IFRS 9: SPPI, Impairment Testing & Expected Credit Loss

Global Insurance Solutions

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BACKGROUND

J.P. Morgan Asset Management ("JPMAM") investment team's primary role is to manage our client's portfolios in accordance with their individual guidelines and objectives while being mindful of the current and upcoming changing regulatory environment. Because of various balance sheet and income statement considerations, JPMAM deploys additional resources such as our team of investment accounting and regulatory specialists, whose role is to assist our clients with any accounting related queries and portfolio analysis, e.g. for International Financial Reporting Standard (IFRS) 9 compliance and impairment purposes.

DEFINING POLICY AND PROCEDURES

In this document, we provide our thoughts, based on our professional judgement, on IFRS 9 and other related issues, with the expectation that clients would provide definitive clarity on their individual policies and investment guidelines regarding the following aspects of IFRS 9:

1. **Solely Payments of Principal and Interest ("SPPI") test:** details of the SPPI policy that is adopted per IFRS 9, including the exact definitions of what should be analysed for instruments to qualify under the SPPI policy
2. **Impairment testing policy:** details of impairment test including what quantitative and qualitative criteria are assessed for a holding to be considered for impairment
3. **Expected Credit Loss (ECL) policy:** assumptions and details on how ECL is calculated, including probability of default and loss given default; and
4. **Guidelines:** changes to any existing investment guidelines based on the implementation of IFRS 9. Also, an open and ongoing dialogue between JPMAM investment teams and each client will be important regarding any securities and the impact of the new IFRS 9 rules, once the framework is implemented.

Once a framework for the above mentioned issues is in place, we can continue to provide support through our own independent analysis and expertise on particular investment-related accounting and regulatory guidance matters. However, any final decision on policy and procedures resides with the client and its auditors to define at their own discretion.

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J.P. Morgan's Global Insurance Solutions Group is dedicated to delivering customized and integrated solutions to insurers globally.

FURTHER DETAILS ON IFRS 9 CAN BE FOUND IN THE J.P. MORGAN ASSET MANAGEMENT REGULATORY PUBLICATION LINKS BELOW:

2018 IFRS Conference Summary:
https://am.jpmorgan.com/gi/getdoc/1383557915981

Preparing for IFRS 9: Investment implications for insurers:
https://am.jpmorgan.com/gi/getdoc/1383328872612

2017 IFRS Conference Summary:
https://am.jpmorgan.com/gi/getdoc/1383507071114

FOR MORE INFORMATION

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J.P.Morgan
Asset Management

1. SPPI test:

Based on our understanding of the IFRS 9 rules regarding SPPI testing, our view is that:

- Any fixed income instrument with the ability to be converted into equity shares should not meet the SPPI criteria
  - This is supported by the fact that convertibility can alter an instrument's contractual cash flows (interest received going forward, principal repayment) and the instrument's value can also be impacted by the issuer's equity, and not solely by the net present value of all future cash flows
- In addition to the above we would also like to highlight that corporate hybrid instruments may also receive more scrutiny than other fixed income securities when considering SPPI eligibility, due to their potentially perpetual nature and the cumulative or non-cumulative nature on its coupons.
- Other characteristics that because of their unique structure, may warrant further analysis include:
  - Whether contractual cash flow characteristics are "not genuine" or "de minimis"
  - Rights in bankruptcy or when non-payment happens
  - Arrangements denominated in a foreign currency
  - Prepayment and term extending options
  - Other contingent payment features
  - Non-recourse arrangements
  - The time value of money element of interest
  - Contractually linked instruments (tranches) and negative interest rates

Based on the logic above, we will identify any fixed income holdings that, in our opinion, **do not** meet the SPPI test.

Example:

ISIN	NAME	SPPI ANALYSIS
XS12345XXXX	XYZ Co.	Fail - Convertible into equity shares

Investment guidelines: Based on the criteria above, adjustments to the investment guidelines may need to be considered:

Example:

- No investments allowed in contingent convertible securities
- No investments allowed in hybrid securities.

2. Impairment testing policy:

In our experience, using our professional judgement, when constructing an impairment testing policy for clients under IFRS 9, we would propose an approach that consistently identifies securities on the basis of both quantitative and qualitative factors and puts them on an *Impairment Watchlist*. Once a security has been put on the watchlist, it should be evaluated for whether it is Performing, Underperforming or whether it is Non-Performing and meets the credit-impaired definition. The section below deals with a framework for determining securities on the watchlist. Section 3 in this document focuses on calibrating the probability of default and loss given default for a fixed income instrument if it is credit-impaired.

Some examples of the criteria that clients can consider when putting a security on the Impairment Watchlist include:

1. A security with a ratio of market value / book value less than 0.80 or 80%
2. Top 10 holdings when measured by unrealized losses as a percentage of market value
3. The top 5 holdings when measured by unrealized loss, remaining in an unrealized loss position for greater than 12 successive months
4. A security with a market value decline of 10% or more during the quarter
5. A security which has experienced a ratings downgrade of more than 2 notches (when measured on the basis of middle of three or lower of 2 ratings as per the investment guidelines) during the previous 4 quarters
6. Holdings rated as BBB- or equivalent (when measured on the basis of middle of three or lower of 2 ratings as per the investment guidelines)
7. A holding from an issuer that is recognised by the investment manager as of a potential risk of downgrade to below investment grade (when measured on the basis of middle of three or lower of 2 ratings as per the investment guidelines) in the next 12 months
8. Any holding that is rated below investment grade by at least one of 3 rating agencies

The above criteria from 1-8 are illustrative of a starting point of criteria that clients could use and a determination needs to be made on the final criteria that should be used.

Example:

ISIN	NAME	REASON
XS23456XXXX	123 Co.	2
FR010101XXXX	Utility Co.	2 & 3
XS987654XXXX	Telephone Co.	8

Investment guidelines changes: Based on the logic above, the following changes to the investment guidelines may need to be considered:

Example:

- 10% limit on investment holdings rated below BBB- by at least one of three rating agencies.

3. Expected Credit Loss policy:

Companies compliant with IFRS 9 are required to record loss allowances on their investment portfolio in the amount equal to the 12-month or lifetime expected credit losses at each reporting date until the assets are sold, mature or derecognized. Clients will need to calibrate these loss allowances and communicate that to both JPMAM and their investment accounting provider.

	STAGE 1: ASSETS THAT ARE PERFORMING	STAGE 2: ASSETS THAT HAVE SIGNIFICANT INCREASE IN DEFAULT RISK (UNDERPERFORMING)	STAGE 3: CREDIT IMPAIRED (NON-PERFORMING)
ECL Stages	Financial instruments that have not had a significant increase in credit risk since initial recognition or that have low credit risk at the reporting date	Financial instruments that have had a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date) but that do not have objective evidence of impairment	Objective evidence of impairment (OTTI)
ECL Model	12-month ECL	Lifetime ECL	Impairment Recognized
Assessment Frequency	Assess whether a significant increase in credit risk (SICR) has occurred at each reporting period		

In our experience, data such as historical default rates from credit rating agencies can be used as a starting point in calibrating ECL and calculate loss allowances. We also understand that some 3rd party data providers are also providing IFRS 9 related expected credit loss information.

The final calculations should be based on the probability of possible outcomes, and reasonable, supportable information about past events, current conditions and forecasts of future economic conditions.

Due to 3rd party data restrictions, JPMAM is typically prevented from passing on externally sourced default information to our clients. In typical situations, our clients will have relationships with data providers and work with their accounting provider to design a framework around impairment testing. We then should discuss the impact, if any, on portfolio management and our investment guidelines and make any appropriate changes.

CONCLUSION

In the ever changing global regulatory environment and the subsequent accounting standards impact, institutional investors should carefully consider the wide range of investment options and strategies when balancing out their individual objectives. JPMAM has a vast array of experience and resources to help clients think through and collaborate on a tailored solution that meets their investment goals, while understanding the full impact(s) to both the balance sheet and income statement of these decisions. We are dedicated to stay informed and in front of regulatory pronouncements and actively collaborate with our investors on such matters. Please reach out to us to share your thoughts, get more insights, or to request a meeting with our dedicated teams.

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