



IFRS 9 Implementation Guideline

Simplified with illustrative examples

November 2017

This publication and subsequent updated versions will be available on the ICPAK Website (www.icpak.com). A detailed version is also provided on the same website.

However, please note that this guideline is not a substitute to reading the Standard and Implementation Guideline published by the IAS Board.

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List of Abbreviations

BLR	Base Lending Rate
CBK	Central Bank of Kenya
CCF	Credit Conversion Factor
EAD	Exposure at Default
ECL	Expected Credit Loss
EIR	Effective Interest Rate
FVOCI	Fair Value Through Other Comprehensive Income
FVTPL	Fair Value Through Profit or Loss
GCRAECL	Guidance on Credit Risk and Accounting for Expected Credit Losses
IAS	International Accounting Standard
IASB	International Accounting Standards Board
ICPAK	Institute of Certified Public Accountants of Kenya
IFRS	International Financial Reporting Standard
IRB	Internal Ratings Based
LGD	Loss Given Default
PD	Probability of Default
SICR	Significant Increase in Credit Risk
TTC	Through the Cycle

Introduction

In July 2014, the International Accounting Standards Board (IASB) issued the final version of IFRS 9 Financial Instruments (IFRS 9, or the standard), bringing together the classification and measurement, impairment and hedge accounting phases of the IASB's project to replace IAS 39 and all previous versions of IFRS 9.

IFRS 9 – Financial Instruments is a more principles based standard compared to IAS 39 – Financial Instruments – Recognition and Measurement. The similarities between the two standards are with regard to classification and subsequent measurement, with the major difference being in the area of impairment of financial instruments.

The IASB has sought to address a key concern that arose as a result of the 2007 - 2008 financial crisis, in which the incurred loss model in IAS 39 contributed to the delayed recognition of credit losses. Consequently, the IASB has introduced a forward-looking expected credit loss model.

Objective

The objective of this guideline is to discuss impairments of financial assets of a financial institution in accordance with IFRS 9 requirements.

Scope

The new impairment requirements in IFRS 9 are based on an expected credit loss model and replace the IAS 39 incurred loss model. The expected credit loss model applies to debt instruments (such as bank deposits, loans, debt securities and trade receivables) recorded at amortised cost or at fair value through other comprehensive income, plus lease receivables, contract assets and loan

commitments and financial guarantee contracts that are not measured at fair value through profit or loss.

Measurement of expected credit losses

In applying the IFRS 9 impairment requirements, an entity needs to follow one of the approaches below:

- a) The general approach
- b) The simplified approach

The general approach

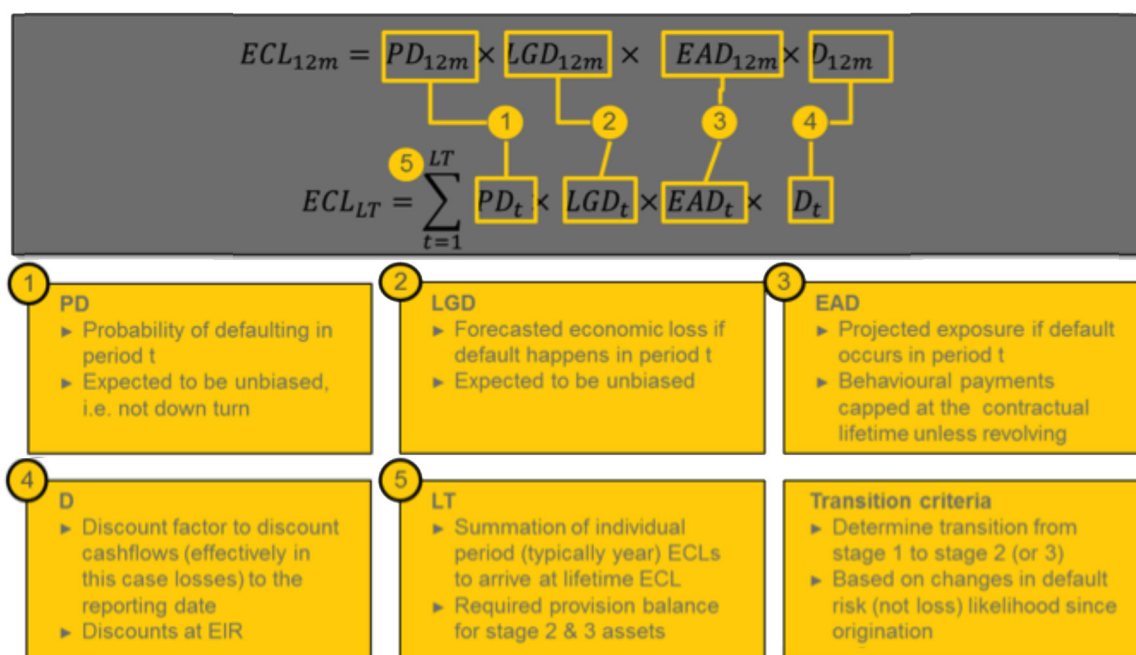
Under the general approach, at each reporting date, an entity recognises a loss allowance based on either 12-month ECLs or lifetime ECLs, depending on whether there has been a significant increase in credit risk on the financial instrument since initial recognition. The changes in the loss allowance balance are recognised in profit or loss as an impairment gain or loss.

Essentially, an entity must make the following assessment at each reporting date

Stage 1 - For credit exposures where there have not been significant increases in credit risk since initial recognition, an entity is required to provide for 12-month ECLs, i.e., the portion of lifetime ECLs that represent the ECLs that result from default events that are possible within the 12-months after the reporting date (12-month ECL as per formula below).

Stage 2 - For credit exposures where there have been significant increases in credit risk since initial recognition on an individual or collective basis, a loss allowance is required for lifetime ECLs, i.e., ECLs that result from all possible default events over the expected life of a financial instrument (ECL LT as per formula below).

Measurement of expected credit losses



• Loss Given Default ('LGD') is the estimate of the loss arising in case a default occurs at a given time. This is based on the difference between the contractual cash flows due and what the Bank would expect to receive, including receipts from the realization of collateral.

• Probability of Default ('PD') is the estimate of the likelihood of default over a given time horizon (e.g. from t_{i-1} to t_i). A default may only happen at a t_i horizon if the facility has not been previously derecognized and is still in the portfolio.

• Exposure at Default ('EAD') – 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, whether scheduled by contract or otherwise, expected drawdowns on committed facilities, and accrued interest from missed payments.

Example to illustrate Loss Given Default ('LGD')

On 01 January 2016, a Bank originates a 7-year bullet corporate loan with gross carrying

amount of Kshs 1,000,000. The loan is secured by a property whose present value (PV) at 31 December 2016 was Kshs 700,000 (i.e. having taken into consideration the forced sale value of the collateral and discounting the cash flows that would be received from the sale of collateral, based on the time expected to be taken to realise it) There are no transaction cost and the loan attracts a fixed interest rate of 14%.

a) The Loss Given Default (LGD) calculations
The Loss Given Default (LGD) is calculated as the difference between the contractual cash flows due and what the Bank would expect to receive, including receipts from the realization of collateral.

$$\begin{aligned} \text{LGD} &= (\text{EAD} - \text{PV Expected Cash flow}) / \text{EAD} \\ &= (1,000,000 - 700,000) / 1,000,000 \\ &= 0.3 \text{ or } 30\% \end{aligned}$$

b) As at period end, management estimates a 12-month probability of default of the facility to be 0.13% and lifetime probability of default of 0.906%. The 12 month and lifetime credit losses given the above LGD of 30% is calculated as follows:

Rollout Date	Elapsed time	Cumulative PD	Marginal PD	LGD	EAD			Marginal	Expected
			A	B	C	D=A*B*C	EIR Rate	ECL discounted	Credit Losses
01-Jan-16	1.0	0.130%	0.130%	30%	1,000,000	390.00	14%	342	12 months ECL
31-Dec-17	2.0	0.260%	0.130%	30%	1,000,000	389.49	14%	300	
31-Dec-18	3.0	0.389%	0.130%	30%	1,000,000	388.99	14%	263	
31-Dec-19	4.0	0.519%	0.129%	30%	1,000,000	388.48	14%	230	
31-Dec-20	5.0	0.648%	0.129%	30%	1,000,000	387.98	14%	202	
31-Dec-21	6.0	0.777%	0.129%	30%	1,000,000	387.47	14%	177	
31-Dec-22	7.0	0.906%	0.129%	30%	1,000,000	386.97	14%	155	
								1,667	Lifetime ECL

Other LGD considerations

It is assumed in the above example that the collateral value will be constant throughout the lifetime of the loan facility.

Floor rate – Where the PV of the collateral is higher than the EAD, management takes a floor rate being cost to realise the assets i.e. legal fees, valuation fees etc.

Computation of Probability of Default

Using Loss Rate approach

12-month Expected Credit Loss measurement based on Loss Rate approach

Bank A originates 2,000 bullet loans with a total gross carrying amount of Kshs 500,000. Bank A segments its portfolio into borrower groups (Groups X and Y) on the basis of shared credit risk characteristics at initial recognition.

Group X comprises 1,000 loans with a gross carrying amount per client of Kshs 200 for a total

gross carrying amount of Kshs 200,000. Group Y comprises 1,000 loans with a gross carrying amount per client of Kshs 300, for a total gross carrying amount of Kshs 300,000. There are no transaction costs and the loan contracts include no options (for example, prepayment or call options), premiums or discounts, points paid, or other fees.

Bank A measures expected credit losses on the basis of a loss rate approach for Groups X and Y. In order to develop its loss rates, Bank A considers samples of its own historical default and loss experience for those types of loans. In addition, Bank A considers forward-looking information, and updates its historical information for current economic conditions as well as reasonable and supportable forecasts of future economic conditions.

Historically, for a population of 1,000 loans in each group, Group X's loss rates are 0.3 per cent, based on four defaults, and historical loss rates for Group Y are 0.15 per cent, based on two defaults.

	Number of clients	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Historic per annum average defaults	Estimated total gross carrying amount at default	Present value of observed loss	Loss rate
Group	A	B	C=AXB	D	E=BXD	F	G=(F/C)
X	1000	Kshs 200	Kshs 200,000	4	Kshs 800	Kshs 600	0.3%
Y	1000	Kshs 300	Kshs 300,000	2	Kshs 600	Kshs 450	0.15%

In accordance with [IFRS 9:5.5.17(b)], expected credit losses should be discounted using the effective interest rate. However, for the purposes of this example, the present value of the observed loss is assumed.

At the reporting date, Bank A expects an increase in defaults over the next 12 months compared to the historical rate. As a result, Bank A estimates five defaults in the next 12 months for loans in Group X and three for loans in Group Y. It estimates that the present value of the observed credit loss per client will remain consistent with the

historical loss per client.

On the basis of the expected life of the loans, Bank A determines that the expected increase in defaults does not represent a significant increase in credit risk since initial recognition for the portfolios. On the basis of its forecasts, Bank A measures the loss allowance at an amount equal to 12-month expected credit losses on the 1,000 loans in each group amounting to Kshs 750 and Kshs 675 respectively. This equates to a loss rate in the first year of 0.375 per cent for Group X and 0.225 per cent for Group Y.

	Number of clients	Estimated per client gross carrying amount at default	Total estimated gross carrying amount at default	Historic per annum average defaults	Estimated total gross carrying amount at default	Present value of observed loss	Loss rate
Group	A	B	C=AXB	D	E=BXD	F	G=(F/C)
X	1000	Kshs 200	Kshs 200,000	5	Kshs 1000	Kshs 750	0.375%
Y	1000	Kshs 300	Kshs 300,000	3	Kshs 900	Kshs 675	0.225%

Bank A uses the loss rates of 0.375 per cent and 0.225 per cent respectively to estimate 12-month expected credit losses on new loans in Group X and Group Y originated during the year and for which credit risk has not increased significantly since initial recognition.

Other methods that can be used include the following:

Method based on migrations of principal balance

This method can be used for all portfolios, but in particular it should be used for portfolios with exposures diversified in terms of granted amount and/or for which the repayments might influence the exposure amount eventually entering the default status.

Under this method, migrations are weighted with principal and thus the yearly migration matrix presents the probabilities that 1 unit of exposure will migrate to defined statuses over one year within a given risk portfolio.

Method based on number of migrating exposures

Transaction approach

The method can be used for portfolios with exposures that do not vary significantly in terms of granted amount and for which exposure amount fluctuates significantly between balance sheet dates. Under this method, two alternative approaches can be applied – transaction approach or client approach.

Matrix calculation under transaction approach means that each transaction is taken into consideration separately. Weight of transaction equals one, i.e. each transaction (contract) relates to one exposure and is counted equally. Thus, the yearly migration matrix presents the probabilities that a single exposure (transaction) will migrate to defined statuses within a given portfolio over one yearly.

Exposure - (i) period of exposure and
(ii) exposure at default

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.

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.

For revolving facilities, IFRS 9 expects lifetime expected loss modelling to extend beyond contractual maturity. The period of exposure for these facilities is based on their behavioural life and is determined by considering the bank's expected credit risk management actions that serve to mitigate

credit risk, including terminating or limiting credit exposure. 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 modelling 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.

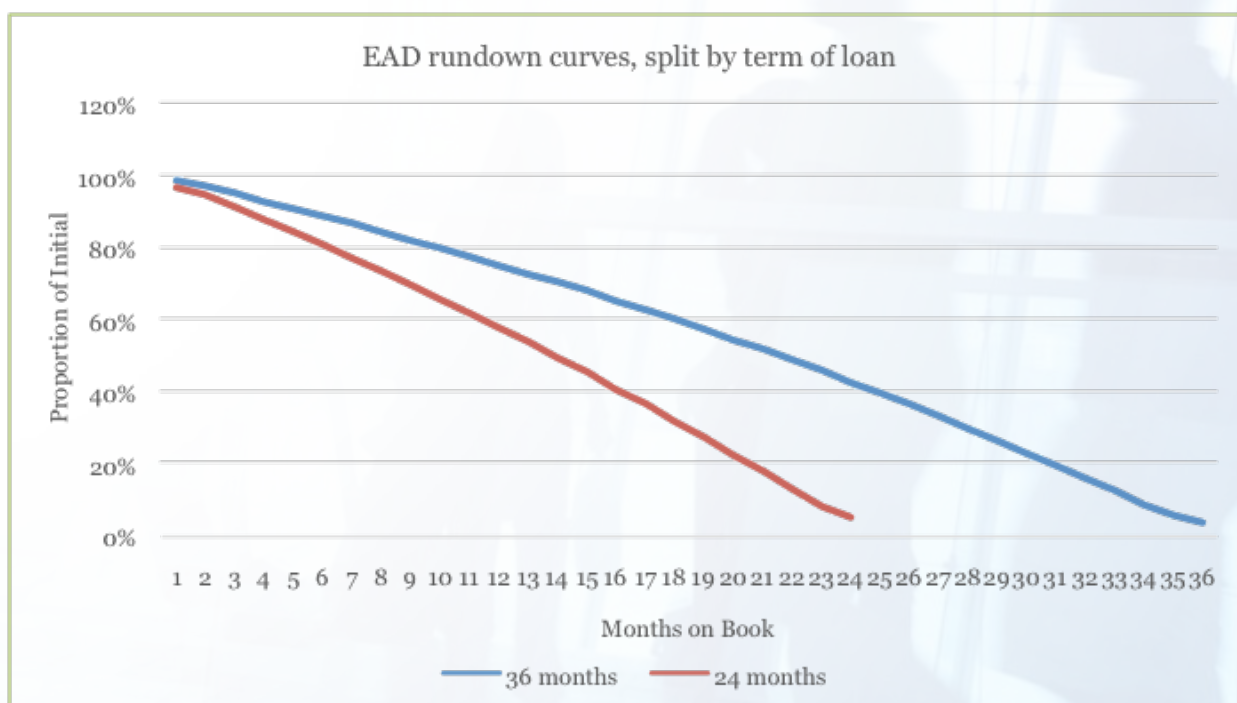
- Credit mitigation actions taken prior to default.

Non-revolving credit facilities

The common approaches for such facilities are highlighted below:

- 1) Estimating repayment patterns from historical actual repayments (change in monthly historical balances), split by portfolio, sector, term of loan, credit rating, etc. These calculations are based on defaulted loans only and we assume future defaults have a similar experience as historical defaults. The split by term of the loan is heavily dependent on data. This is illustrated in the graph below:

Illustration 1:



- 2) Building loan amortisation schedules until contractual maturity, taking into account unique characteristics of each facility e.g. payment waiver for first 6 months etc.

Illustration 2: This approach requires assumptions for average arrears age by Stage, i.e. Stage 1 loans are up-to-date and Stage 2 loans are on average 1 month in arrears,

e.g. assuming that all Stage 1 loans are up-to-date and the EAD used in the ECL calculation is lagged by three months with three months interest added, a Stage 1 loan is assumed to default after three contractual payments have been missed.

Or assuming for Stage 2 loans, that, on average, these loans are 1 month in arrears and 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 uses 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.

In this approach, historical CCFs are determined and development pattern projection techniques are used to arrive at projected CCFs. See illustration below.

Illustration 3: CCFs

		Time to default				
		0	1	2	3	...
Origination year	2001	80%	75%	68%	74%	
	2002	85%	80%	81%		
	2003	88%	81%			
	2004	81%				
	...					

Projected CCF

Development pattern

➔

		Time to default				
		0	1	2	3	...
Origination year	2001	80%	75%	68%	74%	
	2002	85%	80%	81%	71%	
	2003	88%	81%	75%	74%	
	2004	81%	79%	75%	74%	

The key considerations in this approach are:

- Aggregation of data into homogenous risk groups depending on data available
- Stability of development patterns and representativeness of historical experience

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]

Staging

When applying IFRS 9 principles, there are three different stages of measuring impairment. Most exposures will initially be in Stage 1. The bank recognises only the credit loss associated with the probability of default within the next 12 months as a provision against the asset.

However, as soon as the exposure has suffered a significant increase in credit risk ('Stage 2'), the bank recognises an allowance equal to expected credit losses over the lifetime of the loan. IFRS 9 does not specify what constitutes a significant increase in credit risk.

Banks have to establish their own policies for what they consider as default and apply that definition consistently with that used for internal credit risk management purposes. They should consider qualitative factors (e.g financial covenants) when appropriate. Transfers between Stages 1 and 2 are based on relative movement in credit risk since origination rather than based on absolute level of risk. The expected loss over the lifetime of a loan is likely to be significantly higher than the expected loss for the next 12 months.

The standard includes a rebuttable presumption that a default does not occur later than when a loan asset is 90 days past due.

IFRS 9 also presumes that there is a significant increase in credit risk since initial recognition if loan facility is more than 30 days past due.

Banks can consider using the existing Central Bank classification and regulatory provisions as back stopping indicators.

Prudential CBK	Days due	Stage allocation
Normal	0-30	Stage 1
Watch	31-90	Stage 2
Substandard	91-180	Stage 3
Doubtful	Over 180	Stage 3
Loss	Considered uncollectible	Stage 3

Methodology to IFRS staging Considerations

Qualitative	Quantitative
Qualitative staging	
Perform a comparison between qualitative factors used in stage allocation with the relevant factors listed in IFRS 9	Calculate the proportion of stage 2 transfers resulting from the qualitative factors
Methodology	
The methodology should only reflect default risk and no other characteristics of the borrower	All exposures which are more than 30 days past due are correctly allocated to stage 2
Review the alignment of stage 3 with the standard	All exposures which match the definition of default should be correctly allocated to stage 3
Banks should ensure that they assess the completeness of staging criteria by exploring potential sources of forward looking information available from recommended and authentic official sources	Re-perform stage 2 analysis based on the banks other staging criteria and confirm that it is properly implemented
Clear views on the rebuttal of the 30 day past due analysis	Re- perform the justification analysis for rebutting the 30 day past due presumption
Staging should be consistent over different portfolios in a given bank and differences or peculiar situations are well documented.	Impact of the provision as a result of lack of not updating the thresholds for SICR for many years
Process and criteria used in the assessment of SICR	Compute the average time from entering in stage 2 to entering in stage 3 and compare with the average time from entering in 30 days past due to entering stage 3

Increase in credit risk	
Confirm whether SICR has been defined by comparing the lifetime default risk	Re-perform the SICR assessment using more forward looking indicators of default to determine the materiality approach
Confirm that SICR is assessed by comparing the loans default risk at the reporting date to the risk at the origination date	Re-perform stage 2 analysis
Overall logic of the probability of default thresholds used in staging and ensure that absolute threshold are not being used	Tests on the sensitivity of stage allocation or the ECL should be conducted considering any variation in forward looking information.
SICR assessment should consider forward looking information	Re-perform historical default patterns and confirm that they correlate with stage 2 allocation from previous year.
Review treatment of missing origination ratings	
Data	
The data used in the calculation of the transfer threshold should be tested for suitability, representative of the portfolio and calculated over a suitable period	Calculate the threshold from a different data set and compare the results. Assess the materiality threshold choice on the provision computation
Simplifications	
Confirm if there were any assets in the portfolio which the low credit risk exemption will be applied	Assess the impact of this simplified approach on staging percentage and ECL for sample of loans

Macro-economic scenarios

Banks should use external and internal information to generate a 'base case' scenario of future forecast of relevant economic variables along with a representative range of other possible forecast scenarios. The external information used includes economic data published by the Central Bank of Kenya, the Kenya Bureau of Statistics and periodic pronouncements by the Monetary Policy Committee.

benchmark Interest rates	x	x	x	x	x
Base scenario	x	x	x	x	x
Range of upside scenarios	x	x	x	x	x
Range of downside scenarios	x	x	x	x	x

Unemployment rates	2018	2019	2020	2021	2022
Base scenario	x	x	x	x	x
Range of upside scenarios	x	x	x	x	x
Range of downside scenarios	x	x	x	x	x

Sensitivity Analysis

Sensitivity analysis on the assumptions used for macro economic indicators should be performed by banks

Portfolio 1.

Economic Scenario	Probability of occurring at initial recognition	Lifetime PD at initial recognition for the remaining time to maturity	Probability of scenario occurring at 31/Dec/2018	Lifetime PD for the remaining time determined at 31/Dec/2018
1	30%	1%	30%	3%
2	55%	3%	45%	5%
3	15%	8%	25%	10%
	Weighted Average PD	3.2% Weighted PD	Weighted Average PD	5.7%

Example 1.

Bank A is determining expected credit losses at 31/12/20X2, its reporting date.

Bank A uses three economic scenarios and applies probability weightings to each of them to determine significant increases in credit risk and the measurement of expected credit losses in the following way.

Firstly, at the reporting date, Bank A reviews the characteristics of the loans within the portfolio and determines that they continue to share similar credit risk characteristics. Therefore, the assessment of whether there has been a significant increase in credit risk and the measurement of the expected credit loss continues to be performed at the portfolio level.

Bank A determines the probability of default for each of the three economic scenarios when the financial instruments are initially recognised. The Probability-Weighted PD at initial recognition is determined by weighting the PD for a given scenario with the probability of that scenario occurring.

In order to determine whether at the reporting date the credit risk has significantly increased, Bank A must compare the weighted average PD that was expected at initial recognition for the reporting date in question (i.e. reflecting the time to maturity of the financial instruments), with the weighted average PD at the reporting date calculated using current economic scenarios and the associated probabilities of those scenarios occurring.

Economic Scenario	Probability of occurring at initial recognition	Lifetime PD at initial recognition for the remaining time to maturity	Probability of occurring at 31/Dec/2018	Lifetime PD for the remaining time determined at 31/Dec/2018
1	30%	1%	30%	3%
2	55%	3%	45%	5%
3	15%	8%	25%	10%
	Weighted Average PD	3.2% Weighted PD	Weighted Average PD	5.7%

Bank A would then determine if, in accordance with its accounting policy, whether the increase in PD from 3.2 per cent to 5.7 per cent is significant and, therefore, the measurement of expected credit losses must be based on lifetime expected credit losses (not 12-month expected credit losses) in accordance with [IFRS 9:5.5.3].

For illustrative purposes three economic scenarios are used at initial recognition and at the reporting date. In practice, a different

number of economic scenarios may be needed at the reporting date than at initial recognition if further economic scenarios are needed to reflect the distribution of credit losses that arise from different forward looking scenarios.

Example 2.

Bank A considers there are five forward-looking economic scenarios and determines the probabilities of those scenarios occurring and the associated credit losses as follows.

Forward-looking economic scenario	Probability of the forward-looking economic scenario occurring	Credit loss arising for each forward-looking economic scenario	Probability-weighted expected credit losses
	%	KShs (mns)	KShs (mns)
1	10	100	10
2	20	200	40
3	40	500	200
4	15	800	120
5	15	1200	180
		Sum	550

It would not be appropriate for Entity A to measure expected credit losses at Kshs 500 million by considering forward-looking economic Scenario 3 only, say because it is the most likely scenario, given that the credit losses arising from the forward-looking economic scenarios are not normally distributed.

Entity A should calculate the probability weighted-expected credit losses reflecting all five scenarios at Kshs 550 million, being the

unbiased and probability-weighted amount of expected credit losses.

Judgement will be required in determining how many, and which, forward-looking economic scenarios to include in measuring expected credit losses. An entity should not automatically assume credit losses arising from different forward-looking economic scenarios are normally distributed because, often they are not.

This reflects the inherent non-linear nature of credit losses where credit losses will arise if there is partial or full non-repayment of the contractual cash flows, but the best outcome for the holder of the asset is to receive all of the cash flows due in full and on time.

Often credit losses may be insignificant in the most likely economic scenario but may be significant in the less likely, more negative, economic scenarios. The opposite is not true in the less likely, more positive, economic scenarios because the maximum benefit a holder of a loan can achieve is to receive all the contractual cash flows paid back on time and in full.

Example 3.

Forecasts of future economic conditions – new information before the reporting date.

Bank A has a 31 December year end and takes into account forward looking forecasts of future economic conditions when determining significant increases in credit risk and when measuring expected credit losses. This process uses inputs and assumptions that are developed in November each year in order to meet its financial reporting deadlines.

Bank A has a US dollar loan receivable from Entity B. Entity B's local currency is pegged to the US dollar. Entity B's revenue is predominantly earned in Kenya Shillings.

The Central Bank has consistently issued policy statements that it will continue to support the US dollar peg, and it confirms this policy publicly in November 2018. In December 2018, despite its November confirmation to the contrary, the Central Bank ceases to support the currency peg and the value of the Kenyan Shilling immediately falls relative to the US dollar.

In its assessment of significant increase in credit risk and the measurement of expected

credit losses at 31 December 2018, Bank A should incorporate the actions of the Central Bank in December 2018.

This is because:

- [IFRS 9:5.5.9] requires that the assessment as to whether there has been a significant increase in credit risk to be performed at each reporting date and consider reasonable and supportable information that is available without undue cost or effort; and
- [IFRS 9:5.5.17(c)] requires that the measurement of expected credit losses to reflect reasonable and supportable information available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

Macro-economic variable Sources

The Monetary Policy Committee (MPC) paper includes reference to macro-economic variables that may be used for benchmarking on the macro economic data. CBK provides macro-economic statistics on <https://www.centralbank.go.ke/#>.

Government securities impairment considerations

The impairment requirements of IFRS 9 apply to all financial assets measured at amortised cost and those measured at Fair Value through Other Comprehensive Income (FVTOCI). If Government securities such as treasury bills and bonds are measured under any of the two categories then the impairment rules under IFRS 9 apply. As a result, some entities may opt to record impairment on government securities and other financial entities may opt not to record any impairments. It is important to note that there is no history of default on the Kenyan Government securities. Accordingly, it is appropriate to classify government securities as low credit risk financial instruments and only record impairments if there is evidence of expected default on Government securities.

Statutory loan loss reserves

On transition, if the CBK prudential provisions are less than the IFRS 9 provisions, the excess charges resulting should be transferred from the regulatory reserve account to the general reserve account to the extent of the non-distributable reserve previously recognised. In this case the impairment charges under IFRS will be considered adequate.

On transition, if the CBK provisions are higher than the provisions under IFRS, the excess provision shall be treated as an appropriation of retained earnings and not expenses in determining profit or loss. Any credits arising from the reduction of such amounts results in an increase in retained earnings and is not included in the determination of profit or loss.



Appendix

Insurance Regulatory Authority Guidance on IFRS 9 Impairment Requirements for Insurers