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IFRS 9
Financial Instruments

IICPAK: **The Financial Reporting Workshop**
4th and 5th December 2014
Hilton Hotel, Nairobi

Why are we discussing this topic?

- Area that is subject to significant changes
- Practical application can be complex.
- Need to be ready before effective date

Agenda

Classification, Measurement & Recognition

Impairment

Hedge Accounting

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Classification and Measurement

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Introduction

On 24 July 2014, the International Accounting Standards Board (IASB) issued the final version of IFRS 9 *Financial Instruments*

IFRS 9 covers classification and measurement, impairment and hedge accounting of financial instruments

IFRS 9 also proposes the expected credit loss model to determine impairment losses.

Introduction to IFRS 9

IFRS 9 is structured around three phases

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Effective date was 2015 but now deferred to 2018

Phases of IFRS 9	Scope of Changes
Classification and Measurement	■ Requirements for assets based on 'business model' and 'contractual cash flow characteristics' ■ Three classes of financial assets: amortised cost, fair value through other comprehensive income (FVOCI) or FVTPL ■ Financial assets are measured at 'amortised cost' if held within a business model whose objective is to collect contractual cash flows that are 'solely payments of principal and interest' ('SPPI') ■ How to handle the third business model

Impairment	■ Concept of 'expected credit loss' to replace IAS 39 incurred loss model
	■ Dual measurement approach:
	    ■ Bucket 1: '12 months' expected credit losses' ; and
	    ■ Bucket 2/3: 'Lifetime expected credit losses' if there has been significant deterioration in credit quality since initial recognition
	■ Extensive disclosures

Hedge Accounting	■ Hedge accounting follows risk management ■ No bright line for hedge effectiveness assessment ■ Rebalancing of hedge relationship when hedged ratio is changed for risk management purposes ■ Macro hedging to follow later ■ Choice to apply IAS 39 hedging until macro-hedging is completed

Classification of financial assets

The standard introduces principles-based requirements for classification and measurement. The classification and measurement of financial assets depends on two assessments: the financial asset's contractual cash flow characteristics and the entity's business model for managing the financial asset.

The contractual cash flow characteristics test identifies financial assets for which amortised cost information would be relevant, with interest revenue or expense allocated over a relevant period, using the effective interest method. Such instruments potentially qualify for measurement at amortised cost or at fair value though other comprehensive income (FVOCI).

All other financial assets are measured at fair value through profit or loss (FVPL).

Classification of financial assets-Cont'd

The business model assessment determines whether financial assets held in a portfolio must be measured at amortised cost, FVOCI or FVPL. The first two categories, amortised cost and FVOCI, only apply to portfolios of instruments which have also passed the contractual cash flow characteristics test. The business model assessment is dependent on the particular objective of the business model under which those portfolios of assets are held.

With the exception of certain equity securities, IFRS 9 (2009) initially reduced the number of measurement categories for financial instruments to only two: FVPL, for which fair value information is relevant; and amortised cost, for which amortised cost information is relevant. In addition, IFRS 9 introduces a FVOCI measurement category for debt instruments.

Business model impact and assessment

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Business model	Relevant information		
	P&L	OCI	Statement of financial position
Held to collect	Amortised cost	-	Amortised cost
Both held to collect and for sale	Amortised cost	Fair value changes	Fair value
Others: • Maximise cash flows through sale • Trading • Manage assets on a fair value basis	Fair value changes	-	Fair value

NEW

Both fair value and amortised cost information relevant

Financial asset classification

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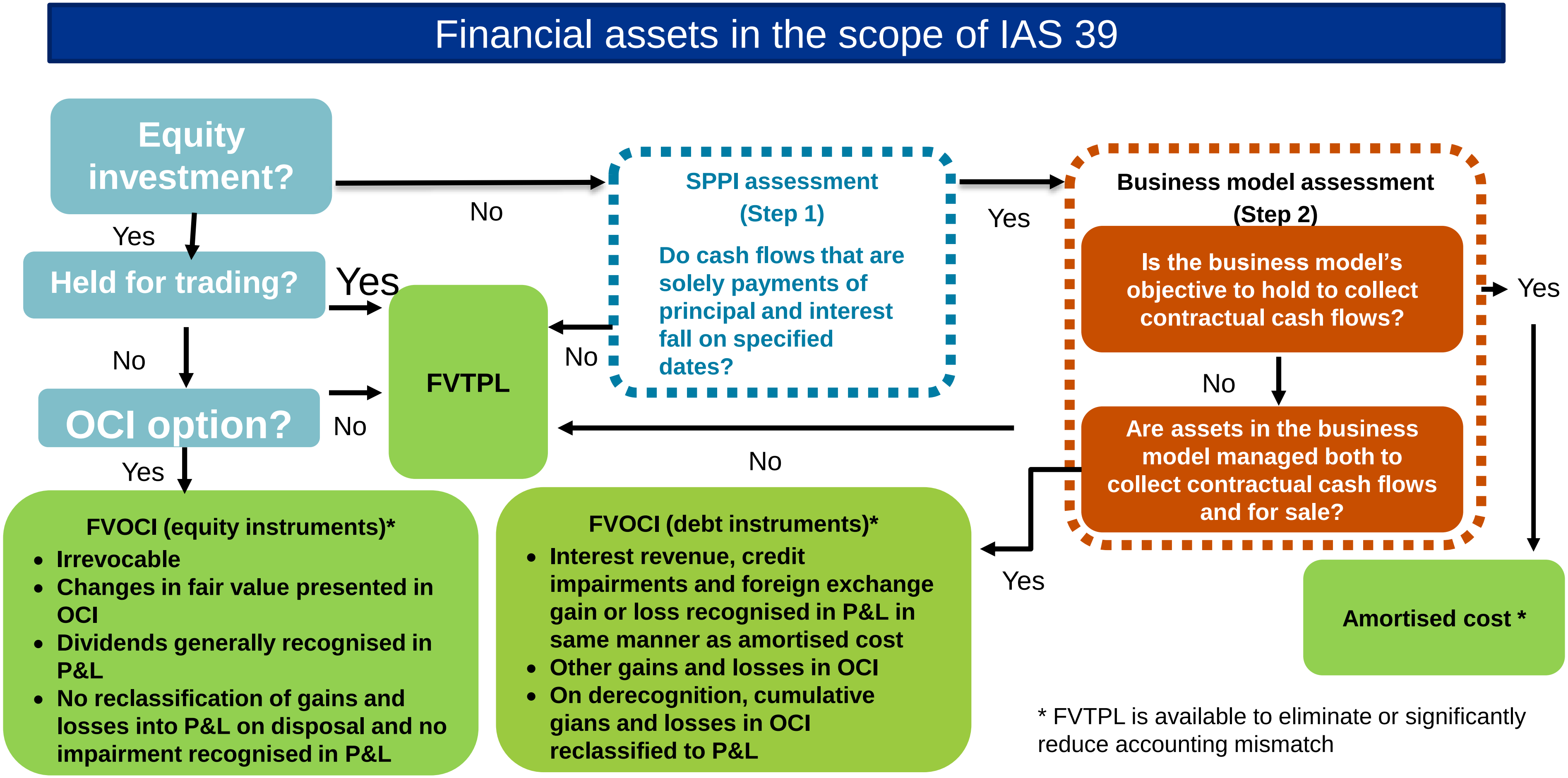

Financial liability classification

Option to designate financial liabilities at FVTPL:

Avoid accounting mismatch

Managed on a fair value basis

Contains an embedded derivative that would require separation

Designation on initial recognition (irrevocable)

Classification & Measurement
Loan portfolios is the basis for impairment and hedge accounting

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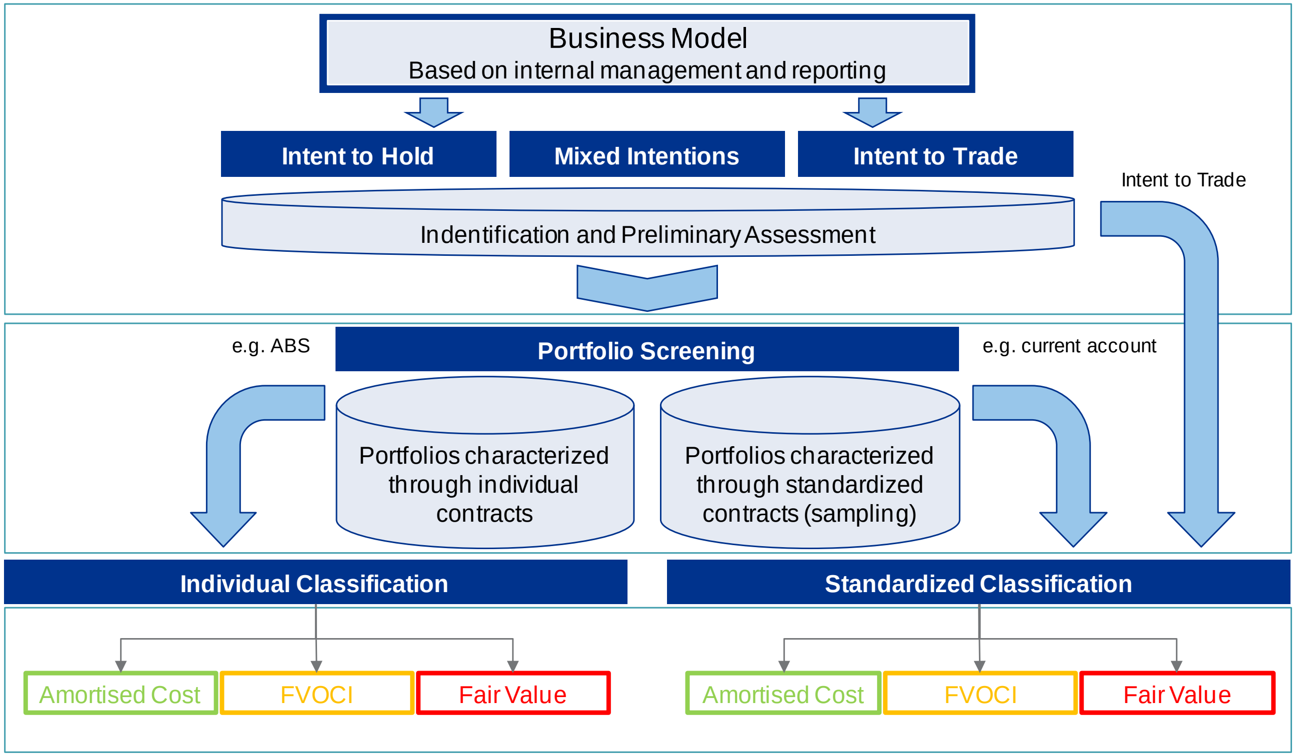
Project Approach for IFRS 9 Classification



Comments

- The goal of the approach is minimize the number of individual loans that have to be classified
- This goal is reached through a multi-step model
- The first step is to determine the relevant business model for all relevant portfolios
- A standardized classification for homogeneous portfolios can cover a significant portion of the loans
- After successful clustering, some financial instruments remain to be classified at single deal level

A tool-based approach allows for an efficient individual classification

Measurement

A financial asset would be required to be measured at FVOCI if it:

- meets the SPPI test
- is held in a business model in which assets are managed <u>both</u>
  - in order to collect contractual cash flows; <u>and</u>
  - for sale.

Gains and losses on an FVOCI financial asset would be recognised in (OCI), except that the following will be recognised in profit or loss in the same manner as for financial assets measured at amortised cost:

- ➢ interest income;
- ➢ credit impairment losses/reversals; and
- ➢ foreign exchange gains and losses.

- When the financial asset is derecognised, the cumulative gain or loss previously recognised in OCI is reclassified from equity to profit or loss as a reclassification adjustment.

Measurement-cont'd

For debt financial instruments at FVOCI, fair value changes are recognised in other comprehensive income. Interest revenue, foreign exchange revaluation and impairment losses or reversals are recognised in profit or loss. Interest revenue and expected credit losses are computed and recognised in the same manner as financial assets measured at amortised cost. Upon derecognition, the net cumulative fair value gains or losses recognised in other comprehensive income are recycled to profit or loss.

Equity securities are measured at FVPL unless the entity choses, on initial recognition, to present fair value changes in other comprehensive income (OCI). This option is irrevocable and applies only to equity instruments which are not held for trading. Unlike debt instruments, gains and losses in OCI are not recycled on sale and there is no impairment accounting. Derivatives are also measured at FVPL.

Impairment Losses: Expected Credit Losses

Impairment losses

- Recognise expected credit losses on financial assets and on commitments to extend credit, using <u>current estimates</u> of expected shortfalls in cash flows on those financial instruments as at the reporting date
- Recognise expected credit losses as a loss allowance or as a provision
- Estimates of expected credit losses would be based on the relevant information that is available <u>without undue cost</u> or effort, including:
  - past events, such as historical loss experience for similar financial instruments;
  - current conditions; and
  - reasonable and supportable forecasts that affect the expected collectability of future cash flows on the financial instrument.
- Always reflect the probability that a credit loss might occur <u>and</u> that it might not occur
  - The proposals prohibits an entity from estimating expected credit losses solely on the basis of the most likely outcome.

Impairment Model - General

Credit quality deterioration since initial recognition

Impairment recognition

Stage 1	Stage 2	Stage 3
12-month expected loss	Lifetime expected loss	Lifetime expected loss

Interest revenue recognition

Stage 1	Stage 2	Stage 3
EIR on gross amount (excl loss allowance)	EIR on gross amount (excl loss allowance)	EIR on amortised cost (net of loss allowance)

Stage 1	***Stage 2***	***Stage 3***
Performing	*Under-Performing*	*Non-Performing*
“The Good”	*“The Bad”*	*“The Ugly”*

EIR: Effective interest rate

Impairment losses

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Overview

- New ‘expected loss’ impairment methodology to replace current ‘incurred loss’ mode
- Dual measurement approach requires recognition of either
  - -12-month expected credit losses; or
  - - lifetime expected credit losses
- IASB and FASB propose different expected loss models – i.e. no convergence at this stage

Differences from current practice

- Impairment allowance would cover both incurred losses *and* (some) expected future credit losses
- Impairment trigger no longer required before impairment allowance is recognised
- Model would apply to certain guarantees and loan commitments, but not to equity investments

What are the main proposals? (continued)

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Expected credit losses on financial instruments

12 month expected credit losses:

- <u>Not deteriorated</u> significantly in credit quality since initial recognition or
- <u>Low credit risk</u>, e.g. that are "investment grade"

Expected shortfalls in contractual cash flows, taking into account only the potential for default in the next 12 months

Lifetime expected credit losses:

- Deteriorated significantly in credit quality since initial recognition

Expected shortfalls in contractual cash flows, taking into account the potential for default at any point during the life of the financial instrument

The simplified approach

- The simplified approach is available for trade receivables and lease receivables.
- Short term trade receivables:
  - should <u>always</u> recognise a loss allowance at an amount equal to lifetime expected credit losses.
- Long-term trade receivables and lease receivables:
  - entities have the <u>accounting policy choice</u> to always recognise a loss allowance at an amount equal to lifetime expected credit losses.
- No need for an entity to consider whether credit quality has deteriorated significantly since initial recognition.

Impairment Implementation: Banks faces operational challenges in the implementation of impairment

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Our practical experience at banks across Europe shows a trend of common issues surrounding IFRS 9 impairment

Data Quality	▪ Nearly all banks have insufficient data warehouses to perform analysis without significant involvement from multiple divisions across the bank ▪ When proxy information is available, determining the most appropriate is a challenge (such as effective interest rate vs. contractual interest vs. market interest)
Population	▪ IFRS 9 Classification defines the relevant population for IFRS 9 impairment, but this is often performed after beginning quantitative analyses for impairment ▪ Depending on the business model and portfolio structure, there can be surprises in the classification exercise
PDs	▪ Determining expected losses (particularly multi-year ELs) is problematic ▪ Even if the bucket allocation can be performed with delinquency information, quantifying the provision is a challenge
Scoping	▪ Calculating multi-year expected losses offers the potential for analysis on a large number of input parameters and the correlations among these ▪ Determining an appropriate scope is a function of available data and resources, but this exercise can quickly become very expansive
Risk Data and Risk Models	▪ Existing data and models are appropriate for their current purposes (i.e. Basel compliant) but may not be compliant with IFRS 9 expectations ▪ The results generated by with such input data are subject to change as the discussions and implementation progress

A risk management focused hedge accounting model

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Hedged Items and risks

- Risk components of non-financial items
- Certain net positions and layer components
- Aggregated positions (Combination of non-derivative and a derivative exposures)
- Inflation components in a fixed rate instruments
- Equity instruments at FVOCI

Hedge Instruments

- All derivatives (excl some options and embedded derivatives)
- Non-derivative financial assets/liabilities (excl if credit risk changes in OCI)
- May exclude costs of hedging

- Alignment of hedge accounting with risk management
- More judgement needed to apply new requirements
- Hedge accounting available for a broader range of strategies
- Differences from current practice
- Changes for processes and systems

Hedge (dis)continuation

Bright line of 80% - 125% removed

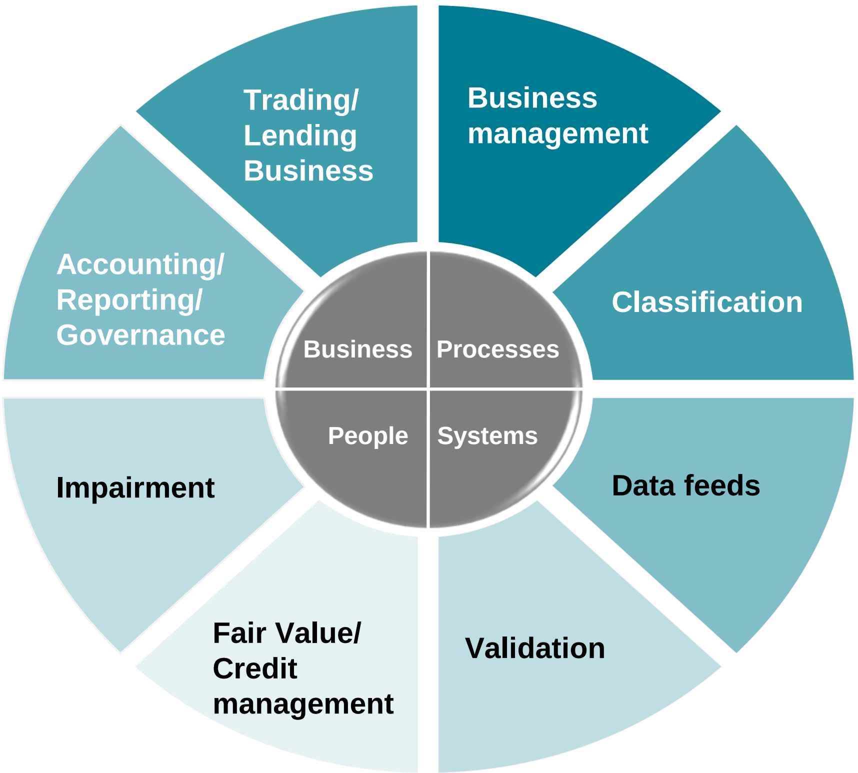
Focus on:

- Economic relationship
- Presence of credit risk
- Rebalancing the hedge relationship
- Hedge ratios aligned to hedge relationship

Additional Relief

- 'Own use' contracts can be measured at fair value through profit or loss
- Can measure credit exposures managed with credit derivatives at fair value through profit or loss

Conclusion
IFRS 9 affects more than just Accounting



- Business areas have to be involved up from the beginning
- Adjustment of product design and portfolio management in 2013 reduces effects in 2016
- Total effect on equity capital requires an integrated view in accounting & risk

What do we foresee

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- Significant judgements involved in determining credit losses
- For long term instruments e.g. mortgages a lot of judgement will be required to determine the amount of information available to determine lifetime expected credit losses
- A lot of preparations required to implement the new approach. This might also impact on the comparatives – to ensure comparability in the AFS
- Initially the amount of credit losses recognised in the AFS will be high
- Single impairment approach to all financial instruments, loan commitments and financial guarantees simplify the requirements and makes them aligned to the way banks manage credit risk
- Equity investments no longer tested for impairment – helpful simplification

Transition

Effective date and transition

The standard applies to annual periods beginning on or after 1 January 2018, although early application is permitted. Retrospective application is required, however, transition reliefs are provided (including no restatement of comparative period information). Entities will only be permitted to early apply a previous version of IFRS 9 if their date of initial application is before 1 February 2015. However, if an entity has early applied a previous version of IFRS 9 before 1 February 2015, the entity is permitted to continue to apply that version until IFRS 9 becomes mandatorily effective in 1 January 2018.

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Questions

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Thank you

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