IFRS 9: New for 2018

Author: Leon Sinclair, Executive Director – Private Equity

This article consolidates the pertinent and practical implications of IFRS 9 for general partners and investors in alternative investment funds, particularly those involved in Private Debt. This discussion formed part of a broader presentation given by Leon Sinclair at the Nordic Asset Allocation Forum.

Since 2015, European banks have been preparing for the implementation of International Financial Reporting Standard 9, a new accounting principle for financial instruments that became effective in January 2018. IFRS 9 will change the way banks classify and measure financial assets, introduce a three-stage model for impairments (stage 3 being nonperforming), and reform hedge accounting. Banks have dedicated most of their efforts to technical and methodological issues—in particular, how to incorporate forward-looking assumptions and macroeconomic scenarios into their existing models and approaches. Debate on the impact on banks has been well covered by the media, the banks themselves, national regulators and supervisory bodies.

However, what has been less debated are the huge consequences of the standard change for general partners and investors in alternative investment funds, as the classification and measurement of financial assets introduced by IFRS 9 (replaced IAS 39 as of January 1, 2018).

Management teams and specifically CFOs are making important choices over the measurement and reporting of private debt investments. In many cases this is happening in consultation with, or at least being monitored by, institutional investors for which these choices will have a profound impact on cash profiles and liability matching properties.

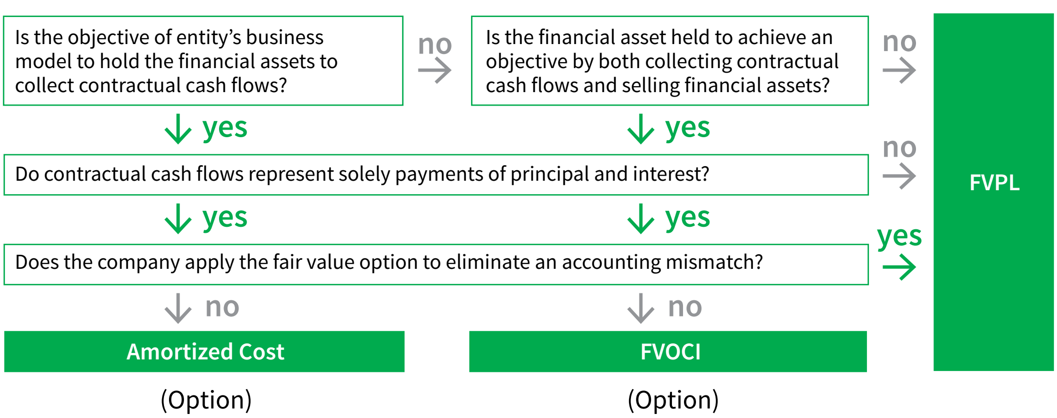
Under IFRS 9 the classification determines how financial assets are categorised and measured in the financial statements. Requirements for classification and measurement are thus the foundation of the accounting for financial instruments.

The requirements for impairment and hedge accounting are also based on this classification.

Financial assets are classified in their entirety rather than being subject to complex bifurcation requirements. There is no separation of embedded derivatives from financial assets under IFRS 9.

The new standard effectively sets out three major classifications; namely amortised cost (AC), fair value through profit or loss (FVTPL) and fair value through other comprehensive income (FVOCI).

IFRS 9's new model for classifying and measuring financial assets after initial recognition



The purpose of IFRS 9 has been to simplify and improve the accounting for investments under what was previously IAS 39, under which financial assets had been classified into several more categories, which some argued were misaligned with the requirements of some financial statement users.

Central to the implications of IRFS 9 for Private Debt Managers is the differentiation between accounting for investments at amortized cost and fair value. From our discussions with strategic allocators to alternative debt funds the developments have been well received. This is mainly due to their NAV statements being prepared based on Fair Value. Why is this the case?

- Fair Value is the norm for real money investors for their own financial reporting purposes. Solvency II reporting / prudential valuation requirements have made this even more important for insurance groups.
- Liability driven investors use Fair Value as a common basis to make asset allocation and specific investment manager selection decisions, track-record appraisals over different time horizons are vital.
- Fair Value assessment forms part of allocator performance evaluation and can be an important consideration in compensation decisions.

Without the best practise appraisal that Fair Value enables for the underlying portfolio companies, how can an institutional investor exercise their fiduciary responsibilities, including the need to measure and control risk? Portfolio company appraisals must be performed in a consistent, clear framework which is supported by a robust valuation policy.

If satisfying investor requirements mentioned above isn't enough of a driver for GPs to apply Fair Value measurement, following the 'cash flow characteristics' and 'business model' tests under IFRS 9 will inexorably lead sophisticated GPs to conclude that Fair Value is the only viable option for private debt investments. One may ask why is the amortised cost approach many banks take in certain circumstances (i.e. on their retail banking book) not extensible to private debt GPs should they want to appease their institutional investors?

Business Model test

While IAS 39 focuses on how the entity intends to realize individual assets in classifying financial assets, IFRS 9 focuses on the business model or models the entity uses to realize them. IFRS 9 recommends applying the Business Model test before applying the SPPI test because this may eliminate the need to apply the more detailed SPPI test, which is applied at a more granular level. However, the ordering of the tests will not change the outcome.

The basic steps for applying the Business Model test, involves four basic steps:

1	2	3	4
Subdividing as necessary loans and receivables into separate groups or portfolios according to the way they are managed.	Identifying the objectives the entity is using in the course of its business to manage each grouping or portfolio.	Based on those objectives, classifying each group or portfolio as being "held to collect", "held to collect and to sell", or "other".	For assets classified as being held to collect, evaluating the appropriateness of the classification by back-testing against past activities. The following text box summarizes the key factors and other guidance in IFRS 9 for classifying assets as held for collection, held for collection and sale, and other.

A private debt investment may only be accounted for at amortized cost if, firstly, the investment gives rise on specified dates to cash flows that are solely payments of principal and interest and, secondly, the investment is held within a business whose sole objective is to hold financial assets to maturity to collect contractual cash flows.

SPPI Test

Under IFRS 9 a necessary condition for classifying loans and receivables at Amortized Cost or FVOCI is that the contractual payments give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

In its Basis for Conclusions, the IASB explains the rationale for limiting the use of Amortized Cost and FVOCI to financial assets that meet the SPPI test. The IASB considers that these bases of accounting are meaningful only for "basic" or "simple" loans and receivables. More complex arrangements must be measured at FVPL.

IFRS 9 identifies the following factors as being relevant in applying the SPPI test:

1	Whether payment terms are "not genuine" or "de minimis"
2	Rights in bankruptcy or when non-payment happens
3	Arrangements denominated in a foreign currency
4	Prepayment and term extending options
5	Other contingent payment features
6	Non-recourse arrangements
7	The time value of money element of interest
8	Contractually linked instruments (tranches) and negative interest rates

Now fast forward to a practical scenario. By applying for amortised cost treatment the IRR / excess returns strategies used by most GPs become unavailable and it would likely be viewed as remiss to change the funds strategy, (and access to excess IRR) simply to avoid fair valuation of underlying assets (cast your mind to the use of PIKs, warrants and refinancing as opportunities.) Clearly this would also impact their performance relative to peer managers and their ability to fundraise. Most GPs require sufficient flexibility to enable them to generate returns for investors which should naturally lead them to fair value measurement.

In the instance the GP opts to measure private debt investments at amortized cost, they will now be required to perform more onerous impairment testing under IFRS 9, which must include a forwardlooking assessment of expected credit losses. This will be similar to the analysis performed by banks and other financial institutions. Please see an earlier piece by Gavan Nolan on the use of CDS data in such impairment testing, this is just one framework for PD frameworks and we've proposed alternative methods as well as CDS for the few private debt GPs that have chosen this route.

We believe the pursuit of fair value is a positive development for a segment of the market where best practise in the form of valuation polices and fair value is becoming increasingly vital to institutional investor Due Diligence and Strategic Asset Allocation requirements.

Author

Leon Sinclair
Executive Director – Private Equity

E leon.sinclair@ihsmarkit.com
T +44 20 3367 0491

For more information www.ihsmarkit.com

AMERICAS
T +1 212 931 4900

EUROPE, MIDDLE EAST, AFRICA
T +44 20 7260 2000

ASIA PACIFIC
T +65 6922 4200

E sales@ihsmarkit.com

About IHS Markit

IHS Markit (Nasdaq: INFO) is a world leader in critical information, analytics and solutions for the major industries and markets that drive economies worldwide. The company delivers next-generation information, analytics and solutions to customers in business, finance and government, improving their operational efficiency and providing deep insights that lead to well-informed, confident decisions. IHS Markit has more than 50,000 key business and government customers, including 85 percent of the Fortune Global 500 and the world's leading financial institutions. Headquartered in London, IHS Markit is committed to sustainable, profitable growth.

227343302-MFT-0418