Overview

Why the introduction of IFRS 9 ?

Response to G20 and Financial Stability Board (FSB)

Respond to the April 2009 call of the G20 and the recommendation of the FSB for risk based provisioning and consistent financial reporting globally.

2008 Financial crisis

Excessive risk-taking by banks and late recording of impairments on instruments which had significant credit risk.

Risk based impairment model

IASB decided towards a risk model better aligned with banks credit management systems

Change from rule based to principles based

Replace IAS 39, a very rule based standard that was difficult to understand, apply and interpret

Address cyclical concerns

Address cyclical concerns through taking into changes in the economic variables

Ensure transparency

Robust disclosures on key judgements and assumptions on how the provisions are derived.

Overview

Major amendments by IFRS 9

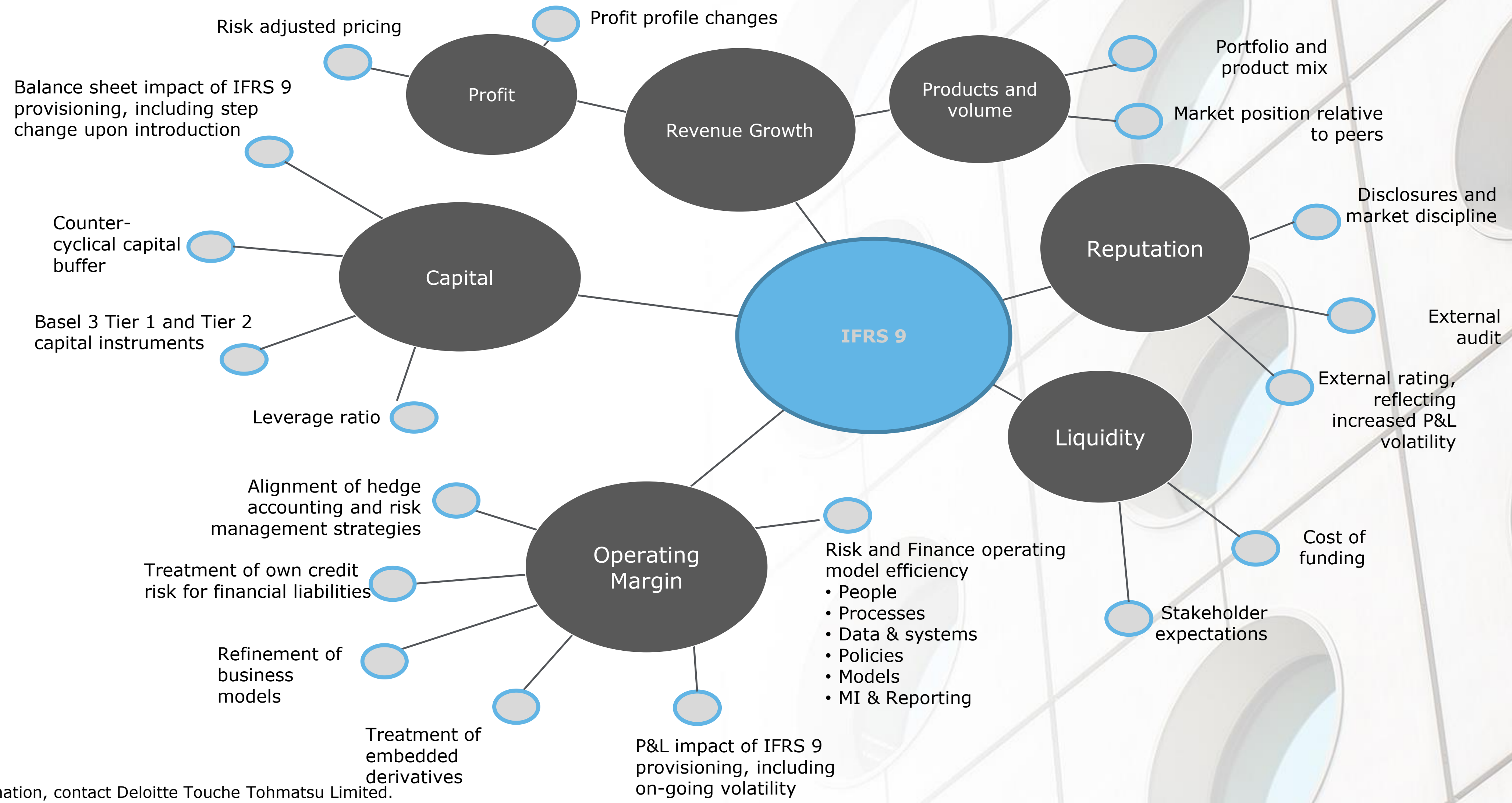
	Amendments compared to IAS 39?
Scope	None
Recognition & derecognition	None
Classification and measurement of financial assets	New model regarding the classification and measurement based on : • the entity’s business model (portfolio perspective) and • the contractual cash flow characteristics (CCC criterion)
Classification and measurement of financial liabilities	• No amendments regarding classification • New OCI presentation for an entity’s own debt where the FVO has been applied (own credit issue)
Embedded derivatives	No bifurcation for financial assets (CCC test applied to hybrid instrument) Same rules as IAS 39 for financial liabilities and embedded derivatives in a non-financial instrument host contract
Amortised cost measurement	None
Impairment	Change to expected loss model
Hedge Accounting (HA)	• New model more closely aligns HA with risk management activities • Accounting policy choice to apply IFRS 9 or IAS 39 • Separate active project on accounting for macro hedging activities

Who does it affect?

Examples of organizations affected and how?

Business-wide ramifications

IFRS 9 creates business-wide challenges for organisations. IFRS 9 has a direct, quantifiable impact on impairments and provisions feeding into the P&L but it also has an indirect but material impact on a wide range of factors contributing to shareholder value. These ramifications will need to be incorporated into the overall project plan and are detailed below:



Classification and Measurement

Overview – What is a financial instrument?

A contract that establishes a financial asset for one party and a financial liability or equity instrument for the other party

Financial asset

- Investments in equity instruments
- Investments in debt instruments e.g. Government securities
- Trade receivables
- Cash and cash equivalents
- Derivative assets
- Interests in subsidiaries, associates and join ventures accounted for under IFRS 9, and
- Deferred or contingent consideration receivable in a business combination (seller)

Financial instrument

Financial liability
A liability that is an obligation to:

- Deliver cash or another financial asset
- Right to exchange financial instruments with another party under unfavourable conditions
- Settle by delivering a variable number of the entity's own instruments

Or

Equity instrument
A contract that represents a residual interest in an entity's assets

All organizations have financial instruments of some form.

Classification - What are the differences?

IAS 39 Classification

- Rule-Based
- Complex and difficult to apply
- Own credit gains and losses recognized in P&L for fair value option (FVO) liabilities
- Complicated reclassification rules

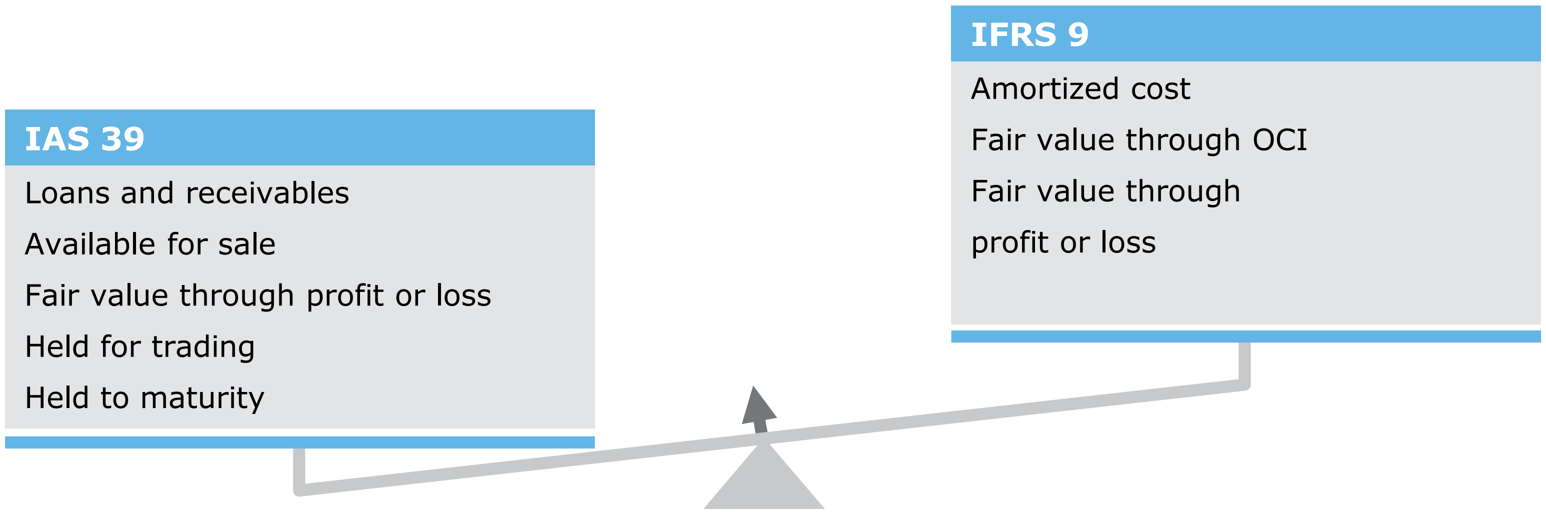
IFRS 9 Classification

- Principle-based
- Classification based on business model and nature of cash flows
- Own credit gains and losses recognized in OCI for FVO liabilities
- Business model-driven classification

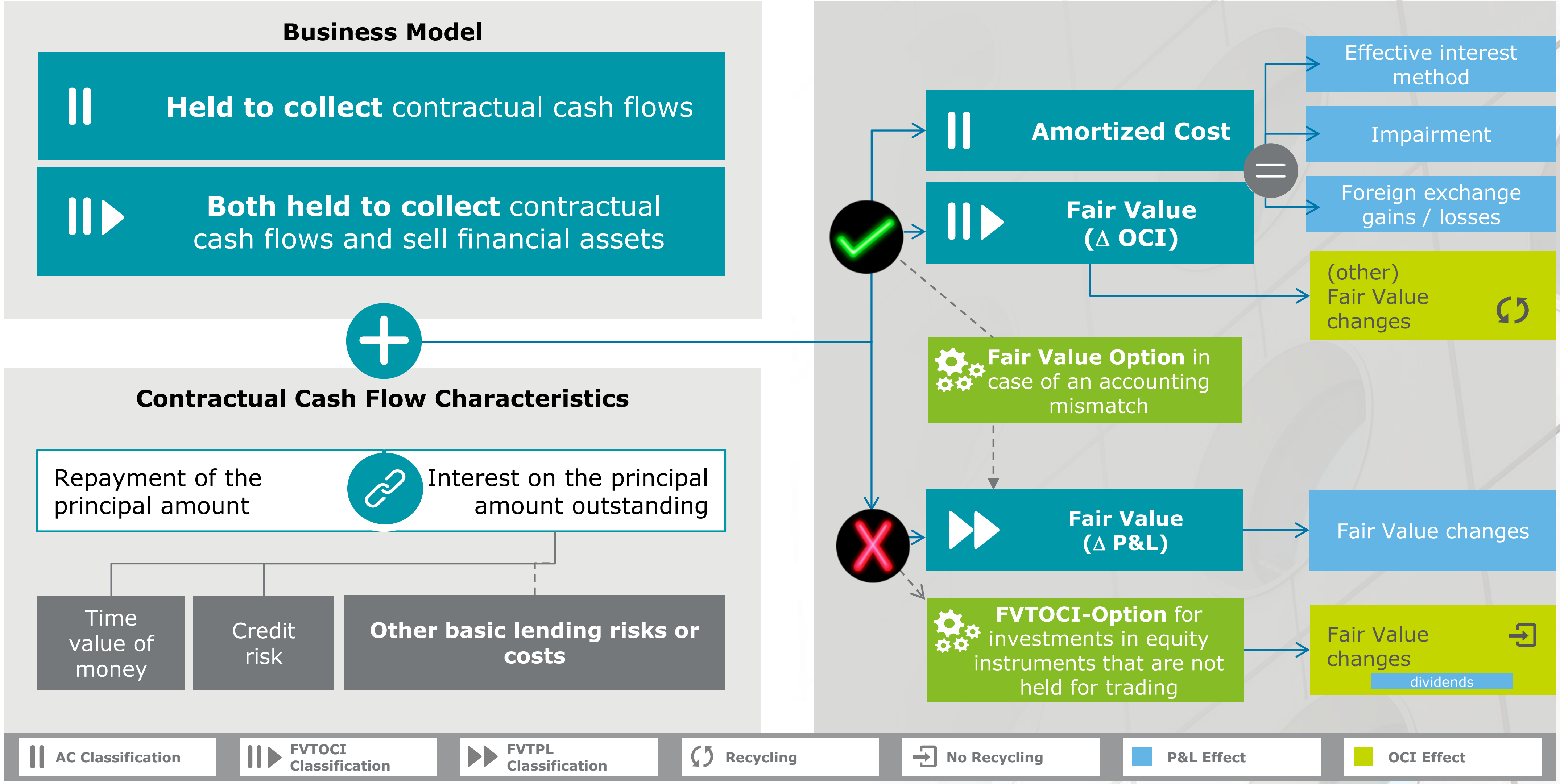
Classification of financial instruments

Financial assets – Summary of changes

- IFRS 9 uses a principles based approach to classify financial assets.
- IFRS 9 has three measurement categories instead of five.
- All financial assets must be classified into one of three categories based on a two step test.
  - New optional irrevocable designations available.
- No significant changes to the classification of financial liabilities.
  - New requirement for presentation of gains and losses associated with ‘own credit risk’ related to financial liabilities designated as FVTPL.



Classification & Measurement of Financial Assets



Classification & Measurement – Financial assets decision tree

Is the objective of the entity's business model to hold the financial assets to collect contractual cash flows?

No

Is the financial asset held to achieve an objective by both collecting contractual cash flows and selling financial assets?

No

Yes

Yes

Do contractual cash flows represent solely payments of principal and interest?

No

Yes

Yes

Does the company apply the fair value option to eliminate an accounting mismatch?

Yes

No

No

Amortised cost

Fair Value (∆ OCI)

Fair Value (∆ P&L)

Business Model

Business model is determined by the entity's *key management personnel* (as defined in IAS 24)

Management of groups of financial assets to achieve a particular business model

Business model assessment according to IFRS 9

Evaluation of performance of the business model and internal reporting

Risk that affect the performance of the business model and management of those risks

How managers are compensated (e.g. based on fair value)

Business Model "Held to collect"

Objective of the business model is
to hold assets in order to collect contractual cash flows

Sales are not an integral part of the AC business model but may be consistent with it if:

Insignificant even if frequent	Infrequent even if significant in value	Close to maturity	Due to an increase in credit risk (or other reason consistent with the business model)

Regardless of whether caused internally or externally

Consequences of sales that are inconsistent with an objective to hold financial assets in order to collect contractual cash flows:

No reclassification without a change in business model of the existing financial assets

Not an error according to IAS 8

Business model for new financial instruments may have changed

Business Model "Held to collect and sell"

Objective is achieved by both **collecting contractual cash flows and selling financial assets**

Both collecting contractual cash flows and selling financial assets **are integral** to achieving the objective of the business model

No threshold for frequency, or value of sales that must occur

Typically involves greater frequency and value of sales compared to a "Held to collect" business model

Example liquidity portfolio

Frequent sales to actively manage the return on the portfolio which consists of collecting contractual payments as well as gains and losses from sales

Contractual Cash Flow Characteristics

Fair Value at initial recognition

Principal

Interest on the principal amount outstanding

- **Time value of money**
- **Credit risk**
- **Other basic lending risks or costs**

Consideration for the passage of time

For example
- Liquidity risk
- Administrative costs
- Profit margin
- etc.

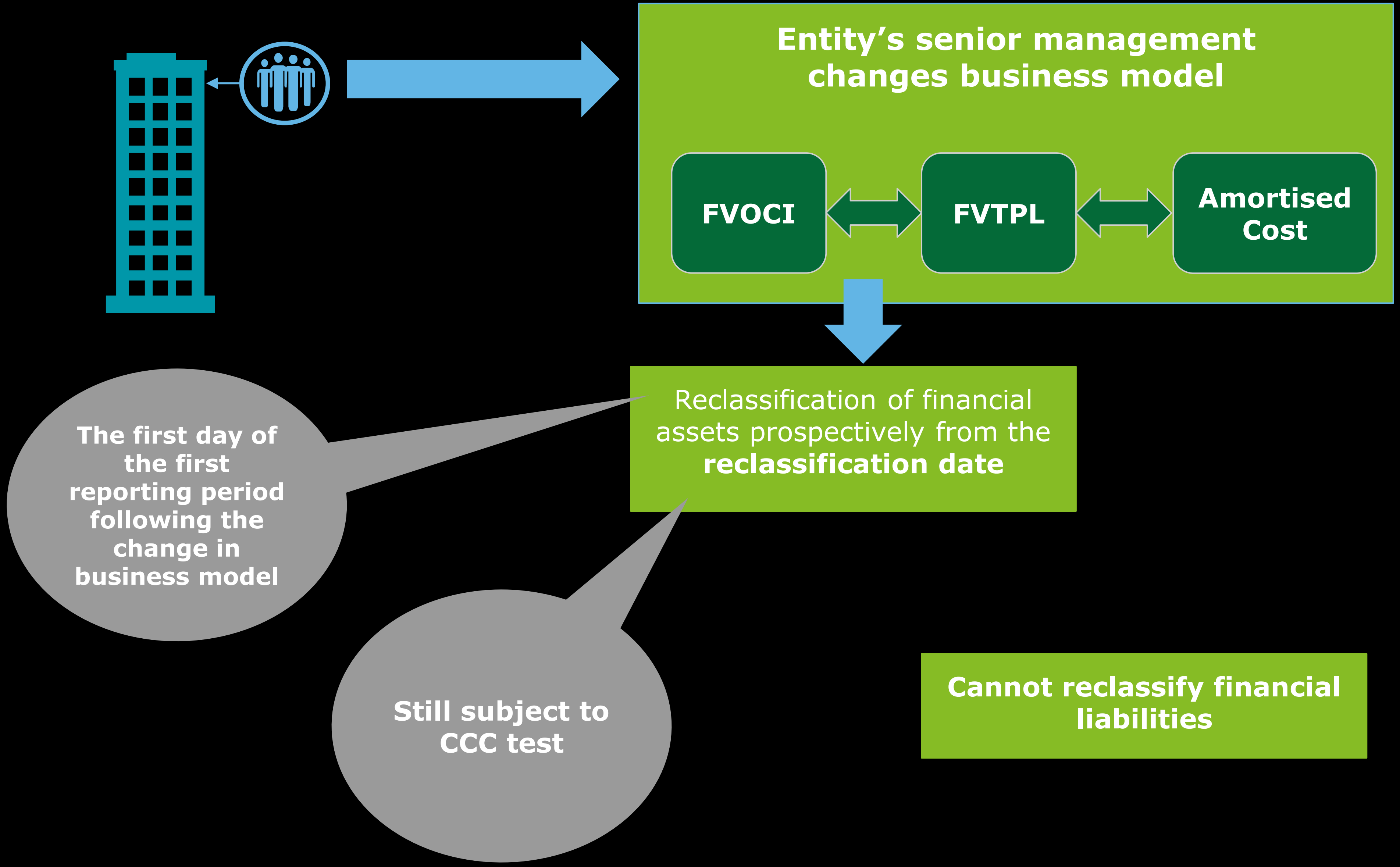
Options for Financial Assets

Before designation	Requirements	After designation
For debt instruments: Amortised Cost Fair Value (Δ OCI)	**Fair-Value-Option** eliminates or significantly reduces an "accounting mismatch"	Fair Value (Δ **P&L**) • Only on initial recognition • Designation is irrecovable
For equity instruments: Fair Value (Δ P&L)	**Fair-Value-Through-OCI- Option**, provided that not held for trading	Fair Value (Δ **OCI**) • Only on initial recognition • Designation is irrecovable • Only P&L effect: dividends if they do not represent a recovery of part of the cost of the investment • No recycling

Measurement of Financial Assets

Initial recognition	Fair Value measurement (IFRS 13)			
	plus transactions costs	plus transactions costs		plus transactions costs
Subsequent measurement	Amortised cost	FVOCI - Debt	Fair value	FVOCI - Equity
Statement of financial position	Amortised cost	Fair value	Fair value	Fair value
P&L	Effective interest method, impairment & foreign exchange differences	Effective interest method, impairment & foreign exchange differences	(all) Fair value changes	Dividends
OCI	---	(other) Fair value changes	---	(all) Fair value changes
Recycling	---	Yes	---	No

Reclassification of Financial Assets



Modification of financial assets

IDENTIFY RENEGOTIATIONS OF FINANCIAL ASSETS

REASSESSMENT OF SIGNIFICANT INCREASE IN CREDIT RISK

TRACKING OF MODIFIED FINANCIAL ASSETS

MODIFICATION GAIN OR LOSS

Step 1: Determine if there is derecognition. If not, continue to step 2

Step 2: Recalculate the gross carrying amount as the PV of expected cash flows excluding expected credit losses (except for purchased/originated credit impaired financial assets). Recognise modification gain or loss in P&L

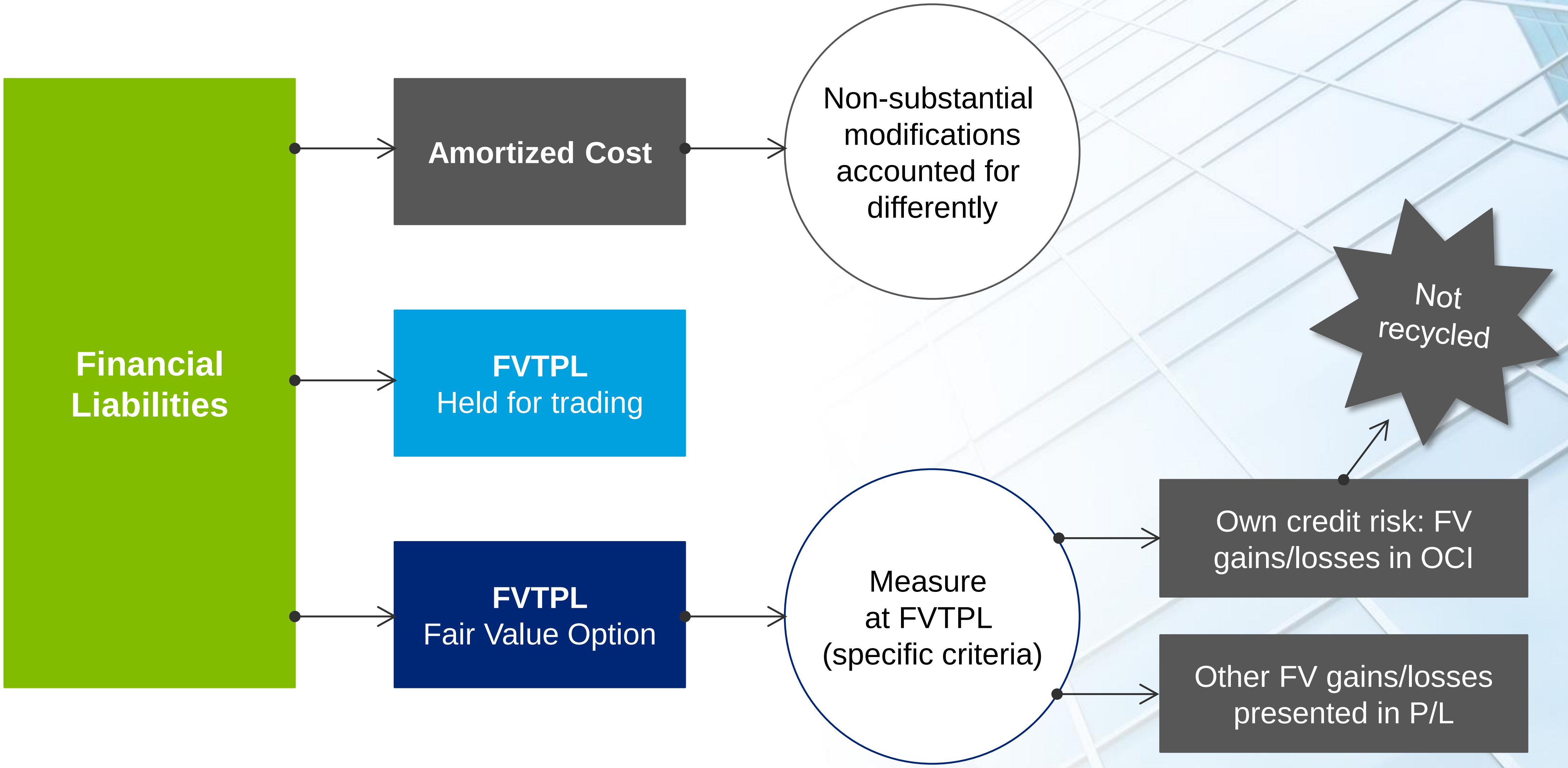
TRANSFER TO STAGE 2 OR 3

The loss allowance should be reassessed comparing the credit risk at the modification date to the original unmodified credit risk at initial recognition

IFRS 7 DISCLOSURES

IFRS 7 has added extensive disclosures for modified financial assets which will require tracking of modified financial assets.

Classification & Measurement - Financial Liabilities



Talking Points

Classification and Measurement of Financial Assets

1

Classification of financial assets

- Business model driven by key management personnel
- Contractual cash flow test may result in more FV'd financial assets

2

Revised presentation of gains and losses for **FVOCI**:

- Impairment in P&L for debt instruments
- Recycling of fair value movements (equity instruments)

3

Reclassifications due to change in business model

- Still subject to contractual cash flow test
- Delay to first day of next reporting period (anti-abuse)

Different reclassification scenarios and their accounting consequences:

Original category	New category	Accounting impact
Amortized cost	FVPL	Fair value is measured at reclassification date. Difference from carrying amount should be recognized in profit or loss.
FVPL	Amortized Cost	Fair value at the reclassification date becomes its new gross carrying amount.
Amortized cost	FVOCI	Fair value is measured at reclassification date. Difference from amortized cost should be recognized in OCI. Effective interest rate is not adjusted as a result of the reclassification.
FVOCI	Amortized cost	Fair value at the reclassification date becomes its new amortized cost carrying amount. Cumulative gain or loss in OCI is adjusted against the fair value of the financial asset at reclassification date.
FVPL	FVOCI	Fair value at reclassification date becomes its new carrying amount.
FVOCI	FVPL	Fair value at reclassification date becomes carrying amount. Cumulative gain or loss on OCI is reclassified to profit or loss at

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

1

Trade Receivables

How will this instrument be classified and measured under IFRS 9?

- Entity A has sold goods and services and recognises trade receivables
- The payment terms are between 10 and 30 days
- Entity A does not sell the receivables, i.e. entity A does not enter into factoring or other financing arrangements

II Amortised cost

The objective of the entity’s business model to hold the financial assets to collect contractual cash flows

2

Corporate Bond, fixed interest (asset)

How will this instrument be classified and measured under IFRS 9?

II Amortised cost

The objective of the entity's business model to hold the financial assets to collect contractual cash flows

The corporate bond

- has a duration of 4 years and
- is repayable at the end of the 4 years period at par
- with no prepayment or extension option
- interest is payable annually in arrears at a fixed rate of 7%
- There are no other features in the contractual terms, which result in any variability in the contractual cash flows
- The entity intends to hold the bond until maturity

3

Certain debt securities

How will this instrument be classified and measured under IFRS 9?

Certain debt securities are held by an entity in separate portfolios to meet everyday liquidity needs. The entity’s management seeks to minimize the costs of managing those liquidity needs and therefore actively manages the return on the portfolio. That return consists of collecting contractual payments as well as gains and losses from the sale of financial assets.

Fair Value
(□ OCI)

The financial asset or group of financial assets is not held within the hold to collect or the hold to collect and sell business model, then it should be measured at FVPL.

4

Government Bond (asset)

How will this instrument be classified and measured under IFRS 9?

Fair Value (Δ P&L)

The financial asset or group of financial assets is not held within the hold to collect or the hold to collect and sell business model, then it should be measured at FVPL.

Entity A has purchased a Government bond that

The entity holds in separate portfolios and manage them with an objective of realizing cash flows through sale. The entity primarily focuses on fair value information and uses that information to assess the securities' performance and to make decisions

Disclosures

The disclosures enable users of financial statements to understand the effect of the credit risk on the amount, timing and uncertainty of future cash flows

RoMM

1

Credit risk management practices and their relation to the recognition and measurement of ECLs

2

Evaluation of the amounts in the financial statements arising from expected credit losses

3

An entity's credit risk profile including significant credit risk concentrations

Comprehensive disclosures

Disclosures

The disclosures enable users of financial statements to understand the effect of the credit risk on the amount, timing and uncertainty of future cash flows

1 Credit risk management practices and their relation to the recognition and measurement of ECLs

Disclosure of accounting policies chosen and judgement applied

- Transfer out of stage 1 & 2
- Definition of default
- Forward-looking information
- Assumptions, inputs, etc.
- Changes in estimation techniques
- Modifications
- Grouping of assets

2 Evaluation of the amounts in the financial statements arising from expected credit losses

- Reconciliation of the loss allowance
- Reconciliation in gross carrying amount
- Write-off
- Modifications
- Collaterals (and other credit enhancements)

3 An entity's credit risk profile including significant credit risk concentrations

Disclosure by credit risk rating grade:

- Gross carrying amount of financial assets
- Exposure to credit risk on LCs and FGCs

Significant concentration of credit risk, e.g. loan-to-value groupings, geographical concentrations, industry concentrations, etc.

! Comprehensive disclosures

Disclosures

Example: Changes in the loss allowance

Mortgage Loan - Loss Allowance	**Stage 1** 12-month ECL	**Stage 2** Lifetime ECL (collectively assessed)	**Stage 2** Lifetime ECL (individually assessed)	**Stage 3** Lifetime ECL
Loss allowance as at 1 January	**X**	**X**	**X**	**X**
Changes due to financial instruments recognized as at 1 January				
Transfer into Stage 1	X	(X)	(X)	--
Transfer into Stage 2	X	X	X	--
Transfer into Stage 3	X	--	(X)	X
Financial assets derecognized during period	X	(X)	(X)	X
New financial assets originated or purchased	X	--	--	--
Write-offs	--	--	(X)	(X)
Changes in model / risk parameters	X	X	X	X
Foreign exchange and other movements	X	X	X	X
Loss allowance as at 31 December	**X**	**X**	**X**	**X**

Disclosures

Example: Changes in the loss allowance

Mortgage Loan - Loss Allowance		**Stage 2** Lifetime ECL (collectively assessed)	**Stage 2** Lifetime ECL (individually assessed)	**Stage 3** Lifetime ECL
Loss allowance as at 1 January	**X**	**X**	**X**	**X**
Changes due to financial instruments recognized as at 1 January				
Transfer into Stage 1		(X)		
Transfer into Stage 2		X		
Transfer into Stage 3	X	--	(X)	X
Financial assets derecognized during period	X	(X)	(X)	X
New financial assets originated or purchased	X			--
Write-offs	--			(X)
Changes in model / risk parameters	X			X
Foreign exchange and other movements	X	X	X	X
Loss allowance as at 31 December	**X**	**X**	**X**	**X**

By class of financial instrument

Increased data requirements at derecognition

Increased data requirements for transfer

Increased data requirements at initial recognition

Disclosures

Example: Significant changes in the gross carrying amount

Mortgage loans- gross carrying amount	**Stage 1** 12-month ECL	**Stage 2** Lifetime ECL (collectively assessed)	**Stage 2** Lifetime ECL (individually assessed)	**Stage 3** Lifetime ECL
Gross carrying amount as at 1 January	**X**	**X**	**X**	**X**
Transfer into Stage 1 – individual financial assets	(X)	--	X	--
Transfer into Stage 3 – individual financial assets	(X)	--	(X)	X
Transfer from Stage 3 – individual financial assets	X	--	X	(X)
Financial assets assessed on collective basis	(X)	(X)	--	--
New financial assets originated or purchased	X	--	--	--
Write-offs	--	--	(X)	(X)
Financial assets that have been derecognized	(X)	(X)	(X)	(X)
Changes due to modifications that did not result in derecognition	(X)	--	(X)	(X)
Other changes	X	X	X	X
Gross carrying amount as at 31 December	**X**	**X**	**X**	**X**

Disclosures

Example: Significant changes in the gross carrying amount

Mortgage loans- gross carrying amount		**tage 2** time ECL (collectively assessed)	**Stage 2** Lifetime ECL (individually assessed)	**Stage 3** Lifetime ECL
Gross carrying amount as at 1 January	**X**	**X**		
Transfer into Stage 1 – individual financial assets				
Transfer into Stage 3 – individual financial assets				
Transfer from Stage 3 – individual financial assets			X	(X)
Financial assets assessed on collective basis			--	--
New financial assets originated or purchased	X	--	--	--
Write-offs	--	--	(X)	(X)
Financial assets that have been derecognized	(X)	(X)	(X)	(X)
Changes due to modifications that did not result in derecognition	(X)			(X)
Other changes	X			X
Gross carrying amount as at 31 December	**X**			**X**

By class of financial instrument

Increased data requirements for transfer

Increased data requirements for loss allowance for collectively assessed financial assets

Increased data requirements for modifications

Recognition and Disclosure Requirements

- CBK is aware that there are diverse supervisory policies in respect of provisioning for impairments and capital in other jurisdictions, which makes it necessary for regulatory authorities to provide guidance. In this regard, CBK requires institutions to take into account the following while implementing IFRS 9: -

- **3.2.1 Recognition of additional provisions under ECL provisioning:** All provisions under the ECL model should be charged to the income statement. However, the provisions relating to performing facilities/loans should be added back over a five-year period for purposes of computing core/total capital. The expected credit losses to be added back shall be those relating to facilities/loans existing and performing as at the end of 2017 and new facilities/loans booked in the year 2018 and performing. All provisions under the ECL model for facilities/loans issued after 2018 shall be provided in full in compliance with IFRS 9 for purposes of computing regulatory capital.
- **3.2.2 Disclosure:** During the transition period, institutions should disclose, in their published results, their core and total capital ratios including adjusted ratios after the additional expected credit loss provisions have been added back. This is aimed at facilitating assessment of the impact of the additional ECL provisions on the institution's capital position.
- **3.2.3 Statutory Loan Loss Reserve:** Where the CBK provisions are higher than IFRS 9, the excess provisions shall be treated as an appropriation of retained earnings and not expenses in determining profit and loss. Therefore, such excess provisions shall be credited to the statutory loan loss reserve as provided in the Central Bank Prudential Guideline, CBK/PG/04 on Risk Classification of Assets and Provisioning.

4.0 Transition Period

- Institutions will have a five-year transition period beginning January 2018, to fully comply with IFRS 9 in the computation of regulatory capital.

Deloitte.

LIGHT
THE WAY