# IFRS 9 – Financial Instruments: IFRS 9 vs Prudential Guidelines Training

3 May 2019

# TRAINING OUTLINE

Key market themes in Kenya post IFRS 9 implementation

IFRS 9 Central Bank of Kenya Guidelines

IFRS 9 vs Prudential guidelines

# Key market themes in Kenya post IFRS 9 implementation

**Increased provisions**

Increase in impairment provisions on the statement of financial position which resulted in the statutory provisions being reduced

**Modified retrospective approach adopted**

Most entities adopting a modified retrospective approach to adopting the standard which requires that the initial impact is accounted for in returned earnings.

**Impact on unsecured lending**

Some financial institutions are shifting away from unsecured lending.

**Capital guidelines not extensively used**

CBK guide on capital over a 5 year period with very few banks taking up the extension.

**Data improvement**

Improving data quality challenges

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**Model goverance**

Entities setting up governance process to improve controls around IFRS 9 model governance

# IFRS 9 Central Bank of Kenya Guidelines

The Central Bank of Kenya 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 proposed the following on the implementation of IFRS 9

## Summary of considerations

### Recognition of additional provisions under ECL provisioning

Any incremental provisions under the ECL model should be charged to the income statement but the same should be added back over a five-year period for purposes of computing core capital to lower the impact of the additional provisions on core capital during the transition period.

### Disclosure

During the transition period, institutions should disclose, in their published results, their core and total capital ratios both *before* and *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 and bottom line.

### Transition period

CBK proposes five-year transition period during which the incremental provisions may be added back to earnings for purposes of computing core capital. The expected credit losses to be added back shall be those relating to loans existing and performing as at the end of 2017 and new loans booked in the year 2018.

**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 expensed in determining profit and loss. Therefore, such excess shall be credited to the statutory loan loss reserve as provided in CBK/PG/04 on Risk Classification of Assets and Provisioning

# IFRS 9 vs Prudential guidelines

| | Classification | Probability of default | Loss given default |
| --- | --- | --- | --- |
| **Prudential guidelines** | Normal 0 – 30 days<br>Watch 30 – 90 days<br>Sub-standard 90 – 180 days<br>Doubtful 180 to 360 days<br>Loss 360 days and over<br><br>Determined used the above DPD and qualitative indicators. | The following minimum percentage amounts for provisioning are to be maintained according to assigned classifications.<br>i. For loans classified "Normal" 1%<br>ii. For loans classified "Watch" 3%<br>iii. For loans classified "Substandard" 20%<br>iv. For loans classified "Doubtful" 100%<br>v. For loans classified "Loss" 100% | • Institutions will be expected to progressively discount the forced sale value of securities over the five-year period at a discount rate of 20% p.a.<br>• However, for the purpose of reporting to Central Bank, institutions will be required to discount their securities at a rate of 5% every quarter. |
| **IFRS 9** | Stage 1 0 – 30 days<br>Stage 2 30- 90 days<br>Stage 3 90 days and over<br><br>Determined used the above backstop indicators and qualitative indicators. | • 12-month or lifetime ECL depending on credit quality of the asset (including fully performing loans). From substandard 100% PD is applied.<br>• Reflects current and future economic cycles to the extent relevant to the remaining life of the loan on a PIT basis. | • Security is discounted using the effective interest rate.<br>• Historical recovery rates and cure rates are considered.<br>• Reflects current and future economic cycles to the extent relevant to the remaining life of the loan. Should reflect current economic conditions (PIT) as well as the expected impact of future macro-economic conditions. |

# IFRS 9 vs Prudential guidelines

| | Exposure at Default | Impairment determination | Interest income on NPLs |
|---|---|---|---|
| **Prudential guidelines** | Based on actual exposure (on-balance-sheet). | Based on incurred loss model and predetermined rates and minimum provisioning rates. | When a loan is classified to non-performing category, an institution should either cease the accrual of interest or continue to accrue interest suspended in accordance with the criteria in guideline and should not be treated as income. Interest in suspense shall be taken into account in the computation of provisions for non-performing loans. |
| **IFRS 9** | Based on EAD, which includes undrawn commitments and contingent facilities such letters of credit and financial guarantees. | Based on expected credit loss taking into account future expected performance of the macro economic environment. | Financial institutions reporting under IFRS should recognize interest income on the amortized cost of credit-impaired loans and advances (stage 3 loans/ NPLs) in line with IFRS 9 requirements |

# IFRS 7 – Financial Instruments: Disclosure requirements
# 3 May 2019

# TRAINING OUTLINE

Overview and Scope of IFRS 7

Classes of Financial Instruments and Level of Disclosure

Significance of Financial Instruments for Financial Position and Performance

Nature and Extent of Risk Arising from Financial Instruments

# IFRS 7 Financial Instruments
## Overview and Scope of IFRS 7

**All financial instruments**

**Except**

Interests in subsidiaries not accounted for using FV election

Interests in associates not accounted for using FV election

Interests in joint arrangements not accounted for using FV election

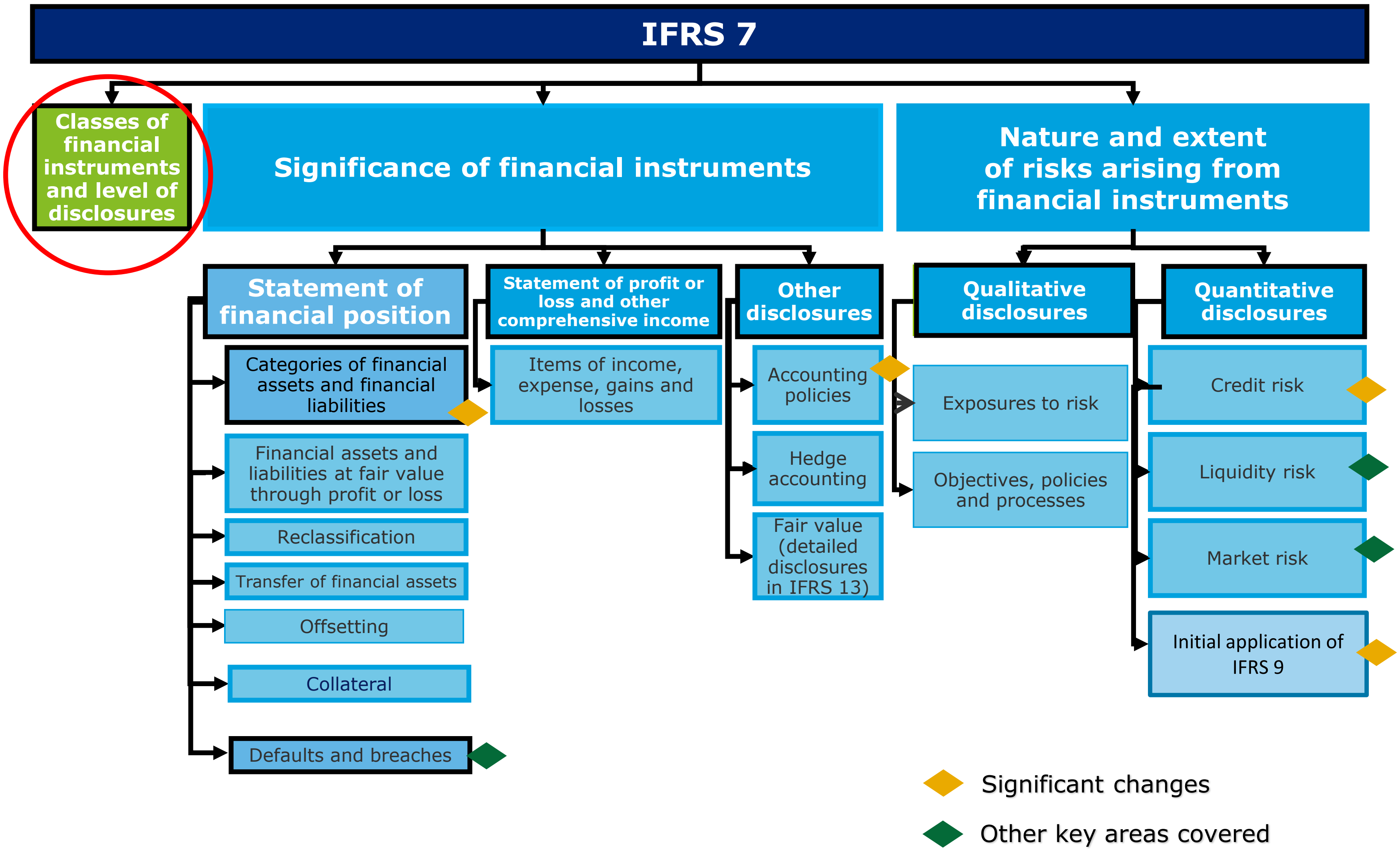
Employee benefit plan's rights and obligations under IAS 19

Insurance contracts under IFRS 4

IFRS 2 arrangements

Instruments classified as equity instruments in the financial statements of the issuer

# IFRS 7 Financial Instruments
## Classes of financial instruments and level of disclosures

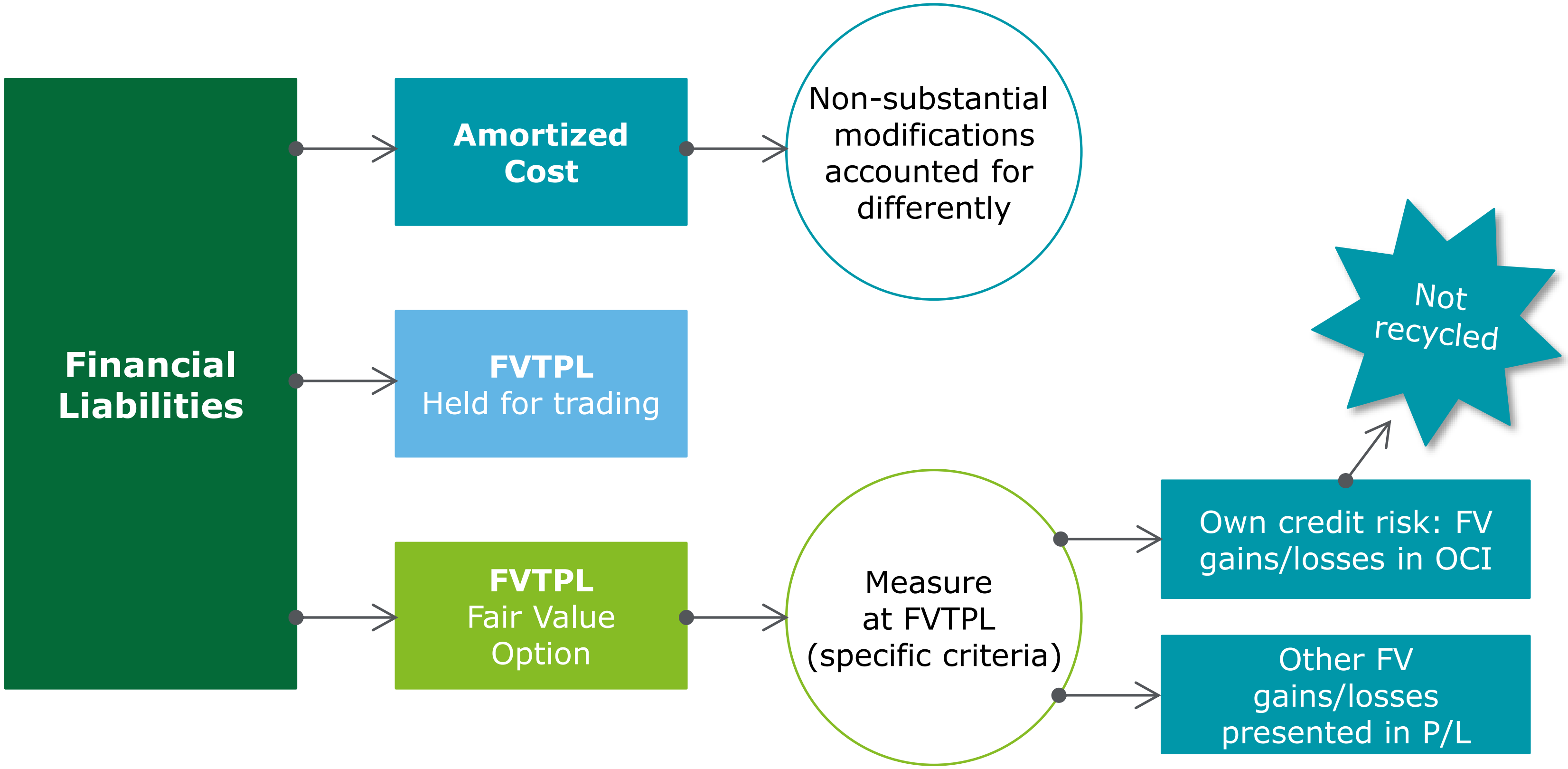


# IFRS 7 Financial Instruments

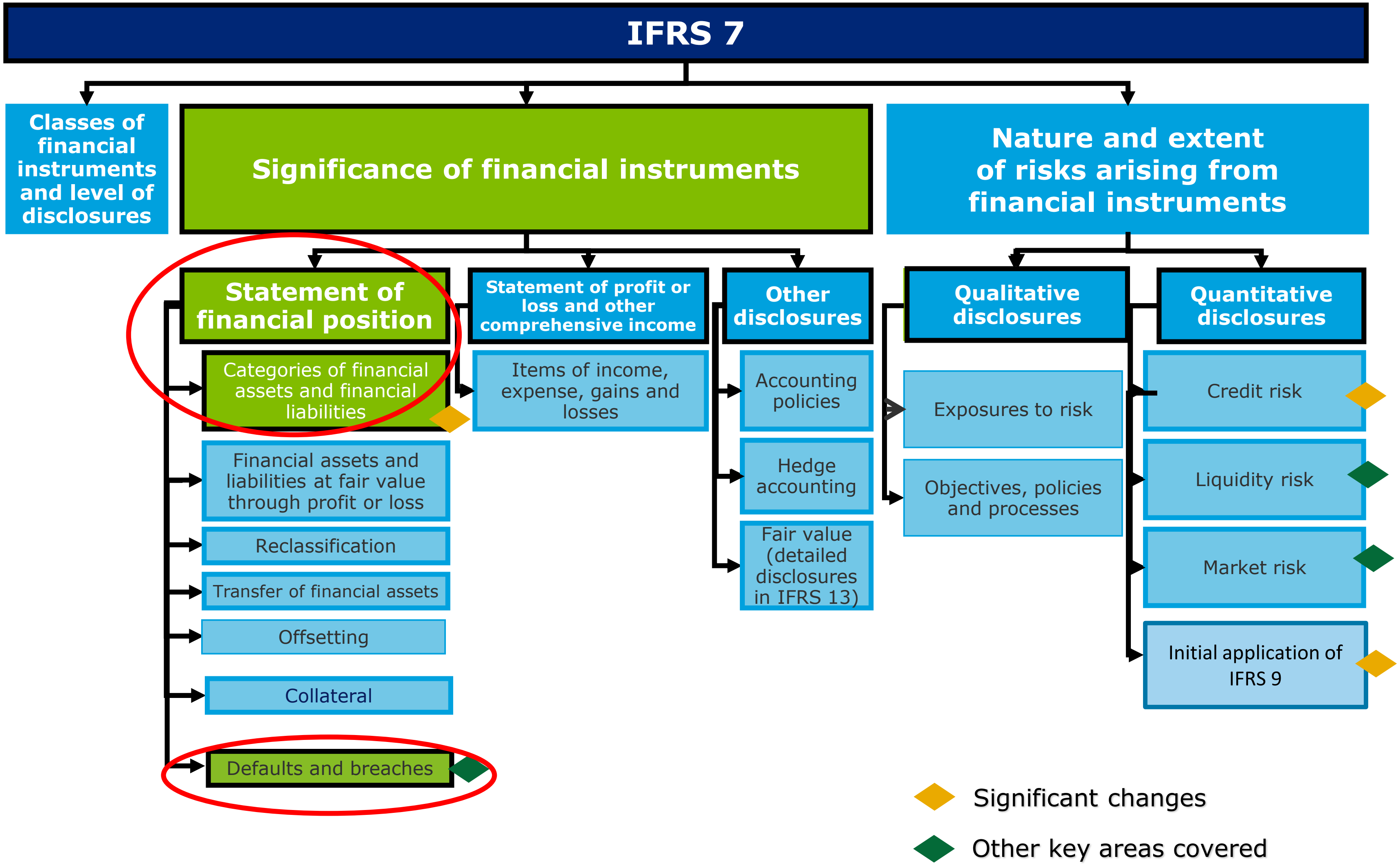
## Classes of Financial Instruments and Level of Disclosure

| | Fair Value measurement (IFRS 13) | | | |
|---|---|---|---|---|
| Initial recognition | 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 |

# IFRS 7 Financial Instruments
## Classes of Financial Instruments and Level of Disclosure



# IFRS 7 Financial Instruments
## Significance of financial instruments



# IFRS 7 Financial Instruments

## Categories of financial assets and financial liabilities – Example disclosures

| 31 December 2018<br>*In millions of Ksh* | Mandatorily at FVTPL | Designated as at FVTPL | FVOCI – debt instruments | FVOCI – equity instruments | Amortised cost | Total carrying amount |
|---|---|---|---|---|---|---|
| Cash and cash equivalents | - | - | - | - | 2,907 | 2,907 |
| Pledged trading assets | 540 | - | - | - | - | 540 |
| Non-pledged trading assets | 16,122 | - | - | - | - | 16,122 |
| Derivative assets held for risk management | 858 | - | - | - | - | 858 |
| Loans and advances to banks | - | - | - | - | 5,555 | 5,555 |
| Loans and advances to customers: | | | | | | |
| Measured at fair value | 3,986 | - | - | - | - | 3,986 |
| Measured at amortised cost | - | - | - | - | 58,950 | 58,950 |
| Investment securities: | | | | | | |
| Measured at fair value | 1,623 | 2,879 | 1,363 | 27 | - | 5,892 |
| Measured at amortised cost | - | - | - | - | 410 | 410 |
| Other assets | - | - | - | - | 56 | 56 |
| Total financial assets | 23,129 | 2,879 | 1,363 | 27 | 67,878 | 95,276 |
| Trading liabilities | 7,026 | - | - | - | - | 7,026 |
| Derivative liabilities held for risk management | 828 | - | - | - | - | 828 |
| Deposits from banks | - | - | - | - | 11,678 | 11,678 |
| Deposits from customers | - | - | - | - | 53,646 | 53,646 |
| Debt securities issued: | | | | | | |
| Measured at fair value | - | 1,250 | - | - | - | 1,250 |
| Measured at amortised cost | - | - | - | - | 9,977 | 9,977 |
| Subordinated liabilities | - | - | - | - | 5,642 | 5,642 |
| Total financial liabilities | 7,854 | 1,250 | - | - | 80,943 | 90,047 |

# IFRS 7 Financial Instruments
## Defaults and breaches

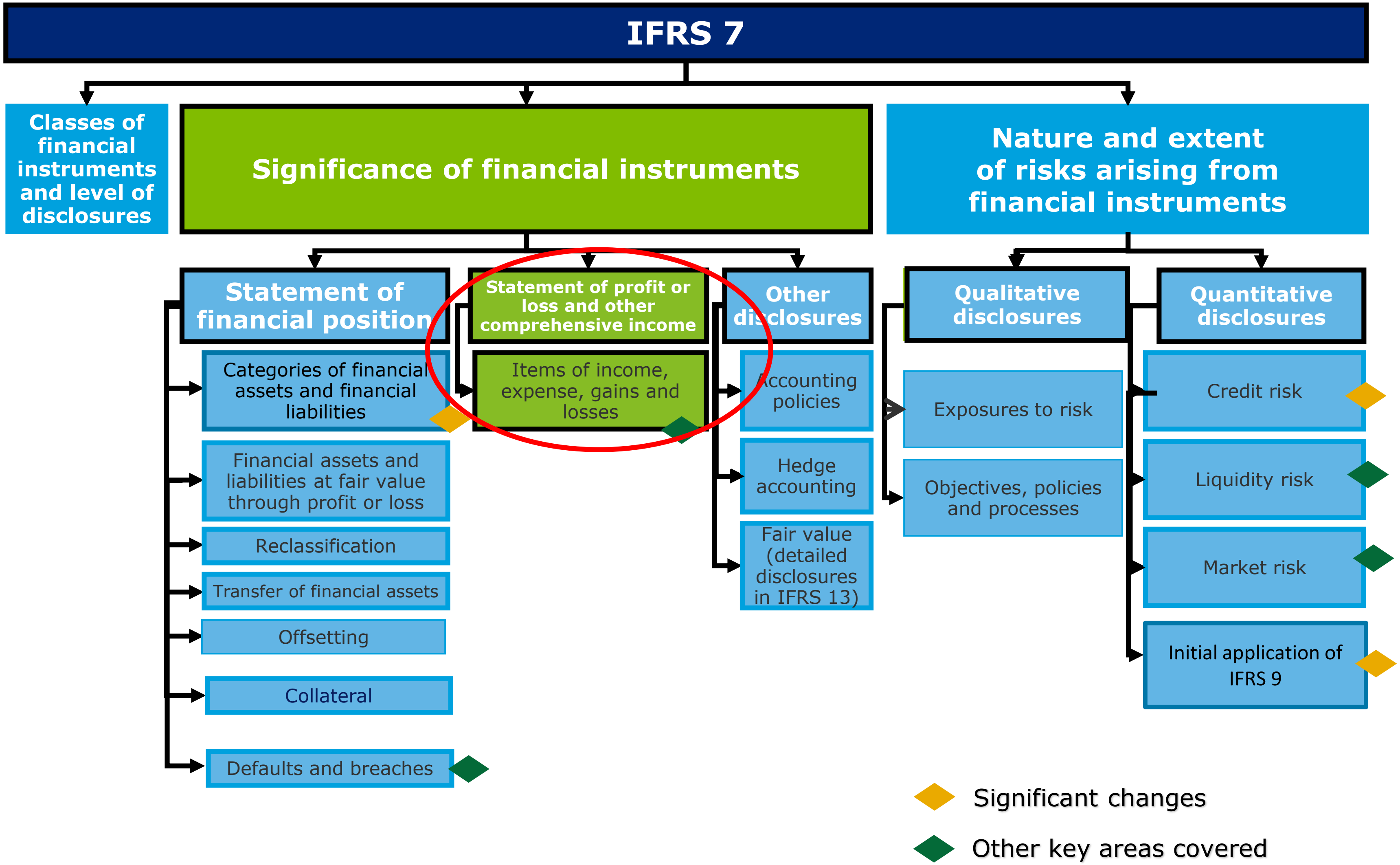
For loans payable:

a. details of any defaults

b. the carrying amount of the loans payable in default at the end of the reporting period; and

c. whether the default was remedied, or the terms of the loans payable were renegotiated, before the financial statements were authorised for issue.

# IFRS 7 Financial Instruments
## Significance of financial instruments



IFRS 7 Financial Instruments
Significance of financial performance

The following items are to be disclosed in the statement of comprehensive income or the notes:

| Items of the statement of comprehensive income | Comments |
|---|---|
| Net gains and net losses | • Required for each category<br>• Split between designated and FVTPL<br>• Equity reconciliation for FVOCL |
| Total interest income and expenses | • Aggregated amount excluding FVTPL instruments<br>• Gross amounts<br>• Calculated using effective interest rate method |
| Fee income and fee expenses | • Separately disclose fees from trust or fiduciary activities |
| Impairment losses | • Required for each class |

# IFRS 7 Financial Instruments

## Items of income, expense, gains and losses – Example disclosures

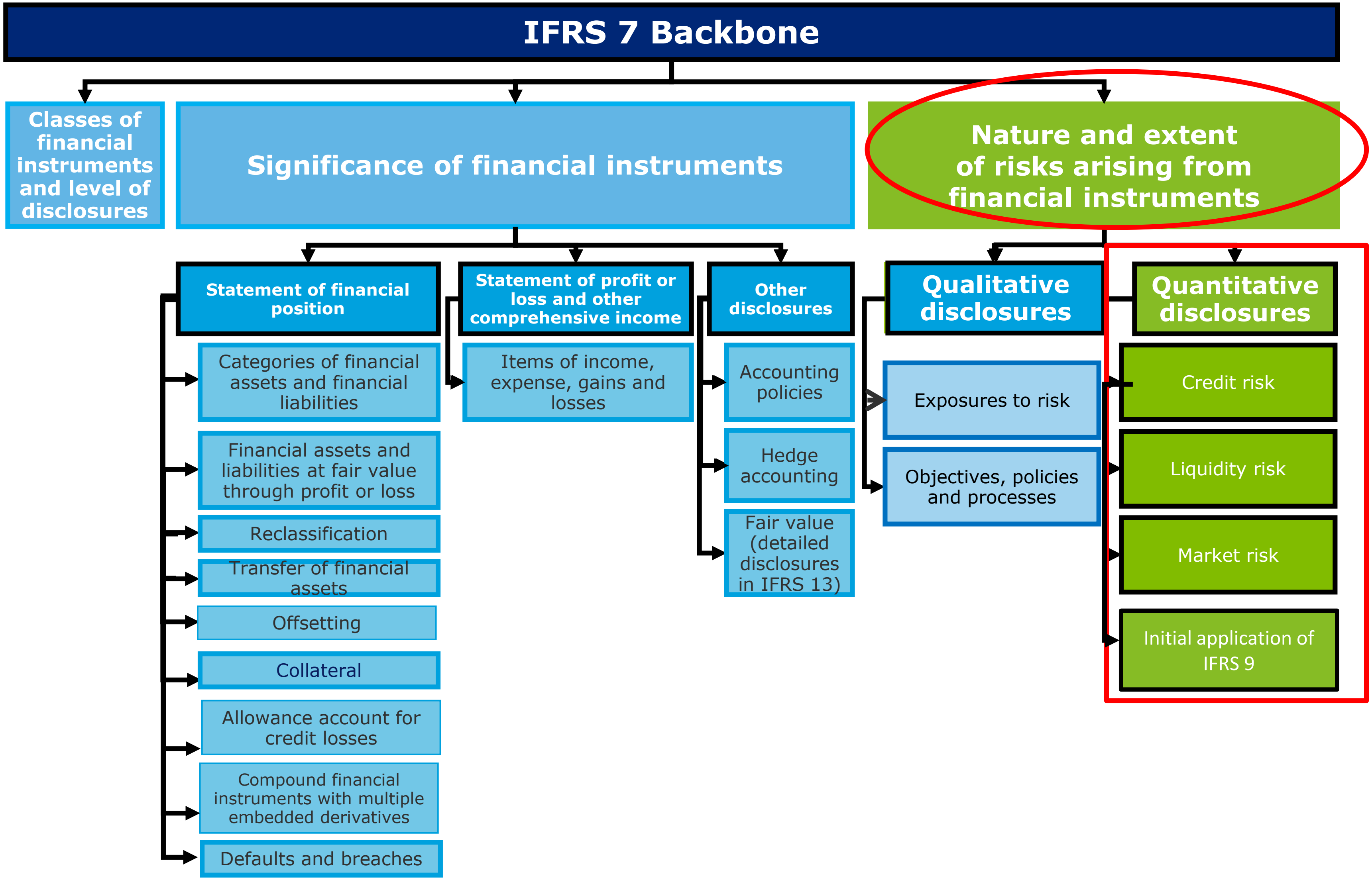
| *In millions of Ksh* | 2018 | 2017 |
|---|---|---|
| **Interest income** | | |
| Cash and cash equivalents | **86** | 86 |
| Loans and advances to banks | **282** | 247 |
| Loans and advances to customers | **2,756** | 3,007 |
| Investment securities at amortised cost | **119** | 75 |
| Investment securities at FVOCI (2017: available-for-sale) | **20** | 30 |
| Derivatives in a qualifying hedging relationship | **56** | 64 |
| Total interest income calculated using the effective interest method | **3,319** | 3,509 |
| Other interest income – interest income on finance leases | **22** | 19 |
| Total interest income | **3,341** | 3,528 |
| **Interest expense** | | |
| Deposits from banks | **54** | 48 |
| Deposits from customers | **469** | 897 |
| Debt securities issued | **343** | 316 |
| Subordinated liabilities | **410** | 353 |
| Other interest expense | **10** | 12 |
| Derivatives in a qualifying hedge relationship | **120** | 60 |
| Total interest expense | **1,406** | 1,686 |
| Net interest income | **1,935** | 1,842 |

Included within various line items under interest income for the year ended 31 December 2017 is a total of Ksh8 million relating to impaired financial assets.

The amounts reported above include interest income and expense, calculated using the effective interest method, that relate to the following financial assets and financial liabilities.

| *In millions of Ksh* | 2018 | 2017 |
|---|---|---|
| Financial assets measured at amortised cost | **3,243** | 3,415 |
| Financial assets measured at FVOCI (2017: available-for-sale) | **20** | 30 |
| Total | **3,263** | 3,445 |
| Financial liabilities measured at amortised cost | **1,286** | 1,626 |

# IFRS 7 Financial Instruments
## Nature and extent of risks



# IFRS 7 Financial Instruments
## Credit risk

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

- Significant increase in credit risk
- 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**

- Credit quality
- 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.

# IFRS 7 Financial Instruments

## Credit risk – Example disclosures on credit quality

***Credit quality analysis***

| | 2018 | | | | | 2017 |
|---|---|---|---|---|---|---|
| *In millions of Ksh* | Stage 1 | Stage 2 | Stage 3 | POCI | Total | Total |
| **Loans and advances to banks at amortised cost** | | | | | | |
| Grades 1–6: Low–fair risk | **5,115** | **556** | **-** | **-** | **5,560** | 4,692 |
| Grades 7–9: Higher risk | **-** | **-** | **-** | **-** | **-** | - |
| Grade 10: Substandard | **-** | **-** | **15** | **-** | **15** | 12 |
| Grade 11: Doubtful | **-** | **-** | **7** | **-** | **7** | 6 |
| Grade 12: Loss | **-** | **-** | **2** | **-** | **2** | 2 |
| | **5,115** | **556** | **24** | **-** | **5,584** | 4,712 |
| Loss allowance | **(6)** | **(14)** | **(9)** | **-** | **(29)** | (22) |
| Carrying amount | **5,109** | **542** | **15** | **-** | **5,555** | 4,690 |
| **Loans and advances to customers at amortised cost[a]** | | | | | | |
| Grades 1–6: Low–fair risk | **48,354** | **5,312** | **1,282** | **-** | **54,948** | 46,550 |
| Grades 7–9: Higher risk | **-** | **3,181** | **-** | **-** | **3,181** | 3,806 |
| Grade 10: Substandard | **-** | **-** | **977** | **-** | **977** | 2,446 |
| Grade 11: Doubtful | **-** | **-** | **349** | **100** | **449** | 1,139 |
| Grade 12: Loss | **-** | **-** | **126** | **50** | **176** | 380 |
| | **48,354** | **8,493** | **2,734** | **150** | **59,731** | 54,321 |
| Loss allowance | **(507)** | **(551)** | **(628)** | **(17)** | **(1,703)** | (1,170) |
| Carrying amount | **47,847** | **7,942** | **2,107** | **133** | **58,028** | 53,151 |

# Credit risk – Example disclosures on Collateral

### Collateral held and other credit enhancements

The Group holds collateral and other credit enhancements against certain of its credit exposures. The following table sets out the principal types of collateral held against different types of financial assets.

Type of credit exposure

| | Percentage of exposure that is subject to collateral requirements | | |
|---|---|---|---|
| *In millions of euro* | 31 December 2018 | 31 December 2017 | Principal type of collateral held |
| Trading derivative assets[a] | **97** | 98 | Cash |
| Derivative assets held for risk management[a] | **100** | 100 | Cash |
| **Loans and advances to banks** | | | |
| Reverse sale-and-repurchase agreements[a] | **100** | 100 | Marketable securities |
| Securities borrowing[a] | **100** | 100 | Marketable securities |
| **Loans and advances to retail customers** | | | |
| Mortgage lending | **100** | 100 | Residential property |
| Personal loans | **-** | - | None |
| Credit cards | **-** | - | None |
| **Loans and advances to corporate customers** | | | |
| Finance leases | **100** | 100 | Property and equipment |
| Other | **91** | 92 | Commercial property, floating charges over corporate assets |
| Reverse sale-and-repurchase agreements | **100** | 100 | Marketable securities |
| **Investment debt securities** | **-** | - | None |

# IFRS 7 Financial Instruments

## Credit risk – Example disclosures on forward looking information

### Incorporation of forward-looking information

The economic scenarios used as at 31 December 2018 included the following key indicators for Kenya for the years ending 31 December 2019 to 2023.

| | 2019 | 2020 | 2021 | 2022 | 2023 |
|---|---|---|---|---|---|
| Unemployment rates | Base 8% Upside 7% Downside 10% | Base 6% Upside 5% Downside 8% | Base 5% Upside 4% Downside 8% | Base 5% Upside 4% Downside 8% | Base 4% Upside 3% Downside 6% |
| Interest rates | Base 1% Upside 0.5% Downside 2% | Base 2% Upside 1% Downside 3% | Base 2.5% Upside 1.5% Downside 3.5% | Base 3% Upside 2% Downside 3.5% | Base 3% Upside 2% Downside 3.5% |
| GDP growth | Base 1.5% Upside 2.5% Downside 0% | Base 2% Upside 3% Downside 0.5% | Base 2.5% Upside 3% Downside 1.5% | Base 3% Upside 2.5% Downside 3.5% | Base 3% Upside 2.5% Downside 4% |
| House prices | Base 3% growth Upside 5% Downside 2% | Base 5% growth Upside 8% Downside 3% | Base 6% growth Upside 9% Downside 4% | Base 6.5% growth Upside 8% Downside 5% | Base 7% growth Upside 9% Downside 6% |

# IFRS 7 Financial Instruments
## Credit risk – Example disclosures on reconciliation of the loss allowance

The following tables[a] show reconciliations from the opening to the closing balance of the loss allowance by class of financial instrument. Comparative amounts for 2017 represent the allowance account for credit losses and reflect the measurement basis under IAS 39.

| | 2018 | | | | 2017 |
|---|---|---|---|---|---|
| *In millions of Ksh* | Stage 1 | Stage 2 | Stage 3 | Total | Total |
| **Loans and advances to banks at amortised cost** | | | | | |
| Balance at 1 January | **2** | **5** | **5** | **12** | 10 |
| Transfer to Stage 1 | **-** | **-** | **-** | **-** | |
| Transfer to Stage 2 | **(2)** | **2** | **-** | **-** | |
| Transfer to Stage 3 | **-** | **(3)** | **3** | **-** | |
| Net remeasurement of loss allowance | **4** | **10** | **8** | **22** | 12 |
| New financial assets originated or purchased | **4** | **-** | **-** | **4** | |
| Financial assets that have been derecognised | **-** | **(3)** | **(5)** | **(8)** | - |
| Write-offs | **-** | **-** | **(3)** | **(3)** | - |
| Foreign exchange and other movements | **(2)** | **3** | **1** | **2** | - |
| Balance at 31 December | **6** | **14** | **9** | **29** | 22 |

# IFRS 7 Financial Instruments
## Credit risk – Example disclosures on modifications

**Modified financial assets**

The following table provides information on financial assets that were modified while they had a loss allowance measured at an amount equal to lifetime ECL.

| *In millions of euro* | **2018** |
|---|---|
| **Financial assets modified during the period** | |
| Amortised cost before modification | **450** |
| Net modification loss | **17** |
| **Financial assets modified since initial recognition** | |
| Gross carrying amount at 31 December of financial assets for which loss allowance has changed to 12-month measurement during the period | **14** |

# IFRS 7 Financial Instruments
## Liquidity risk

**Liquidity risk:**

The risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities

**Disclosure required:**

- Maturity analysis for non- derivative financial liabilities that shows remaining contractual maturities
- Maturity analysis for derivative financial liabilities
- Description of how entity manages liquidity risks inherent

# IFRS 7 Financial Instruments
## Liquidity risk- maturity analysis for financial liabilities and financial assets

| 31 December 2018<br>*In millions of Ksh* | *Note* | Carrying amount | Gross nominal inflow/ (outflow) | Less than 1 month | 1–3 months | 3 months –1 year | 1–5 years | More than 5 years |
|---|---|---|---|---|---|---|---|---|
| **Financial liability by type** | | | | | | | | |
| **Non-derivative liabilities** | | | | | | | | |
| Trading liabilities | | **6,618** | **(6,882)** | **(5,625)** | **(926)** | **(331)** | **-** | **-** |
| Deposits from banks | | **11,678** | **(12,713)** | **(10,683)** | **(1,496)** | **(534)** | **-** | **-** |
| Deposits from customers | | **53,646** | **(53,646)** | **(37,624)** | **(741)** | **(3,540)** | **(11,741)** | **-** |
| Debt securities issued | | **11,227** | **(12,881)** | **-** | **-** | **(201)** | **(12,680)** | **-** |
| Subordinated liabilities | | **5,642** | **(6,660)** | **-** | **-** | **-** | **(5,499)** | **(1,161)** |
| Issued financial guarantee contracts | | **32** | **(740)** | **-** | **-** | **(740)** | **-** | **-** |
| Issued loan commitments | | **6** | **(1,201)** | **(1,201)** | **-** | **-** | **-** | **-** |
| | | **88,849** | **(93,688)** | **(54,781)** | **(2,480)** | **(5,346)** | **(29,920)** | **(1,161)** |
| **Financial asset by type** | | | | | | | | |
| **Non-derivative assets** | | | | | | | | |
| Cash and cash equivalents | | **2,907** | **2,907** | **2,537** | **370** | **-** | **-** | **-** |
| Pledged trading assets | | **540** | **550** | **390** | **125** | **35** | **-** | **-** |
| Non-pledged trading assets | | **15,144** | **15,300** | **13,540** | **1,460** | **270** | **30** | **-** |
| Loans and advances to banks | | **5,555** | **5,620** | **4,480** | **450** | **690** | **-** | **-** |
| Loans and advances to customers | | **62,936** | **76,829** | **10,180** | **5,256** | **14,280** | **25,000** | **22,113** |
| Investment securities | | **6,302** | **6,790** | **2,713** | **234** | **932** | **2,643** | **268** |
| | | **93,384** | **107,996** | **33,840** | **7,895** | **16,207** | **27,673** | **22,381** |

# IFRS 7 Financial Instruments
## Market risk - definitions

**Market risk:**

The risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices

**Market risk comprises of:**

- currency risk
- interest rate risk
- other price risk.

**Interest rate risk:**

Arises on interest-bearing financial instruments recognised in the statement of financial position.

**Currency risk:**

Arises on financial instruments that are denominated in foreign currency

**Other price risk:**

Arises on financial instruments because of changes in commodity prices or equity prices

# IFRS 7 Financial Instruments
## Market risk – value at risk positions example disclosures

The following is a summary of the VaR position of the Group's trading portfolios at 31 December and during the period (based on a 99% confidence level and 10-day holding period).

| *In millions of Ksh* | At 31 December | Average | Maximum | Minimum |
|---|---|---|---|---|
| **2018** | | | | |
| Foreign currency risk | **12.04** | **10.04** | **15.06** | **7.97** |
| Interest rate risk | **27.41** | **22.05** | **39.48** | **17.53** |
| Credit spread risk | **9.07** | **6.97** | **9.52** | **5.66** |
| Other price risk | **3.28** | **3.01** | **4.02** | **2.42** |
| Covariance | **(2.76)** | **(3.08)** | **-** | **-** |
| Overall | **49.04** | **38.99** | **62.53** | **34.01** |
| **2017** | | | | |
| Foreign currency risk | 9.28 | 8.40 | 12.05 | 4.64 |
| Interest rate risk | 20.43 | 18.05 | 26.52 | 13.72 |
| Credit spread risk | 6.08 | 5.11 | 8.83 | 3.50 |
| Other price risk | 3.32 | 2.89 | 4.56 | 2.07 |
| Covariance | (2.24) | (2.08) | - | - |
| Overall | 36.87 | 32.37 | 47.64 | 26.68 |

# Questions