

Invested Assets of Insurance Companies

Global Accounting Requirements and the IFRS 9 Implications for Chinese Insurers

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IN BRIEF

- The accounting requirements of insurance companies' invested assets can vary significantly among jurisdictions around the world.
- For many insurers, national requirements (or local GAAP) retain broad use, as required by national and local regulators.
- But in an effort to establish a common accounting language, IFRS standards have helped to converge accounting requirements for firms that operate across borders or have access to public markets, which brings greater transparency and comparability to global markets.
- The introduction of IFRS 9 attempts to refine the financial reporting requirements for financial instruments in response to deficiencies that were highlighted by the global financial crisis.
- As a response to the low yield environment, insurers have begun to incorporate more non-traditional and/or riskier fixed income assets into their portfolios. Because of the significant changes IFRS 9 brings, insurers will need to consider the accounting implications of any desired asset allocation changes.
- In China, IFRS 9 will likely result in a higher proportion of FVTPL assets from equity and non-traditional debt assets. It is important for Chinese insurers to incorporate IFRS 9 into broader investment objectives and align with other regulatory reforms including C-ROSS Phase II and new ALM requirements.

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1. ACCOUNTING REQUIREMENTS FOR U.S. INSURERS' INVESTED ASSETS

INSURANCE COMPANIES IN THE U.S. ARE REGULATED BY THE NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS (NAIC). Insurance regulation in the U.S. follows a state-based regulatory system (as opposed to federal or national regulation), whereby the NAIC is governed by the chief insurance regulators from all 50 U.S. states, the District of Columbia and five U.S. territories, a.k.a. the U.S. statutory system.

Statements of Statutory Accounting Principles (SSAPs) are the primary accounting practices and procedures promulgated by the NAIC. While insurers are regulated by the states they are

domiciled in, SSAPs were designed in a uniform manner that uses a framework that is based off U.S. GAAP, but is tailored specifically to the insurance industry. This customization of accounting standards assists in state regulators' oversight of insurance companies' financial conditions.

SSAPs will generally have individual statements that define and govern the accounting treatment for various asset classes (**EXHIBIT 1**).

EXHIBIT 1: NOTABLE INVESTMENT-RELATED SSAPs

SSAP 2R	Cash, Cash Equivalents and Short-Term Investments
SSAP 26R	Bonds
SSAP 30R	Unaffiliated Common Stock
SSAP 32	Preferred Stock
SSAP 37	Mortgage Loans
SSAP 40	Real Estate Investments
SSAP 43R	Loan-Backed and Structured Securities (LBaSS)
SSAP 48	Joint Ventures, Partnerships and Limited Liability Companies
SSAP 86	Derivatives
SSAP 100R	Fair Value

Source: NAIC; as of December 31, 2019

The NAIC has also developed its own security valuation framework that is responsible for determining the credit quality of insurers' invested assets for regulatory purposes. This task is performed through the issuance of NAIC designations. NAIC designations, which range from NAIC 1 (highest quality) to NAIC 6 (lowest quality), are akin to credit ratings issued by NRSROs¹ (**EXHIBIT 2**). And while these designations will drive the minimum amount of capital insurers are required to keep to support their operations—the NAIC's Risk-Based Capital (RBC) framework—NAIC designations also drive the carrying value of fixed income assets held on insurers' balance sheets.

¹ Nationally recognized statistical rating organizations (NRSRO) are credit rating agencies that issue credit ratings that the U.S. Securities and Exchange Commission (SEC) permits other financial firms to use for certain regulatory purposes.

EXHIBIT 2: CREDIT RATING EQUIVALENTS PER THE NAIC

Example: S&P credit rating equivalents per the NAIC	NAIC
AAA, AA+, AA, AA-, A+, A, A-	1
BBB+, BBB, BBB-	2
BB+, BB, BB-	3
B+, B, B-	4
CCC+, CCC, CCC-	5
CC, C, D	6

Source: NAIC; see appendix 1

Statutory accounting guidance requires life insurance companies to recognize as liabilities an Asset Valuation Reserve (AVR) and an Interest Maintenance Reserve (IMR)². There is no such requirement for property & casualty (P&C) and health insurance companies. Because AVR and IMR only pertain to life insurers, there is a difference in how life insurers and how P&C and health insurers account for investments.

Bonds, including loan-backed and structured securities (LBaSS), are reported on the balance sheet at either amortized cost or fair value, which depends on the type of insurance company and its NAIC designation (**EXHIBIT 3**). This provides a conservative measure of such securities in accordance with the conservatism concept that exists within statutory accounting. Changes in unrealized gains and losses, if they occur, are recorded as a direct charge or credit to surplus.³

² The AVR is a reserve to offset potential credit-related investment losses on all invested asset categories excluding cash, policy loans, premium notes, collateral notes and income receivable. The IMR captures the realized capital gains and losses resulting from changes in the general level of interest rates. These gains and losses are to be amortized into investment income over the expected remaining life of the investments sold.

³ An insurance term referring to retained earnings. Companies are required to maintain their capital and surplus at an amount equal to or in excess of a specified amount to help assure the solvency of the company by providing a financial cushion against expected losses or misjudgments. It is generally measured as a company's admitted assets minus its liabilities.

EXHIBIT 3: BALANCE SHEET VALUATION FOR BOND HOLDINGS—BONDS AND LOAN-BACKED AND STRUCTURED SECURITIES (LBaSS)

NAIC designation	Statement carrying value
LIFE AND FRATERNAL COMPANIES	
1	Amortized Cost
2	Amortized Cost
3	Amortized Cost
4	Amortized Cost
5	Amortized Cost
6	Lower of Amortized Cost or Fair Value
P&C, HEALTH, TITLE AND NON-AVR LIFE AND FRATERNAL COMPANIES	
1	Amortized Cost
2	Amortized Cost
3	Lower of Amortized Cost or Fair Value
4	Lower of Amortized Cost or Fair Value
5	Lower of Amortized Cost or Fair Value
6	Lower of Amortized Cost or Fair Value
LEGEND: BALANCE SHEET VALUATION FOR BOND HOLDING	
Below investment grade	Above investment grade

Source: NAIC; as of December 31, 2019

Realized gains and losses for bonds and LBaSS are also recorded differently and are based on the type of insurance company. For P&C and health insurers, realized gains and losses are captured in the income statement. But for life insurers, realized gains and losses resulting from changes in interest rates are initially deferred (into IMR) and subsequently amortized into income over the remaining expected life of the investment sold, while realized gains and losses that are credit related are included as a component of AVR.

For bonds and LBaSS that have suffered an impairment⁴ that is considered “other-than-temporary” (OTTI), if there is intent to sell the security before maturity or it is probable that the insurer will be unable to collect all contractual cash flows, the security should be written down and an impairment loss will be recognized as a realized loss into either AVR or IMR (for life insurers) or the income statement (for P&C and health insurers). For bonds, the impairment loss is calculated as the difference between fair value and carrying value (e.g. amortized cost), and the security is written down to fair value. For LBaSS, the impairment loss will be determined based on the present value of the discounted cash flows (PVODCF) expected to be collected. The LBaSS security will be written down to PVODCF if an impairment has been determined.

⁴ A security in an unrealized loss position—fair value is below its carrying value (or amortized cost).

While most non-fixed income asset classes follow more traditional accounting principles (**EXHIBIT 4**), bond mutual funds and ETFs⁵ have been afforded special accounting treatment that allows them to be treated as bonds for accounting, reporting and RBC purposes. Bond ETFs specifically are allowed to be reported at fair value or systematic value⁶, depending on the type of insurance company and its NAIC designation (similar to Exhibit 3), which differs from the traditional accounting treatment of ETFs.

Insurance companies in the U.S. that are publicly traded firms are also required to produce separate financial statements in compliance with U.S. GAAP. U.S. GAAP accounting standards are maintained by the Financial Accounting Standards Board (FASB), a private, non-profit organization standard-setting body whose primary purpose is to establish and improve GAAP standards within the United States. Insurers that comply with both SSAP and U.S. GAAP will often address the differences that exist between the accounting bases within the footnotes of their financial statements. The objectives of SSAP and U.S. GAAP differ primarily due to the needs of the users of the financial statements. U.S GAAP financials

⁵ Must be analyzed by the NAIC and assigned a corresponding designation to be eligible for bond treatment.

⁶ Systematic value is an alternative accounting method, akin to an amortized cost, where the calculated value is derived in a manner similar to the effective interest method applied to individual fixed income securities, but also reflects the changing composition of an ETF’s underlying bond portfolio and cash flows that will occur over time. This allows bond ETFs to receive a stable valuation that is not prone to market volatility or changes in interest rates.

EXHIBIT 4: NOTABLE STATUTORY ACCOUNTING TREATMENT FOR NON-FIXED INCOME ASSET CLASSES

Asset class	Guidance	Balance sheet valuation	Unrealized gains and losses	Impairment (Life)	Impairment (P&C/Health)
Common Equity (Public)	SSAP 30R	Fair value	Surplus / AVR	AVR	Income statement
Preferred Equity	SSAP 32	Amortized cost or fair value (depends on NAIC designation and if AVR reserve is maintained)	Surplus / AVR	AVR	Income statement
Mutual Funds (excluding bond funds)	SSAP 30R	Fair value	Surplus / AVR	AVR	Income statement
Exchange-Traded Funds (excluding bond ETFs)	SSAP 30R	Fair value	Surplus / AVR	AVR	Income statement
Alternative Funds (Private Equity, Hedge Funds, Infrastructure, Real Estate Funds, etc.)	SSAP 48	Fair value	Surplus / AVR	AVR	Income statement
Mortgage Loans (Direct)	SSAP 37	Amortized cost	N/A	AVR	Income statement
Real Estate (Direct, wholly owned)	SSAP 40	Depreciated cost	N/A	Income statement	Income statement
Derivatives (Hedge Accounting)	SSAP 86	Same as hedged instrument	Same as hedged instrument	Same as hedged instrument	Same as hedged instrument
Derivatives (non-Hedge Accounting)	SSAP 86	Amortized cost or fair value (depends on transaction)	Treatment varies based on transaction type	Treatment varies based on transaction type	Treatment varies based on transaction type

Source: NAIC, J.P. Morgan Asset Management; as of December 31, 2019

EXHIBIT 5: NOTABLE INVESTMENT-RELATED ASC TOPICS

ASC 310	Receivables (Loans)
ASC 320	Investments—Debt and Equity Securities
ASC 321	Investments—Equity Securities
ASC 323	Investments—Equity Method and Joint Ventures
ASC 325	Investments—Other (Securitized Financial Assets)
ASC 326	Financial Instruments—Credit Losses
ASC 815	Derivatives and Hedging
ASC 820	Fair Value Measurements
ASC 825	Financial Instruments
ASC 946	Financial Services—Investment Companies

Source: FASB; as of December 31, 2019

are designed to address the needs of various stakeholders (investors, regulators, etc.), while SSAP financials are designed to solely address the concerns of regulators. As a result, U.S. GAAP stresses the measurement of earnings of a company from period to period, while SSAP stresses the measurement of an insurer's ability to pay claims (i.e., solvency). This results in SSAP being much more conservative than U.S. GAAP in areas that impact investments, such as valuation and income recognition.

EXHIBIT 6: U.S. GAAP TREATMENT FOR VARIOUS ASSET CLASSES

Asset class	Balance sheet valuation	Unrealized gains and losses	Impairment model	Notes
Bonds	Amortized cost or fair value (depends on investment classification)	Mark-to-market in OCI or P&L, depends on investment classification	CECL (HTM) or AFS impairment model	Investment classifications: 1) HTM = Held to Maturity; 2) AFS = Available for Sale; 3) Trading
Preferred Equity (Non-redeemable)	Fair value	P&L	N/A - All valuation changes in P&L	Redeemable preferred equity is captured within the bond guidance above
Common Equity (Public)	Fair value	P&L	N/A - All valuation changes in P&L	Must use Equity Method accounting where the investor has the ability to exercise significant influence or joint control. Generally seen as 20%-50% voting control.
Mutual Funds & Exchange-Traded Funds (ETFs)	Fair value	P&L	N/A - All valuation changes in P&L	NAV (net asset value) is a permissible measure of fair value
Alternative Funds (Private Equity, Hedge Funds, Infrastructure, Real Estate Funds, etc.)	Fair value	P&L	N/A - All valuation changes in P&L	Often formed as partnerships or LLCs. Must use Equity Method accounting where the investor has the ability to exercise significant influence over partnership operating and financial policies. Generally seen as 3%-5% ownership level.
Mortgage Loans (Direct)	Amortized cost	N/A	CECL	The intent of CECL is for the balance sheet to reflect the net amount expected to be collected
Derivatives (Hedge Accounting)	Fair value	Same as hedged instrument	Must assess portions of risks that are not hedged	Must maintain formal documentation and perform recurring qualitative and quantitative hedge effectiveness testing to qualify for hedge accounting
Derivatives (non-Hedge Accounting)	Fair value	P&L	N/A - All valuation changes in P&L	Economic hedges where hedge accounting isn't sought

Source: FASB, J.P. Morgan Asset Management; as of December 31, 2019

The majority of the U.S. GAAP guidance that covers insurers' investments is found in the asset section (Section 300) of FASB's accounting standards codification (ASC), but there are also sections of the codification that cover other areas that will impact insurers' invested assets (**EXHIBIT 5** and **EXHIBIT 6**).

One of the biggest recent changes in global accounting standards has been in the accounting of credit-related losses. The global financial crisis exposed weaknesses in current GAAP that delayed the recognition of credit losses, which resulted in the overstatement of assets. This resulted in a new, current expected credit loss (CECL) model for the impairment of assets measured at amortized cost, which includes loans and held-to-maturity bonds. It replaces the probable, incurred loss model that existed under previous GAAP. The change is significant, as it will:

- change the mindset from a backward-looking to a forward-looking approach in formulating and recognizing credit loss allowances
- require an update to loss forecasting models and processes, depending on the chosen method⁷ of estimating credit losses

⁷ Common methods for calculating expected credit losses include loss rate methodologies, a probability of default method or a discounted cash flow model.

For assets in scope of the CECL model, lifetime expected credit losses are recorded at initial recognition as an allowance. The allowance is a valuation account deducted from the amortized cost of the asset to present the net amount expected to be collected. Companies must create a model to calculate those allowances, which will be based on a mix of past events, current conditions and reasonable and supportable forecasts. Each reporting period, changes in the estimate of expected credit loss are recognized through net income.

The new impairment rules will also change the impairment model for available-for-sale bonds. Credit losses will now be recorded as an allowance, rather than a direct reduction in amortized cost. Reversals of the allowance are permitted, as credit losses change over time and any recognized losses will be limited to the amount by which fair value is less than amortized cost (i.e., a fair value floor).

2. ACCOUNTING REQUIREMENTS FOR EUROPEAN INSURERS' INVESTED ASSETS

European insurers that are listed on regulated exchanges are required to use International Financial Reporting Standards (IFRS) standards for the preparation of their consolidated financial statements. This has been a requirement, as a part of European Union (EU) regulations, since 2005⁸. For non-listed companies, most EU member states do not require the use of IFRS, which makes these firms subject to national rules or local GAAP. As a result, the accounting treatment of financial instruments tends to vary at the national level.

In the UK, entities are given a choice between applying the recognition and measurement requirements of:

- FRS 102 Financial Instruments (UK GAAP⁹)
- IAS 39 Financial Instruments¹⁰ (old IFRS)
- IFRS 9 Financial Instruments (new IFRS)

Under UK GAAP, financial instruments are classified as either basic financial instruments or other financial instruments, and the accounting treatment varies depending on the classification. There are four types of basic financial instruments:

- Cash
- Debt instruments, subject to meeting certain conditions¹¹

⁸ Source: REGULATION (EC) No 1606/2002 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 19 July 2002 on the application of international accounting standards.

⁹ The Financial Reporting Council sets United Kingdom and Ireland accounting standards.

¹⁰ Subject to change as IAS 39 is phased out.

¹¹ Features of a basic financial instrument include it having a fixed return for the lender or the return being a positive fixed or variable rate (i.e. linked to a single observable interest rate).

- Basic loan commitments
- Investments in non-convertible preference shares and non-puttable ordinary or preference shares

Basic debt instruments are generally accounted for at amortized cost (unless they are chosen to be measured at FVTPL). Non-basic debt instruments, along with other financial instruments¹², are measured at FVTPL.

For German GAAP,¹³ the treatment of financial assets depends on whether the asset is current or non-current. The distinction between current and non-current is determined by the intention to serve the business operation in the long term. Current investments are measured at the lower of cost or its quoted/market price, while non-current assets are carried at amortized cost (or in the case of non-temporary impairment, at the lower fair value).

For French GAAP¹⁴, there are no formal classification categories for financial assets, which, other than derivatives, are measured at amortized or acquisition cost. In contrast, Dutch GAAP¹⁵ provides many more options for measuring financial assets. Under Dutch GAAP, bonds and loans held to maturity are measured at amortized cost. All other bonds and loans are measured at amortized cost or fair value. If fair value is chosen, any changes in fair value can be recognized in either P&L or in the equity section of the entity's balance sheet. Any financial assets held for trading are measured at fair value through profit or loss. Investments in listed equity instruments not held for trading are measured at fair value, with a choice of recognizing fair value changes in profit or loss or in equity, while investments in non-listed equity instruments can be measured at cost or fair value. If the latter option is applied, the entity may also choose to recognize the changes in fair value in profit or loss or within equity.

These are just notable examples from some of the EU's prominent economies, but it's indicative of the differing requirements that exist in the region. It's also a testament to why the use of a common accounting language, such as IFRS, has become central to harmonizing financial reporting standards across jurisdictions.

¹² Examples includes convertible debt/shares, ordinary and preference shares, equities and derivatives not used for hedge accounting.

¹³ Germany: German Commercial Code (Handelsgesetzbuch—HGB); The Accounting Standards Committee of Germany (ASCG).

¹⁴ France: French Commercial Code (Code de Commerce); Plan Comptable Général (PCG); Accounting Standards Authority (ANC, Autorité des Normes Comptables).

¹⁵ The Netherlands: Dutch Accounting Standards per the Dutch Accounting Standard Board (DASB).

3. GLOBAL ACCOUNTING STANDARDS: IFRS 9—FINANCIAL INSTRUMENTS

IFRS accounting standards were developed to serve as a high-quality, single set of global accounting standards designed to enhance the international comparability and quality of financial information used by various stakeholders around the world. There are currently 144 jurisdictions¹⁶ around the world (which includes 15 of the G20 members) that require the use of IFRS standards in some capacity. IFRS standards are maintained by the IFRS Foundation’s standard-setting body, the International Accounting Standards Board (IASB).

In response to the financial crisis, interested parties highlighted deficiencies in investment-related reporting requirements, which included the timeliness in the recognition of credit losses, the complexity of multiple impairment models and rigid hedge accounting requirements. To address these deficiencies, IFRS 9 was introduced in 2014 to replace IAS 39 as the new global accounting standard covering financial instruments (**EXHIBIT 7** and **EXHIBIT 8**. Companies subject to IFRS rules were required to comply with the new standards by 2018, but insurance companies were given a deferral option that allows them to delay IFRS 9 adoption until 2023, to allow for simultaneous adoption with the new accounting standard for insurance contracts, IFRS 17.

¹⁶ Source: IASB, IFRS.

EXHIBIT 7: IAS 39 INVESTMENT CLASSIFICATIONS

Fair value through profit or loss (FVTPL)	Held-to-maturity (HTM)	Loans and receivables	Available-for-sale (AFS)
<ul style="list-style-type: none"> Assets that are bought and held principally for the purpose of selling them in the near term (trading) Derivatives (except when effectively hedging) Reported at fair value All changes in fair value are reported in earnings 	<ul style="list-style-type: none"> Assets with fixed or determinable payments and a fixed maturity that an entity has the positive intention and ability to hold to maturity Reported at amortized cost less impairment No unrealized gains and losses 	<ul style="list-style-type: none"> Non-derivative financial assets with fixed or determinable payments that are not quoted in an active market Reported at amortized cost less impairment No unrealized gains and losses 	<ul style="list-style-type: none"> Non-derivative assets not classified as either FVTPL, HTM or Loans and Receivables Reported at fair value Unrealized gains and losses are excluded from earnings Once disposed, any realized gains and losses are included in earnings

Source: IASB, J.P. Morgan Asset Management; as of December 31, 2019

EXHIBIT 8: IFRS 9 NEW INVESTMENT CLASSIFICATIONS

CLASSIFICATION CATEGORIES FOR FINANCIAL ASSETS			
Three New Classifications	Amortized Cost	FVOCI (Fair Value Through Other Comprehensive Income)	FVTPL (Fair Value Through Profit/Loss)
Balance Sheet Valuation	Amortized Cost (Book Value)	Current Market Value	Current Market Value
Business Model Assessment	Holding to collect contractual cash flows	Hold and sell model	Held for trading or short-term interests
Changes in Market Value	N/A	Other Comprehensive Income (Balance Sheet)	Profit or Loss (Income Statement)

SPPI CRITERION / BUSINESS MODEL ASSESSMENT

Assets must pass the “SPPI criterion—solely payments of principal and interest” test, while also having a business model to collect contractual cash flows to determine if it’s allowed to be classified under Amortized Cost or FVOCI

Source: IASB, J.P. Morgan Asset Management; as of December 31, 2019

3.1 New classification and measurement requirements

One criticism of IAS 39 was that it contained many different classification categories and impairment models. The IASB decided that the most effective way to address such issues was to create new classifications that are principle-based and are driven by entities’ business models and the nature of an investment’s cash flows.

Regarding an entity’s business model, a business model refers to how an entity manages its financial assets in order to generate cash flows—by collecting contractual cash flows, selling financial assets or both. This should be determined on a level that reflects how financial assets are managed to achieve a particular business objective, and should be made on a higher level of aggregation (i.e., not necessarily dependent on an entity’s intentions for individual instruments).

Financial assets at amortized cost are held in a business model whose objective is to hold assets in order to collect contractual cash flows. Sales information in isolation doesn’t determine the business model; however, it does provide evidence about how the business objective is achieved and how cash flows are realized. When determining whether this business model is applicable, an entity should consider past sales information and expectations about future sales activity. Having some sales activity is not necessarily inconsistent with this business model. For example, sales that are infrequent or insignificant in value may be consistent with this business model, as are sales that occur as a result of an increase in

credit risk. However, if more than an infrequent number of sales occur and those sales are more than insignificant in value, an entity needs to assess whether and how such sales are consistent with an objective of collecting contractual cash flows.

Financial assets classified and measured at fair value through other comprehensive income (FVOCI) are held in a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets. Compared to a business model whose objective is to hold financial assets to collect contractual cash flows, this business model will typically involve greater frequency and volume of sales. Various objectives may be consistent with this business model; for example, to manage liquidity, maintain a particular interest yield profile or to match the duration of financial liabilities to the duration of the assets they are funding.

Any financial assets that are not held in one of the two business models mentioned above are measured at fair value through profit or loss. As such, fair value through profit or loss represents a “residual” category. Financial assets that are held for trading and those managed on a fair value basis are also included in this category.

IFRS 9 also requires financial assets to be reclassified between measurement categories when, and only when, the entity’s business model for managing them changes. This is a significant event and thus is expected to be uncommon. This ensures that users of financial statements are always provided with information reflecting how the cash flows on financial assets are expected to be realized.

One of the criteria for determining the classification of a financial asset is whether the contractual cash flows are “solely payments of principal and interest” (SPPI). Only financial assets with such cash flows are eligible for amortized cost or FVOCI measurement dependent on the business model in which the asset is held. Often it will be readily apparent whether contractual cash flows meet the SPPI criteria but sometimes a more in-depth analysis is required. For contractual cash flows to be SPPI, they must include returns consistent with a basic lending arrangement, so, for example, if the contractual cash flows include a return for equity price risk, then that would not be consistent with SPPI (**EXHIBIT 9**).

EXHIBIT 9: INVESTMENT CLASSIFICATIONS FOR NOTABLE ASSET CLASSES UNDER IAS 39 VS. IFRS 9

Asset Class	Old: IAS 39	New: IFRS 9
<ul style="list-style-type: none"> • Government bond • Corporate bond • Floating rate bond 	<ul style="list-style-type: none"> • HTM • AFS (default category - fair value through OCI) • FVTPL (with fair value option) 	<p>If SPPI = Pass:</p> <ul style="list-style-type: none"> • Amortized cost (for hold-to-collect) • FVOCI (for hold-and-sell) • FVTPL (residual category)
<ul style="list-style-type: none"> • Interest rate reset bond • Inflation-linked bond • Mezzanine debt • Tranches of CDO/ABS • Perpetual bond • Bond with prepayment option (e.g. callable) 	<ul style="list-style-type: none"> • HTM • AFS (default category - fair value through OCI) • FVTPL (with fair value option) 	<p>SPPI = case-by-case analysis (must analyze cash flow characteristics)</p> <ul style="list-style-type: none"> • If SPPI = Pass (see above) • If SPPI = Fail (FVTPL)
<ul style="list-style-type: none"> • Inverse floater 	<ul style="list-style-type: none"> • HTM • AFS (default category - fair value through OCI) • FVTPL (with fair value option) 	FVTPL
<ul style="list-style-type: none"> • Leveraged asset (using option, forward, swaps, etc.) • Hybrid / convertible debt 	Separate treatment on host vs. embedded derivative (or designate entire contract at FVTPL)	FVTPL
<ul style="list-style-type: none"> • Loans / direct lending (project finance, real estate loans, infrastructure loans, etc.) 	Loans & receivables (unless held for trading)	<ul style="list-style-type: none"> • Amortized cost (unless held for short term, then FVTPL) • FVOCI in rare cases
<ul style="list-style-type: none"> • Equity 	<ul style="list-style-type: none"> • AFS (not for trading) • FVTPL (held for trading) <ul style="list-style-type: none"> – if no FV, cost basis permitted 	<ul style="list-style-type: none"> • FVTPL • FVOCI - irrevocable option with no recycling of gains / losses
<ul style="list-style-type: none"> • Private equity (fund) • Open-ended funds 	AFS or FVTPL	FVTPL
<ul style="list-style-type: none"> • All derivatives 	Held for trading (FVTPL) unless designated as effective hedge via hedge accounting	FVTPL unless designated as effective hedge via hedge accounting

Source: J.P. Morgan Asset Management; as of December 31, 2019

A financial asset may contain contractual terms that could change the timing or amount of contractual cash flows. An entity must assess whether the contractual cash flows that could arise both including and excluding the effect of those contractual terms are consistent with SPPI. For example, for a prepayable financial asset to have contractual cash flows that are SPPI, the cash flows if prepayment occurs and the cash flows if prepayment does not occur must both be consistent with SPPI. In order for the financial asset to have contractual cash flows that are SPPI, the cash flows resulting from the change in contractual terms should be consistent with a basic lending arrangement.

3.2 Simplified impairment model

During the financial crisis, the delayed recognition of credit losses on loans and other financial instruments was identified as a weakness in existing accounting standards. Specifically, the existing impairment model in IAS 39 (an “incurred loss” model) delays the recognition of credit losses until there is evidence of a trigger event. This was designed to limit an entity’s ability to create hidden reserves that can be used to manipulate earnings during bad times.

As the financial crisis unfolded, it became clear that the incurred loss model gave room to a different kind of earnings management, namely to postpone losses. Even though IAS 39 did not require waiting for actual default before impairment is recognized, in practice this was often the case. The complexity of IAS 39, which used multiple impairment models for financial instruments, was also identified as a concern.

The main objective of the new impairment requirements is to provide more useful information about an entity’s expected credit losses on financial instruments. The model requires an entity to recognize expected credit losses (ECL) at all times and to update the amount of ECL recognized at each reporting date to reflect changes in the credit risk of its financial instruments. This model is forward-looking and it eliminates the threshold for the recognition of ECL, so that it is no longer necessary for a trigger event to have occurred before credit losses are recognized. Consequently, more timely information is required to be provided about ECL.

Furthermore, when credit losses are measured in accordance with IAS 39, an entity may only consider those losses that arise from past events and current conditions. The effects of possible future credit loss events cannot be considered, even when they are expected. The requirements in IFRS 9 broaden the information that an entity is required to consider when determining its expectations of credit losses. Specifically, IFRS 9 requires an entity to base its

measurement of ECL on reasonable and supportable information that includes historical, current and forecast information.

In addition, under IFRS 9 the same impairment model is applied to all financial instruments that are subject to impairment accounting, removing a major source of current complexity. This includes financial assets classified as amortized cost or FVOCI.

3.3 Three stages of impairment

As soon as a financial instrument is originated or purchased, 12-month expected credit losses are recognized in profit or loss and a loss allowance is established. This serves as a proxy for the initial expectations of credit losses (Stage 1, see **EXHIBIT 10**). Interest revenue is calculated on an asset’s gross carrying amount (i.e., without deduction for ECL). If a financial instrument’s credit risk has increased significantly since initial recognition and is not considered low, lifetime ECLs are recognized (Stage 2). The calculation of interest revenue remains the same as for Stage 1. If a financial instrument’s credit risk increases to the point where it is considered credit impaired (Stage 3), interest revenue is calculated based on the asset’s amortized cost (i.e., the gross carrying amount less the loss allowance). Lifetime ECL amounts will continue to be recognized.

When assessing significant increases in credit risk (SICR), an entity will need to identify relevant quantitative and qualitative factors that indicate a SICR based on facts and circumstances specific to the financial asset and how the entity manages credit risk.

EXHIBIT 10: EXPECTED CREDIT LOSS STAGING UNDER IFRS 9

	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		

Source: IASB, J.P. Morgan Asset Management; as of December 31, 2019

EXHIBIT 11: HEDGE ACCOUNTING QUALIFYING CRITERIA: IAS 39 VS. IFRS

IAS 39	IFRS 9
FORMAL DESIGNATION AND DOCUMENTATION OF	
<ul style="list-style-type: none"> • Risk management objective and strategy • Hedging instrument • Hedged item • Nature of risk being hedged • Hedge effectiveness (including how it will be calculated) 	<ul style="list-style-type: none"> • Risk management objective and strategy • Hedging instrument • Hedged item • Nature of risk being hedged • Hedge effectiveness (including sources of ineffectiveness and how the hedge ratio is determined)
ELIGIBLE ITEMS	
Hedging relationship consists only of eligible hedging instruments and eligible hedged items.	The general requirement remains unchanged. However, some items that were not eligible as hedged items or hedging instruments under IAS 39 are now eligible under IFRS 9 (which includes some non-derivative items).
HEDGE EFFECTIVENESS REQUIREMENTS	
<ul style="list-style-type: none"> • Effectiveness can be reliably measured. • Hedge is expected to be highly effective (prospective testing). • Hedge is assessed on an ongoing basis and determined actually to have been highly effective (retrospective testing 80%-125%). 	<ul style="list-style-type: none"> • Economic relationship exists. • Credit risk does not dominate value changes. • Designated hedge ratio is consistent with risk management strategy. • All tested prospectively.
DISCONTINUATION OF HEDGE ACCOUNTING	
Voluntary discontinuation of hedge accounting is allowed.	Discontinuation of hedge accounting only under specified circumstances (e.g., the risk management objective for a hedge relationship has changed).

Source: FASB, PwC, J.P. Morgan Asset Management; as of December 31, 2019

Performing a quantitative assessment will generally consist of analyzing the relative change in the probability of default over the expected life of the instrument at the reporting date with the risk of default at the date of initial recognition, while qualitative assessments will involve analyzing:

- General market conditions
- Adverse changes in business, financial and/or economic conditions in which the borrower operates
- Changes to contractual terms (actual or expected principal/interest deferral or restructuring)
- Signs of cash flow/liquidity problems
- Credit ratings (internal and external)

3.4 Overhauled hedge accounting requirements

The objective of hedge accounting is to represent in the financial statements the effect of an entity's risk management activities when it uses financial instruments to manage exposures arising from particular risks. The rules on hedge accounting in IAS 39 were often criticized for being disconnected from common risk management practices. This made achieving hedge accounting very difficult and costly, even where the hedge is an economically rational risk management strategy.

The new hedge accounting model makes some fundamental changes to the current requirements by removing or amending some of the key prohibitions and rules within IAS 39. It also improves the usefulness of financial statements by better aligning hedge accounting with the risk management activities of an entity (**EXHIBIT 11**).

One of the more onerous requirements of IAS 39 was the requirement involving the measurement of hedge effectiveness. For a hedge relationship to be deemed highly effective, entities were required to perform quantitative assessments on a prospective and retrospective basis, to demonstrate that actual results of the hedge are within a range of 80%-125% effectiveness. This meant that many valid economic hedges failed because they were not hedged enough for hedge accounting purposes.

IFRS 9 does not prescribe a specific method for assessing whether a hedging relationship meets the hedge effectiveness requirements (and removes the 80%-125% bright line effectiveness test). An entity must use a method that captures the relevant characteristics of the hedging relationship, including the sources of hedge ineffectiveness that are expected to affect the hedging relationship during its term. A qualitative assessment is always necessary and, depending on the characteristics of the hedge relationship, entities might also need to perform a quantitative assessment. For example, in a simple hedge where all the critical terms match (or are only slightly

different), a qualitative test might be sufficient. On the other hand, in highly complex hedging strategies, some type of quantitative analysis would likely need to be performed.

The assessment for IFRS 9 relates to expectations about hedge effectiveness, and so is only forward-looking. Such an assessment should be performed at inception and on an ongoing basis at each reporting date or on a significant change in circumstances, whichever comes first. The intention behind these requirements is to ensure that only economically viable hedging strategies (that is, those reflecting the underlying economic relationship and aligned to the risk management strategy) qualify for hedge accounting purposes.

3.5 Investment implications of IFRS 9

In response to the low yield environment, insurers have begun to incorporate more non-traditional and/or riskier fixed income assets into their portfolios. Insurers will need to consider the accounting implications of any desired asset allocation changes.

Under IFRS 9, the introduction of the SPPI assessment has brought about changes to the accounting treatment for non-traditional fixed income. Assets such as convertible debt, or certain esoteric bond structures, which may be attractive from a yield perspective, can cause unwanted P&L volatility when forced to be reported at FVTPL.

The treatment of equities and fund holdings has also brought about some undesired changes for some. Under IFRS 9, equities and fund holdings are measured at fair value with changes in fair value recognized in P&L¹⁷. Most insurers' primary objective for buying assets is to generate a steady, reliable stream of cash flow. Dividends and/or cash distributions from equities and funds certainly meet this objective, but having to introduce market volatility into P&L from changes in fair value could outweigh any cash flow considerations and negatively affect a company's profitability during down markets.

Assets not held at FVTPL are subject to new impairment rules that require an ECL allowance from the initial recognition of the asset. Due to a greater emphasis on forward-looking information, this will cause potential credit losses on riskier fixed income assets to impact P&L sooner than under previous accounting requirements.

¹⁷ For equity holdings, at initial recognition, an entity may make an irrevocable election to present changes in the fair value in OCI on an instrument-by-instrument basis—the "FVOCI election." The FVOCI election is not available for equity instruments that are held for trading purposes—acquired for the purpose of selling or repurchasing it in the near term or as part of a portfolio where there is evidence of a recent actual pattern of short-term profit-taking. If an entity applies the FVOCI election, it does not assess these instruments for impairment and cannot reclassify to P&L gains or losses previously recognized in OCI upon disposal of these instruments, also referred to as "recycling."

So as market and economic conditions deteriorate, the probability of default within ECL calculations should rise as a result, which would negatively impact P&L, ultimately making insurers' financials more sensitive to changes in credit quality (removing the ability to "back-end" potential losses while chasing current yields).

IFRS 9 also removed most of the stringent requirements needed to qualify for hedge accounting. Companies may be further compelled to use accounting mechanisms to reduce exposures within their financials. This could open up opportunities to explore new markets or asset classes where, for example, the impact of FX exposures may have muted interest in certain strategies or regions.

The new accounting standard for insurance contracts, IFRS 17, will also impact insurers' investment activities primarily through its interaction with IFRS 9 and the effects of accounting elections on asset-liability matching within an entity's financial statements. IFRS 17 requires insurance liabilities be valued using discount rates based on current market conditions. IFRS 17 also allows for the changes in valuation due to discount rates to be recognized in OCI or P&L. Because of this, it becomes imperative that entities choose accounting elections pertaining to their liabilities in consideration with the treatment of their assets. Entities will need to ensure that IFRS 17-related accounting elections are in sync with IFRS 9 investment classifications to ensure that balance sheet mismatches are minimized and that any desired accounting outcomes are produced (e.g. the reduction of income volatility).

4. IMPLICATIONS FOR CHINESE INSURERS

China fully understands the central role that a sound financial reporting system plays in the process of economic development. The Chinese Ministry of Finance (MOF) has set itself the objectives of fostering investors' confidence in financial information and increasing transparency of financial reporting, in order to reduce the costs of raising capital by enterprises and alleviate the risks of financial crisis.

China has already made significant progress in harmonizing Chinese accounting standards with IFRS standards. In 2017, the MOF issued four financial instrument accounting standards, including CAS 22 Recognition and Measurement of Financial Instruments, CAS 23 Transfer of Financial Assets, CAS 24 Hedge Accounting and CAS 37 Presentation of Financial Instruments. These standards introduced new requirements for classification and measurement, impairment and hedge accounting of financial instruments to align with IFRS 9.

IFRS 4 amendments “Applying IFRS 9 Financial Instruments with IFRS 4 Insurance Contracts” permit eligible entities to defer the implementation date of IFRS 9 until the effective date of IFRS 17. With the exception of Ping An, all public-listed Chinese insurers have chosen to take advantage of the temporary exemption and defer the adoption of IFRS 9 until IFRS 17 has been adopted. Ping An adopted IFRS 9 in 2018, as its activities at the group level were not predominantly connected with insurance at the time of the assessment.

The following sections aim to analyze the practical impact of IFRS 9 on the Chinese insurance industry.

4.1 Classification and measurement

4.1.1 Equity investments

Chinese insurers would generally prefer measuring equity instruments at FVTPL to FVOCI, in order to reflect subsequent fair value gains (or losses) in P&L and management KPI. The industry’s allocation to equity and mutual funds totaled 10.8% as of end-2018, which is expected to be the largest source of P&L volatility after adopting IFRS 9 since most of these instruments will be measured at FVTPL. The effect will be more acute for smaller companies that tend to have a higher allocation to equity and funds due to yield pressures.

To enhance net investment yield and reduce P&L volatility, insurers may irrevocably elect to measure at FVOCI for certain equity investments not held for trading, such as dividend stocks and preferred shares. Although this has been a popular strategy for companies such as Ping An, the industry remain cautious about the wider application of FVOCI equity for the following key reasons:

1. The election for FVOCI equity is irrevocable and there is no recycling of gains and losses in P&L.
2. Presenting fair value changes in OCI disallows management to recognize investment performance in key company KPIs—quarterly earnings, ROE, EPS, etc.
3. High dividend “blue-chip” stocks that meet insurer’s income requirement are in short supply in the domestic market.
4. Applying FVOCI may cause accounting mismatches for universal life and participating policies, for which the crediting rates are paid from P&L but the capital gains are recorded in OCI.

Similarly, as companies look to increase long-term equity allocations, the use of “equity method”¹⁸ accounting may also become of greater interest as firms attempt to gain more control over their equity investments and reduce P&L volatility from market value fluctuations. On the down side, if evidence of impairment exists, a writedown may need to be recorded to an amount that better reflects the investee’s fair value¹⁹.

After adopting IFRS 9, Ping An’s proportion of FVTPL assets increased to 18.5% in end-2018 from 1.9% in end-2017. The company classified 66% of its equity investments and 100% of equity funds as FVTPL. In order to mitigate the overall equity P&L volatility, Ping An elected the option to designate as FVOCI for most of its investments in dividend stocks and preferred shares. High dividend stocks, long-term and strategic investments together account for ~60% of Ping An’s total equity holdings.

4.1.2 Debt investments and the SPPI test

While we expect that most of the debt investments in China, such as government bonds, financial bonds, corporate bonds and standard debt instruments, will be able to pass the SPPI test and therefore avoid the FVTPL treatment, the prevalence of non-standard debt assets in China will likely cause uncertainties. The potential difficulty in satisfying the criteria for complex and fund-type non-traditional debt instruments is likely to result in more debt instruments being classified as FVTPL than under IAS 39.

While many insurers are opting to defer IFRS 9 implementation, Chinese public listed insurers are required to make disclosures on financial asset classification and measurement, including financial assets with contract terms that do not pass the SPPI test. In the 2018 and 2019 H1 financial reports, China Life, CPIC, Xinhua and PICC reported that 16%-36% of their financial assets do not pass the SPPI test and therefore would have been classified as FVTPL under IFRS 9. The high proportion of FVTPL debt assets is likely to cause increased P&L volatility. For example, the average actual 2018 net income of the four listed companies is RMB 14.2 bn and the average fair value impact from these debt assets failing the SPPI test is RMB -18.7 bn in 2018, representing -132% of the 2018

¹⁸ Under equity method accounting, the investor recognizes its share of the earnings and losses of the investee. As the investee earns and reports income, this increases the investor’s stake. Subsequently, the investor’s stake will decrease if it collects a dividend from the investee.

¹⁹ Techniques for assessing fair value include:

^{a)} the present value of the investor’s share of estimated future cash flows from the investee’s operations, including proceeds from the investment’s disposal

^{b)} the present value of the investor’s estimated future dividends from the investee and estimated proceeds from the investment’s disposal

net income. We expect the high proportion of debt assets failing the SPPI test will gradually decrease, as the industry moves closer to the IFRS 9 implementation time.

In China, most of the debt assets failing the SPPI test are non-traditional debt assets such as wealth management products, trust plans, asset management products, etc. These products have the benefits of higher yields and longer duration but some may have complex and opaque structures that cannot pass the contractual cash flow characteristic test under IFRS 9.

In 2018, China launched the new asset management regulations that bar banks from making guarantees in their wealth management products. Instead, banks are required to market new wealth management products based on net asset value (NAV), and to phase out products that do not comply with the new rules before the extended transition period. The new asset management regulations are part of China's broader efforts to reduce financial risks by breaking implicit payment guarantees, eliminating multi-layer nesting, prohibiting channeling and capital pooling business and limiting maturity mismatches.

On March 25, the CBIRC released the "Interim Rules on Insurance Asset Management Products," which will come into effect on May 1, 2020. The new measures will help unify regulatory standards for insurance asset management products and guide insurance funds to better serve the real economy. The forms of insurance asset management products include debt investment plans, equity investment plans and mixed-asset products. Compared with other financial products, insurance asset management products have largely remained prudent and focused on long-term investments with lower risks of excessive leverage.

From an accounting perspective, the bank wealth management products and some asset management products that are compliant with the new regulations, especially the new NAV-based products, will not be able to pass the SPPI test and therefore will be classified as FVTPL under IFRS 9. The insurance asset management mixed-asset products are also likely to be classified as FVTPL, as they mainly invest in public market equities and bonds under a fund structure. Foreseeing an increase in P&L volatility from investing in these non-traditional assets after the new asset management regulations and IFRS 9 effective date, the industry is also seeing new product solutions that are designed to avoid the FVTPL treatment, which include products such as "Amortized Cost funds," for example.

4.2 Expected credit loss (ECL) model

The new ECL model under IFRS 9 is expected to generally increase the industry's accumulated amount of impairment loss compared to the amount recognized under IAS 39. Under IFRS 9, any change in macroeconomic fundamentals, such as GDP growth or unemployment forecasts, can prompt auditors to adjust their models and demand higher buffers for ECL. We believe the overall industry-wide impact from this change should be small, as most large companies tend to follow a prudent strategy for fixed income investments. For companies that have high allocation to riskier corporate credit and non-traditional debt assets, the ECL provision is expected to be higher in comparison.

Compared with banks, Chinese insurers generally lack internal credit modeling capabilities and credible sources for default and credit loss data to fulfill the new IFRS 9 requirements on ECL. This is especially true for the small and medium-sized insurers. Therefore, the industry will require significant efforts to develop such capabilities and eventually integrate credit risk management with internal accounting systems.

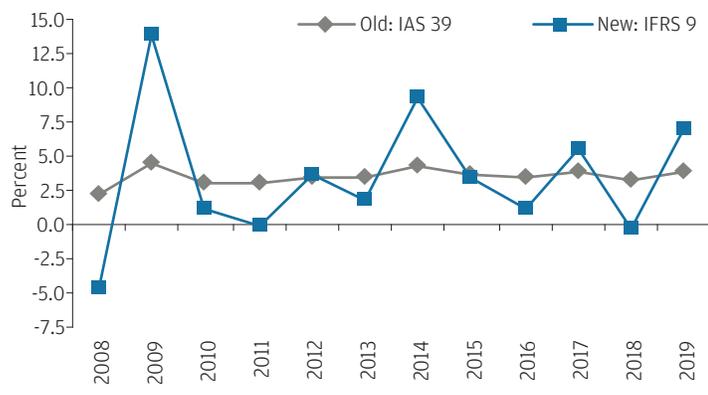
Conversely, some leading Chinese insurers have developed sophisticated forward-looking ECL models that are linked to both internal and external data sources and forward-looking macroeconomic factors, supplemented by simulation analysis and scenario testing. The year-end 2018 ECL provision reported by Ping An is RMB 9.0 bn, which is equivalent to 41 bps of total debt assets classified as amortized cost or FVOCI.

4.3 Historical back-testing

To illustrate the impact of IFRS 9 on Chinese insurers' accounting P&L, we collected market data from 2008 to 2019 for major asset classes in China and ran back-tests in our model for the selected period. The asset allocation in our model is based on the year-end 2019 asset allocation of China's insurance industry published by the Insurance Asset Management Association of China (IAMAC). We also made in-house assumptions on the accounting classifications before and after the IFRS 9 implementation for each asset class based on industry research.

Our analysis illustrates the annual accounting P&L (excluding impairments) under the IAS 39 vs. IFRS 9, using historical back-tests from 2008 to 2019 (**EXHIBIT 12**). As expected, the back-test results show that IFRS 9 would have resulted in much higher volatility in accounting P&L, mostly driven by the significant increase of FVTPL assets for both equity and debt assets failing the SPPI test.

EXHIBIT 12: ANNUAL ACCOUNTING P&L (EXCL. IMPAIRMENTS) UNDER THE IAS 39 VS. IFRS 9, USING HISTORICAL BACK-TESTS FROM 2008 TO 2019



Source: Bloomberg, Insurance Asset Management Association of China 2019-2020 report, J.P. Morgan Asset Management analysis and illustration. The illustrated accounting P&L excludes impairments.

CONCLUSION

It is important for insurance companies to holistically assess the impact and align implementation for IFRS 9 and IFRS 17, as both accounting standards include many options to reduce accounting mismatches. The aim is to reflect changes in insurance liabilities and the associated backing assets in the same place, either in P&L or in OCI.

For Chinese insurers, it is also important to incorporate the new accounting standards into broader objectives, and to better align companies' business and investment strategies with the upcoming C-ROSS Phase II guidelines in 2020 and CBIRC's new measures to strengthen the insurance industry's asset-liability management.

Minimizing volatility alone should not be the only objective for insurance investments. Going forward, the key for insurance investment in China will be the ability to strike a sound balance among multi-dimensional objectives across yield, capital, accounting and economic considerations. It is important for insurers to consider P&L volatility as part of the investment risk appetite and incorporate this accounting dimension as one of the key objectives and/or constraints within their strategic asset allocations.

*Appendix 1 Disclosure for Exhibit 2

The NAIC assigns designations to bonds that are largely based on credit ratings as determined by the NAIC's approved credit rating providers (see appendix). Unrated bonds are required to be sent to the NAIC for a credit assessment; the NAIC will then assign an appropriate designation. NAIC's approved credit rating providers: Standard & Poor's (S&P), Moody's Investors Service, Fitch Ratings, Dominion Bond Rating Service (DBRS), A.M. Best Company, Morningstar Credit Ratings, Kroll Bond Rating Agency, Egan Jones Rating Company, HR Ratings de Mexico, S.A. de C.V.

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