amortized Cost or FVOCI, for which one of the classification requirements is that cash flows from the structured notes (after allowing for the effect of the embedded derivatives) must satisfy the SPPI criteria.

It should be noted that certain types of embedded derivatives, which could have avoided the bifurcation requirement under IAS39, may fail the SPPI test under IFRS 9. These include some inverse floaters (where the coupon payment is inversely linked to the level of interest rates) and some interest rate index-related range accruals. As a result, the entire structured note (the host contracts plus the embedded derivatives) will need to be classified as FVTPL under IFRS 9, and therefore both the host contract and the embedded derivatives may generate potential balance sheet and P&L volatility.

Conclusion and afterword

In this paper, we have highlighted some of the potential impacts of IFRS 9 on bond and equity investment strategies and styles. Specifically, we have discussed three main potential effects:

- The importance of more detailed credit analysis and active management of bond portfolios
- The shift of preference towards higher dividend equities
- More active use of derivatives to manage certain portfolio risks

The effect of the change in accounting standards may extend beyond these specific areas. In fact, the issuers of bonds and equities may also adjust the features of capital instruments based on the new investment preference created by the accounting rule changes.

Until investors in insurance companies better understand the cause and nature of the fluctuations in the P&L statement and balance sheet under IFRS 9, any such additional volatility may be interpreted as an increase in the risk and hence the move to IFRS 9 could affect the valuation of insurance companies.

APPENDIX I

CALCULATING EXPECTED CREDIT LOSSES FOR BONDS: 12-MONTH ECL VS. LIFETIME ECL

According to IFRS 9, credit loss is defined as below:

$$\begin{aligned}
 \text{Credit Loss} &= \text{PV (All the cash shortfalls expected over the life)} \\
 &= \text{PV (Contractual cash flows that are due to an entity under the contract} \\
 &\quad - \text{cash flows that the entity expects to receive)}
 \end{aligned}$$

Lifetime ECL are the expected present value measure of all cash shortfalls that arise if a default occurs in the lifetime of the bond, which are the weighted by the probability of default.

$$\begin{aligned}
 \text{Lifetime ECL}_1 &= PD_1 \times (\text{Credit Loss | default in period 1}) \\
 &\quad + PD_2 \times (\text{Credit Loss | default in period 2}) \\
 &\quad + \dots + PD_N \times (\text{Credit Loss | default in period N})
 \end{aligned}$$

where PD_i=Probability of default in period i

12-month ECL are a portion of lifetime ECL and represent the lifetime cash shortfalls that will result if a default occurs in the next 12 months after the reporting date, weighted by the probability of that default occurring.

$$\text{12-month ECL}_1 = PD_1 \times (\text{Credit Loss | default in period 1})$$

Note that the 12-month ECL **do not** only measure the cash shortfalls that are predicted over the next 12 months, but it covers the cash flow shortfalls that are predicted over the lifetime of the bond, if a default was to occur in the next 12 months.

For a bond that is not considered credit impaired at purchase, initial ECL shall be measured at an amount that equals 12-month ECL. At each subsequent reporting date, an entity is required to re-assess the credit risk of the bond. The loss allowance shall continue to be measured at the 12-month basis if its credit risk has not increased significantly since initial recognition; otherwise a loss allowance shall be measured at an amount that equals the lifetime ECL. This ECL measurement switch is not required if the bond is still considered to have low credit risk at the reporting date.

The loss allowance is discounted to the reporting date using the effective interest rate determined at initial recognition.

To determine whether the bond has low credit risk, an entity may use its internal credit risk ratings or other methodologies that are consistent with a globally understood definition of low credit risk. An external rating of “investment grade” can be viewed as an attribute of low credit risk.

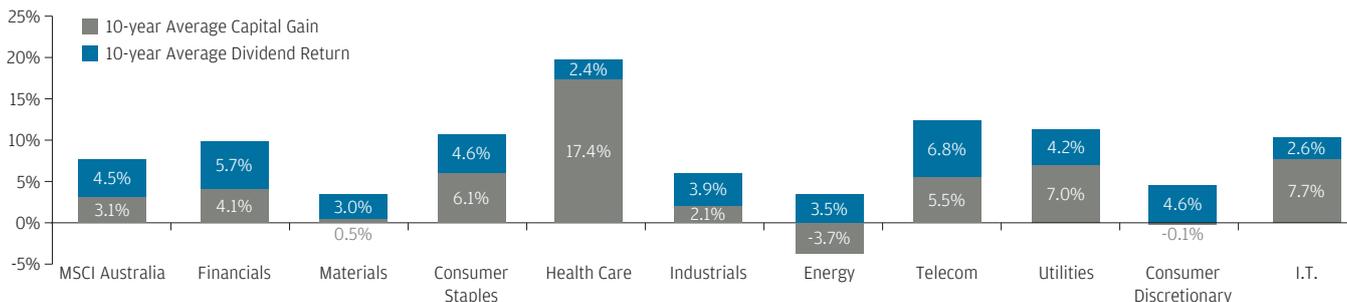
Relatively significant P&L volatility can potentially be created as the loss allowance calculation changes between the 12-month and the lifetime ECL pools.

APPENDIX II

HISTORICAL DIVIDEND RETURN AND CAPITAL GAIN FROM SELECT ASIAN PACIFIC MARKETS

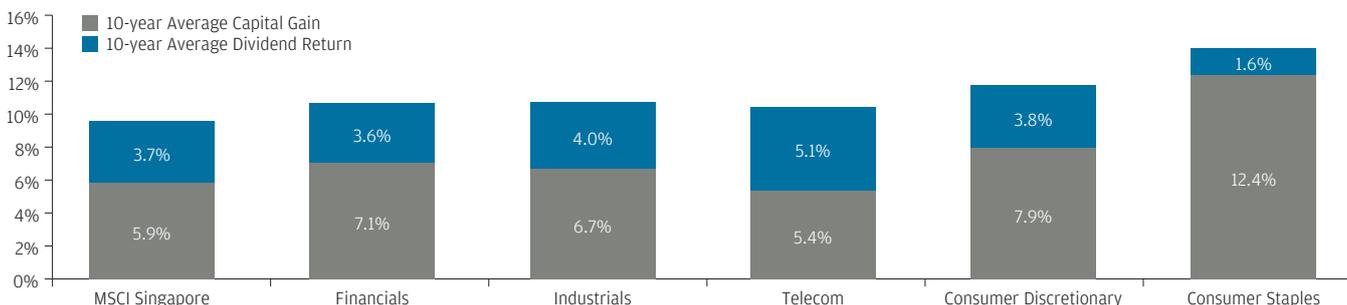
Exhibits 10A, 10B and 10C show the 10-year historical average capital gain and dividend return for the Australia, Singapore and Hong Kong markets across sectors, respectively.

EXHIBIT 10A: MSCI AUSTRALIA – HISTORICAL DIVIDEND RETURN VS. CAPITAL GAIN ACROSS SECTORS



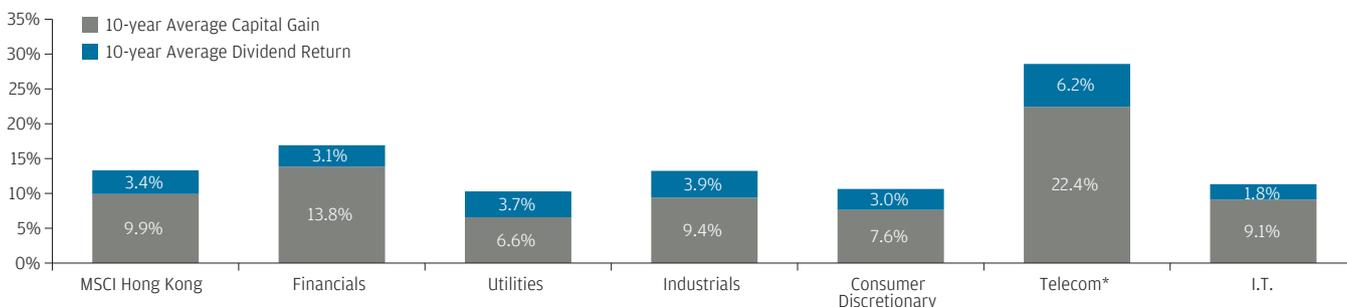
Source: Bloomberg, MSCI, J.P. Morgan Asset Management. Data as of 31 December 2015. Period covered from 31 December 2006 to 31 December 2015. From the left of the horizontal axis, the sectors are sorted in a descending order according to the weightings in MSCI Australia as of 31 December 2015. Price return is the annual price return. For example, the price return for 2015 is the percentage change between the price index levels (Bloomberg field "PX_LAST") on 12/31/2015 and 12/31/2014. 10-year average annual price return is the arithmetic average of the annual returns for 2006 to 2015. Annual dividend return is calculated as the net dividend per share received in the past 12 months at year end (Bloomberg field "NET_12M_DPS_AGGTE") divided by the price index level from 12 months ago. 10-year average annual dividend return is the arithmetic average of the annual returns for 2006 to 2015. Returns are in local currency terms.

EXHIBIT 10B: MSCI SINGAPORE – HISTORICAL DIVIDEND RETURN VS. CAPITAL GAIN ACROSS SECTORS



Source: Bloomberg, MSCI, J.P. Morgan Asset Management. Data as of 31 December 2015. Period covered from 31 December 2006 to 31 December 2015. From the left of the horizontal axis, the sectors are sorted in a descending order according to the weightings in MSCI Australia as of 31 December 2015. Price return is the annual price return. For example, the price return for 2015 is the percentage change between the price index levels (Bloomberg field "PX_LAST") on 12/31/2015 and 12/31/2014. 10-year average annual price return is the arithmetic average of the annual returns for 2006 to 2015. Annual dividend return is calculated as the net dividend per share received in the past 12 months at year end (Bloomberg field "NET_12M_DPS_AGGTE") divided by the price index level from 12 months ago. 10-year average annual dividend return is the arithmetic average of the annual returns for 2006 to 2015. Returns are in local currency terms.

EXHIBIT 10C: MSCI HONG KONG – HISTORICAL DIVIDEND RETURN VS. CAPITAL GAIN ACROSS SECTORS



Source: Bloomberg, MSCI, J.P. Morgan Asset Management. Data as of 31 December 2015. Period covered from 31 December 2006 to 31 December 2015. From the left of the horizontal axis, the sectors are sorted in a descending order according to the weightings in MSCI Hong Kong as of 31 December 2015. Energy, Health Care and Materials had zero weighting as of 31 December 2015. Consumer Staples is not considered as this sector index is only available from 2014 onwards. Price return is the annual price return. For example, the price return for 2015 is the percentage change between the price index levels (Bloomberg field "PX_LAST") on 12/31/2015 and 12/31/2014. 10-year average annual price return is the arithmetic average of the annual returns for 2006 to 2015. Annual dividend return is calculated as the net dividend per share received in the past 12 months at year end (Bloomberg field "NET_12M_DPS_AGGTE") divided by the price index level from 12 months ago. 10-year average annual dividend return is the arithmetic average of the annual returns for 2006 to 2015. Returns are in local currency terms. *MSCI Hong Kong Telecommunication Services Index is rebased in 2009, therefore the figures represent a 6-year annual average from 2010-2016.

INVESTMENT INSIGHTS

REFERENCES

International Accounting Standard 39 *Financial Instruments: Recognition and Measurement*

International Financial Reporting Standard 9 *Financial Instruments*

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