IFRS 9 – Impairment of financial assets

Presentation by:

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IFRS 9

- Impairment of financial assets
- Expected credit loss provisioning

Financial assets

❑ Equity

Under IFRS 9, all equity instruments are measured at FV and are not subject to impairment considerations unlike IAS 39.

❑ Debt instruments

Dent instruments could be measured at:

a) Amortised cost

b) Fair value through profit or loss (no impairment consideration)

c) Fair value through OCI

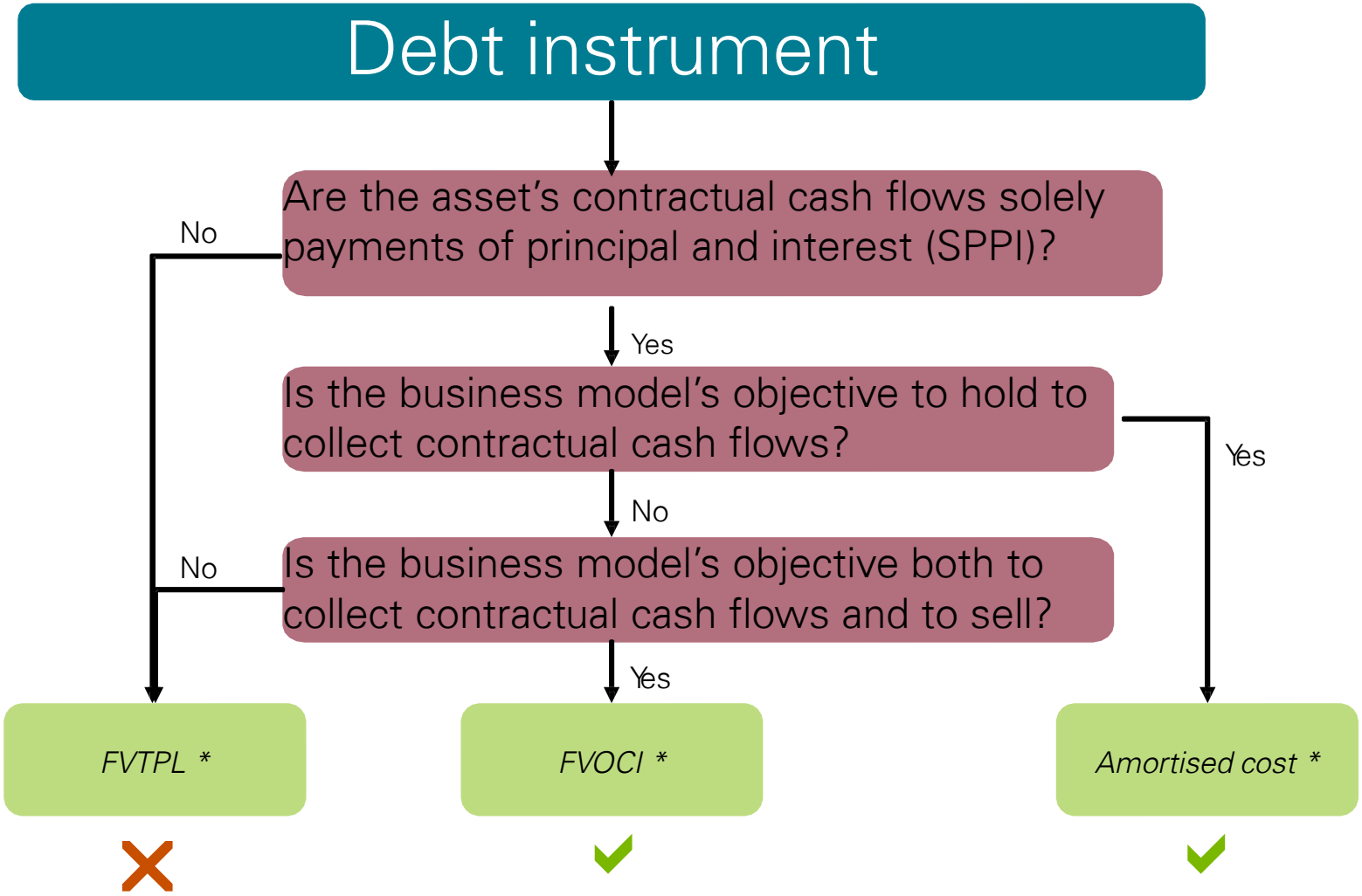
Impairment of financial assets

- A financial asset is assessed at each reporting date to determine whether there is any objective evidence that it is impaired.
- A financial asset is considered to be impaired if objective evidence indicates that one or more events have had a negative effect on the estimated future cash flows of that asset that can be estimated reliably.
- An impairment loss is the difference between the carrying amount, and the present value of the estimated future cash flows discounted at the original effective interest rate.

Impairment of financial assets

- Individually significant financial assets are tested for impairment on an individual basis.
- The remaining financial assets are assessed collectively in groups that share similar credit risk characteristics.
- All impairment losses are recognised in profit or loss and reflected in an allowance account.
- An impairment loss is reversed if the reversal can be related objectively to an event occurring after the impairment loss was recognised.

Impairment


Debt instrument
Are the asset's contractual cash flows solely payments of principal and interest (SPPI)?
No
Yes
Is the business model's objective to hold to collect contractual cash flows?
Yes
No
Is the business model's objective both to collect contractual cash flows and to sell?
No
Yes
FVTPL *
FVOCI *
Amortised cost *

Principal Changes From IAS 39

	IAS 39	IFRS 9
Type of model	Incurred loss	Expected loss
Scope	Expanded	
Equity instruments	Impairment recognised for AFS*	No impairment for equity instruments
Judgement	Expanded	

* AFS – Available for sale

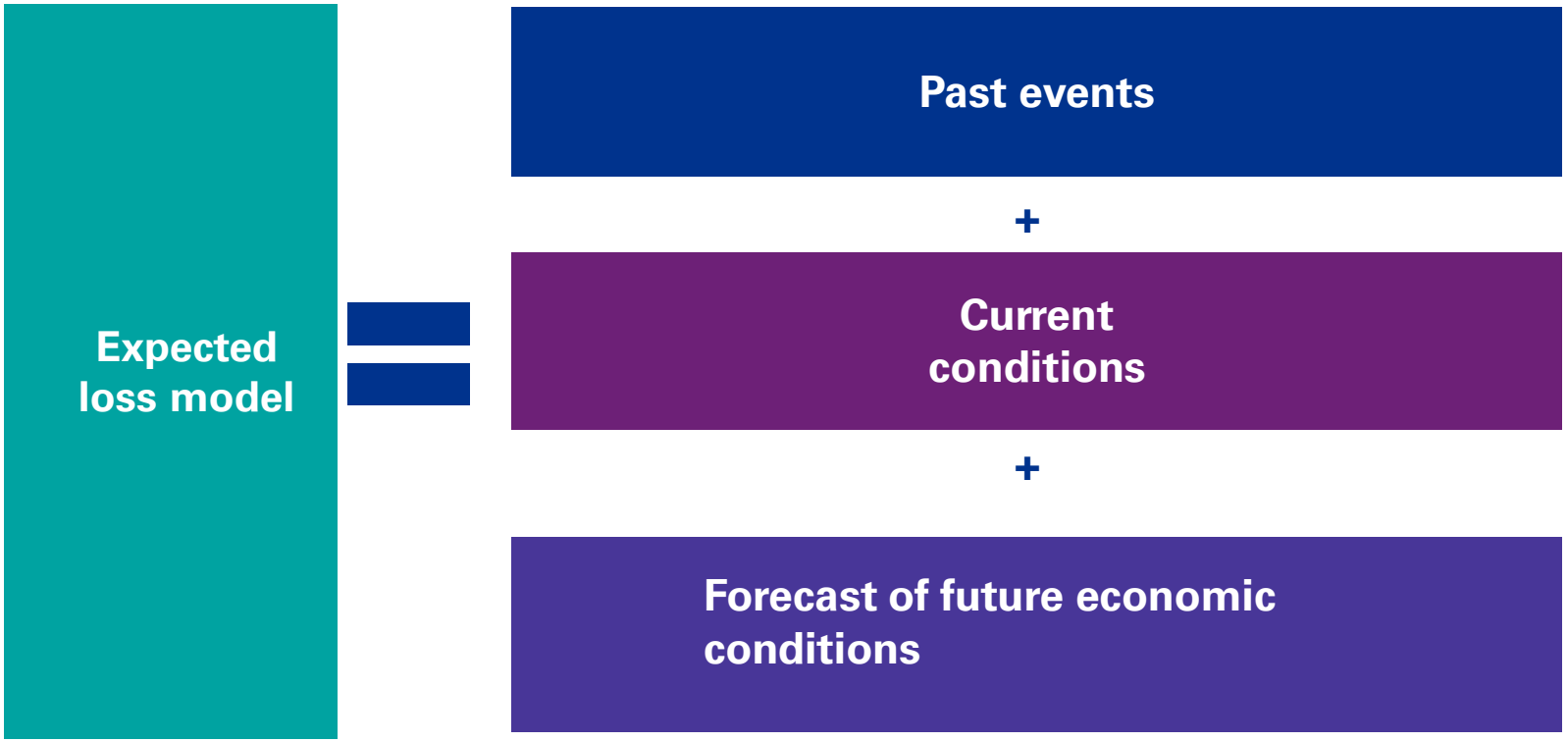
Scope of the impairment requirements

- The following table sets out instruments that are in and out of scope of IFRS 9's impairment requirements:

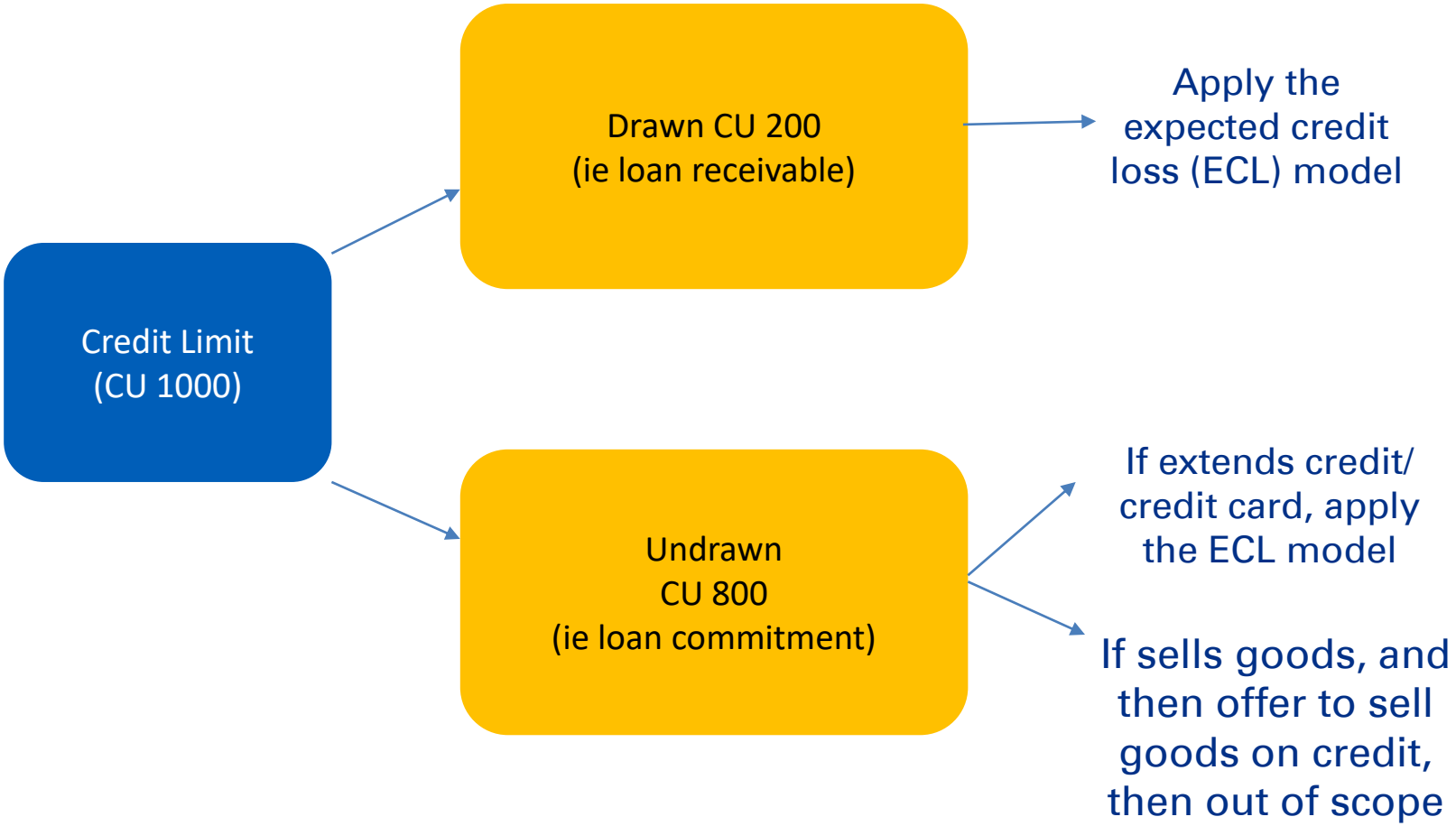
In scope	Out of scope
— Financial assets measured at amortised cost or at FVOCI (this includes loans, trade receivables and debt securities) — Loan commitments not at FVTPL — Financial guarantee not at FVTPL — Lease receivables (IAS 17/ IFRS 16) — Contract assets (IFRS 15)	— Equity investments — Loan commitments at FVTPL — Other financial instruments measured at FVTPL

Expected credit loss model

Impairment – the new model



Off-balance Sheet



Impairment - high level overview

EL = PD x LGD x EAD

EL

- Expected loss is a statistical measure used to reflect expectations of future losses based on historical data
- The three primary components are derived based on observation, empirical evidence and expert judgment
- The objective is to quantify loss expectations over a 12 month forecast

PD

- Probability of default for an asset or class of assets over the next year
- PD represents an average expectation over the course of an entire business cycle (through-the-cycle) as opposed to specific current expectations (point-in-time)

LGD

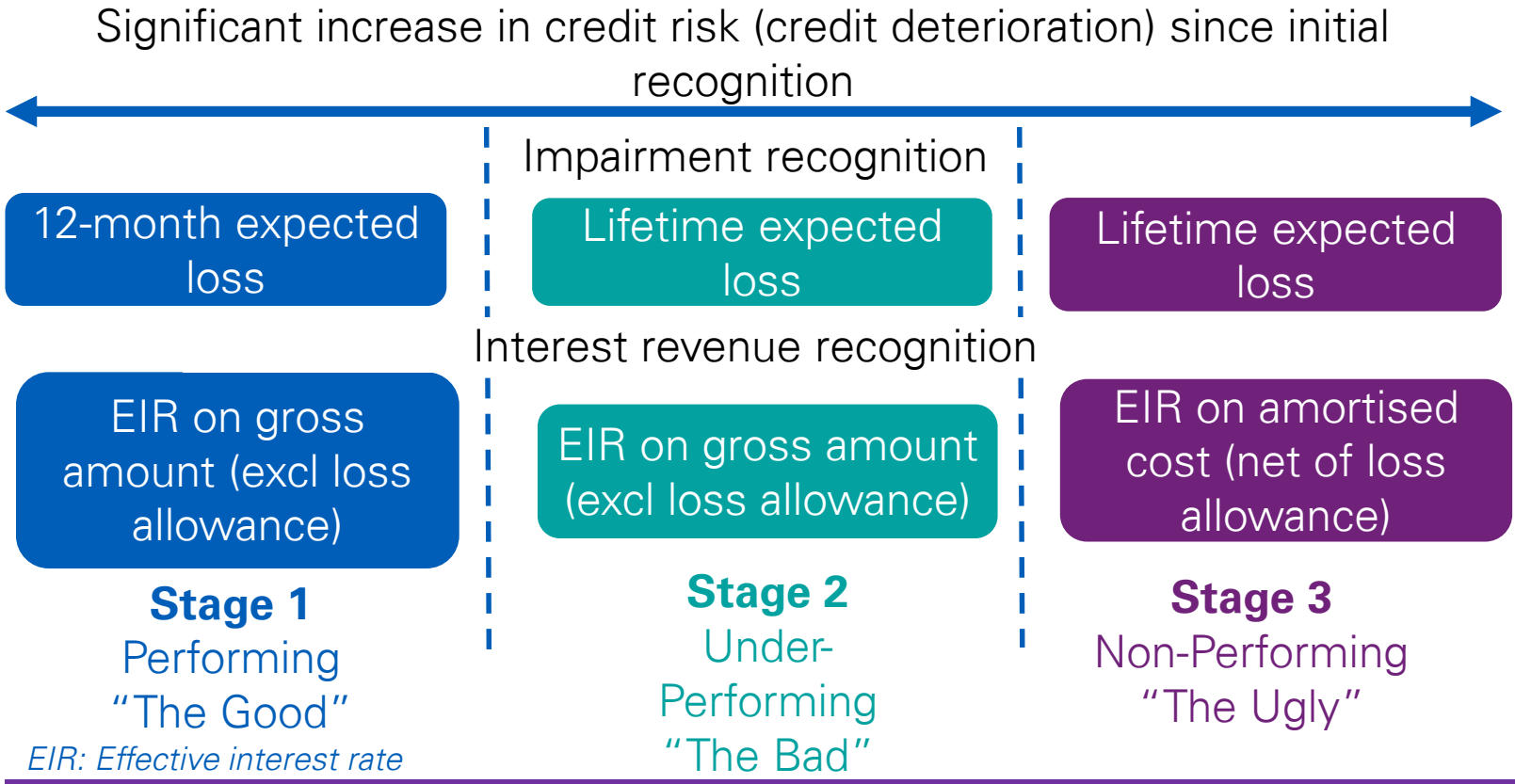
- Loss given default based on losses resulting from defaults over the next 12 months
- Ideally the LGD will be separated for secured and unsecured portions of an exposure
- LGD is a prudent parameter based on an assumed downturn in the economic conditions

EAD

- Exposure at default represents the amount a financial institution stands to lose in the event of a default event
- For a 12 month horizon, the EAD is defined as the current exposure without considering payments
- Undrawn commitments are factored in using statistical probabilities of drawing

- Changes to existing models are necessary to comply with lifetime expected credit loss (LECL) requirements

IFRS 9 ECL – General model



EIR: Effective interest rate

12-month ECLs are the portion of lifetime expected credit losses that represents losses resulting from default events that are possible within 12 months

Lifetime ECLs are the expected credit losses that result from all possible default events over the expected life of a financial instrument

Impairment Model – Simplified approach

Credit quality deterioration since initial recognition

Impairment recognition

12-month ECL	Lifetime ECL	Lifetime ECL
Stage 1 ***Performing*** ***"The Good"***	***Stage 2*** ***Under-Performing*** ***"The Bad"***	***Stage 3*** ***Non-Performing*** ***"The Ugly"***

12-month ECLs are the portion of lifetime expected credit losses that represents losses resulting from default events that are possible within 12 months

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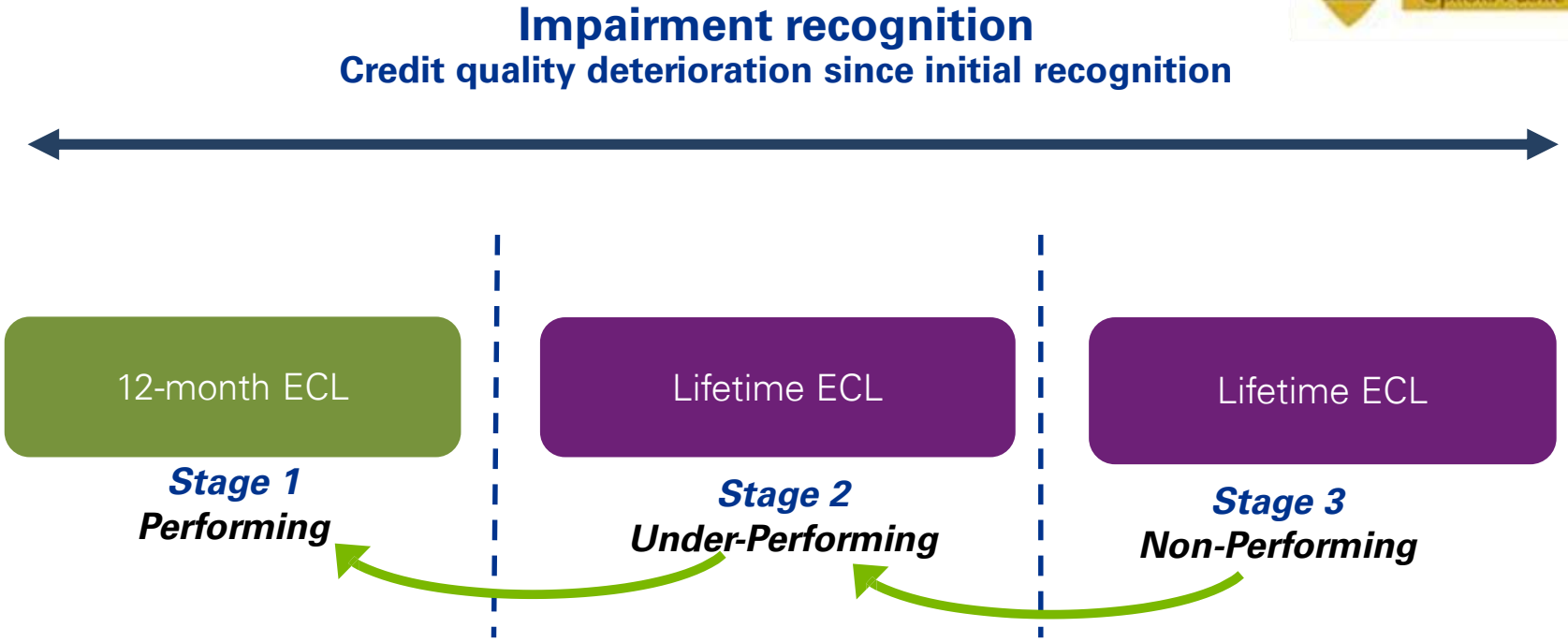
Impairment Model – General model



Transfer of **individual assets** back to stage 1 when criteria above are no longer met (**symmetric model**)

Transfer of **individual assets** back to stage 2 when asset has **recovered from default***

Key technical battlegrounds

- Significant deterioration
- Maturities
- Application to modified assets
- Data quality and limitations – undue cost and effort
- Practical expedient of low-credit risk threshold
- 90 days past due rebuttable presumption of default
- Delinquency plus vs behavioural score approach
- Stress-testing
- Economic forward guidance
- Key modelling parameters

Impairment for corporates (non-financial institutions)

Provision matrix

Provisioning Matrix for Calculating Lifetime ECL's

- Manufacturer M operates only in one geographical location, and has a portfolio of trade receivables of CU30million on 31 December 20X1.
- The customer base consists of a large number of small clients.
- The trade receivables have common risk characteristics.
- The trade receivables do not have a significant financing component.
- M uses a provision matrix to calculate impairment.

Provision matrix estimate:

	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%

The provision matrix is based on:

- historical default rates over the expected life of the trade receivables; and
- adjustment for forward-looking estimates.

Constructing default rates (1/3)

Historical loss-rate

Adjust future expectations

Management judgement overlay

Constructing default rates (2/3)

Take a snapshot at point of time (e.g. 1 January). In the example this is CU 5million. Take a second snapshot after 90 days. Compare how much of the balance moved into more than 90 days past due.

Gross carrying amount	Current	1-30 days past due	31-60 days past due	61-90 days past due	More than 90 days past due
Current (1st snapshot)	CU 15m	CU 7.5m	CU 4m	CU 2.5m	CU 1m
2nd snapshot (How much of the balance moved to more than 90 dpd)	CU 45 000	CU 120 000	CU 144 000	CU 165 000	CU 106 000
Construct default rate: (2nd snapshot / 1st snapshot)	0.3%	1.6%	3.6%	6.6%	10.6%

Constructing default rates (3/3)

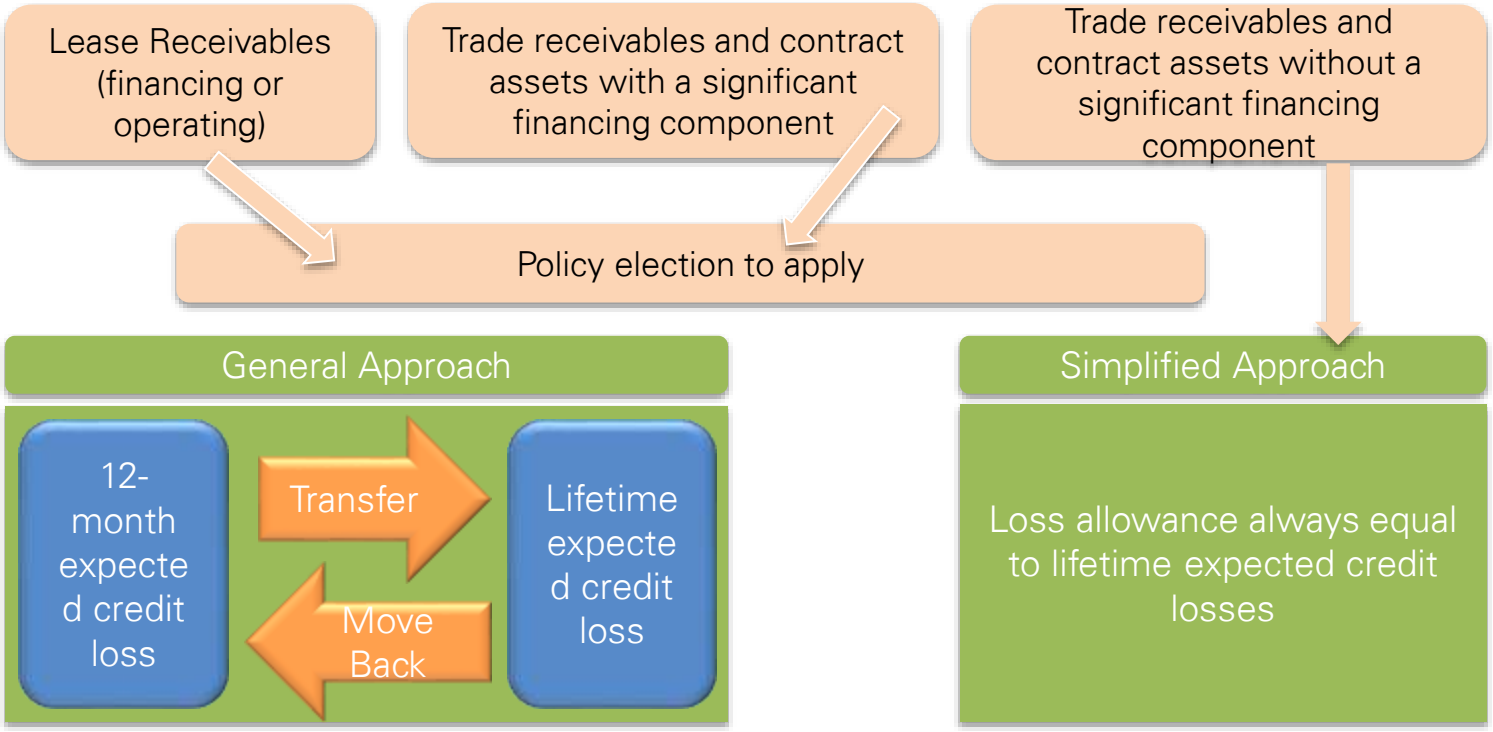
Due to Company M's nature of receivables (a large number of small clients, categorised by common risk characteristics that are representative of the customers' abilities to pay all amounts due and trade receivables do not have a significant financing component), the loss allowance for such trade receivables is always measured at an amount equal to lifetime ECL.

Company M uses a provision matrix to calculate ECL using the following provision matrix:

	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%
Gross carrying amount	CU 15m	CU 7.5m	CU 4m	CU 2.5m	CU 1m
Lifetime ECL	CU45,000	CU120,000	CU144,000	CU165,000	CU106,000

The lifetime ECL for the large number of small customers is accordingly the total of **CU580,000**

Impairment – General approach versus Simplified approach

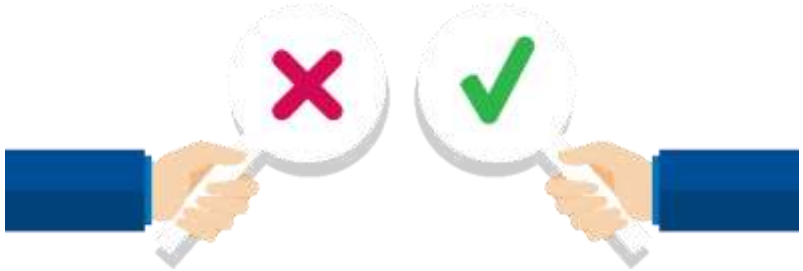


Provision matrix

Calculating the probability-weighted expected credit loss

This involves defining your probability parameters of when an expected loss will occur.

Probability = event / number of outcomes



For example, the event could be defined as non-payment of an invoice within the stipulated credit terms and the number of outcomes is therefore 2, being the debtor either paid or did not pay the invoice within the stipulated credit terms.

Provision matrix (cont.)

Example continued: Probability weighted expected credit loss

Company T sells goods on credit with invoices payable within 30 days of invoice date. Based on historic data, all invoices were either paid in full or not paid (i.e. there were no partial payments of invoices). Company T has defined the event in the probability calculation as non-payment of an invoice within 30 day credit term. Historic data showed the following trend in invoice payments:

Number of invoices paid within 30 days	1 400
Number of invoices paid after 30 days or still outstanding at reporting date	50
Total number of invoices	**1 450**

Based on the above table, the probability that a debtor will not pay their invoice within the 30 day credit term is 3.4% (50/1450). This is the base expected credit loss to be applied to all the buckets.

PD considerations

Probability of default considerations

- Segmentation
- Definition of default – consistent, document rebuttal
- External rating agency vs Internal ratings Vs modelled PDs (investment securities)
- Time horizon – amount of data
- Count vs Value
- Average/ Sum Vs most recent Data Vs cure rate
- 12-month PD and Life-time PDs

Forward looking information

Incorporating FLI & macroeconomic factors (1/2)

1 Identify the relevant macro-economic factors and obtain the historical figures

2 Assess how the Organisation's historical default rates have changed relative to the change in each of the relevant macroeconomic factors

Year	Δ PD	Δ GDP	Δ FX rate	Δ Interest rate
0	-	-	-	-
1	0.31%	1.70%	2.04%	2.94%
2	0.18%	1.40%	1.68%	2.42%
3	0.55%	3.70%	4.44%	6.39%
4	0.08%	0.50%	0.60%	0.86%
5	0.47%	1.10%	1.32%	1.90%

3 Estimate an empirical relationship between the portfolio PDs and macroeconomic variables through regression analysis

$$f(\Delta PD) = (\beta_1 * \Delta GDP) + (\beta_2 * \Delta FX_{Rate}) + (\beta_3 * \Delta Interest\_Rate) + \varepsilon_t$$

4 Maintain only variables with significant coefficients, which also have the sign expected under the working hypotheses

LGD considerations

Loss Given Default considerations

- Secured Vs Unsecured loans
- Data - collateral listings and collections/ recoveries data
- Data – system generated or off the system
- Collateral quality – type, recoverability
- Force sale value and Haircuts
- Discounting and years of discount
- LGD floor and proxy LGDs

EAD considerations

Exposure at Default considerations

- Repayment structure and contractual term
- Prepayments
- Assumptions – revolving facilities

Q&A

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