



# STRONGER PORTFOLIOS BUILT FOR A CHANGING WORLD

## Adopting IFRS 9: A case study for insurers

- › Clearwater Analytics
- › J.P. Morgan Asset Management

## Introduction

- The International Accounting Standards Board finalised “International Financial Reporting Standard 9 (IFRS 9): Financial Instruments” in July 2014 as part of its reforms to the accounting treatment of financial instruments. IFRS 9 will 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, while also overhauling the requirements for impairments, which results in the earlier recognition of credit losses. Some of these accounting changes will have implications for the level and volatility of reported profits, which may in turn drive changes in investment behaviour. IFRS 9 also includes new hedging guidance designed to ease the application of hedge accounting, which will better assist insurers with risk management activities.
- While IFRS 9 is currently in use for most IFRS-compliant entities, the effective date and application of IFRS 9 has a deferral option available to insurers (required to be applied for annual periods beginning on or after 1 January 2022), due to the release of new accounting standards for insurance contracts, IFRS 17.
- This case study looks at the new reporting standard requirements using the real-life experience of an insurance client of J.P. Morgan Asset Management and Clearwater Analytics, showing how a strong partnership with an experienced asset manager and the use of an automated investment accounting and reporting solution can help insurers implement IFRS 9 successfully.

## Charting a course to IFRS 9: Case study

This case study looks at the experience of an insurance company that made the move to IFRS 9 with help from its asset manager, J.P. Morgan Asset Management, and from its portfolio reporting partner, Clearwater Analytics, with the intention of helping other insurers as they plan and implement their own adoption of the new reporting standard.

All insurers are required to move to IFRS 9 and therefore, the implementation process provides a good opportunity to carry out detailed analysis of their investment portfolios to determine what approach is best suited for their IFRS reporting. A downscaled, simplified reporting methodology may be sufficient, but an in-depth approach may be beneficial if the insurer's portfolio can provide detailed, quality data.

In this case study, the decision was taken early in the process to carry out a deep-dive on the portfolio data and have it all stored in one place, using Clearwater's integrated accounting and reporting solution. Clearwater aggregates, validates and reconciles investment data on a daily basis, enabling efficient analysis and reporting. The insurer also engaged with its asset manager, J.P. Morgan Asset Management, at the same time as talking to Clearwater, to ensure everyone was on the same page.

As some insurers may see a minimal impact from the new reporting standard at first, it's probably worthwhile taking a gradual approach to the transition to IFRS 9 to reduce workload and ensure timely implementation before the regulatory deadlines. The objective is to have everything in working order, with a robust business-as-usual structure and reliable quarterly updates, even if the initial impact is relatively limited.

Ultimately, while the change to IFRS 9 is challenging, it is well worth the upfront efforts.

## Groundwork and preparation

Preparation for the move to IFRS 9 began with a review of all the asset types and the measurement of the material impact of adoption using an external consultant. The results suggested that the insurer could move to IFRS 9 immediately, so the decision was taken to proceed and not to apply for a temporary exemption (in compliance with IFRS 4).

Nevertheless, the complexity of the task required a specific team to be set up, and strong collaboration with J.P. Morgan Asset Management and Clearwater. After reviewing the guidance, the three parties worked together to get a good grasp of the project before kicking off. Weekly calls were arranged with J.P. Morgan Asset Management and Clearwater to cover each component of the IFRS 9 adoption process.

### What preparation was needed?

Before embarking on a process to implement IFRS 9, it is crucial to fully understand the requirements of the new accounting standard in relation to the investment portfolio.

In this case study three milestones were set to ensure the IFRS 9 move was on track:

- 1 The SPPI test:** The insurer needed to be able to test whether the contractual cash flows generated by its financial assets were “solely payments of principal and interest” (SPPI) on the principal amount outstanding.
- 2 The impairment watchlist:** IFRS 9 contains tighter credit loss rules, including a forward-looking impairment model (as opposed to the incurred loss model used in IAS 39). The watchlist is critical, enabling detailed portfolio analysis within tough financial reporting deadlines. See “Expert Analysis: Building an Impairment Watchlist” later in this case study for more details.
- 3 The ECL calculation:** The expected credit loss (ECL) calculation required the insurer to follow technical accounting requirements and to ensure professional judgements were used to complete the impairment watchlist and SPPI testing.

## Expert analysis: Understanding SPPI

**CLEARWATER**  
ANALYTICS.

### CLEARWATER ANALYTICS

Establishing whether cash flows from securities are solely payments of principal and interest (SPPI) requires professionals to determine if those cash flows consist only of principal and interest. Principal is defined as the original amount due to be paid to the debt security holder, which may be paid back at maturity, or prepaid over the life of the security.

Interest is the compensation for the time value of money and credit risk, which can also include a consideration for basic lending risks, such as liquidity and costs. Most commonly held securities are likely to pass this test, but complex or non-traditional vehicles may require more consideration.

Contractual features that introduce exposure to risks or volatility in the contractual cash flows that are unrelated to a basic lending arrangement, such as exposure to changes in equity or commodity prices, do not give rise to contractual cash flows that are SPPI.

For example, convertible bonds, inverse floaters and profit participating loans will not meet the SPPI conditions. Some embedded derivatives may also not meet the SPPI criteria.

## How were the SPPI test and impairment watchlist agreed?

Firstly, the main characteristics of the instruments that fail to meet the IFRS 9 SPPI criteria were defined or identified, where further analysis was required. To better define and support the insurer's professional judgement the SPPI eligibility definition was independently verified. The insurer also revised its investment guidelines in regards to securities that may fail the SPPI test.

For the impairment watchlist, Clearwater designed a set of specific reports based on a defined methodology, allowing the insurer to aggregate and import data on individual securities efficiently for further analysis.

## How frequently are securities assessed for credit risk?

The insurer runs SPPI tests and makes ECL calculations on a quarterly basis. Therefore, their exposure at default (EAD) risk is updated every three months using actual data. Probability of default (PD) and loss given default (LGD) are determined at least annually.

Unless an insurer has a very volatile portfolio, it's unlikely that they would have the need to assess securities on a monthly basis.

## Changes to classification of measurement

### What investment business model was chosen?

Under IFRS 9, insurers need to classify and measure fixed income securities based on whether their business model is to manage their assets to collect contractual cash flows, sell the bonds or both.

In this case, the insurer chose the hold-to-collect-and-sell business model, recognising unrealised gains/losses on its balance sheet as part of other comprehensive income (OCI). By choosing this business model, they are required to perform an SPPI test on each financial instrument that they own.

### Expert analysis: IFRS 9 business models

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### CLEARWATER ANALYTICS

The business model test in IFRS 9 is based on how organisations manage assets and report performance. It also reflects how groups of assets are managed together to meet an objective and determines the intent of holding a security.

The “hold-to-collect” business model dictates that while companies do not have to hold all instruments to maturity, sales or transfers should be infrequent and insignificant.

The “hold-to-collect-and-sell” business model addresses the fact that although many investments could be classified as hold-to-collect, they could also be sold at an amount representing unpaid principal and interest on the principal amount outstanding. The hold-to-collect-and-sell business model helps manage liquidity needs, maintain a yield, match assets to liabilities, and more.

There is also a residual business model category that eliminates the need for SPPI testing, impairment watchlists and expected credit loss calculations. As a result, we have seen a few IFRS 9 clients elect to move their portfolio from “fair value through other comprehensive income” (FVTOCI, which is comparable to “available for sale” in IAS 39) to “fair value through profit or loss” (FVTPL, which is comparable to “held-for-trading”).

## How was it determined which securities meet the SPPI criteria?

The insurer works closely with its asset manager, J.P. Morgan Asset Management, to determine whether securities meet the SPPI criteria. J.P. Morgan Asset Management provides its SPPI assessment three days before quarter end, based on both independent third party analysis and its own proprietary research. The report covers every security, providing enough time to make a decision on those securities where the SPPI analysis is not clear. The insurer then receives a final document after the end of the reporting period, with the same data for any end-of-month trades.

When there are differences between the third party data and J.P. Morgan Asset Management's opinion on a particular security, the insurer decides whether the security passes or fails the SPPI test.

This approach speeded up the process, because instead of a deep dive at every individual security level, only a few select securities needed to be looked at. This approach has also been helpful for the insurer's auditors, who are satisfied that the professional judgement of J.P. Morgan Asset Management is leveraged to make the final SPPI decision. Once the SPPI test is complete, the data is added to the Clearwater system.

## Did the insurer have the flexibility to invest in securities that do not meet the SPPI criteria, and therefore are recorded in profit and loss, if they make good investments?

To reduce risk, the insurer decided that it would not hold securities that fail the SPPI test. As a result, J.P. Morgan Asset Management includes IFRS 9 analysis in its security selection to ensure the insurer's objectives are met. Of course, market conditions, options and security characteristics can change. Furthermore, the SPPI test is also subjective. Therefore, the insurer is able to make the final decision on whether a security passes or fails.

## Expert analysis: SPPI and security selection

**J.P.Morgan**  
Asset Management

### J.P. MORGAN ASSET MANAGEMENT

At J.P. Morgan Asset Management, we use our professional judgement to review each security to determine if it passes or fails the SPPI test. We also compare our assessment to independent third parties to ensure it aligns with market expectations.

A security's characteristics and structuring will define the outcomes that can be produced, as it pertains to its return profile. We feel it's our responsibility to take into account any accounting considerations that may have an adverse impact on our clients' financials.

Because of the low-yield environment, this responsibility is particularly important, as non-traditional fixed income assets could potentially provide higher yielding opportunities but may produce unwanted income volatility due to price changes via an unfavourable investment classification.

For this reason, we include IFRS 9 analysis in our security selection process, to ensure outcomes meet our clients' objectives.

## How can securities that fail the SPPI be restricted?

In this case, to reduce risk the insurer took the decision to amend its investment guidelines to exclude securities that are likely to fail the SPPI test. To further reduce the number of securities that fail the SPPI test, the insurer added some exclusions, such as hybrids and convertibles, which could change the security test result.

The decision to change investment guidelines depends on the insurer's risk appetite. There is no mandate to update investment guidelines to exclude securities that could fail the SPPI test, but there are implications of doing so. Examples include the added complexity of dealing with those securities if they do fail and potential increased volatility in the profit and loss statement. Narrowing the investment universe of the insurer's asset manager may achieve the objective of removing securities failing the SPPI test but also narrows the opportunities to invest in securities that could potentially increase portfolio returns.



## Does the insurer have direct communication with the desk?

J.P. Morgan Asset Management provides direct access to its portfolio managers and investment specialists, allowing the insurer to be fully cognisant of active decisions and market views in real-time. Late cycle investing brings added complexities, which can cause potential outcomes to shift rather quickly.

J.P. Morgan Asset Management's open approach means that insurers are fully aware of any responses to shifting dynamics. J.P. Morgan Asset Management is also always available to answer any questions that may be of interest.

## How does the insurer account for investments in equities, investment funds and liquidity funds?

In this case, the insurer does not invest in equities. However, those insurers that are required to classify IFRS 9 equities held for trading as fair value through profit or loss. For other equities, insurers can make an irrevocable election on initial recognition to present fair value changes in "other comprehensive income" rather than the profit and loss statement. All funds are recorded as fair value through profit and loss. Liquidity funds are classified as financial assets at fair value through profit or loss, so unrealised gains or losses are recorded in the income statement.

## What checks are made to the accuracy of SPPI data?

After the final decision is made, the insurer will instruct Clearwater to update reports with any securities that fail the SPPI test. Exhibit 1 shows an example of the Clearwater SPPI report, which shows if there are any securities that have failed the SPPI test. This process is important for the analysis of unrealised gains/losses and for cross checking. The insurer has access to this SPPI report through its relationship with J.P. Morgan Asset Management. This report allows the insurer to review its portfolio at the security level, including individual SPPI test results.

Exhibit 1: SPPI IFRS Report in Clearwater

| <b>SPPI IFRS Report</b><br><b>JPM Aggregate</b> <small>202410</small> <b>Base Currency: EUR as of 01/10/2018</b> ▼ |            |             |               |            |
|--|------------|-------------|---------------|------------|
|  | Account ID | SPPI Test ▲ | Security Type | Identifier |
| ⊕ Fail   | 64303      | Fail        | CORP          | ---        |
| ⊕ Pass   | ---        | Pass        | ---           | ---        |

Source: Clearwater, J.P. Morgan Asset Management.

Having all SPPI data available in the Clearwater system is central to this, as it provides a single framework and single place in which to do all the necessary calculations. No calculations should be performed outside the system, as this makes it difficult for the auditors. Using Clearwater, clients can extract an entry file that can automatically be uploaded into their accounting ledger.

## Expert analysis: Classification of financial instruments

**CLEARWATER**  
ANALYTICS

### **CLEARWATER ANALYTICS**

Clearwater handles the financial instrument classifications through FVTOCI or FVTPL at a security level rather than at a portfolio level. This granularity allows the general ledger accounting journals to automatically adjust depending on whether our clients wish to pass or fail a specific security.

The unrealised gains or losses will then flow through the FVTPL (as holding gain/losses), or FVTOCI (as unrealised gains/losses) depending on whether a security passes or fails the SPPI test.

## Defining the impairment methodology

### How is credit deterioration assessed?

IFRS 9 fundamentally changes how companies view and respond to impairment. The existing incurred loss model based on IAS 39 was criticised for delaying the recognition of losses, for being inconsistent with how businesses and risk are managed, and for being difficult to understand and apply.

IFRS 9's new impairment methodology requires the recognition of an allowance for FVTOCI or amortised cost securities (debt-like assets not measured at FVTPL) at purchase based on probabilities, the time value of money, and reasonable and supportable information on past events, current conditions, and forecasts of future economic conditions. This method asks companies to take a forward-looking approach to assessing impairments rather than resolving impairment issues after they have already occurred.

While this methodology encourages a more proactive and forward-looking approach, it requires additional review and analysis. Identifying such factors as probabilities of default and expected losses can be challenging. Automated investment accounting solutions can help alleviate the burden of these additional requirements.

One of the key duties of the impairment methodology assessment is to review financial instruments for staging. In this case, the insurer leverages J.P. Morgan Asset Management's investment expertise and Clearwater's reporting functionality to create numerous reports that help it assess those securities that are at risk of credit deterioration.

### Expert analysis: Building an impairment watchlist

**J.P.Morgan**  
Asset Management

### J.P. MORGAN ASSET MANAGEMENT

Credit analysis is fundamental to the managing of core fixed income for insurance companies. We feel that a well-defined policy to identify credit deterioration is key to prudent investment management.

The analysis, in the form of a credit watchlist, should include both quantitative and qualitative inputs, while also defining a criteria and policy that includes reference to the IFRS 9 staging framework for recognising credit risk.

Because of the staging requirements, clients may also look to institute changes to their investment guidelines, to ensure their guidelines align with their credit risk objectives. This is particularly important at IFRS 9 adoption if, for example, clients desire to minimise exposure to assets in Stage 2 (where credit risk has increased significantly since initial recognition) because of the tougher ECL calculation applied to these assets.

## Has the insurer had exposure to Stage 3 securities where the asset is credit impaired?

To avoid risk, the insurer seeks to avoid securities moving into Stage 3 using its investment guidelines, which only allow investment in investment grade securities. With these guidelines in place, and supported by J.P. Morgan Asset Management's security selection, the insurer would not expect securities to fall into Stage 3.

Once staging is complete, the next step is to determine the probability of default (PD) and loss given default (LGD) for the asset. Assessing whether the asset is in Stage 1 (where credit risk has not increased significantly since initial recognition) or in Stage 2, will determine if a 12-month or lifetime ECL should be applied.

Considering the nature of financial instruments and the availability of credit risk information, the insurer in this case assesses impairment on an individual security basis. Each quarter, a loss allowance is recognised based on a 12-month or lifetime ECL, depending on whether the asset has suffered a significant increase in credit risk since its initial recognition. It can be assumed that credit risk has not increased significantly since initial recognition if the financial asset is assessed as having low credit risk.

If credit risk is not low, staging is applied to securities based on analysis of the impairment watchlist. With the assistance of J.P. Morgan Asset Management and Clearwater, the insurer created 10 different filters in the Clearwater system to isolate the securities it believes should be on the watchlist. Securities are assessed based on a valuation review, which looks at unrealised gains/losses and price movements, and a credit risk review, which looks at rating downgrades (or changes to outlooks) and changes in option-adjusted spreads, as well as taking into account some final checks on debt seniority, convertibility etc. This review saves time and brings together all the necessary data needed for staging analysis.

## How is the probability of default determined and what testing is performed?

Once staging is complete, the parameters for the ECL model need to be determined, which includes exposure at default (EAD), probability of default (PD), and loss given default.

A rating system can be used to estimate the PD, which is determined separately for corporate and sovereign securities.

The PD is computed by the insurer and then reviewed by the external auditor.

## How is loss given default (LGD) calculated?

Recovery rate (portfolio or benchmark), credit insurance and legal/post default classification details need to be considered in order to define LGD, each specific exposure at default, date of default, guarantee and deposit information.

The recovery rate is determined under the Basel II foundation approach: large corporates and small/medium-sized entities are assigned a 45% LGD. Start-ups and other borrowers are assigned a 75% LGD.

## What data point is used as the discounting factor?

In this case the insurer uses the purchase yield per guidance. Once the staging has been completed and the PD and LGD has been estimated with the assistance of Clearwater, the insurer is able to calculate the discounted expected credit loss using tax lot reports, amortised cost, purchase yields and client-determined data points.

Clearwater generates a report with all the necessary data points, and the insurer uses this information to calculate the ECL. This is calculated at the lot level, as the cost or purchase price of each security needs to be considered.

## How is the ECL used once calculated?

The insurer sends the ECL calculation to Clearwater, where an additional review is performed and then uploaded into the system. The accounting journals are automatically generated and uploaded into the insurer's accounting ledger.

## What testing was performed before “going-live”?

The insurer used data as of 1 January 2018 to test the system and then subsequently performed the same calculation later in 2018. The external auditor also reviewed the model, the main assumptions used and the final calculation.

Technical checks were made by Clearwater.

## Based on this case study, how much time would insurers need to test and implement IFRS 9?

Leveraging the expertise of J.P. Morgan Asset Management and Clearwater helped expedite the insurer's implementation process. Nevertheless, from start to finish—including dry-run testing and installation of the new process—insurers should allow 6-9 months for implementation.

## Further reading

For a more detailed analysis of SPPI testing and the implications for impairment and credit loss calculations, see “IFRS 9: SPPI, Impairment Testing & Expected Credit Loss”, J.P. Morgan Asset Management Global Insurance Solutions (September 2018).

For more information on IFRS 9 business models, see “Preparing for IFRS 9: What You Need to Know”, Sam Hobbs CPA, Clear Insights (September 2017) [www.clearwater-analytics.com/clearinsights](http://www.clearwater-analytics.com/clearinsights).

### About Clearwater Analytics

Clearwater Analytics is a global SaaS solution for automated investment data aggregation, reconciliation, accounting, and reporting. Clearwater helps thousands of organisations make the most of their investment portfolio data with a world-class product and client-centric servicing. Clearwater also offers a full complement of middle- and back-office solutions like client billing, composite management, client statements, and more. Since its founding in 2004, Clearwater has provided a cloud-native solution that helps investors make the most of their data. Every day, investment professionals in 49 countries trust Clearwater to deliver timely, validated investment data and in-depth reporting.

For more information, visit [www.clearwateranalytics.com](http://www.clearwateranalytics.com).

### About J.P. Morgan Asset Management

J.P. Morgan Asset Management is a global leader in asset and wealth management services. The Asset & Wealth Management line of business serves institutional, ultra-high net worth, high net worth and individual clients through its Asset Management and Wealth Management businesses. With client assets of £2.3 trillion and assets under management of £1.7 trillion, we are one of the largest asset and wealth managers in the world. (Assets as of 31 March 2019.) Throughout its long and distinguished history, Asset & Wealth Management has been steadfastly committed to putting its clients' interests first.

Our dedicated insurance team covers all services including Client Advisory, Strategy & Analytics, Portfolio Management, Investment Accounting & Reporting and Client Account Management. With \$220 billion of general account assets under management (as at 30 June 2019), we are one of the fastest growing asset managers in the insurance industry.



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with our clients in an effort to build stronger  
portfolios drives everything that we do.

We are committed to sharing our  
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all asset classes to help make better  
investment decisions. Whatever you are  
looking to achieve, together we can solve it.



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