Amundi
ASSET MANAGEMENT

IFRS

Will the European Commission instigate new accounting rules for financial assets?

While most insurers do not yet apply IFRS 9, several modifications to the way in which equity investments are recognised are currently under consideration. Potential effects of the accounting treatment of equities on long-term investment were a concern of the European Commission as early of 2017 and more recently, it has requested proposals for alternative treatment to fair value measurement in its sustainable finance action plan.

The one-year deferral of IFRS 17 is being used to make slight adjustments. However, the concomitant introduction of IFRS 9 and IFRS 17 could be inappropriate. To address certain issues, the French Accounting Standards Authority (ANC) recommends changing the rules for classifying debt instruments.

Changes to IFRS 9 for equity investments?

Reminder of the accounting treatment of equity investments under IFRS 9

Under IFRS 9, investments in securities considered to be equity instruments are measured at fair value.

By default, they are recognised at fair value through profit or loss (FVPL). However, if the instruments are not held in a trading business model, the entity can choose to present changes in fair value through other comprehensive income (FVOCI). In this case, gains or losses recorded in OCI (other comprehensive income) are not recyclable to profit or loss at the time of the sale of the securities (contrary to the accounting treatment of securities classified as available-for-sale assets under the previous standard, IAS 39) and only dividends are recognised in P&L. This choice is made on an instrument-by-instrument basis and is irrevocable.

As the equities are carried at fair value, provisions for permanent impairment recorded under IAS 39 no longer exist. These provisions had been criticised for being evaluated by models that would be potentially overly subjective.

The European Commission has asked EFRAG[1] for technical advice on the accounting treatment applicable to equity instruments from a long-term investment perspective.

The Commission requested a two-stage response, the first setting out the problem and the second proposing possible solutions.

In January 2018, EFRAG published a report including quantitative data on amounts invested in equity instruments, their accounting classification and the expected impact of the application of IFRS 9 on long-term investments, drawing on 2016 and 2015 financial statements and a consultation held in 2017.

It showed that the portion of equity instruments classified as available for sale under IAS 39 varies considerably between entities. Among respondents, seven insurance companies intended to apply the FVOCI option under IFRS 9 for their strategic or long-term investments. The impact of IFRS 9 on asset allocation also varies between entities. Nearly half of respondents (primarily insurance companies) expect to adjust their asset allocation, some by reducing their equity investments in favour of fixed income products or loans.

EFRAG published a report on possible solutions in November 2018 after analysing reactions to its discussion paper, "Equity Instruments – Impairment and Recycling", published in March 2018.

When asked about reintroducing recycling for equities measured at FVOCI, the large majority of respondents consider that recycling better reflects the financial performance of long-term investors. Almost all respondents are in favour of adding an impairment model if recycling is reintroduced. Some would like to see these provisions applied as an amendment to IFRS 9 soon, so they can apply them when IFRS 17 takes effect.

While IFRS 9 on Financial Instruments entered into force in January 2018, insurance entities have been granted a temporary exemption.

1. European Financial Reporting Advisory Group.
2. IFRS 17 was initially due to take effect on 1 January 2021 but the IASB deferred its application by one year on 14 November 2018.
3. The European Union is currently in the process of approving IFRS 17.

They can defer application of IFRS 9 until 1 January 2022[2], when IFRS 17[3] on Insurance Contracts also takes effect.

EFRAG suggests exploring two ways of reducing the drawbacks of the accounting treatment applied to equities under IFRS 9 and its predecessor IAS 39.

- The first solution would be a "revaluation" model. Under this model, equities would be recognised at FV (Fair Value) and any changes in FV below the acquisition cost[4] would be recognised in profit or loss, while any changes above the acquisition cost would be recorded through OCI.

  By removing any form of judgement from the measurement, this model improves comparability, which was considered insufficient under IAS 39. However, it would cause some volatility in profit or loss, which is avoided with the OCI option in IFRS 9.

- The other solution would be to apply a new impairment model with less subjectivity than under IAS 39, and recycling. Unlike IAS 39, the new model would allow impairment reversals.

  The majority of respondents prefer this solution but the difficulty lies in establishing relevant criteria without affecting comparability.

- Some participants consider that the introduction of thresholds, such as a maximum percentage decline for the "significant" criterion and a maximum time period for the "prolonged" criterion, would not be appropriate. Establishing a standard decline threshold that ignores volatility in the securities is not necessarily relevant. Similarly, as the average holding period of securities can vary considerably between entities, setting a standard time limit for all entities is also contentious. These respondents believe that each entity should set its own thresholds.

Improvements in accounting regulations and the incorporation of sustainability in prudential capital requirements are among the reforms envisaged by the European Commission to support sustainable finance.

Financing for sustainable growth could lead to new accounting provisions for equity investments

In its action plan, the European Commission asked EFRAG to explore potential alternative accounting treatments to fair value measurement for long-term investment portfolios of equity and equity-type instruments.

The treatment methods set out in IFRS 9 dissuade long-term investors from holding equity instruments and this could curb financing for sustainable projects.

The EFRAG secretariat has drafted a document setting out a series of possible accounting methods and criteria to establish the scope of application of a new accounting treatment. A consultation period ending on 5 July will gather the opinions of different stakeholders on these alternative accounting treatments.

EFRAG first presents two accounting treatments that are widely used:

- recognition at historical cost,
- recognition at average fair value (an average over 90 days is mentioned). This type of measurement is sometimes used for tax calculations.

However, EFRAG's document shows that the use of an average fair value does not always reduce profit or loss volatility in relation to the use of fair value at the reporting date. As for recognition at historical cost, by ignoring events occurring after the purchase of the equity instrument, this method does not reflect the entity's real exposure to risk arising from its ownership of the asset.

Other approaches are considered, but their implementation would cause operational problems. EFRAG proposes the following alternative methods:

- adjusted cost (adjusting for the entity's share of the investee's profit or loss or for observable market transactions),
- adjusted fair value,
- allocation-based approach.

In the allocation-based approach, price changes would be recognised in P&L over a period reflecting the investment perspective. This model could be based either on an estimate of the holding period at initial recognition and of an expected return rate, or on the expected duration and rate of a linked liability (designated on acquisition).

To determine the scope of application of the alternative accounting treatment, it is necessary both to stipulate the types of eligible financial instruments and to define what constitutes a "long-term" investment. As regards the types of instruments, the ownership of equities (or other equity instruments) via fund units[5] should not result in these investments being excluded from the scope (IFRS 9 is even more restrictive for investments in funds than for direct equity instruments because changes in fair value can only be recognised through profit or loss).

The concept of "Long-term investment" is particularly difficult to define. Should it be based on the business model or on a minimum holding period, or should it require the selection of liabilities that would ensure a long holding period for the associated assets?

To obtain stakeholders' opinions on different investment scenarios, EFRAG asked for their preferred choice of accounting treatment from 7 variants – the five approaches presented in the information document plus current provisions and any other proposal, for:

- an investment in non-transferable shares in a wind farm with predetermined useful life,
- an investment in shares in an unlisted single equity instrument with no holding constraints,

4. Both declines and recoveries in value if the FV remains below the acquisition cost.
5. Excluding bespoke funds treated under the look-through approach.

- the ownership of an open portfolio of mostly unlisted equity instruments held with a view to service a long-term insurance obligations. (The assets are assigned to a liability over 30 years),
- a similar situation to the previous scenario but the liability is not an insurance obligation,
- a long-term investment held indirectly through an ETF (the entity presents itself as a long-term investor but past practice indicates that, on average, it will hold these units for approximately six months, although the holding period varies considerably from one investment to another),
- a similar situation to the previous scenario but for an unlisted fund.

The Solvency II prudential framework includes provisions allowing more advantageous treatment for certain investments intended to be held over the long term

In the standard formula, an investment in listed equities in an OECD country gives rise to a capital charge(1) of 39%(2), while investments in unlisted equities or those listed in a non-OECD country generate a charge of 49%(2).

1. Before impact of diversification, absorption by technical provisions and deferred taxes.
2. Plus a symmetric adjustment ranging from +10% to -10% aimed at reducing the capital charge following a decline in the equity markets and increasing it after a rise.

However, there are several provisions allowing the application of a capital charge of 22% for some equity investments.

- This favourable treatment applies to **strategic investments**. An investment qualifies as a strategic investment essentially if there is a lasting relationship with the partially owned company and if the insurer exercises real influence over it.
- **Equities held to meet occupational pension obligations** can also be assigned a 22% capital charge. The insurance company must obtain approval from its supervisory authority to apply this treatment. An average duration of liabilities of over twelve years is required and the asset/liability management process must show that it is compatible with holding equities for the long term.
- The Regulation adopted by the European Commission on 8 March also applies a 22% capital charge to "**Long-term equity investments**"
  The scope is limited to equities listed in the EEA and unlisted equities of companies having their head office in an EEA member country. Ownership over a very long period must be compatible with the insurer's obligations and the asset/liability management process must ensure that, at all times, the sub-portfolio of equities will not be subject to forced sales for at least 10 years (including under stress scenarios).

Investments in infrastructure also benefit from more favourable prudential treatment.

- Shortly after its application, the Solvency regulation was amended to introduce a 30% capital charge (+77% of the symmetric adjustment) for investments in infrastructure projects that meet certain criteria.
- A new amendment was adopted in 2017 to assign an intermediate capital charge (36% +92% of the symmetric adjustment) to shares in eligible infrastructure companies.

The amendments proposed by EIOPA to integrate sustainability risks introduce additional constraints

In July 2018, to further its action plan on financing sustainable growth, the European Commission asked EIOPA and ESMA to provide technical advice on the integration of sustainability risks and factors in its delegated acts and directives applicable to insurance activities, asset management and the distribution of financial products (the Solvency II, UCITS, AIFM, MiFID II, IDD directives).

EIOPA submitted its response in April 2019.

As regards the Solvency II prudential framework, EIOPA recommends incorporating sustainability risks in risk management processes, in the prudent person principle that governs insurers' investments and in the opinion expressed by the actuarial function on the underwriting policy.

Sustainability risks and climate change in particular should also be integrated in insurers' own risk and solvency assessment (ORSA).

The European Commission also requested EIOPA's opinion on Solvency II and sustainability, in particular on aspects relating to climate change, in order to take it on board in the 2020 review of the Solvency II framework. EIOPA has recently issued a consultation and will submit its opinion to the Commission in late September, after analysing participants' responses.

Will the European Commission instigate new accounting rules for financial assets?

Interaction between IFRS 9 and IFRS 17

Under IFRS 17 insurance contracts are recognised at market value

The reserve corresponding to premiums received is broken down into three parts:

- the present value of future cash flows (discounted at a rate that is consistent with current observable market prices),
- a risk adjustment reflecting cash flow uncertainty arising from non-financial risks,
- the contractual service margin (CSM), which represents the unearned profit and is allocated to profit or loss over the duration of the policy.

The rate used to discount future cash flows is reviewed at each reporting date in line with market rates.

The general model, also known as the Building Block Approach, has been adapted for insurance contracts with direct participation features, to which the "Variable Fee Approach" (VFA) applies. In the VFA model, the insurer expects to pay the policyholder a substantial portion of the economic return on its investments, and the amounts payable to the policyholder vary considerably based on changes in the fair value of the assets. This model was therefore designed to reflect the fact that the insurer receives a variable fee as the manager of the savings entrusted to it.

Both approaches include an option to break down financial income from insurance activities between P&L and other comprehensive income (OCI).

If the period covered by the policies is not over one year, the insurer can simplify the measurement of its liabilities by using the premium allocation approach (PAA).

SUMMARY BALANCE SHEET

Assets - IFRS 9	Liabilities - IFRS 17
Assets at amortised cost	Own funds
	Contractual service margin
Asset at FVOCI*	Risk adjustement
Assets at FVPL**	Present value of future cash flows

OCI = Other Comprehensive Income;
(*)FVOCI = Fair Value through OCI; (**)FVPL = Fair Value through Profit or Loss

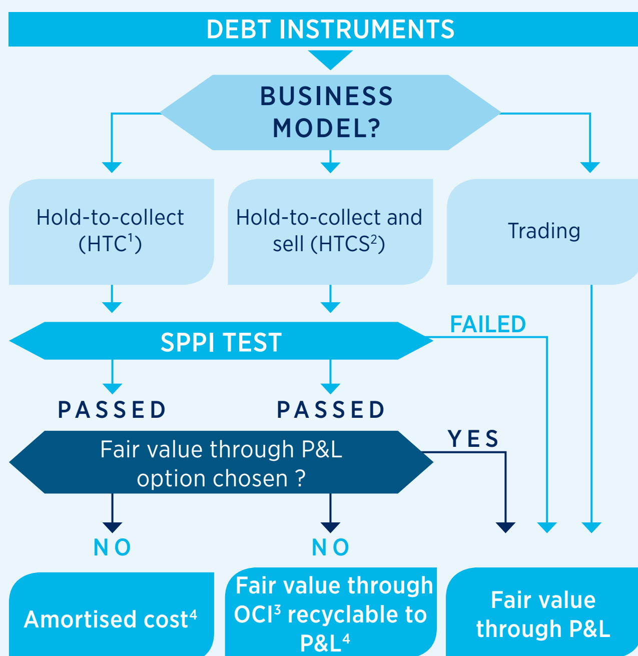
Accounting treatment of investments in debt instruments under IFRS 9

While the business model is most often the main factor used in determining the classification of a debt investment, the instrument's characteristics may require measurement at fair value through profit or loss.

Debt instruments must be measured at FVPL if they are not qualified as SPPI (Solely Payments of Principal and Interest). An instrument is categorised as SPPI if its contractual cash flows are solely payments of principal and interest on the principal that is still owed.

In contrast, the entity may choose to measure assets at fair value through profit or loss if doing so allows it to eliminate or significantly reduce accounting mismatches.

In addition, in contrast to IAS 39 rules, which take an approach that reacts to an event once it has occurred, the IFRS 9 impairment model has a forward-looking approach. On initial recognition, the entity measures expected losses caused by a possible default event in the following 12 months (stage 1). If credit quality deteriorates significantly, the security or loan commitment is considered to have entered stage 2, and expected losses in the event of a default must be taken into account throughout the lifetime of the security or loan.



1. Hold-to-collect contractual cash flows
2. Hold-to-collect and sell contractual cash flows
3. Other Comprehensive Income
4. Subject to impairment

The application of IFRS 9 and IFRS 17 could give rise to accounting mismatches

At the beginning of May, the French Accounting Standards Authority (ANC) submitted a draft discussion of interaction between IFRS 9 and IFRS 17 to the IASB. The ANC highlighted several situations of accounting mismatches and proposed amendments to IFRS 9, IFRS 17 and IFRS 40 (on Investment Property).

Equity investments

The ANC emphasised that in general, the measurement of equities at FVOCI not recyclable to profit or loss is not appropriate. Owing to the inverted cycle of insurance businesses, investments are an essential component of performance and not recognising cumulative gains in OCI poses a real problem.

Fixed income investments

The ANC explained the impact of measurement choices in an illustrative example of investment contracts with a discretionary participation feature.

In this simplified model, premiums are assumed to be fully invested in fixed rate bonds ensuring asset/liability matching and the bond yield is used on initial recognition to discount expected returns.

Factoring in changes in market rates, account closing calculations are simulated for each measurement method possible for the assets and the insurance liabilities. These simulations identify which classification choices are appropriate and those that generate volatility in P&L and/or OCI. In the VFA model, if the assets are measured at FVPL, the impacts of the change in interest rates on profit or loss[5] offset each other.

<table>
<tr><th>Contracts (IFRS17)</th><th>Assets (IFRS 9)</th><th>Impact on P&L*</th><th>Impact on OCI</th></tr>
<tr><td rowspan="3">With recognition of part of income and expenses in OCI</td><td>Amortised cost</td><td>None</td><td>Potentially significant</td></tr>
<tr><td rowspan="2">FVOCI</td><td rowspan="2">None</td><td>General model: limited</td></tr>
<tr><td>VFA: offset</td></tr>
<tr><td rowspan="4">Without use of OCI option</td><td>Amortised cost</td><td>Potentially significant</td><td>None</td></tr>
<tr><td>FVOCI</td><td>Potentially significant</td><td>Potentially significant</td></tr>
<tr><td rowspan="2">FVPL</td><td>General model: limited</td><td rowspan="2">None</td></tr>
<tr><td>VFA: offset</td></tr>
</table>

(*) Before the release of the CSM to profit or loss.

Also in this model, if the assets are measured at FVOCI and the OCI option is applied for the policies, the impact on OCI is neutral.

If the general model is applied, the offsetting impact is limited because the CSM is not revalued at the new market rate.

However, regardless of the options chosen for the policies, the recognition of debt instruments at amortised cost generates accounting mismatches.

Yet for loans, which fall within the hold to collect business model, and which fulfil SPPI criteria, the only classifications possible are Amortised Cost or FVPL. For this reason, the ANC recommends adding an option allowing these instruments to be measured at FV through OCI, if this avoids an accounting mismatch.

5. Before the release of the CSM to profit or loss.

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COMMISSION DELEGATED REGULATION (EU) 2017/1542 of 8 June 2017 amending Delegated Regulation (EU) 2015/35 concerning the calculation of regulatory capital requirements for certain categories of assets held by insurance and reinsurance undertakings (infrastructure corporates)

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