INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF KENYA

International Financial Reporting Standard (IFRS) 9

Implementation guidelines for financial institutions

Professional Standards Committee (PSC) Discussion Draft

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Contents

List of Abbreviations

ECL	Expected credit loss
GCRAECL	Guidance on Credit Risk and Accounting for Expected Credit Losses
IRB	Internal Ratings Based
PD	Probability of default
TTC	Through the Cycle

PART A: EXPECTED CREDIT LOSS METHODOLOGY

1. Expected Credit Loss Methodology

Principle
IFRS 9 requires a bank to determine an expected credit loss (ECL) amount on a probability-weighted basis as the difference between the cash flows that are due to the bank in accordance with the contractual terms of a financial instrument and the cash flows that the bank expects to receive. Although IFRS 9 establishes this objective, it generally does not prescribe particular detailed methods or techniques for achieving it.

In determining the cash flows that the bank expects to receive, many banks are planning to adopt a sum of marginal losses approach whereby ECLs are calculated as the sum of the marginal losses occurring in each time period from the balance sheet date. The marginal losses are derived from individual parameters that estimate exposures and losses in the case of default and the marginal probability of default for each period (the probability of a default in time period X conditional upon an exposure having survived to time period X).

Banks will need to adopt sound ECL methodologies commensurate with the size, complexity, structure, economic significance and risk profile of their exposures. This means that, in general, the larger and more complex a portfolio or institution, and the larger and more volatile ECLs are expected to be, the more sophisticated a bank's approach should be. [GCRAECL.15].

IFRS 9 requires ECLs to reflect:
■ An unbiased and probability-weighted amount that reflects a range of possible outcomes; and
■ Reasonable and supportable information that is available without undue cost or effort about past events, current conditions and forecasts of future conditions. [IFRS 9.5.5.17]
ECLs are a probability-weighted estimate of the present value of cash shortfalls (i.e., the weighted average of credit losses, with the respective risks of a default occurring in a given time period used as the weights).

ECL measurements are unbiased (i.e. neutral, not conservative and not biased towards optimism or pessimism) and are determined by evaluating a range of possible outcomes. [IFRS 9.B5.5.41-43, BC5.86] Consistent with regulatory and industry best practices, ECL calculations are based on four components:

■ **Probability of Default ("PD") –** This is an estimate of the likelihood of default over a given time horizon.

■ **Exposure at Default ("EAD") –** This is an estimate of the exposure at a future default date, taking into account expected changes in the exposure after the reporting date, including repayments of principal and interest, and expected drawdowns on committed facilities.

■ **Loss Given Default ("LGD") –** This is an estimate of the loss arising on default. It is based on the difference between the contractual cash flows due and those that the lender would expect to receive, including from any collateral. It is usually expressed as a percentage of the EAD.

■ **Discount Rate –** This is used to discount an expected loss to a present value at the reporting date using the effective interest rate (EIR) at initial recognition.

Banks should regularly review their methodology and assumptions to reduce any differences between the estimates and actual credit loss experience. [IFRS 9.B5.5.52]

Measuring ECLs

Overview of the impairment model

ECL are generally measured based on the risk of default over one of two different time horizons, depending on whether the credit risk of the borrower has increased significantly since the exposure was first recognized by comparing the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive discounted at the original effective interest rate.

IFRS 9 outlines a 'three-stage' model for impairment based on changes in credit quality since initial recognition:

CHANGE IN CREDIT QUALITY SINCE INITIAL RECOGNITION

STAGE ONE	STAGE TWO	STAGE THREE

RECOGNITION OF EXPECTED LOSSES

12 MONTH EXPECTED CREDIT LOSSES >EXPECTED CREDIT LOSSES THAT RESULT FROM DEFAULT EVENTS THAT ARE POSSIBLE WITHIN 12 MONTHS	LIFETIME EXPECTED CREDIT LOSSES >LIFETIME EXPECTED CREDIT LOSSES THAT RESULT FROM POSSIBLE DEFAULT EVENTS OVER THE LIFE OF THE FINANCIAL INSTRUMENT	LIFETIME EXPECTED CREDIT LOSSES (100% PD) >LIFETIME EXPECTED CREDIT LOSSES THAT RESULT FROM POSSIBLE DEFAULT EVENTS OVER THE LIFE OF THE FINANCIAL INSTRUMENT
PERFOMING >AT INITIAL RECOGNITION*	UNDERPERFOMING >ASSETS WITH SIGNIFICANT INCREASE IN CREDIT RISK SINCE INITIAL RECOGNITION* & NOT LOW CREDIT RISK.	NON-PERFORMING >CREDIT IMPAIRED ASSETS
PORTFOLIO IMPAIRMENTS	PORTFOLIO IMPAIRMENTS	SPECIFIC IMPAIRMENTS

INTEREST REVENUE

EFFECTIVE INTEREST ON GROSS CARRYING AMOUNT	EFFECTIVE INTEREST ON GROSS CARRYING AMOUNT	EFFECTIVE INTEREST ON AMORTISED COST CARRYING AMOUNT (NET OF CREDIT ALLOWANCE)

(*) Except for purchased or originated credit impaired assets; interest revenue is derived from credit adjusted effective interest rate applied to amortised cost. [IFRS 9.5.4.1 (a),5.4.2]

Figure 1: The 'three-stage' general model for impairment

As such, the loss allowance for those exposures that have not increased significantly in credit risk ('stage 1' exposures) is based on 12-month ECLs. The allowance for those exposures that have suffered a significant increase in credit risk ('stage 2' and 'stage 3' exposures) is based on lifetime ECLs. The staging assessment is discussed in section 2.7. [IFRS 9.5.5.3, 5.5.5]

Stage 1 includes financial instruments that have not had a significant increase in credit risk since initial recognition or that have low credit risk at the reporting date. For these assets, 12-month expected credit losses ('ECL') are recognized and interest revenue is calculated on the gross carrying amount of the asset (that is, without deduction for credit allowance). 12-month ECL are the expected credit losses that result from default events that are possible within 12 months after the reporting date. It is not the expected cash shortfalls over the 12-month period but the entire credit loss on an asset weighted by the probability that the loss will occur in the next 12 months. [IFRS 9.A, B.5.5.43]

Stage 2 includes financial instruments that have had a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date) but that do not have objective evidence of impairment. For these assets, lifetime ECL are recognized, but interest revenue is still calculated on the gross carrying amount of the asset. Lifetime ECL are the expected credit losses that result from all possible default events over the expected life of the financial instrument. Expected credit losses are the weighted average credit losses with the probability of default ('PD') as the weight. [IFRS 9.A]

Stage 3 includes financial assets that have objective evidence of impairment at the reporting date. For these assets, lifetime ECL are recognized and interest revenue is calculated on the net carrying amount (that is, net of credit allowance). [IFRS 9.A]

Staging Assessment

In order to assess both the staging of exposures and to measure a loss allowance on a collective basis, the bank groups its exposures into segments on the basis of shared credit risk characteristics.

Examples of shared characteristics include: geographical region, type of customer (such as wholesale or retail), industry, product type (such as 'normal' repayment mortgages, interest-only mortgages and mortgages on rented property), customer rating, date of initial recognition, term to maturity, the quality of collateral and the loan to value (LTV) ratio. The different segments reflect differences in PDs and in recovery rates in the event of default. To assess the staging of exposures, the grouping of exposures also takes into account the credit quality on origination in order to identify deterioration since initial recognition. [IFRS 9 B5.5.5]

The bank performs procedures to ensure that the groups of exposures continue to share credit characteristics, and to re-segment the portfolio when necessary, in the light of changes in credit characteristics over time. The procedures also guard against inappropriate reliance on models that may arise if re-segmentation is too frequent or granular so as to result in segments that are too narrow.

Collective calculations and segmentation

ECLs on individually large exposures and credit-impaired loans are generally measured individually. For retail exposures and many exposures to small and medium-sized enterprises, where less borrower-specific information is available, ECLs are measured on a collective basis. This incorporates borrower-specific information, such as delinquency, collective historical experience of losses and forward-looking macroeconomic information.

Challenges

The approach to implementing these concepts (above) will vary depending on the circumstances. Reasonable and supportable information will not generally present itself to management as such – rather management will need to determine what is relevant in the context of the impairment requirements and to actively gather and analyse data and use it to make estimates. For a bank, impairment is an area of high estimation uncertainty that is typically material to the bank's financial statements. Judgments made in applying accounting policies for impairment are typically complex and have a significant effect on amounts recognised in the financial statements. Care is required before determining that the acquisition or development of apparently relevant information is unduly burdensome. In particular, if a bank already collects and uses relevant data for regulatory or risk management purposes, it would be expected to use that data for IFRS 9 purposes.

However, in many cases, there comes a point where increasing the amount of data or increasing the complexity and detail of analysis will yield an insignificant – if any – marginal improvement in the quality of the resulting output that is outweighed by the marginal cost.

Application of IFRS 9 is subject to the concept of materiality and it should be applied to all material portfolios. The materiality of portfolios and exposures and the related risks of material misstatement therefore will also be a factor in management's selection of an approach and the design of related internal controls. However, this should not result in individual exposures or portfolios being considered immaterial if cumulatively they represent a material exposure. [GCRAECL.15]

To help a bank determine the level of sophistication required in implementing IFRS 9's ECL requirements for a particular portfolio, the following factors may be considered:

Entity-level factors
■ Extent of systemic risk posed by the bank, as indicated by categorisation (for example, G-SIFI, D-SIB, etc.) or extent of regulatory supervision.
■ Listing status and distribution of ownership of issued debt and equity securities
■ Status as a public interest entity
■ Total size of balance sheet and off-balance sheet credit exposures
■ Level and volatility of historical credit losses

Portfolio-level factors
■ Size of portfolio, relative to entity's total balance sheet and credit exposures
■ Complexity of products in the portfolio
■ Sophistication of other lending-related modeling methodologies, such as regulatory capital methodology (i.e.Advanced IRB, Foundation IRB or Standardised), stress testing methodology, pricing methodology, etc
■ Extent of relevant data available for the portfolio but not restricted solely to the data the bank currently has.1 |
■ Level of historical credit losses experienced on the portfolio.
■ Level and volatility of potential future credit losses from the portfolio.

To illustrate the application of these factors to different types of portfolios:
■ A significant portfolio of bespoke lending facilities, with significant historical and potential future losses, and widespread data available. The bank would typically be expected to use a sophisticated approach for this portfolio.
■ An insignificant portfolio of mortgages in a particular territory, with insignificant historical and potential future credit losses. A bank would typically be justified in using a simpler approach for this portfolio unless it is aware that the local regulator in this particular territory will require a more sophisticated approach.

Due to expected challenges above, we suggest the following approaches to ECL that will be simpler:

Term to maturity approach

This approach does not estimate PD, EAD and LGD for separate time intervals over the term of the loan but, instead, uses a single measure of each for the remaining term in order to measure lifetime ECLs. This is easier to apply than a more sophisticated approach, but is more suited to exposures that are non-amortising and cannot be prepaid (so that assumptions about the EAD are a less significant variable) and shorter term (so that assumptions about when during the term a borrower is more likely to default and the effect of discounting are less significant).

Loss rate approach

Using a 'loss rate' approach, the PD and LGD are assessed as a single combined measure, based on past losses, adjusted for current conditions and forecasts of future conditions. It may be easier to use when there is insufficient data to measure the separate components. This approach is, as with the term to maturity approach, more suited to exposures that are non-amortising and shorter term. Although an adjusted loss rate approach may be used to measure ECLs, an entity needs to be able to separate the changes in the risk of a default occurring from changes in other drivers of ECLs for the purpose of the staging assessment. [IFRS 9.B5.5.12]

Segment parameters

Whereas, in a sophisticated approach, individual exposures within a group of exposures used for measurement of ECLs will each be assigned an individual PD, it is possible that a single PD and LGD might be applied to all exposures in the segment. This is likely to be appropriate only when segments are sufficiently granular that there is no reason to believe, based on reasonable and supportable evidence, that the individual exposures do not share a similar PD or LGD.

A simpler approach is not necessarily a lower quality approach if it is applied to an appropriate portfolio of credit exposures. Irrespective of where a portfolio is positioned overall on the sophistication spectrum, the approach must comply with IFRS 9, and therefore not be designed or implemented to introduce material bias. It may not be necessary for every single component of the ECL approach (for example, probability of default (PD) model, staging assessment, segmentation, etc.) to be at the same level of sophistication as indicated for the portfolio overall.

However, management would be expected to provide particular justification for the use of any individual components with a much lower level of sophistication than is indicated for the portfolio overall. Management will also need to consider how disclosures will adequately describe the use of different approaches to users of the financial statements.

A bank will need to monitor whether its approaches continue to be appropriate in light of changes in circumstances after transition and have internal controls to ensure that this objective is achieved.

In particular, there may be improvements in the availability of data or in understanding the relationship between data and credit losses that may allow the adoption of more sophisticated modeling. Our expectation is that over time, banks will make enhancements to better implement the requirements of IFRS 9 as the availability of data improves.

Scope Exception from the 'three stage' general model

Purchased or originated credit-impaired assets

The general impairment model does not apply to purchased or originated credit-impaired assets. A financial asset is considered credit-impaired on purchase or origination if there is evidence of impairment (IFRS 9 Appendix A) at the point of initial recognition (for instance, if it is acquired at a deep discount). For such assets, impairment is determined based on full lifetime ECL on initial recognition. However, lifetime ECL are included in the estimated cash flows when calculating the effective interest rate on initial recognition. The effective interest rate for interest recognition throughout the life of the asset is a credit-adjusted effective interest rate. As a result, no loss allowance is recognized on initial recognition. Any subsequent changes in lifetime ECL, both positive and negative, will be recognized immediately in profit or loss. [IFRS 9.5.5.13]

Financial Instruments with low credit risk

As an exception to the general model, if the credit risk of a financial instrument is low at the reporting date, management can measure impairment using 12-month ECL, and so it does not have to assess whether a significant increase in credit risk has occurred. In order for this operational simplification to apply, the financial instrument has to meet the following requirements:
  i. it has a low risk of default;
  ii. the borrower is considered, in the short term, to have a strong capacity to meet its obligations; and
  iii. the lender expects, in the longer term, that adverse changes in economic and business conditions might, but will not necessarily; reduce the ability of the borrower to fulfil its obligations. [IFRS 9.B5.5.22]

The credit risk of the instrument needs to be evaluated without consideration of collateral. This means that financial instruments are not considered to have low credit risk simply because that risk is mitigated by collateral. Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the entity's other financial instruments or relative to the credit risk of the jurisdiction within which the entity operates. [IFRS 9.B5.5.22]

Financial instruments are not required to be externally rated. An entity can use internal credit ratings that are consistent with a global credit rating definition of 'investment grade'. [IFRS 9.B5.5.23]

The low credit risk simplification is not meant to be a bright-line trigger for the recognition of lifetime ECL. Instead, when credit risk is no longer low, management should assess whether there has been a significant increase in credit risk to determine whether lifetime ECL should be recognized. This means that just because an instrument's credit risk has increased such that it no longer qualifies as low credit risk, it is not automatically included in Stage 2, Management needs to assess if a significant increase in credit risk has occurred before calculating lifetime ECL for the instrument. [IFRS 9.B5.5.24]

What is not Compliant?

i. Using fair value models to estimate ECLs without appropriately adjusting for changes in market rates of interest and yields that should not be reflected in ECLs. [IFRS 9.A (definition of credit loss), IFRS 9.BC5.123]
ii. Using expected losses as calculated for regulatory purposes without assessing whether any adjustments are required to reflect the requirements of IFRS 9. [IFRS 9.5.5.17(c), B5.5.49-54, BC5.283]
iii. Groupings of exposures for collective assessment and measurement that result in segments that do not share credit risk characteristics such that changes in credit risk in a part of the portfolio may be masked by the performance of other parts of the portfolio. [IFRS 9.B5.5.5, GCRAECL.A11-12]
iv. Excluding the effects of contractual repayments and expected prepayments on loans, and of expected drawdowns on committed facilities. [IFRS 9.B5.5.30-31, 51]

2. Default

Principle

➢ IFRS 9 does not define the term default but instead requires each entity to do so. However, the IFRS seems to indicate that default takes place no later than 90 days past due. (Global Public Policy Committee, 2016)

➢ However, as each entity defines default, the definition must be consistent with the following: (Global Public Policy Committee, 2016)

1) the entities internal definitions of default based on its internal risk management guidelines eg as contained in credit policies or board approved guidelines.

2) Regulator definitions of default.

➢ Credit impaired financial assets definition:

Under IFRS 9 (Appendix A), a financial asset is credit-impaired when one or more events have occurred and have a significant impact on the expected future cash flows of the financial asset. It includes observable data that has come to the attention of the holder of a financial asset that could indicate impairment.

Challenges

i) There are likely to be differences in the definition of default for regulatory purposes and per the IFRS resulting in some assets that may be considered by the regulator to be in default but not in default by as per the IFRS 9 and vice versa. (Global Public Policy Committee, 2016)

For banks, the regulator has a provision for statutory reserves to account for the differences. However, more disputes with tax authorities are expected since the regulators definition of default does not factor expected default but only considers default when it has occurred. KRA to advise.

ii) Data to determine the whether an asset is likely to be credit impaired /predict future may not be easily available eg a borrower may be in financial difficulties which becomes evident only on default.

iii) Determining the probability/likelihood of impairment for particular portfolios or individual loans may be difficult due to data unavailability or data inaccuracy.

iv) Before the models become well refined as the IFRS 9 is better understood, impairment provisions may fluctuate significantly year to year thus making financial performance difficult to measure for individual institutions and also making it difficult to compare peer institutions since each institution may have its own definition of default.

iv) For entities with diverse and more complex credit products, their models will need to be more sophisticated and will require expertise to develop and refine later so as to more accurately reflect differing characteristics of the financial instruments. This will be at a financial cost if there are no in house skills. Smaller institutions may not have the requisite skills to develop models to determine impairment as per the IFRS 9.

v) Institutions may have to invest more in their systems to cater for increased customer/portfolio data capture and retention requirements.

Suggested approach

➢ Entities can opt to use either the sophisticated or simpler models (Global Public Policy Committee, 2016).

➢ For entities using the sophisticated approach, they should analyse both definitions of default by the IFRS and the regulator and apply a consistent single definition of default for both regulatory and financial reporting purposes and if not, document the reasons. (Global Public Policy Committee, 2016)

➢ Entities may opt to use simple models developed for regulatory purposes using the definition of default used in the models but however adjust the model for the effect of the differences between the regulatory and accounting definitions. If differences are believed to result in immaterial outcomes, the entity should be able to support this view. (Global Public Policy Committee, 2016)

- IFRS 9 paragraph 5.5.1 requires that the same impairment model apply to all of the financial assets measured at amortised cost and at Fair value through Other comprehensive income (FVTOCI) and Loan commitments when there is a present obligation to extend credit (except where these are measured at Fair value through profit or loss (FVTPL). (Deloitte, 2017)

- In summary Impairment of financial assets is recognised in 3 stages as follows (IFRS Foundation, 2017), :

  Stage 1—as soon as a financial instrument is originated or purchased, 12-month expected credit losses are recognised in profit or loss and a loss allowance is established. This serves as a proxy for the initial expectations of credit losses. For financial assets, interest revenue is calculated on the gross carrying amount (ie without deduction for expected credit losses).

  Stage 2—if the credit risk increases significantly and is not considered low, full lifetime expected credit losses are recognised in profit or loss. The calculation of interest revenue is the same as for Stage 1.

  Stage 3—if the credit risk of a financial asset increases to the point that it is considered credit-impaired, interest revenue is calculated based on the amortised cost (ie the gross carrying amount less the loss allowance). Financial assets in this stage will generally be assessed individually. Lifetime expected credit losses are recognised on these financial assets.

- **Purchased or originated credit-impaired financial assets**

  (IFRS 9 paragraphs 5.5.13 – 5.5.14)

  For these assets, an entity would recognise changes in lifetime expected losses since initial recognition as a loss allowance with any changes recognised in profit or loss. Under the requirements, any favourable changes for such assets are an impairment gain even if the resulting expected cash flows of a financial asset exceed the estimated cash flows on initial recognition.

- **General approach (IFRS 9 paragraphs 5.5.3 and 5.5.5)** (Deloitte, 2017)

  With the exception of purchased or originated credit impaired financial assets expected credit losses are required to be measured through a loss allowance at an amount equal to:

  - the 12-month expected credit losses (expected credit losses that result from those default events on the financial instrument that are possible within 12 months after the reporting date); or

  - full lifetime expected credit losses (expected credit losses that result from all possible default events over the life of the financial instrument).

- A loss allowance for full lifetime expected credit losses is required for a financial instrument if the credit risk of that financial instrument has increased significantly since initial recognition, as well as to contract assets or trade receivables that do not constitute a financing transaction in accordance with IFRS 15. [IFRS 9 paragraphs 5.5.3 and 5.5.15]

Additionally, entities can elect an accounting policy to recognise full lifetime expected losses for all contract assets and/or all trade receivables that do constitute a financing transaction in accordance with IFRS 15. The same election is also separately permitted for lease receivables. [IFRS 9 paragraph 5.5.16]

➢ For all other financial instruments, expected credit losses are measured at an amount equal to the 12-month expected credit losses. [IFRS 9 paragraph 5.5.5]

What is not compliant

i) When models used to estimate default result in fewer default events than the actual result of what is observed and monitored in the credit risk management by the entity.

ii) Using information meant for regulatory purposes without making adjustments as to whether the information is fit for use under IFRS 9.

iii) Not applying the 90 days past due back stop unless the entity has documented reasonable and supportable information to justify a more lagging default criterion (greater than 90 days) is appropriate.

3. Probability of default

Principle

Probability of default is an estimate of the likelihood of default of a financial instrument over a given time horizon.

Many banks plan to use PD's as a key component both in calculating ECL's and in assessing whether a significant increase in credit risk has occurred. A PD used for IFRS 9 should reflect management's current view of the future and should be unbiased. (I.e. it should not include any conservatism or optimism).

Two types of PD's are used for calculating PD's:
- 12-month PD's -This is the estimated probability of default occurring within the next 12 months (or over the remaining life of the financial instrument if that is less than 12 months). This is used to calculate 12 month ECL's
- Life time PD's-this is the estimated probability of default occurring over the remaining life of the financial instrument. This is used to calculate life time ECL's for stage 2 and 3 exposures.

PD's may be broken down further into marginal probabilities for sub periods within the remaining life.

Suggested approach and challenges

A sophisticated approach

PD's are limited to the maximum period of exposure required by IFRS 9.

(a) 12-month PD's

If a bank uses IRB models for regulatory purposes, the bank may use the outputs from its IRB models as a starting point for calculating IFRS 9 PDs. However, the PDs from these IRB models may in some organisations be determined using a through the cycle (TTC) rating philosophy (or hybrid point-in-time approach) or may include certain conservative adjustments (such as floors). Therefore, these PDs are appropriately adjusted if they are to be used for IFRS 9 purposes. Examples of adjustments include:

- Conversion to an unbiased (rather than conservative) estimate.
- Removal of any bias towards historical data (for example, TTC) that does not reflect management's current view of the future.
- Aligning the definition of default used in the model with that used for IFRS 9 purposes.
- Incorporating forward-looking information.

If a bank does not have IRB models, new models are developed to produce 12-month PDs for IFRS 9 purposes. All key risk drivers and their predictive power are identified and calibrated based on historical data over a suitable time period. This could take the form of a scorecard approach. A scorecard approach uses a set of loan-specific or borrower-specific factors which are weighted to produce an assessment of credit risk.

(b) Lifetime PD's

To determine lifetime PD's, the bank either builds from the 12-month PD model or develops a lifetime PD model separately.

If the bank builds from the 12-month PD model, it develops lifetime PD curves or term structures to reflect expected movements in default risk over the lifetime of the exposure.

This involves:

- Sourcing historical default data for the portfolio.
- Performing vintage analysis (performance comparisons between portfolio segments where data is grouped based on the origination month) to understand how default rates change over time.
- Extrapolating trends to longer periods where default data are not available for the maximum period of exposure.
- Performing analysis at an appropriately segmented level, such that groups of loans with historically different lifetime default profiles are modelled using different lifetime default curves.

If the bank is able to incorporate detailed forecasts of future conditions in developing PD estimates only for a period that is shorter than the entire expected life, it applies a documented policy for determining the longer-term trend in rates of default based on historical and other available reasonable and supportable information.

If the bank develops a new model to produce lifetime PD's, it will be necessary to ensure all key risk drivers and their predictive power are identified and calibrated based on historical data over a suitable time period. This could take the form of a scorecard approach.

Considerations for a simpler approach

(a) 12-month PD's

Where there is insufficient default history for a particular portfolio (e.g. a portfolio of new products), the bank uses internal benchmarking to a similar risk portfolio, or a reduced level of risk segmentation (i.e. grouping similar risks / portfolios to increase data credibility), and where relevant, uses external ratings and external benchmarking.

There may be simpler alternatives to a scorecard approach available to a bank. For example, adaptations of collective methodologies such as roll/transition rates may be possible. Roll/transition rate methods are commonly used under IAS39 to assess credit losses by analysing the movement of exposures between different risk buckets (e.g. delinquency states) over time. Such methods use historical observed rates to estimate the amounts of exposure that are expected to roll into default over a specified period.

When a bank relies on external ratings, internal benchmarking or grouping risks together, the bank should perform adequate analysis to justify this approach, and consider and document its limitations. For example, grouping risks together may mask underlying credit losses or increases in credit risks, if the segments are not sufficiently homogeneous. Therefore, the bank should support the suitability of any groupings of risks with sufficient evidence.

(b) Lifetime PD's

A bank may apply simpler extrapolation techniques to the 12-month PD. For example, the bank may assume that the default rate does not change during the lifetime of the loan or use less segmentation than under a more sophisticated approach. This may be more common for shorter-term products. The bank should justify this approach with analysis evidencing that the PD profiles are appropriately similar.

If a bank uses an extrapolation approach to determine lifetime PDs, then it may combine different risk segments if they are considered to have similar lifetime PD profiles.

This will simplify the modelling required and reduce the number of explicit PD profiles to be calculated at each reporting date. The bank should justify this approach with analysis supporting the assertion that the underlying PD profiles are appropriately similar.

Challenges

(a) Limited use of effective interest rate

In Kenya, most banks may lack the data capacity to evaluate the effective interest rate of a loan. Most may not have a system in place to monitor direct costs and costs that are attributable to credit risk, in order to determine which costs should be amortized over the lifetime of the loan. The Bank would also need to model the costs of a loan for the period of the loan to maturity in order to determine the effective interest rate.

A simplified approach that can be used may include making certain reasonable assumptions e.g. management may assume the interest rate applied on a loan approximates the effective interest rate and this is then used as the discount factor. Over the lifetime of a loan, the most significant cost is the interest expense so the effective interest rate would not be expected to differ significantly from the interest rate of the loan instrument.

(b) Source of data for PD

The determination of the probability of default is largely determined by the Bank's determination of "significant increase in credit risk", based on both qualitative and quantitative parameters. This then drives the staging criteria of the loan which then flows into the PD calculation. The standard advocates for the Bank to determine the loan classification at the origination of the loan and then review its loan classification at the reporting period. The movement noted would then determine whether there has been a significant increase in credit risk. The most significant limitation expected for local banks is that they may not have developed an internal risk rating model that is applied to the loan portfolio. It may therefore not possible to determine what the original risk rating was for a loan or the risk rating at the reporting date. For local Kenyan Banks, the classification being used is the Central Bank ratings of "Normal", "Watch", "Substandard", "Doubtful" and "Loss". This rating is however, largely based on "days past due", which is the number of days a loan repayment has been due for payment and the migration between buckets is largely determined by the days past due. While this is an acceptable approach for the standard, it is also very punitive.

The calculation of PD also requires loan classification data for the last two to three years in order to determine the transition of the loan book between different loan classifications. While most Banks may use this days past due approach to calculate their PD's currently, there are a few who do not have the historical data required for modelling. This may poses a challenge as various assumptions would need to be discussed to come up with a reliable probability of default for different sectors of the portfolio.

(c) Lack of general models

IFRS 9 requires banks to now develop impairment models that not only consider past and current events, but also future macro-economic information. Most Banks may not have an internal process in place to monitor future macroeconomic information and how it affects the various portfolios in the Bank. This may require Banks to put in place such processes internally, in the absence of regular information from external sources.

The complexity of the IFRS 9 methodology may also require Banks to consider automation of the impairment process as this has largely been run manually in local Banks. The calculation of PD requires statistical modelling which may be easier implemented in a system than manually (excel worksheets). Data governance will also need to change in order to be able to implement this standard with the least amount of effort on the Bank. The data that is captured at origination of a loan will need to be input in specific templates and Banks need to ensure there is a database in place to store historical data for use in the impairment model.

In the absence of historical data, the Bank may need to use proxy information that is available publicly from the Central Bank until they can build enough historical information to model internally. Examples of historical data required are historical migration of loans between different classification buckets, loan recoveries from the non-performing book in the past three to five years and history of write-offs and any recoveries from the same.

What is not compliant?

- Leveraging existing models without, based on reasonable and supportable information, validating that these models are fit for purpose under IFRS 9 and/or making and documenting appropriate adjustments. [IFRS 9.5.5.17(c), B5.5.49-54, BC5.283]

- Assuming a constant marginal rate of default over the remaining lifetime of a product without appropriate supporting analysis. [IFRS 9.5.5.17(c), B5.5.49-54]

- Grouping together exposures that are not sufficiently similar. [IFRS 9.B5.5.5]

4. Exposure – (i) period of exposure and (ii) exposure at default

Principle

Exposure at default (EAD) can be defined as the gross exposure under a facility upon default of an obligor. It is an estimation of the bank's exposure to its counterparty at the time of default.

EAD is a key component of ECL calculations and understanding how loan exposures are expected to change over time is crucial to an unbiased measurement of ECLs. This is particularly important for 'stage 2' loans, where the point of default may be several years in the future. While the relevance of EAD in assessing ECL is obvious, estimating it is less so. In practice, the estimation of EAD relates to contractual payment terms, prepayment and refinancing assumptions and the exposure's expected life. For defaulted accounts, EAD is usually just the

amount outstanding at the point of default. However, for performing accounts, the following elements are needed for computation of EAD under IFRS 9 at the instrument/facility level:

> ➢ The exposure's expected life
> ➢ Contractual payments of cash flows
> ➢ Prepayment or refinancing options and for revolving facilities an estimation of credit conversion factors (CCFs). A CCF is a modelled assumption which represents the proportion of any undrawn exposure that is expected to be drawn prior to a default event occurring.

The EAD model therefore needs to consider:

> ➢ Forward looking information to determine what the EAD will be at the time of a default.
> ➢ Lifetime perspective - EADs need to take into account the *whole life of facility*

It is also necessary to determine the period of exposure that is considered for IFRS 9 purposes. The period of exposure limits the period over which possible defaults are considered and thus affects the determination of PDs and measurement of ECLs.

This section discusses how the period of exposure may be determined and EAD may be calculated for IFRS 9 purposes.

Challenges

i)   Period of exposure

Period of exposure may be difficult to determine for revolving facilities as this is based on the behavioral life that could be longer than the contractual term.

ii)   Exposure at default

The main challenge for banks on EAD is limitation on historical data to estimate assumptions e.g. on prepayments and refinancing.

Suggested approach

i)   Period of Exposure

Expected life or period of exposure is equal to the maximum contractual period over which the entity is exposed to credit risk. This maximum contractual period is determined in accordance with the terms of the contract, including the bank's ability to demand repayment or cancellation, and the customer's ability to require extension.

Revolving facilities

IFRS 9 expects lifetime expected loss modelling to extend beyond contractual maturity for all revolving facilities. The period of exposure for these facilities is based on their behavioural life.

For such facilities within the scope of IFRS 9.5.5.20 (i.e. that include both a loan and an undrawn commitment component, and the bank's contractual ability to demand repayment and cancel the undrawn commitment does not limit the bank's exposure to credit losses to the contractual notice period), the period of exposure is determined by considering the bank's expected credit risk management actions that serve to mitigate credit risk, including terminating or limiting credit exposure. In doing this, the bank:

- Considers how it mitigates credit risk, its past practice and future intentions and expected credit risk mitigation actions.
- Analyses what happens in practice as a result of each of these types of actions and demonstrates that there is sufficient historical evidence that such actions are executed and impact the lifetime of the exposure. The analysis should consider historical information and experience about the period over which the bank was exposed to credit risk on similar instruments and the length of time for defaults to occur on similar instruments following a significant increase in credit risk. [IFRS 9.5.5.20, B.5.5.40]

Periodic assessments are not sufficient for 12-month behavioural life assumptions for these facilities. Evidence is required, e.g. on limits cut, additional collateral and cancellations.

A Practical approach to determining expected life could be the time taken for a significant portion, e.g. 90% or 95%, of the loans to have defaulted, closed or otherwise been derecognised. However, the remaining portion of the loans needs to be tested to show that it is not material

ii)   Exposure at default

The modeling approach for EAD reflects changes that are expected in the balance outstanding over the life of the loan exposure that are permitted by the current contractual terms, including:

- Required repayments/amortisation schedule.
- Full early repayment (e.g. early refinancing).
- Monthly overpayments (i.e. payments over and above required repayments but not for the full amount of the loan).
- Changes in utilisation of an undrawn commitment within agreed credit limits in advance of default.

- Credit mitigation actions taken prior to default.

Non revolving credit facilities

The common approaches for such facilities include;

1) Estimating repayment patterns from historical actual repayments. This approach is very data dependent.

2) Building loan amortisation models until contractual maturity, taking into account unique characteristics of each facility, e.g. payment waiver for first 6 months. Additional assumptions are normally required for average arrears age by Stage of loan e.g

   ➢ All Stage 1 loans can be assumed to be up-to-date and the EAD used in the ECL calculation lagged by three months with three months interest added. A Stage 1 loan is assumed to default after three contractual payments have been missed.
   ➢ Stage 2 loans can be assumed to be 1 month in arrears on average. The EAD used in the ECL calculation is thus lagged by two months with two months interest added. A Stage 2 loan is assumed to default after two additional contractual payments have been missed.

3) Back-testing results with the actual outstanding balances and making necessary adjustments, e.g. for loan prepayments

   The key considerations in this approach are:

   ➢ Loan level characteristics (product type, borrower income level, loan-to-value)
   ➢ Linking PDs and LGDs to macroeconomic variables (interest rates, unemployment rates, GDP, inflation)
   ➢ Additional loan features such as refinancing

Revolving facilities:

The common approach for these facilities include;

1) Credit Conversion Factors where 12-month ECLs are calculated based on the portion of the loan commitment that is expected to be drawn within 12 months of the reporting date while lifetime ECL is calculated based on the portion of the loan commitment that is expected to be drawn over the expected life of the loan commitment.

   The key considerations in this approach are:

   ➢ Aggregation of data into homogenous risk groups
   ➢ Stability of development patterns and representativeness of historical experience

EAD models are differentiated to reflect the different risk characteristics of different portfolios. The bank considers these different underlying drivers in determining the different inputs to EAD models. The inputs into the EAD model are also reviewed to assess their suitability for IFRS 9 and adjusted, where required, to ensure an unbiased ECL calculation reflecting current expectations and forward-looking information.

Simplified approach

Period of exposure

If the period of exposure is taken to be less than the full period specified by IFRS 9, the bank should provide reasonable and supportable evidence that the impact on ECLs of selecting this shorter period for the remaining balance is not material.

All other principles detailed in the suggested approach also apply for simpler implementations, although the level of detail required in addressing each principle may be reduced.

Exposure at default

If a bank decides to use an approximation of the current 12-month EAD as a proxy for the EAD over the remaining life, the bank should provide reasonable and supportable evidence that this is appropriate for the specific product or portfolio.

This is because a proxy may hold only for certain portfolios where the balance is not anticipated to change significantly in the future.

Using segmented credit conversion factor (CCF) models could be appropriate if the approach is justifiable with analysis showing that exposures within each CCF segment are expected to behave similarly.

Under a simpler approach, a bank may use fewer levels of risk segmentation, if it provides reasonable and supportable information evidencing that this is appropriate.

What is not compliant?

i)   Period of exposure

Defining the period of exposure to be:

a)   Shorter or longer than the maximum contractual period over which the entity is exposed to credit risk (except for certain revolving credit facilities). [IFRS 9.5.5.19-20, B5.5.38]

b)   Equal to the historical average life of loans without checking consistency with forward-looking expectations based on reasonable and supportable information. [IFRS 9.5.5.17(c), B5.5.52]

For revolving credit facilities within the scope of IFRS 9.5.5.20:

a)   Using the legally enforceable contractual period unless analysis of historical information shows that, in practice, management limits the period of exposure to the contractual period. [IFRS 9.5.5.20, B5.5.39-40]

b)   Failing to consider all relevant historical information that is readily available with minimal cost and effort when determining the exposure period [IFRS 9.5.5.17(c), B5.5.40]

ii)   Exposure at default

Using new or existing EAD models developed for other purposes such as regulatory capital without demonstrating that these models are fit for purpose under IFRS 9, including justifying and documenting the completeness and basis for inputs and adjustments to inputs. [IFRS 9.5.5.17(c), B5.5.49-54, BC5.283]

Using 12-month EADs as a proxy for lifetime EADs without justification. [IFRS 9.B5.5.13-14, IFRS 9.5.5.17(c), B5.5.49-54]

5. Loss given default

Principle

This refers to the portion of asset(s) that's lost when a borrower defaults. The guiding principle of the expected loss given default model is to reflect the general pattern of deterioration or improvement in the credit quality of financial instruments.

The standard provides the basis upon which the model can be applied upon consideration of portfolio coverage, underlying data, and establishment of discounting factor among others. The principle is consistent with Basel core principles on credit risk rating is developed as it considers all relevant and forward looking information and macro-economic factors in assessing and measuring default.
IFRS-9 requires LGD's to be lifetime (stage 2) upon significance increase in credit risk.

Challenges

Likely challenges to be encountered in the implementation are listed as follows
- Unavailability of past data and forward looking information
- Training to the regulators, practicing accountants and reporting entities on requirements of IFRS-9
- Non-Compliance with key regulatory ratios e.g. capital ratios due to increased provisions

- Varying results where data applied is different, i.e. one institution may use its specific data while another may adopt macro-economic data
- Significant increase in loan provisioning
- Inadequate disclosures hence compromising standardization and quality of reports
- Dual provisioning framework on loans (performing, watch, substandard, doubtful and loss)

Suggested approach

While appreciating that the two modelling approaches are not affected by staging, more specific data is preferred to model the LGD. Key factors should be considered before adopting a particular model. This is so in appreciation of various loans issued by the financial institutions, i.e. collateralized and non-collateralized.

It is however recommended that simpler approach is adopted due to unavailability of data. The sophisticated approach should be applied where data is available and risk of error is minimal.

What's not compliant

Full adoption and implementation is expected as regards;
o Failure to perform analysis
o Failure to make adjustments to comply with regulatory requirements

6. Discounting

Principle

An entity shall measure expected credit losses in a way that reflects the time value of money1. For financial assets, a credit loss is the present value of the difference between:

a) The contractual cash flows that are due to an entity under the contract; and

b) The cash flows that the entity expects to receive.2

IFRS 9 requires expected credit losses (ECL) to be discounted to the reporting date using the effective interest rate (EIR) determined at initial recognition or an approximation of it3. This is because the original carrying amount of the asset would have been based on the discounted contractual cash flows, and so not to discount cash flows that are now not expected to be received would overstate the loss. If the instrument has a variable interest rate, the ECL should be discounted using the current EIR.

The effect of discounting may be significant because default events and/or associated cash shortfalls may occur a long time into the future. The determination of the EIR has not changed from IAS 39.

Challenges

There may be a challenge in generating original EIR across all or some portfolios.

Also, the discount rate used varies across entities. Therefore, entities will have to come up with ways to adjust their Loss Given Defaults (LGDs) to reflect the discounting effect required by the standard (i.e., based on a rate that approximates the original EIR and over the entire period from recoveries back to the reporting date).

This could be achieved either by extracting the expected undiscounted cash flow recoveries from the LGD and discounting them back using the appropriate rate over the entire period, or by directly adjusting the LGD to approximate the correct calculation. Given the requirement to use an approximation to the EIR, entities will need work out how to determine a rate that is sufficiently accurate. One of the challenges is to interpret how much flexibility is afforded by the term 'approximation'.

Suggested approach

The summary below sets out the discount rates to be used for different types of financial instruments.

Instrument Discount rate to be used as follows;

Fixed rate assets

• effective interest rate determined at initial recognition

Variable rate assets

• current effective interest rate; or a projected rate based on forward yield curves.

Purchased or originated credit-impaired

financial assets

• credit-adjusted effective interest rate determined at initial recognition.

Lease receivables

• same discount rate as used in the measurement of the lease receivable

Loan commitments

• effective interest rate, or an approximation of it, that will be applied when recognising the financial asset resulting from the loan commitment

Loan commitments for which the effective interest rate cannot be determined

• a rate that reflects the current market assessment of the time value of money and the risks specific to the cash flows (unless adjustment has instead been made to the cash shortfalls)

Financial guarantee contracts

• a rate that reflects the current market assessment of the time value of money and the risks specific to the cash flows (unless adjustment has instead been made to the cash shortfalls)

What is not compliant?

The following are not compliant:

- Using the discount rate employed for regulatory purposes in the calculation of ECL / LGD without making appropriate adjustments or evidencing that the impact of such adjustments would not be material.4

- Continuing to use IAS 39 EIR approximations without assessing whether their use is appropriate for the purposes of IFRS 9, particularly given the longer time horizons over which amounts may be discounted under IFRS 9.5

- Not reflecting the effect of the time value of money in ECL, or using discount rates which do not suitably approximate the EIR of the instrument or portfolio (e.g. current funding rates or risk-free rates).

7. Macro-economic forecasts and forward-looking information

Principle
A measure of ECL is an unbiased probability-weighted amount that is determined by evaluating a range of possible outcomes and using reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions. [IFRS 9.5.5.17]

When incorporating future information, an entity should consider information from a variety of sources in order to ensure that the information used is reasonable and supportable. Further, the information considered can vary depending on the facts and circumstances, including the level of sophistication of the entity and the particular features of the portfolio of financial assets.

While IFRS 9.5.5.18 and [IFRS 9.B5.5.42] do not expect an entity to consider every possible forward-looking economic scenario, the scenarios considered should reflect a representative sample of possible outcomes. This is noted in [IFRS 9.BC5.265,] which states that the calculation of an expected value need not be a rigorous mathematical exercise whereby an entity identifies every single possible outcome and its probability but, when there are many possible outcomes, an entity may use a representative sample of the complete distribution for determining the expected value.

Banks must demonstrate that the forward-looking (as well as past and current) information selected has a link to the credit risk of particular loans or portfolios. For a variety of reasons, it may not always be possible to demonstrate a strong link in formal statistical terms between individual types of information, or even the information set as a whole, and the credit risk of some exposures or portfolios. Particularly in such circumstances, a bank's experienced credit judgment will be crucial in establishing an appropriate level for the individual or collective allowance.

When there is a non-linear relationship between the different forward-looking scenarios and their associated credit losses, more than one forward-looking scenario would need to be incorporated into the measurement of expected credit losses to meet the above objective. Macroeconomic forecasts and other relevant information should be applied consistently across portfolios, where the credit risk drivers of the portfolios are affected by these forecasts/assumptions in the same way.

Challenges

- Firms are required to evaluate the impact of forward-looking economic changes on their expected credit losses under a range of unbiased possible economic outcomes.
  Their process is required to consider both possibilities: that credit loss occurs, or not. Many firms have difficulty in developing credible economic scenarios to measure expected credit losses that reflect an unbiased, probability-weighted outcome.

- Availability and relevance of forward looking (macro-economic) data points in the Kenyan Market. To find accurate forward looking factors, financial institutions may rely on historical information to identify correlations between different (macro-economic) factors and eventual credit losses. These factors are then mapped and monitored going forward.

Suggested approach

The overall approach to calculating ECL involves either to:

- Take the weighted average of the credit loss determined for each of the multiple scenarios selected, weighted by the likelihood of occurrence of each scenario *plus/minus* a separate adjustment for 'additional' factors; or

- Take the credit loss determined for the base scenario *plus/minus* a separate modelled adjustment to reflect the impact of other less likely scenarios and the resulting non-linear impacts (as a proxy for the above method) *plus/minus* a separate adjustment for 'additional' factors.

Additional factors are alternative economic scenarios or events not taken into account in the scenarios used in the main calculation (e.g. more extreme or idiosyncratic events not otherwise reflected in historical or forecast information such as impact of elections or terrorist attack).

The following principles are applied within the approach adopted:

- **Number of economic scenarios:** Representative scenarios that capture material non-linearities are modelled (e.g. a base scenario, an upside scenario and a downside scenario). Different numbers of scenarios may be appropriate depending on the facts and circumstances - e.g. in periods of expected increased volatility. [IFRS 9.BC5.265]

- **Determining alternative economic scenarios:** Scenarios may be internally developed or, for less sophisticated banks, may be vendor-defined. For internally developed scenarios, a bank should have a variety of experts, such as risk experts, economists, business managers and senior management, assist in the selection of scenarios that are relevant to the bank`s credit risk exposure profile. When developing and using internal forecasts, a bank considers third party data and views and justifies differences from external forecasts, but this does not mean it must replicate them. For vendor-defined scenarios, a bank should ensure that the vendor tailors the scenarios to reflect its own business and credit risk exposure profile, as the bank remains responsible for those scenarios.

- **Representative scenarios**: upside and downside scenarios used are not biased to extreme scenarios such that the range and weighting of scenarios used is not representative.

- **Base scenario:** the base scenario is consistent with relevant inputs to other estimates in the financial statements (e.g. deferred tax recoverability and goodwill impairment assessments), budgets, strategic and capital plans, and other information used in managing and reporting by the bank. However, these inputs should not be lagging or biased.
- **Sensitivities and asymmetries:** scenarios selected are representative and take account of key drivers of ECL, particularly non-linear and asymmetric sensitivities within portfolios. The sensitivity of ECL to each individual forward economic parameter is monitored to identify key drivers and to estimate effects of changes in parameters on ECL.

- **Parameter coherence:** in developing the detail of a specific economic scenario (e.g. a scenario with individual point estimates of future GDP, unemployment, interest rates, etc.), any expected correlation or other interrelationship between parameters (e.g. an increase in unemployment is expected to result in a decrease in interest rates) is considered in the development of the scenario so that it is realistic.

Considerations for a simpler approach

The level of detail used in addressing each principle may be proportionately less for a simpler approach. A bank may be able to perform a simpler analysis of historical relationships between observed defaults / credit losses and the overall position within the economic cycle at the time, which can then be used to estimate ECLs at different future estimated points in the economic cycle.

Where a bank does not have its own data to do this, it makes use of available external data sources such as industry data. This approach would involve three steps firstly obtaining historical macroeconomic variables, determine the macroeconomic variables that affect impairment parameters and lastly obtain or project future macroeconomic variables under various scenarios and assign probability to them.

Data sources

One of the challenges identified availability and relevance of forward looking (macroeconomic) data points in the Kenyan Market. The following table illustrates data sources that may be used for macroeconomic information.

Data source	Type of data
Local established agencies such as Kenya National Bureau of statistics and Central Bank of Kenya	GDP, Industry performance , demographics, Inflation , interest rates, exchange rates etc.
International rating agencies such as: Moody and Standard & Poor	Country ratings, forecast macroeconomic information.
Financial data vendors terminal such as: Bloomberg, Thomson Reuters, BMI Research	GDP, Industry performance , demographics, Inflation , interest rates, exchange rates etc.

What is not compliant?

- Considering only a single future economic scenario for a portfolio with no separate adjustments to take account of non-linear impacts, unless the portfolio has no potentially material asymmetric exposures to ECL and this is evidenced by appropriate analysis. [IFRS 9.5.5.17, B5.5.42, BC5.263].

- Forecasts that are only developed internally or that only reference a single external source. Although a bank does not need to consult all available sources, it should consider information from a variety of sources and understand whether it supports or contradicts the bank's own forecasts of the future, in order to ensure that the information used is reasonable and supportable. [IFRS 9.5.5.17, B5.5.51].

PART B: SIGNIFICANT ACCOUNTING POLICIES

Off Balance Sheet items and loan Commitments

Principle:

Provisions for off-balance sheet financial items such as loan commitments and financial guarantees (when those items are not measured at FVTPL) are currently within the scope of IAS 37 Provisions, Contingent Liabilities and Contingent Assets which results in a different recognition approach from the incurred loss model in IAS 39 Financial Instruments. Under IFRS 9, the scope of the three-stage impairment model is extended to apply to the accounting for: – Loan commitments by the issuer and Financial instruments that include a loan and undrawn commitment components.

Under IFRS 9, the scope of the three-stage impairment approach is extended to apply to such off-balance sheet items. An entity would consider the expected portion of the loan commitment that will be drawn down within the next 12 months when estimating 12-month expected credit losses, and the expected portion of the loan commitment that will be drawn down over the remaining life of the loan commitment when estimating lifetime expected credit losses.

Expected credit losses are an estimate of the present value of all cash shortfalls over the remaining life of the financial instrument arising either from defaults within the next 12 months or over the life of the instrument. A cash shortfall for undrawn loan commitments is the difference between: – The present value of the principal and interest cash flows due to the entity if the holder of the loan commitment draws down the loan; and – The present value of the cash flows that the entity expects to receive if the loan is drawn down. The remaining life of a loan commitment and of financial guarantees is the maximum contractual period during which an entity has exposure to credit risk. Consequently, if a lender has the ability to withdraw a loan commitment, the maximum period to consider when estimating credit losses is the period up to the date on which the entity is able to cancel the facility and not a longer period, even if that would be consistent with its business practice.

Similar to IAS 39, IFRS 9 requires some loan commitments to be measured at fair value through profit or loss (those that can be net cash-settled or which oblige the issuer to lend at a below-market rate). Unlike, IAS 39, however, other loan commitments are subject to IFRS 9's impairment model. This is an important change compared to IAS 39

The application of the model to financial guarantees and loan commitments, however, warrants some further specification regarding some of the key elements, such as the determination of the credit quality on initial recognition and cash shortfalls and the EIR to be used in the ECLs calculations.

The impairment requirements of IFRS 9 apply to all loan commitments, other than loan commitments measured as at fair value through profit or loss or those used to provide a loan below market rate. The term 'loan commitment' is not defined in IFRS, but the basis for conclusions to IFRS 9 states that: "loan commitments are firm commitments to provide credit under pre-specified terms and conditions

Challenge:

The impairment requirements of IFRS 9 apply to all loan commitments, other than loan commitments measured as at fair value through profit or loss or those used to provide a loan below market rate. The term 'loan commitment' is not defined in IFRS, but the basis for conclusions to IFRS 9 states that: "loan commitments are firm commitments to provide credit under pre-specified terms and conditions"

Implications for financial institutions that manage off-balance sheet loan commitments and financial guarantee contracts using the same credit risk management approach and information systems as loans and other on-balance sheet items; this might prove to be a simplification. For other institutions that issue these types of instruments, the new requirements could be a significant change, necessitating adjustments to systems and monitoring processes for financial reporting purpose

Suggested Approach

To determine whether a transaction is a loan commitment that is in the scope of IFRS 9's impairment requirements, an entity has to answer the following questions.

- ➢ Is it a loan commitment?
- ➢ Is the definition of a financial instrument met?
- ➢ Is the contract specifically excluded from the scope of IFRS 9?

Maximum period for Expected Credit Losses

The Standard defines the maximum period to consider when measuring expected credit losses to be the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice.

However, section 5.5.20 Notes that some financial instruments include both a loan and an undrawn commitment component and that the entity's contractual ability to demand repayment and cancel the undrawn commitment does not limit the entity's exposure to credit losses to the contractual notice period. For such financial instruments, and only those financial instruments, the entity shall measure expected credit losses over the period that the entity is exposed to credit risk and expected credit losses would not be mitigated by credit risk management actions, even if that period extends beyond the maximum contractual period.

The treatment of the maximum period of Expected credit losses may take two approaches; The Sophisticated and the simple approach.

Sophisticated Approach shown below

- Except for some revolving credit facilities, the maximum period over which expected credit losses are measured is the maximum contractual period over which the entity is exposed to credit risk. [IFRS 9.5.5.19]
- This maximum contractual period is determined in accordance with the substantive terms of the contract, including the bank's ability to demand repayment or cancellation, and the customer's ability to require extension. [ITG April 2015.33-35, 38]
- Where the period of exposure is taken to be the full contractual period, historical behavioral information (e.g. on prepayments) is reflected in the Exposure At Default (EAD) model.
- Where the period of exposure is calculated on the basis of historical behavioral information, the bank considers appropriate segmentation to reflect different behavioral lives for different portfolio segments. Furthermore, the bank gives consideration to whether historical behavioral information captures current conditions and forward-looking information or needs to be adjusted.
- For revolving credit facilities within the scope of IFRS 9.5.5.20 (i.e. that include both a loan and an undrawn commitment component, and the bank's contractual ability to demand repayment and cancel the undrawn commitment does not limit the bank's exposure to credit losses to the contractual notice period), the period of exposure is determined by considering the bank's expected credit risk management actions that serve to mitigate credit risk, including terminating or limiting credit exposure. In doing this, the bank:

  1. Considers its normal credit risk mitigation process, past practice and future intentions and expected credit risk mitigation actions.
  2. Analyses what actually happens in practice as a result of each of these types of actions and demonstrates that there is sufficient historical evidence that such actions are executed and impact the lifetime of the exposure. The analysis considers historical information and experience about the period over which the bank was exposed to credit risk on similar instruments and the length of time for defaults to occur on similar instruments following a significant increase in credit risk. [IFRS 9.5.5.20, B.5.5.40]

The Simple approach

- If the period of exposure is taken to be less than the full period specified by IFRS 9 (e.g. the point at which a specific percentage of the balance has been repaid), the bank should provide reasonable and supportable information evidencing that the impact on ECLs of selecting this shorter period for the remaining balance is immaterial.
- Otherwise, all of the principles detailed under the sophisticated approach also apply for simpler implementations, although the level of detail required in addressing each principle may be reduced.

What is not compliant

- Defining the period of exposure to be shorter or longer than the maximum contractual period over which the entity is exposed to credit risk (except for certain revolving credit facilities). [IFRS 9.5.5.19-20, B5.5.38]
- Determining the period of exposure to equal the historical average life of loans without evaluating whether this is consistent with forward-looking expectations based on reasonable and supportable information. [IFRS 9.5.5.17(c), B5.5.52]

- For revolving credit facilities within the scope of IFRS 9.5.5.20, using the legally enforceable contractual period unless analysis of historical data shows that, in practice, management action consistently limits the period of exposure to the contractual period. [IFRS 9.5.5.20, B5.5.39-40, ITG December 2015.40-42]
- Not considering all relevant historical information that is available without undue cost and effort when determining the exposure period of a revolving credit facility within the scope of IFRS 9.5.5.20. [IFRS 9.5.5.17(c), B5.5.40]

Maximum period for Expected Credit Losses

Principle

Lifetime ECLs are defined as the ECLs that result from all possible default events over the *expected life* of a financial instrument. [IFRS 9 Appendix A]. This is consistent with the requirement that an entity should assess whether the credit risk on a financial instrument has increased significantly since initial recognition by using the change in the risk of a default occurring over the *expected life* of the financial instrument. [IFRS 9.5.5.9].

An entity must therefore estimate cash flows and the instrument's life by considering all contractual terms of the financial instrument (for example, prepayment, extension, call and similar options). There is a presumption that the expected life of a financial instrument can be estimated reliably. In those rare cases when it is not possible to reliably estimate the expected life of a financial instrument, the entity shall use the remaining contractual term of the financial instrument. [IFRS 9, Appendix A, B5.5.51].

However, the maximum period to consider when measuring ECLs should be the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that longer period is consistent with business practice. [IFRS 9.5.5.19]. Although an exception to this principle has been added for revolving facilities the IASB remains of the view that the contractual period over which an entity is committed to provide credit (or a shorter period considering prepayments) is the correct conceptual outcome. The IASB noted that most loan commitments will expire at a specified date, and if an entity decides to renew or extend its commitment to extend credit, it will be a new instrument for which the entity has the opportunity to revise the terms and conditions. [IFRS 9.BC5.260].

Challenges

- When assessing the impact of extension options at the discretion of the borrower, an entity should estimate both the probability of exercise of the extension option as well as the portion of

the loan that will be extended (if the extension option can be exercised for a portion of the loan only). This is consistent with how lifetime expected losses must be assessed for loan commitments where an entity's estimate of ECLs must be consistent with its expectations of drawdowns on that loan commitment. Although the standard is not explicit on this point, the effect of extension options would be best modelled not by estimating an average life of the facility but by estimating the EAD each year over the maximum lifetime. This is because use of an average life would not reflect losses expected to occur beyond the average life. [IFRS 9.B.5.5.31].

- Another degree of complexity in assessing expected prepayments and extensions arises if one considers that the behaviour of borrowers is affected by their creditworthiness. This means that prepayment and extension patterns should probably be estimated separately for stage 1 and stage 2 assets. This may represent a significant challenge, as making such estimates would require distinct historical observations for each of the stage 1 and 2 populations, which are unlikely to be available given that these populations were never identified in the past. Prepayment assumptions for stage 2 assets would need to factor in the probabilities that some may subsequently default and some may cure. A further complication is that expected prepayment and extension behaviour may vary with changes in the macroeconomic outlook.

Suggested approach

When assessing the impact of extension options at the discretion of the borrower, an entity should estimate both the probability of exercise of the extension option as well as the portion of the loan that will be extended (if the extension option can be exercised for a portion of the loan only). This is consistent with how lifetime expected losses must be assessed for loan commitments where an entity's estimate of ECLs must be consistent with its expectations of drawdowns on that loan commitment. Although the standard is not explicit on this point, the effect of extension options would be best modelled not by estimating an average life of the facility but by estimating the EAD each year over the maximum lifetime. This is because use of an average life would not reflect losses expected to occur beyond the average life. [IFRS 9.B.5.5.31].

Measurement of financial instruments

A financial asset is a non-physical asset whose value is derived from a contractual claim. IFRS 9 groups financial assets as follows;

- Equity instruments
- Debt instruments.

Initial measurement of financial instruments

All financial instruments are initially measured at fair value plus or minus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs. [IFRS 9, paragraph 5.1.1]

Subsequent measurement of financial assets

IFRS 9 divides all financial assets that are currently in the scope of IAS 39 into two classifications - those *measured at amortized cost* and those *measured at fair value.*

Where assets are measured at fair value, **_gains and losses are_** either recognized entirely in profit or loss (fair value through profit or loss, **_FVTPL_**), or recognized in other comprehensive income (fair value through other comprehensive income, **_FVTOCI_**).

For **_debt instruments_** the FVTOCI classification is **mandatory** for certain assets unless the fair value option is elected. Whilst for **_equity investments_**, the FVTOCI classification is an **election**.
Furthermore, the requirements for reclassifying gains or losses recognized in other comprehensive income are different for debt instruments and equity investments. *The classification of a financial asset is made at the time it is initially recognized,* namely when the entity becomes a party to the contractual provisions of the instrument. [IFRS 9, paragraph 4.1.1] If certain conditions are met, the classification of an asset may subsequently need to be reclassified.

a) Debt instruments

A debt instrument that meets the following **_two conditions must be measured at amortized cost_** (net of any write down for impairment) unless the asset is designated at FVTPL under the fair value option (see below):[IFRS 9, paragraph 4.1.2]

- **Business model test:** The objective of the entity's business model *is to hold the financial asset to collect the contractual cash flows* (rather than to sell the instrument prior to its contractual maturity to realize its fair value changes).

- **Cash flow characteristics test:** The contractual terms of the financial asset *give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.*

A debt instrument that meets the following two **_conditions must be measured at FVTOCI_** unless the asset is designated at FVTPL under the fair value option (see below): [IFRS 9, paragraph 4.1.2A]

- **Business model test:** The financial asset is *held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets.*
- **Cash flow characteristics test:** The contractual terms of *the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.*

All other debt instruments must be measured at fair value through profit or loss (FVTPL). [IFRS 9, paragraph 4.1.4]

Fair value option

Even if an instrument meets the two requirements to be measured at amortized cost or FVTOCI, IFRS 9 contains an option to **designate,** at initial recognition, a financial asset as measured at FVTPL **_if doing so eliminates or significantly reduces a measurement or recognition inconsistency_** (sometimes referred to as an 'accounting mismatch') that would otherwise arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases. [IFRS 9, paragraph 4.1.5]

a) Equity instruments

All equity investments in scope of IFRS 9 are to be *measured at fair value in the statement of financial position, with value changes recognized in profit or loss, except for those equity investments for which the entity has elected to present value changes in 'other comprehensive income'*. There is no 'cost exception' for unquoted equities.
'Other comprehensive income' option

If an equity investment is not held for trading, an entity can make an irrevocable election at initial recognition to measure it at FVTOCI with only dividend income recognized in profit or loss. [IFRS 9, paragraph 5.7.5]

On transition to IFRS 9, entities are generally required to apply the classification and measurements requirements retrospectively as if the new classification under IFRS 9 had always been applied.

Possible Business Model Assessment - *[IFRS 9, paragraph 4.1.2]*

Entities may make an assessment of the objective of a business model in which an asset is held at a portfolio level because this best reflects the way the business is managed and information is provided to management. The information considered may include;

- The stated policies and objectives for the portfolio and the operations of those policies in practice. In particular, whether the management strategy focuses on earning contractual interest revenue, maintaining a particular interest rate profile, matching the duration of the financial asset to the duration of the liabilities that are funding those assets or realizing cash flows through the sale of the assets.
- How the performance of the portfolio is evaluated and reported to the management
- The risks that affect the performance of the business model (and the financial assets held within that business model) and how those risks are managed.
- How ,managers of the business are compensated – e.g. whether compensation is based on the fare value of the assets managed or the contractual cash flow collected; and
- The frequency, volume and timing of sale in prior periods, the reason for such sales and its expectation about future sales activity. However, information about sales activity is not considered in isolation, but as part of an overall assessment of how the group stated objective for managing the financial assets is achieved and how cash flow are realized.
  {IFRS 9.B4.1.2B; B4.1.2C, B4.1.4A, B4.1.5}

Financial asset that are held for trading or managed and whose performance is evaluated on a fair value basis are measured at FVTPL because they are neither held to collect contractual nor held both to collect contractual cash flow and to sell financial assets. (IFRS 9.B4.1.6)

Possible assessments on whether Contractual Cash Flow is solely Payments of Principal and Interest - (*IFRS 9.4.1.3, B4.1.7a)*

For the purposes of this assessment, principal is defined as the fair value of the financial asset on initial recognition. Interest is defined as consideration for the time value of money and for the credit risk associated with the principal amount outstanding during a particular period of time and for other basis lending risks and costs (e.g. liquidity risks and administrative costs), as well as profit margin.

In assessing whether the contractual cash flows are solely payments of principal and interest, the entities may consider the contractual term of the instruments. This will include assessing whether the financial asset contains a contractual terms that could change the timing or amount of contractual cash flow such that it would meet this conditions. In making the assessments, entity may consider;

- Contingent events that would change the amounts and timing of cash flows
- Leverage features
- Prepayment and extension terms
- Terms that limit the group claim to cash flows from specified assets (e.g. non- resource assets arrangements)
- Features that modify considerations of the time value of money e.g. periodical reset of interest rates.

Possible Challenges on Implementing IFRS 9

Creating appropriate expected credit loss model

IFRS 9 does not provide any standard model on computing the expected credit losses. In the current Kenyan market there is no methodology to calculate forward looking measurements hence they have to be developed while the cash flow valuation analysis must be scenario-driven.

Possible Approach

Financial institutions will need to reclassify their assets and reconcile them. They will need to map products that can be categorized before the calculations or create a workflow to capture the purpose (business model test).An additional effort could be required to identify those products that can be considered out of scope e.g. short term cash facilities. The rating and scoring systems may have to be updated.

I. *Availability and acquisition of high- quality data with acceptable granularity.*

IFRS 9 requires financial institutions to take into account forecast of the future conditions in calculating expected credit losses.

Possible Approach

IFRS 9 will require significant changes to credit processes and information systems. These changes will mean new data requirements, processes and models, and entities will need to consider appropriate level of governance and financial controls over these new requirements and ability to audit them. Data governance and quality is key – everything depends on the data going in. If the data sources are not reliable, expect the results to be conflicting and sometimes unexplainable.

II. *Integrating IFRS 9 with existing accounting framework*

IFRS 9 changes accounting and reporting system i.e. general ledger must be re-defined to capture Expected credit loss provisions. This makes the provisioning exercise a cross-functional activity, with coordination needed across the risk, finance, accounting and business functions.

Possible Approach

Financial institutions will have to coordinate finance, credit and risk resources for which current accounting systems are not equipped. The accounting systems used by financial institution in Kenya will have to change significantly to calculate and record changes requested by IFRS 9 in a cost effective way.

III.   *Measuring and mitigating the impact of IFRS 9 on the bottom line*

IFRS 9 will lower operating margins and   profitability of financial institution as they will set aside larger amounts in loan loss provisions.

Possible Approach

Financial institutions will have to estimate and book an upfront, forward- looking expected loss over the life of the financial facility and monitor the ongoing credit- quality deterioration. Retrieval of old portfolio data will also be necessary.

Non Compliance

Non compliance in this case will arise when financial institutions do not correctly classify there financial assets leading to misstatements in their financial statements.

ILLUSTRATION

1 – Classification and measurement of financial assets

An entity, ABC, purchased a five-year bond on 1 January 2017 at a cost of Kshs 5m with annual interest of 5%, which is also the effective rate, payable on 31 December annually. At the reporting date of 31 December 2017 interest has been received as expected and the market rate of interest is now 6%.

Required:
Account for the financial asset at 31 December 2017 on the basis that:
- (i)   It is classified as FVTPL.
- (ii) It is classified to be measured at amortized cost, on the assumption it passes the Necessary tests and has been properly designated at initial recognition.

Answer:

(i) If classified as FVTPL
This requires that the fair value of the bond is measured based upon expected future cash flows discounted at the current market rate of interest of 6% as follows:

YEAR	EXPECTED CASHFLOW	6% DISCOUNT FACTOR	PRESENT VALUE Kshs in Millions
31/12/2017	5M X 5% =0.25M	0.9434	0.2358
31/12/2018	0.25M	0.8900	0.2225
31/12/2019	0.25M	0.8396	0.2099
31/12/2020	0.25+5M	0.7921	4.1585
			4.8267

Therefore, at the reporting date of 31 December 2017, the financial asset will be stated at a fair value of Kshs 4.8267m, with the fall in fair value amounting to Kshs 0.1733m taken to profit or loss in the year. Interest received will be taken to profit or loss for the year amounting to Kshs 0.25m.

(ii) If classified to be measured at amortized cost

This requires that the fair value of the bond is measured based upon expected future cash flows discounted at the original effective rate of 5%. This will continue to be at Kshs 5m as the following calculation confirms:

YEAR	EXPECTED CASHFLOW	5% DISCOUNT FACTOR	PRESENT VALUE Kshs in Millions
31/12/2017	5M X 5% =0.25M	0.9524	0.2381
31/12/2018	0.25M	0.9070	0.2267
31/12/2019	0.25M	0.8638	0.216
31/12/2020	0.25+5M	0.8227	4.3192
			5.0000

In addition, interest received during the year of Kshs 0.25m will be taken to profit or loss for the year.

Impairment of Financial Assets

IFRS 9 effectively incorporates an impairment review for financial assets that are measured at fair value, as any fall in fair value is taken to profit or loss or other comprehensive income for the year, depending upon the classification of the financial asset.

For financial assets designated to be measured at amortized cost, an entity must make an assessment at each reporting date whether there is evidence of possible impairment; if there is, then an impairment review should be performed. If impairment is identified, it is charged to profit or loss immediately. Quantification of the recoverable amount would normally be based upon the present value of the expected future cash flows estimated at the date of the impairment review and discounted to their present value based on the original effective rate of return at the date the financial asset was issued.

ILLUSTRATION 2 – IMPAIRMENT OF FINANCIAL ASSETS MEASURED AT AMORTISED COST

Using the information contained within Illustration 1, where the carrying value of the financial asset at 31 December 2017 was 5m.If, in early 2018, it was identified the bond issuer was beginning to experience financial difficulties, and there was doubt regarding full recovery of the amounts due to ABC, an impairment review would be required. The expected future cash flows now expected by ABC from the bond issuer are as follows:

Year	Expected Cashflow
31/12/2017	0.20M
31/12/2018	0.20M
31/12/2019	0.20M
31/12/2020	0.20+4.4M

Required: Calculate the extent of impairment of the financial asset to be included in the financial statements of ABC for the year ending 31 December 2018.

Answer:

The future cash flows now expected are discounted to present value based on the original effective rate associated with the financial asset of 5% as follows:

Year	Expected Cash flow	5% Discount Factor	Present Value in Kshs millions
31/12/2017	0.2M	0.9524	0.1905
31/12/2018	0.2M	0.9070	0.1814
31/12/2019	0.2M	0.8638	0.1727
31/12/2020	0.20+4.4M	0.8227	3.7844
			4.3290

Therefore, impairment amounting to the change in carrying value of (5.0m – 4.329m) =0.671m will be recognized as an impairment charge in the year to 31 December 2018.

Additionally, there will also be recognition of interest receivable in the statement of comprehensive income for the year amounting to (4.329m x 5%) = 0.2165m.

Illustration 2 – Fair Value through Other Comprehensive Income (OCI)

An entity purchases a debt instrument with a fair value of 1,000 on 15 December 2017 and measures the debt instrument at FVTOCI. The instrument has an interest rate of 5 per cent over the contractual term of 10 years, and has a 5 per cent effective interest rate. At initial recognition the entity determines that the asset is not purchased or originated credit-impaired.

	DR	CR
Financial assets- FVTOCI	1000	
Cash		1000

(To recognize the debt instrument measured at its fair value)

On 31 December 2017 (the reporting date), the fair value of the debt instrument has decreased to 950 as a result of changes in market interest rates. The entity determines that there has not been a significant increase in credit risk since initial recognition and that expected credit losses should be measured at an amount equal to 12-month expected credit losses, which amounts to 30. For simplicity, journal entries for the receipt of interest revenue are not provided.

	DR	CR
Impairment loss (Profit or loss)	30	
Other comprehensive income	20	
Financial assets- FVOCI		50

(To recognize 12-month expected credit losses and other fair value changes on the debt instrument)

The cumulative loss in other comprehensive income at the reporting date was 20. That amount consists of the total fair value change of 50 (1,000–950) offset by the change in the accumulated impairment amount representing 12-month expected credit losses that was recognized (30).

Possible SWOT Analysis of IFRS 9 to the Financial Sector

Strengths	Weakness
• Reduces the complexity of the classification and measurement of financial assets. • Aligns accounting with the management strategies for managing financial assets • Requires extensive disclosures of the reason behind any change in accounting decision thus preventing manipulation of accounts results. • Simplifies rules dealing with measurements of hybrid contacts containing embedded derivatives.	• Introduces new model that requires use of professional judgments therefore introduce more subjectivity. • Withholds May option and different accounting treatment on several aspects thus not eliminating complexity.

Opportunities	Threats
• Allows use of professional judgments when making several acting decision i.e. choice of business model and use of fair value option. • Gives possibility to reclassify, on initial adoption some financial assets previously measured at fair value to the amortized cost.	• Reduces comparability by allowing too much flexibility when making some choices e.g. business model. • Implementation cost of many provision are difficult to assess now e.g. the impact of information system and business process.

The following table shows the original measurements categories in accordance with ISA 39 and the new measurements categories.

	Financial Asset	Classification as per IAS 39	Classification as per IFRS 9
1	Cash and cash equivalent	Loans and receivables	Amortized at cost
2	Pledged trading assets	FVTPL	FVTPL- Mandatory
3	Non-pledged trading assets	FVTPL	FVTPL- Mandatory
4	Derivative assets held for risk management	FVTPL	FVTPL - Mandatory
5	Loans and advance to banks	Loans and receivables	Amortized costs
6	Loans and advances to customers	Loans and receivables	Amortized costs
7	Investments security debts	FVTPL	FVTPL -designated
8	Investments securities debts	Held for maturity	Amortized costs
9	Investments securities debts	Available for sale	FVOCI
10	Investments securities equity	FVTPL - Designated	FVTPL - Designated
11	Investments securities equity	Available for sale	FVTPL - Mandatory
12	Investments securities equity	Available for sale	FVOCI
13	Other assets- restricted deposits with CBK	Loans and receivables	Amortized at cost

Non Compliance

Non-compliance in this case will arise when financial institutions do not correctly classify there financial assets leading to misstatements in their financial statements.

Revenue Recognition on Debt Instruments
Principle

Classification under IFRS 9 debt instruments

IFRS 9 introduces principle-based requirements for the classification of financial assets, using the following measurement categories:

- Debt instruments at amortised cost
- Debt instruments at fair value through OCI (FVOCI) with cumulative gains and losses reclassified to profit or loss upon derecognition
- Debt instruments, derivatives and equity instruments at FVPL

The classification of financial assets depends on the financial asset's contractual cash flow characteristics and the entity's business model for managing the financial assets. This section discusses how debt instruments may be recognised using any of the three approaches in compliance with IFRS 9.

Debt instruments measurement at amortised cost

A debt instrument is measured at amortised cost if it meets the following two conditions: -

- **Business model test:** The financial asset is held within a business model whose objective is to hold financial assets to collect their contractual cash flows (rather than to sell the assets prior to their contractual maturity to realise changes in fair value).

- **Cash flow characteristics test:** The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal amount outstanding on the principal amount outstanding.

Debt instruments measured at FVOCI

A debt instrument is normally measured at fair value through other comprehensive income (FVOCI) if it is held within a business model in which the assets are managed to achieve a specific objective by both collecting contractual cash flows and selling financial assets, provided it also passes the SPPI test.

The assets under this category are initially recognized and subsequently measured at fair value. The movement in the carrying amount is recorded in the OCI apart from the recognition of impairment gains or losses, interest revenue and foreign exchange gains and losses which are recorded in the profit and loss.

When the debt instrument/financial asset is derecognised the accumulated gain or loss previously recognized in OCI is reclassified from equity to profit or loss.

Examples of financial instruments that may be classified and accounted for at FVOCI under IFRS 9 include:

- Investments in government bonds where the investment period is likely to be shorter than maturity

- Investments in corporate bonds where the investment period is likely to be shorter than maturity. It is unlikely that intercompany loans or trade receivables would be classified in the FVOCI category

Example
Entity A purchases a debt instrument on 1 July 2018. The debt instrument has a fair value of USD 7,000 on initial recognition and is measured at fair value through other comprehensive income.

The instrument has a contractual term of 10 years, and has both a nominal and an effective interest rate of 5 per cent (for simplicity, journal entries for interest revenue have not been given below).

The instrument is determined as not being credit-impaired on initial recognition.

Accounting entries on initial recognition

	Debit	Credit
Financial asset measured at FVOCI	7,000	
Cash		7000

Being recognition of the debt instrument at its fair value

At the reporting date of 31 December 2018, the fair value of the debt instrument has declined to USD 6,750 as a result of changes in market interest rates. The entity determines that there has not been a significant increase in credit risk since initial recognition. Expected credit losses are therefore measured at an amount equal to 12-month expected credit losses, which amounts to USD 150.

Accounting entries on 31 December 2018

	Debit	Credit
Impairment loss (profit or loss)	**150**	
Other comprehensive income	**100**	
Financial asset – FVOCI		**250**

Being recognition of 12-month expected credit losses and other fair value changes on the debt instrument. Note that the cumulative loss in OCI of USD 100 consists of the total fair value change of USD 250 (USD 7,000 – USD 6,750) offset by the accumulated impairment amount recognised of USD 150.

On 1 January 2019, the entity decides to sell the debt instrument for USD 6,750, which is its fair value at that date.

Accounting entries on 1 January 2019

	Debit	Credit
Cash	6,750	
Financial asset – FVOCI		6,750
Loss (profit or loss)	100	
Other comprehensive income		100

To the fair value through other comprehensive income asset and recycle amounts accumulated in other comprehensive income to profit or loss.

NB: The carrying amount of a debt instrument measured at FVOCI is its fair value. The recognition of an impairment loss does not affect the carrying amount of the assets however it is presented as a debit to the P &L and a credit to OCI

Debt instruments measured at FVPL

Fair value through profit or loss (FVTPL) is the residual category in IFRS 9 Financial assets should be classified as FVPL only if they do not meet the criteria of FVOCI or the amortized cost and if using FVPL reduces or eradicates an inconsistency in measurement or recognition (an accounting mismatch)

A financial asset is classified and measured at FVTPL if the financial asset is:

- A held-for-trading financial asset

- A debt instrument that does not qualify to be measured at amortised cost or FVOCI

- An equity investment which the entity has not elected to classify as at FVOCI

- A financial asset where the entity has elected to measure the asset at FVTPL under the fair value option (FVO).

Examples of financial instruments that are likely to fall under the FVTPL category include:

– Investments in shares of listed companies that the entity has not elected to account for as at FVOCI – Derivatives that have not been designated in a hedging relationship, e.g.: – Interest rate swaps – Commodity futures/option contracts – Foreign exchange futures/option contracts – Investments in convertible notes, commodity linked bonds – Contingent consideration receivable from the sale of a business.

Other than for held for trading financial assets that must be carried at FVTPL (e.g. derivatives), the FVTPL category under IFRS 9 is essentially a residual category. This is in contrast to IAS 39, where the residual category is Available for Sale (FVOCI). Under IFRS 9, consideration is first given to whether a financial asset is to be measured at amortised cost or FVOCI and, if it is not, it will be measured at FVTPL.

Challenges

- The new mode of classification and measurement will bring about a challenge particularly for financial institutions as the management will be needed to assess their financial assets classification considering the new business model requirements.

- Entities that hold externally rated debt instruments and rely on external rating agencies data when using the low credit risk simplification need to note that in some situations adjustments may be needed to the ratings like when there is a financial crisis in the market so that they reflect the current market conditions.

- Entities will also need to reassess their business models each reporting period to determine whether the business model has changed since the preceding period. Increasing levels of sales of financial assets held within a business model that previously met the amortised cost or FVOCI criteria may be evidence that the business model has changed and, therefore, warrant reclassification of financial assets.

Suggested Approach

- Entities will need to assess their overall business objective to determine their portfolios of financial assets and decide which model best suits the objectives .i.e. FVOCI business model or the amortized cost business model or if they fall in the FVPL category. It is important to note that the business models for the various individual portfolios may vary widely and judgment will be highly put into use by management.

- Business model assessment will mainly be reliant on the performance and history of the entity for example where entities have recurring sales they need to commence the tracking of information so as to have adequate history that will guide the management analysis.

- Entities may be required to update their disclosures of significant estimates and judgments under IAS 1 to take into account the changes being introduced as a result of adoption IFRS 9. Financial Institutions need to develop practical policies and guidelines to inform these judgements.

- Entities need to identify data gaps and consider practical solutions to collect the necessary data as well as compile information about existing contracts in order to gauge the Standard's impact

What is not compliant?

Impairment

The FVTOCI category for debt instruments is not the same as the available-for-sale category under IAS 39. Under IAS 39, impairment gains and losses are based on fair value, whereas under IFRS 9, impairment is based on expected losses and is measured consistently with amortised cost assets.

Revolving Credit Facilities	
Determining the starting-point of the maximum period to consider when measuring expected credit losses in accordance with paragraph B5.5.40 of IFRS 9; and	The requirements of paragraph B5.5.40 of IFRS 9 do not alter the starting-point of the maximum period to consider when measuring expected credit losses and consequently they noted that the appropriate starting-point should be the reporting date.
Determining the ending-point of the maximum period to consider when measuring expected credit losses in accordance with paragraph B5.5.40 of IFRS 9 - in particular, which credit risk management actions an entity should take into account in making this determination.	An entity should consider: - only credit risk management actions that it expects to take rather than all credit risk management actions that it is legally and operationally able to take; - only those credit risk management actions that serve to mitigate credit risk - consequently, actions that do not mitigate credit risk such as the reinstatement of previously curtailed credit limits should not be considered; and - all credit risk management actions that it expects to take and that serve to either terminate or limit the credit risk exposure in some way.
The maximum period to consider when measuring Expected Credit Losses	For specific financial instruments, such as some types of portfolios of revolving credit facilities, paragraph 5.5.20 of IFRS 9 requires a period in excess of the contractual period over which the entity is exposed to credit risk to be used as the maximum period to consider when measuring expected credit losses. Paragraph B5.5.40 of IFRS 9 also provides guidance about how an entity should determine that appropriate period.

Determining the date of initial recognition for the purposes of assessing significant increases in credit risk	The date of initial recognition is the date that the facility was issued and that this should only be changed if there has been a derecognition of the original facility.
How to determine when changes are sufficiently significant to result in a derecognition of the original facility and recognition of a new facility.	This would be a matter of judgement and some of the factors that might be taken into consideration include: - issuing a new card; - revising credit limits; or conducting credit reviews. However, the judgement required in making this assessment would depend on the specific facts and circumstances. In this regard, the following observations with regard to the above two examples could be made: - in some circumstances issuing a new card may be indicative that the original facility has been derecognised, but in other cases, this may be a purely operational process and thus would not indicate that a new facility has been issued; and - credit reviews in themselves may not indicate that a new facility has been issued.
Whether an exposure in excess of the contractually agreed credit limit could be used when estimating the exposure at default for revolving credit facilities in accordance with IFRS 9 when an entity has a history of allowing customers to exceed their contractually set credit limits.	The impairment model in IFRS 9 is based on the contractual terms of a financial instrument. Specifically: - the definition of credit losses refers to a comparison between the contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive; and - the maximum period to consider when measuring expected credit losses is the maximum contractual period (including extension options) over which the entity is exposed to credit risk and not a longer period, even if that period is consistent with business practice.

Significant increase in credit risk	
Assessing of significant increases in credit risk in accordance with the impairment requirements of IFRS 9.	IFRS 9 requires an entity to assess whether there has been a significant increase in credit risk for all financial instruments, including those with a maturity of 12 months or less. It does not prescribe particular methods of assessing for significant increases in credit risk. However, whichever approach is taken, it should be consistent with the objectives of IFRS 9 and should consider reasonable and supportable information that is available without undue cost and effort, paragraph B5.5.15. An entity should not be limited by only the information available internally, it should consider using third-party information from sources, paragraph B5.5.17(c). The assessment of significant increases in credit risk may include both quantitative and qualitative approaches. When making the assessment of significant increases in credit risk, an entity should consider the possibility of segmenting the portfolio into groups of financial instruments with shared credit characteristics in such a way that similar indicators of credit risk could be used to identify increases in credit risk for specific sub-portfolios.
How an entity should determine whether there has been a significant increase in credit risk for a portfolio of loans advanced to customers across broad credit quality bands with identical pricing and contractual terms, for example, retail loans	The impairment model is based on an assessment of changes in credit risk since initial recognition, rather than the identification of a specific level of credit risk at the reporting date; and A smaller absolute change in the risk of default occurring will be more significant for an asset that is of high quality on initial recognition than for one that is of low quality.

Significant increase in credit risk	
Whether an entity can use behavioural indicators of credit risk as a proxy for the assessment of significant increases in credit risk since initial recognition	In accordance with IFRS 9: - an entity is required to assess whether there has been a significant increase in credit risk since initial recognition - ie the assessment is relative in nature; - when assessing whether there has been a significant increase in credit risk since initial recognition, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument1 ; and - a significant increase in credit risk is expected to occur prior to delinquency and consequently, when making this assessment, an entity is required to consider all reasonable and supportable information, including information that is forward-looking, that is available without undue cost and effort. When considering the use of behavioural indicators, an entity should: - focus on identifying pre-delinquency behavioural indicators of increases in credit risk, for example increased utilisation rates or increased cash drawings on specific products; - only use indicators that are relevant to the risk of default occurring; - establish a link between the behavioural indicators of credit risk and changes in the risk of default occurring since initial recognition; - be mindful that while behavioural indicators are often predictive of defaults in the short term, they are often less predictive of defaults in the longer term; and - consider whether the use of behavioural indicators is appropriate for the type of product being assessed—for example, if a loan has only back-ended payments, behavioural indicators based on timeliness of payment will not be appropriate.

Significant increase in credit risk	
To what extent, would an entity be required to perform a review to determine whether circumstances still support the use of changes in the 12-month risk of a default occurring as an approximation of changes in the lifetime risk of default occurring.	An entity is required to assess changes in the risk of a default occurring over the expected life of a financial instrument when assessing whether a significant increase in credit risk has occurred in accordance with IFRS 9. Paragraphs B5.5.13 - B5.5.14 of IFRS 9 acknowledge that when assessing whether a significant increase in credit risk has occurred, changes in the risk of a default occurring over the next 12 months may be a reasonable approximation of changes in the lifetime risk of a default occurring for some financial instruments and in some types of circumstances. The appropriate type of review that should be undertaken on an on-going basis and observed that while a quantitative review would not necessarily be required, it would depend on the specific facts and circumstances. One way of approaching an on-going review would be as follows: - identify the key factors that would affect the appropriateness of using changes in the 12-month risk of a default occurring as an approximation of changes in the lifetime risk of default occurring; - monitor these factors on an on-going basis as part of a qualitative review of circumstances; and - consider whether any changes in those factors indicated that changes in the 12-month risk of a default occurring were no longer an appropriate proxy for changes in a lifetime risk of default occurring.
Can an entity can use a single forward-looking economic scenario or whether an entity needs to incorporate multiple forward-looking scenarios when assessing significant increases in credit risk.	When there is a non-linear relationship between the different forward-looking scenarios and the associated change in the risk of a default occurring since initial recognition, using a single forward-looking scenario as a basis for this assessment would not meet the objectives of IFRS 9. Consequently, in these cases, an entity would need to incorporate more than one forward-looking economic scenario when assessing significant increases in credit risk. There should be consistency, to the extent relevant, between the forward-looking information used for the measurement of expected credit losses and for the assessment of significant increases in credit risk.

Transitional provisions
IFRS 9 principles

IFRS 9 is effective for annual periods beginning on or after 1 January 2018 and, subject to local endorsement requirements, is available for early adoption. In Kenya, IFRSs are adopted as issued by the IASB and therefore early adoption is available to preparers of financial statements.

Entities are however allowed earlier adoption for specific areas related to the requirements for presentation of gains and losses on financial liabilities designated at fair value through profit or loss, without applying other principles for early adoption.

On initial application, entities are required to apply the standard retrospectively except in respect of:

- Items which have been derecognized by the time of initial application (*the date of initial application is the beginning of the reporting period when the entity first applies IFRS 9, which will be 1 January 2018 for non-early adopters).*
- The following areas relating to classification and measurement at the date of initial application:
    - o The assessment of the entities business model is carried out at the date of initial application, and applied retrospectively, irrespective of the actual business models in prior years.
    - o Where it is impracticable to assess time value of money elements and the significance of fair values of prepayment features in debt instruments, entities need not take into account the effect of modifications to both the time value of money elements and significance of prepayment features.
    - o Fair valuation of hybrid contracts is accounted through an adjustment to opening retained earnings at the date of initial application and not retrospectively

Entities are required to designate *financial assets measured at fair value through profit or loss* and *equity instruments measured at fair value through other comprehensive income* based on facts and circumstances that exist at the date of initial application. This is applied retrospectively.

All revocations and designations of financial assets and liabilities are made based on facts and circumstances that exist at the date of initial application and are applied retrospectively.

Impracticability:

- Where it is impracticable (refer to IAS 8) to retrospectively apply the effective interest method, the fair value of the financial instrument at the end of each comparative period is presented as the previous carrying value under IAS 39 and is assumed to be the carrying value at the date of initial application.

-   Where equity instruments were previously measured at cost under IAS 39, and it is impracticable to determine the fair values for comparative periods, the instrument is measured at fair value at the date of initial application and the difference between fair value and the previous carrying value is adjusted in opening retained earnings.
-   Where entities prepare interim financial reports (refer to IAS 34), retrospective application to previous interim reports is not required, if impracticable.

Impairment:

-   At the date of initial application, reasonable and supportable information that is available without undue cost or effort must be used to determine credit risk at the *date of initial recognition of the financial instrument* and compare that to the credit risk at the date of initial application of IFRS 9 in order to determine changes in credit risk.
-   Impairment of financial instruments for comparative periods needs to be based on the information available at the respective reporting dates without the application of hindsight.

Challenges

Key challenges around transition into IFRS 9 are:

-   Significant amount of historical, current and forward looking data to build credit risk models, disclosures in financial statements and effect changes in measurement and classification, not only at the first reporting date after initial application, but for the last 2 comparative periods (i.e. 31 December 2017 and 1 January 2017 for non-early adopters).
-   Use of significant and difficult judgements on various issues will make implementation tricky.
-   Assessments for restatements need to be implemented using reasonable and supportable information available as at the period of the restatement without being influenced by market factors and information that is subsequently available (i.e. the standards expects that there will be no use of hindsight).

Proposed guidance and implementation notes

IFRS 9 requires retrospective adjustment to financial statements in most areas with only limited exceptions as discussed above. For example, assuming that preparers adopt the standard for periods beginning 1 January 2018, the financial statements will present restated comparative information for the financial years ended 31 December 2016 (effectively the statement of financial position as at 1 January 2017 which will need to be presented under the requirements of IAS 8 and 31 December 2017. Qualitative and quantitative disclosures related to the transition from IAS 39 to IFRS 9 will also be required.

As data collection and models are prepared, preparers need to disclose the *expected* quantitative impact of adopting IFRS 9 on their current financial statements.

IFRS 9 is expected to have a significant impact on reported performance of entities, which is likely to generate additional enquiry from various stakeholders (e.g. financiers, tax revenue authorities, regulators, shareholders etc)

which could have a commercial impact on the entities business. Potential conflicts could arise in the treatment of various financial assets under regulatory and tax guidelines compared to the requirements of IFRS 9. Early planning for data collection and modeling of the impact on the entity's financial statements will alert preparers of any negative impacts to allow for proactive reaction to the same.

Preparers need to understand the enormity of the task above and data collection and simulation should be prioritized.

Preparers will need to be mindful to collect and use information/data would have been available at the period of time to which the restatements are being effected and <u>eliminate the impacts of subsequent information available and hindsight on financial models and simulations.</u> This is likely to pose a significant challenge to auditors who will need to challenge the basis used for restatements and in particular the justification for recognizing impairment provisions and other fair value adjustments in prior periods rather than in the current period. With this in mind, preparers need to ensure that adequate documentation is retained to support the judgments and estimates made.

What is considered non-compliant

Application of IFRS 9 prospectively, except where permitted, will be a departure from the requirements of the Standard.

Non-disclosure of the impact of the transition and related qualitative and quantitative disclosures in the financial statements upon adoption of IFRS 9

<u>Risk characteristics of a portfolio</u>

<u>Principle</u>

With the exception of purchased or originated credit impaired financial assets, expected credit losses are required to be measured through a loss allowance at an amount equal to:

a) the 12-month expected credit losses (expected credit losses that result from those default events on the financial instrument that are possible within 12 months after the reporting date)
b) full lifetime expected credit losses (expected credit losses that result from all possible default events over the life of the financial instrument).

A loss allowance for full lifetime expected credit losses is required for a financial instrument if the credit risk of that financial instrument has increased significantly since initial recognition, as well as to contract assets or trade receivables that do not constitute a financing transaction in accordance with IFRS 15. [IFRS 9 paragraphs 5.5.3 and 5.5.15]

Additionally, entities can elect an accounting policy to recognise full lifetime expected losses for all contract assets and/or all trade receivables that do constitute a financing transaction in accordance with IFRS 15. The same election is also separately permitted for lease receivables. [IFRS 9 paragraph 5.5.16]

For all other financial instruments, expected credit losses are measured at an amount equal to the 12-month expected credit losses. [IFRS 9 paragraph 5.5.5]

Significant increase in credit risk

With the exception of purchased or originated credit-impaired financial assets (see below), the loss allowance for financial instruments is measured at an amount equal to lifetime expected losses if the credit risk of a financial instrument has increased significantly since initial recognition, unless the credit risk of the financial instrument is low at the reporting date in which case it can be assumed that credit risk on the financial instrument has not increased significantly since initial recognition. [IFRS 9 paragraphs 5.5.3 and 5.5.10]

The Standard considers credit risk low if there is a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. The Standard suggests that 'investment grade' rating might be an indicator for a low credit risk. [IFRS 9 paragraphs B5.5.22 – B5.5.24]

The assessment of whether there has been a significant increase in credit risk is based on an increase in the probability of a default occurring since initial recognition. Under the Standard, an entity may use various approaches to assess whether credit risk has increased significantly (provided that the approach is consistent with the requirements). An approach can be consistent with the requirements even if it does not include an explicit probability of default occurring as an input. The application guidance provides a list of factors that may assist an entity in making the assessment. Also, whilst in principle the assessment of whether a loss allowance should be based on lifetime expected credit losses is to be made on an individual basis, some factors or indicators might not be available at an instrument level. In this case, the entity should perform the assessment on appropriate groups or portions of a portfolio of financial instruments.

The requirements also contain a rebuttable presumption that the credit risk has increased significantly when contractual payments are more than 30 days past due. IFRS 9 also requires that (other than for purchased or originated credit impaired financial instruments) if a significant increase in credit risk that had taken place since initial recognition and has reversed by a subsequent reporting period (i.e., cumulatively credit risk is not significantly higher than at initial recognition) then the expected credit losses on the financial instrument revert to being measured based on an amount equal to the 12-month expected credit losses. [IFRS 9 paragraph 5.5.11]

Purchased or originated credit-impaired financial assets

Purchased or originated credit-impaired financial assets are treated differently because the asset is credit-impaired at initial recognition. For these assets, an entity would recognise changes in lifetime expected losses since initial recognition as a loss allowance with any changes recognised in profit or loss. Under the requirements, any favourable changes for such assets are an impairment gain even if the resulting expected cash flows of a financial asset exceed the estimated cash flows on initial recognition. [IFRS 9 paragraphs 5.5.13 – 5.5.14]

Credit-impaired financial asset

Under IFRS 9 a financial asset is credit-impaired when one or more events that have occurred and have a significant impact on the expected future cash flows of the financial asset. It includes observable data that has come to the attention of the holder of a financial asset about the following events:

[IFRS 9 Appendix A]

a) significant financial difficulty of the issuer or borrower;
b) a breach of contract, such as a default or past-due event;
c) the lenders for economic or contractual reasons relating to the borrower's financial difficulty granted the borrower a concession that would not otherwise be considered;
d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
e) the disappearance of an active market for the financial asset because of financial difficulties;
f) the purchase or origination of a financial asset at a deep discount that reflects incurred credit losses.

Suggested Approach

Any measurement of expected credit losses under IFRS 9 shall reflect an unbiased and probability-weighted amount that is determined by evaluating the range of possible outcomes as well as incorporating the time value of money. Also, the entity should consider reasonable and supportable information about past events, current conditions and reasonable and supportable forecasts of future economic conditions when measuring expected credit losses. [IFRS 9 paragraph 5.5.17]

The Standard defines expected credit losses as the weighted average of credit losses with the respective risks of a default occurring as the weightings. [IFRS 9 Appendix A] Whilst an entity does not need to consider every possible scenario, it must consider the risk or probability that a credit loss occurs by considering the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the probability of a credit loss occurring is low. [IFRS 9 paragraph 5.5.18]

In particular, for lifetime expected losses, an entity is required to estimate the risk of a default occurring on the financial instrument during its expected life. 12-month expected credit losses represent the lifetime cash shortfalls that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring.

An entity is required to incorporate reasonable and supportable information (i.e., that which is reasonably available at the reporting date). Information is reasonably available if obtaining it does not involve undue cost or effort (with information available for financial reporting purposes qualifying as such).

For applying the model to a loan commitment an entity will consider the risk of a default occurring under the loan to be advanced, whilst application of the model for financial guarantee contracts an entity considers the risk of a default occurring of the specified debtor. [IFRS 9 paragraphs B5.5.31 and B5.5.32]

An entity may use practical expedients when estimating expected credit losses if they are consistent with the principles in the Standard (for example, expected credit losses on trade receivables may be calculated using a provision matrix where a fixed provision rate applies depending on the number of days that a trade receivable is outstanding). [IFRS 9 paragraph B5.5.35]

To reflect time value, expected losses should be discounted to the reporting date using the effective interest rate of the asset (or an approximation thereof) that was determined at initial recognition. A "credit-adjusted effective interest" rate should be used for expected credit losses of purchased or originated credit-impaired financial assets. In contrast to the "effective interest rate" (calculated using expected cash flows that ignore expected credit losses), the credit-adjusted effective interest rate reflects expected credit losses of the financial asset. [IFRS 9 paragraphs B5.5.44-45]

Expected credit losses of undrawn loan commitments should be discounted by using the effective interest rate (or an approximation thereof) that will be applied when recognising the financial asset resulting from the commitment.

If the effective interest rate of a loan commitment cannot be determined, the discount rate should reflect the current market assessment of time value of money and the risks that are specific to the cash flows but only if, and to the extent that, such risks are not taken into account by adjusting the discount rate. This approach shall also be used to discount expected credit losses of financial guarantee contracts. [IFRS 9 paragraphs B5.5.47]

*Credit risk profiling

Topic: Changes in credit risk profiles

IFRS 9 principles

In contrast to the current 'incurred loss' model in IAS 39 Financial Instruments: Recognition and Measurement, the new impairment model is more forward looking and no longer requires a credit event to have occurred before credit losses are recognized. In estimating credit losses (ECL), IFRS 9 requires entities to use all reasonable and supportable forward looking information and update as expectations change. Entities must therefore go beyond considering historical and current information and also consider the impact of macroeconomic factors in determining expected credit loss levels.

In specific, IFRS 9 requires the recognition of expected credit losses on Financial assets measured at amortised cost or fair value through other comprehensive income (FVOCI), lease receivables, contract assets, loan commitments and financial guarantee contracts.

Financial assets that are held within a business model whose objective is to collect contractual cash flows and the contractual payments have specified dates for repayment of principal and interest are measured at classified either at amortised cost or at FVOCI. This instrument can only be classified at FVOCI if held with in business model whose objective is to collect contractual cash flows and sell and have specified dates for repayment. Debt instrument have these characteristics as they have both an obligation for repayment the principal, plus any interest plus the obligation at specified debts and can be transferred between parties.

The loss allowance on FVOCI financial assets shall not reduce the carrying amount of the financial asset in the statement of financial position beyond its fair value. Instead the impairment allowance will be charged to profit or loss and recognized in other comprehensive income.

Illustration 1 (Refer Example 13 IFRS 9 IE)

Company A purchased a Financial asset for Shs. 20,000. The asset was classified at FVOCI.

At the end of the year the fair value is Shs. 2,000. The ECL for the next 12 months is Shs 500.

Dr Financial asset- FVOCI	2,000	
Cr Impairment Loss-Statement of profit or loss		500
Cr Statement of comprehensive income		1,500

An entity shall measure the loss allowance at an amount equal to the lifetime expected credit losses if the credit risk on the financial instrument has increased significantly since initial recognition. If a credit risk has not significantly increased since initial recognition, then an entity shall measure the loss allowance at an amount equal to 12 months expected losses.12 months expected losses represent the lifetime cash shortfalls that will result if a default occurs in the 12 months (or shorter) after the reporting date, weighted by the probability of that default occurring.

At each reporting period, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition. When making an assessment, an entity shall use the change in the risk of a default occurring over the expected life instead of a change in amount of expected credit losses. The risk of default is compared between the date of initial recognition and the reporting date. The information that is used to make this assessment is that which is available without undue cost and effort up to the reporting date. **Undue cost and effort** is not specifically defined but can be derived from the IFRS for SME definition: where the cost or the employee effort would be excessive in comparison with the benefits gained by users of the financial statements from having that information.

Significant increase in credit risk is not specifically defined and is therefore subject to application of judgment. The main reason given by IASB was that entities manage financial instruments and credit risk in different ways, with different sophistication and by using different information. It left the entities to determine when to recognise expected losses and on a basis that is clear and should be broadly defined and objective based.

An entity may assume that the credit risk on a financial instrument on a financial instrument has not increased significantly since initial recognition if it is determined to have low risk at the reporting date.

If reasonable and supportable information about the future is available without undue cost or effort, an entity cannot rely solely on past due information when determining whether credit risk has increased significantly since initial recognition. If forward information is not available without undue cost or effort, an entity may use past due information to determine if there is a significant increase in credit risk since initial recognition *e.g. changes may be happening in legislation that are effective in the future that may significantly affect the ability of a counterparty to service its debt.*

Regardless of the way in which an entity assesses significant increase in credit risk, there is a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due.

An entity can rebut this presumption if the entity has reasonable and supportable information that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition even though the contractual payments are more than 30 days past due. When an entity determines that there are significant increases in credit risk before contractual payments are more than 30 days past due, the rebuttable presumption does not apply. What this means is that the preparer would have to justify why a financial asset is past due 30 days is not deemed to be default or why is in normal and not watch as in the case of a financial institution.

If the contractual cash flows on the financial asset have been renegotiated or modified and the financial asset is not derecognized, an entity shall assess whether there has been a significant increase in credit risk of the financial instrument by comparing the risk of default at the reporting date based on modified contractual terms and those of the unmodified contractual terms at initial recognition.

Alternative model: Simplified approach for trade receivables, contract assets and lease receivables

IFRS 9 recognises that there are instances where trade receivables, contract assets and lease receivables recognised within the scope of IFRS 15 don't have a significant financing component. It also recognizes the fact that most of these financial asset has a maturity of less than 12 months hence the life time credit losses and the 12 month expected credit losses would be the same or similar. IFRS 15 allows an entity not to adjust the effects of a significant financing component if the entity expects at contract inception, that the period between delivery of goods/services will be one year or less.

A key difference is that the simplified approach does not require an entity to determine whether credit risk has increased significantly since initial recognition. Instead a loss allowance is recognised based on lifetime expected credit losses at each reporting date.

The simplified approach allows a provision matrix as an acceptable method to measure expected credit losses. The provision matrix is can be based on its historical credit loss experience for trade receivables to estimate the 12-month expected credit losses or the lifetime expected credit losses on the financial assets as relevant. One will be expected link the age of the financial asset to risk of nonpayment. A good example where an entity fixed provision rates depending on the number of days that a trade receivable is past due. The fixed rates would be supported by historical data and reviewed/monitored on a regular basis.
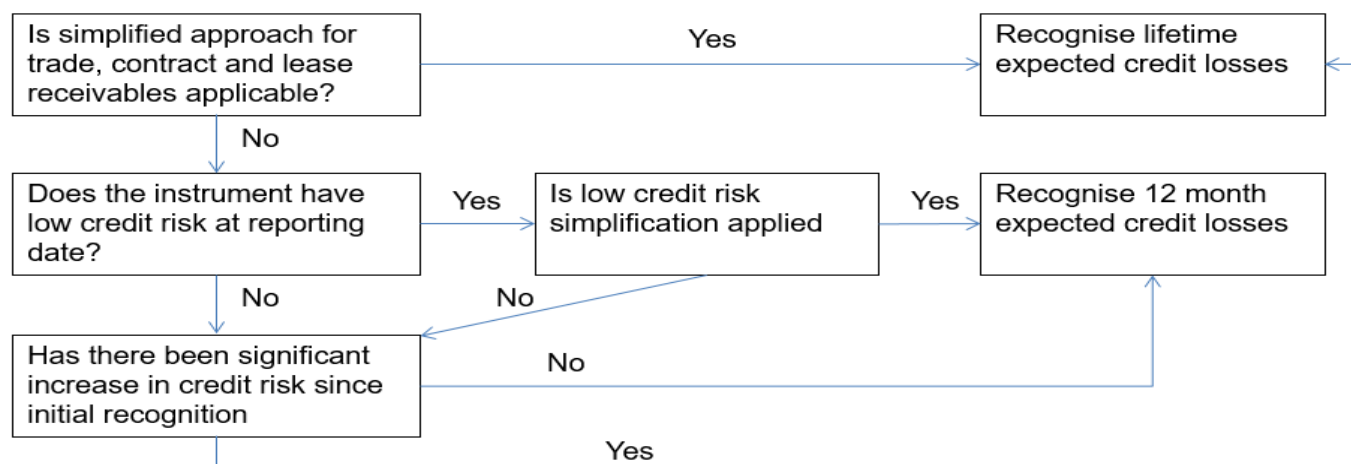
Illustration 2 (Refer Example 13 IFRS 9 IE)

	Current	1-30 days past Due	31-60 days past due	61-90 days past due	More than 90 days past due

| Default rate | 0.3% | 1.6% | 3.6% | 6.6% | 10.6% |

An entity may select its accounting policy for trade receivables, lease receivables and contract assets independently of each other.

Table 1

The Decision Tree

Challenges in credit risk profiling

Credit risk is the risk of default on a financial asset that may arise from a counter-party failing to make required payments. Higher levels of credit risk are normally associated with poor credit ratings, access to lower credit limits and shorter credit periods.

For non-financial sectors the biggest challenge will be now profiling and identifying the customer base into different clusters with similar characteristics, individual risk profile visa vi the industry, when to apply the rebuttable presumption in line with different credit periods etc. Most financial institutions already have systems in place to identify default when in takes place and to categories the same according to similar characteristics.

- **Segmentation of financial asset portfolios**

The biggest challenge when it comes to segmentation of portfolios is how entities segment financial asset portfolios to ensure that risk profiling is unbiased, the integrity of data being used and availability of the same-Entities will be expected to group financial assets based on shared credit characteristics that are expected to react in a similar way to the current environment, forward-looking information and macroeconomic factors (e.g. by instrument type, credit risk ratings, collateral type, industry, geographical location, date of initial recognition, remaining term to maturity, value of collateral). Groupings are to be re-evaluated and re-segmented whenever relevant new information (e.g. change in economic conditions) or expectation of credit risk has changed

- **Determining significant increase in credit risk**
  The IFRS 9 has made various references of significant change when it comes to expected credit losses. The standard has not described what is significant change or given guidelines, it has left the preparer to interpret what is deemed as significant change. This will pose a significant challenge for most entities on how to determine and measure what is deemed to significant or insignificant increase in credit risk.

- **Determining what is the reasonable and supportable future information**
- IFRS 9 requires that all reasonable and supportable information including forward looking to use to determine there has been a significant increase in credit risk since initial recognition. This will be an area that will require significant judgment as different entities will interpret future information differently. Other significant judgment will include probability of the event occurring and impact on the credit risk. Another key challenge is to ensure that there is adequate and sufficient information. This will require additional resources to be employed to assist in information gathering.

- **Definition of default**
- IFRS 9 does not define what is default but invokes a rebuttable presumption of default. It assumes that credit risk has significantly increased in the event of contractual payments being 30 days or more past due. To rebut this presumption an entity needs reasonable and supportable information that demonstrates that the credit risk not significantly increased even though its past due 30 days and offer an alternative criterion and definition default. This will be a significant area of judgment ranging from entity. This will also create difficulty when it comes to setting credit period.

- **Bank overdrafts**
  A key specific risk for financial institution is to determine when an overdrafts facility is considered past due. This is because it does not have specific repayment date or repayment.

- **Complexity in determining the credit ratings**
  Entities are expected to have challenges in coming up with credit ratings. Entities are expected to have in place comprehensive procedures and information systems to monitor the risk profiles of various instruments. These include an effective credit risk rating process that captures the varying level, nature and drivers of credit risk.

- Determining ECL on a sovereign debt
  It has been widely accepted that the general principle is that lending money to a national government in the country's own currency can be deemed to be **risk-free investment** because with limits, the debt can be repaid by the borrowing government by raising their taxes, reducing spending, or simply printing more money. However, in the recent past as a result of global financial crisis it has been determined that not all sovereign debt is risk free. A key challenge would determine the ECL on sovereign debt.

- Significant judgement in the use of undue cost and effort exemption as this is not defined.

Propose guidance and implementation notes

Due to challenges in obtaining reasonable and supportable forward information we propose that: -

o **Financial sector**- To include qualitative information when it comes to profiling the loans and advance as opposed to limiting this to historical information and no of days outstanding. Financial institutions will have to come up with systems and models to ensure that qualitative information up and until the date of reporting including forward looking information is considered e.g. the profiling of agriculture based advance portfolio should change in accordance to expectations of harsh weather conditions

   o **Non-financial sector**-Each entity to come up with specific profiling of business according to unique nature of the various customer. Considerable efforts will have to be put in come with system of linking the credit control and financial reporting.

   o Determine policies and guidance as when and when to apply the rebuttable presumptions taking into specific account of the industry

   o Determine policies and entity specific guidance in defining what is significant

   o Determine what is low risk in terms of using the low risk of default simplified approach

   o Based on nature of financial assets to which impairment will apply, determine key factors appropriately balanced between the past, present and future, entity specific and external etc. to determine the levels of credit risk

What is considered non-compliant

- Failure to recognise all reasonable and supportable information including that which s forward looking e.g. impact of plastic ban on some customers, drought for agriculture based customers etc.
- Failure to determine at the end of each period whether or not there is significant increase in credit risk
- Failure to recognise that there is rebuttable presumption that the credit risk on financial assets has increased significantly since initial recognition when contractual payments are more than 30 days past due.

Credit Cards

Credit card is a card issued by financial institutions giving the holder an option to borrow funds especially at the point of sale. The card charges interest and is largely used for short term financing. The interest is charged a month after one has made a purchase and the borrowing limits set according to the individual's credit rating. The credit card exposes the institution to credit risk and it is prone to default in one way or the other like the loans advanced by the same institutions.

The standard

IFRS 9, financial institutions will be required to measure expected credit losses over the period for which they are exposed to credit risk for credit card customers. This is because financial institutions continue to extend credit for longer periods and may only withdraw the facility after the credit risk of the customer increases.

Challenges

The main challenge is how to incorporate credit risk management actions into determining the period of exposure when measuring expected credit loss for credit cards.

Emerging issues

The emerging issues touches on measuring the expected credit losses, where IFRS 9 requires that the maximum period to take into consideration be the contractual period over which an entity is exposed to credit risk. This means a longer period cannot be used even if this is consistent with the business practice. Again this has exception in that it applies to financial instruments that include loans and off balance sheet component, in cases where the contractual ability to demand repayment and cancel off balance sheet component doesn't limit its exposure to the contractual notice period.

Suggestion/proposal of what need to be done

For purposes of IFRS 9 on credit card, entities should consider the period over which it was exposed to similar financial instruments;

Time taken for related default to occur on similar financial instrument following a significant increase in credit risk;

Credit risk management actions expected to be taken once the credit risk on the financial instrument increases.

Disclosure issues

Given the impact of IFRS 9, it is important for entities to disclose the expected credit loss to enable users of the financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows. This should be through providing information about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses, including the methods, assumptions and information used to measure expected credit losses quantitative and qualitative information.

Financial institutions will need to consider disclosures, including sensitivity analysis, when building IFRS 9 models and systems to ensure they have the necessary information, since it might be difficult to go back and generate it later.

IFRS 9, illustration on how to determine Expected Credit Losses on credit card facility

Financial institution X provides credit cards to customers which has a day notice period after which institution has the contractual right to stop the credit card usage. Nevertheless, financial institution X does not apply its right to cancel the credit cards and only cancels when it becomes aware of an increase in credit risk and begins monitoring customers on an individual basis. Financial institution X therefore does not consider the contractual right to cancel the credit cards to limit its exposure to credit losses to the contractual notice period. For credit risk management purposes, financial institution X considers that there is only one set of contractual cash flows from customers to assess and does not distinguish between the drawn and undrawn balances at the reporting date. The portfolio is therefore managed and expected credit losses are measured on a facility level.

At the reporting date, the outstanding balance on the credit card portfolio is Ksh.60, 000 and the available undrawn facility is Ksh.40, 000. Financial institution X determines the expected life of the portfolio by estimating the period over which it expects to be exposed to credit risk on the facilities at the reporting date, taking into account:
    . The period over which it was exposed to credit risk on a similar portfolio of credit cards;
    . The length of time for related defaults to occur on similar financial instruments; and
    . Past events that led to credit risk management actions because of an increase in credit risk on similar financial instruments, such as the reduction or removal of undrawn limits.

Financial institution X determines that the expected life of the credit card portfolio is 30 months. At the reporting date, financial institution X assesses the change in the credit risk on the portfolio, since initial recognition and determines that the credit risk on a portion of the credit card facilities representing 25% of the portfolio has increased significantly since initial recognition. The outstanding balance on these credit facilities for which lifetime expected credit losses should be recognized is Ksh.20, 000 and the available undrawn facility is Ksh.10, 000.

When measuring the expected credit, financial institution X considers its expectations about future draw-downs over the expected life of the portfolio (30 months) and estimates what it expects the outstanding balance (exposure at default) on the portfolio would be if customers were to default.

By using its credit risk models, financial institution X determines that the exposure at default on the credit card facilities for which lifetime expected credit losses should be recognized is Ksh.25, 000 (which results from the drawn balance of Ksh.20, 000+drawdowns of Ksh.5, 000 from the available undrawn commitment). The exposure at default of the credit card facilities for which 12 month expected credit losses are recognized is Ksh.45, 000 (which results from outstanding balance of Ksh.40, 000+drawdown of Ksh.5, 000 from the undrawn commitment over the next 12 months).

The exposure at default and expected life determined by financial institution X are used to measure the lifetime expected credit losses and 12-month expected credit losses on its credit card portfolio. Financial institution X measures expected credit losses on a facility level and therefore cannot separately identify the expected credit losses on the undrawn commitment component from those on the loan component. It recognizes expected credit losses for the undrawn commitment together with the loss allowance for the loan component in the statement of financial position. To the extent that the combined expected credit losses exceed the gross carrying amount of the financial asset, the expected credit losses should be presented as a provision.

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