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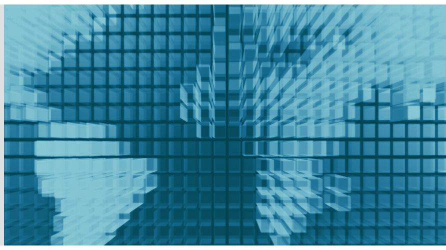

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IFRS 9: evolution or revolution in the new accounting standards?

IFRS 9 accounting standards could have a major impact on the results of banks, insurers and listed companies.

Key takeaways:

- IFRS 9 modifies the classification and measurement of financial instruments. This change in accounting treatment could produce increased volatility in profit and loss statements.
- The P&L statement will be impacted directly by how an instrument is held, i.e., either directly or via an open-ended fund.
- The financial, IT and organisational consequences are important for actors, for whom investments are a large portion of their balance sheet, insurance companies and some large companies in particular. For insurance companies, this comes on top of the IFRS 17 transition.

In July 2014 the International Accounting Standards Board (IASB) finalised the IFRS 9 accounting standard, which, since then, has been adopted by the European Commission (in November 2016). On 1 January 2018 this standard will become applicable to listed European companies, as well as, more broadly, all companies making public offerings. This is the case in particular of major corporate and bank issuers. All insurance companies that report in IFRS, whether listed or not and whether subsidiaries of banking groups or not, may defer application to 2021[1].

What are the changes between IAS 39 and IFRS9?

IFRS 9 is structured in several phases, the first two of which are the most important: phase 1 covers the classification of financial assets based on their nature and holding intention; phase 2 deals with impairment.

IFRS 9 modifies the classification and measurement of financial instruments. The categories of instruments are reviewed, along with holding intentions. In particular, the previous hold to maturity (HTM) category, which was potentially highly penalising, is no longer applicable.

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Nor is the available for sale (AFS) category applicable, with a very big impact: there are no longer any unrealised capital gains or losses on funds and, hence, earnings can no longer be managed by selling these instruments.

This change in accounting standard – from IAS 39 to IFRS 9 – may seem insignificant, but its impact on the profit and loss statement may be crucial, as the accounting treatment of an investment is closely correlated to its income statement, visibility on its profitability and, hence, whether or not it should be acquired.

What impact will the new classifications have on investors?

One expected consequence is the likely increase in volatility in the P&L. This results directly from the classification of assets held. Previously, equities, bonds and funds could be recognised under

1. As of this writing, the amendment to Draft D051300/02, providing for the deferment option for all insurance companies, had not yet been published in the Official Journal of the European Union.

fair value through other comprehensive income (FVOCI). To sum up, the difference between an asset's historical (amortised) accounting value and its market value was recognised on the balance sheet, not the income statement. This "unrealised" impairment could be "recycled" through a sale. Under IFRS 9, for an asset to have access to this type of accounting, there must be the intention to hold it for a relatively longue period, and cash flows from the financial instrument must be "solely payments of principal and interest (SPPI) on the principal amount outstanding" and pass this SPPI test. So: out with equities, funds and overly complex bonds or ones that contain too many options clauses. Full fair value will apply to all these instruments. There is no longer any unrealised value; any change in the value of the instrument will be recognised directly on the income statement.

Is there a loophole?

There is indeed an option for avoiding having to recognise equity instruments on the income statement whose market valuations are volatile – equity, for example. Changes in value may be recognised at FVOCI. But this option comes at a very high price: the inability to recycle into income. The change in the instrument's value no longer affects P&L, nor the realized capital gain once the instrument sold.

Surprisingly, the same asset with the same holding intention will not have the same accounting impact, depending on whether it is held directly or via a fund! For example, for bonds that pass the SPPI test and that are held directly (via a mandate), the investor will have the choice between recognising them at amortised cost or at FVOCI with recycling or even in full fair value. That is to say, the choice between recognising its capital gain or loss off the balance sheet, on the balance sheet, or on the income statement. It's the holding business model (detention intention) that matters. If these same assets are held via a fund, they must be recognised in full fair value. As for instruments such as equities, if the investor holds them directly, he may avail itself of the waiver to classify them as "Other Comprehensive Income" with no income statement impact, but he will not have this option if they are held via a fund. In other words, the vehicle has an impact on the choice of measurement and, hence, on the income statement!

What about impairment?

Impairment now applies only to securities that pass the SPPI test and for which the decision is made to not recognise them at full fair value. For the others, any change in value is either automatically recognised on the income statement or is never done so. So there is no reason to depreciate, i.e., to force the recognition of a loss on the income statement.

This a big change in model. Previously, you had to wait until a credit event occurred or for an almost certain probability of default before depreciating the security. This was an ex-post impairment loss. Henceforth, you will have to provision it when it is acquired (ex-ante), based on the probability of default (losses expected one year out). Then, depending how risk evolves on the security, this impairment will be raised, and expected losses upon maturity will be provisioned. Investors will therefore be forced to adopt a model similar to that used by banks' risk control departments for monitoring their credit portfolio. Banks' risk departments are familiar with such an approach, but, for insurance companies, this will be a major undertaking in terms of changes to IT systems and accounting entries.

Why for insurance companies in particular?

The consequences are especially noteworthy for banks and insurance companies as they hold an especially large portion of such assets on their balance sheets. This is potentially less the case for large corporates. In their case, everything depends on the size of their investment portfolio (for example, to cover employee-related liabilities) impacted by these accounting standards relative to the size of their balance sheet.

IFRS 9 has already modified the manner in which accounting information is stored, managed and used. This required changes in software and database, with, potentially, hundreds or thousands of man-days needed. For insurance companies in particular, this comes on top of the IFRS 17 transition, which deals with the very manner that insurance contracts are recognised. So it makes some sense that all insurance companies, whether or not that is their main activity, could obtain a deferment on the application of IFRS 9 to 2021 the implementation date for the new standard on recognition of insurance contracts (IFRS 17, which was previously known as phase 2 of IFRS 4)[1].

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1. As of this writing, the amendment to Draft D051300/02, providing for the deferment option for all insurance companies, had not yet been published in the Official Journal of the European Union.

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