Practical Workshop for NBU Staff

What’s New? IFRS 9: financial instruments. An overview.

Centre for Financial Reporting Reform

WORLD BANK GROUP
Governance

STAREP
Strengthening Auditing and Reporting in the Countries of the Eastern Partnership

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Pascal Frèrejacque

Senior Operations Officer, CFRR

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Introduction – Case study

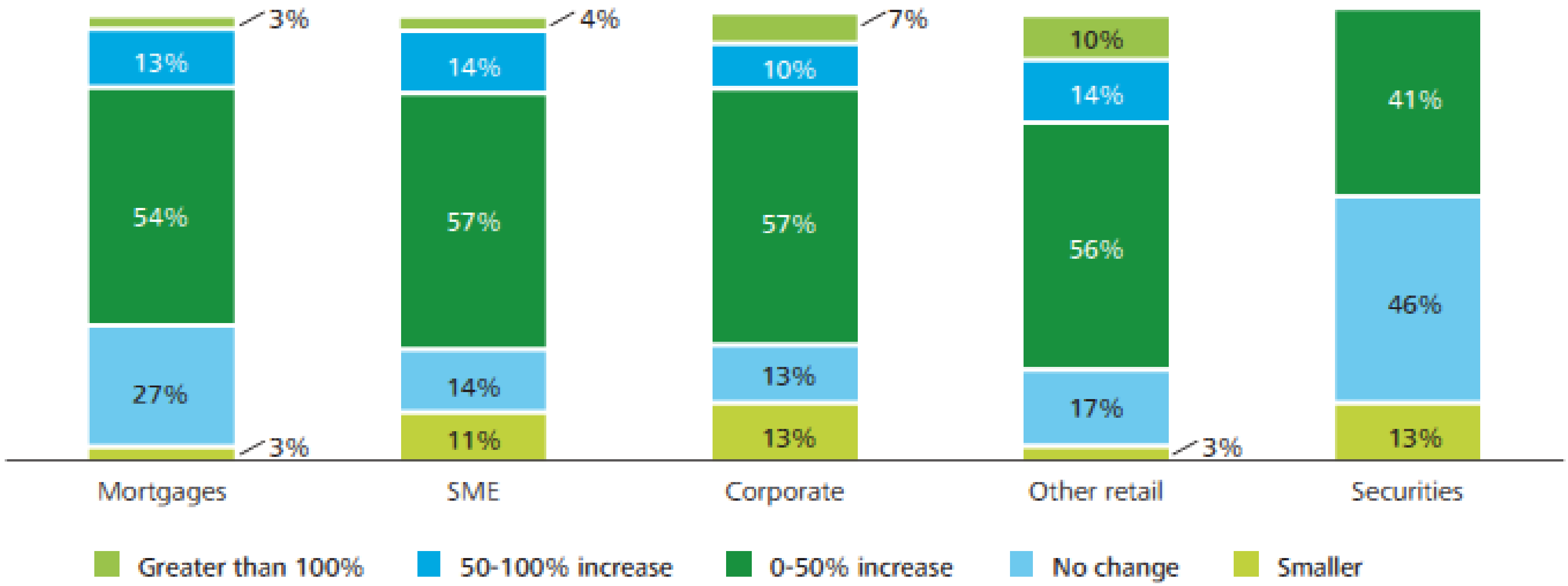
- Financial Times case study: the impairment of financial assets
  - A bank makes a five-year loan of $1,000,000 to Company A in the last quarter of 2018. The bank makes an initial credit assessment consistent with the economics of the lending decision.
  - As long as a loan is performing as expected when money was first lent, no credit loss is suffered economically, so IFRS 9 requires a portion of lifetime expected credit losses to be recognized (12-month expected credit losses).
  - In this instance, the bank assesses that there has been no change in the credit risk – ie the risk of a default occurring – since initial recognition. The bank estimates the loan loss allowance based on 12-month expected credit losses to be $1,250.
  - A year later, at December 31 2019, the bank assesses the credit risk over the life of the loan based on currency conditions and relevant forecast conditions over the remaining life of the loan. While the loan is currently performing, the bank determines that the credit risk on the loan – the likelihood of it defaulting – has increased significantly.
  - When a loan's credit risk increases significantly from the initial expectations the lender is no longer being compensated for the losses to which it is exposed and so IFRS 9 requires lifetime expected credit losses to be recognized.
  - The bank estimates that at December 31 2019 the lifetime expected credit losses for the loan are $9,000.
- **Questions: Is the loan performing? Has it's credit risk deteriorated? What are accounting treatment of the losses under IAS 39, IFRS 9?**

Introduction – Case study

- Accounting under IAS 39
  - Impairment of financial assets is recognized on an incurred loss basis, which requires objective evidence of likely impairment before a provision can be made.
  - At December 31 2018, there is no objective evidence of impairment, hence no provision is made.
  - At December 31 2019, the bank continues to recognize the loan at $1,000,000 because there is still no objective evidence of impairment that has an impact on the estimated future cash flows of the financial asset, even though the risk of impairment has increased significantly.
- Accounting under IFRS 9
  - Impairment of financial assets is recognized on an expected credit loss basis, which requires historic, current and forecast information to be considered in determining the loss allowance.
  - At December 31 2018, the bank recognizes a loss allowance at an amount equal to 12-month expected credit losses of $1,250. The bank recognizes an impairment loss of $1,250 in profit or loss.
  - At December 31 2019, the bank has assessed that the credit risk of the loan has increased significantly since initial recognition and therefore recognizes a loss allowance of an amount equal to lifetime expected credit losses. The bank recognizes an additional impairment loss of $7,750 (or $9,000-$1,250) in profit or loss accordingly.

Deloitte Belgium's survey 2014

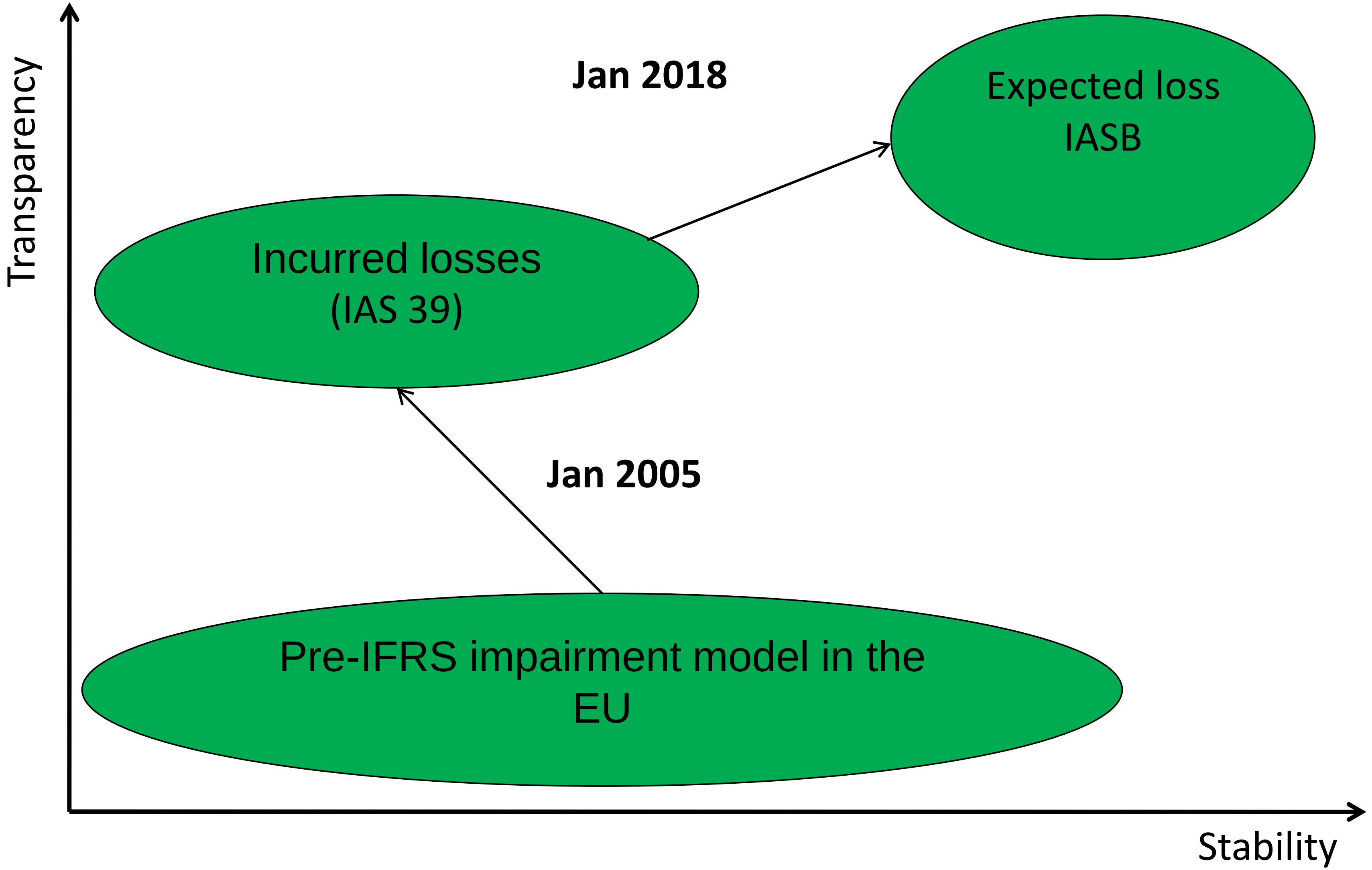
» Assuming today's credit environment were to apply, how is your bank's total impairment provision likely to change on transition to IFRS 9? (Deloitte Belgium's survey 2014)



Introduction

- 2 constraints for the IASB when preparing a new accounting standard
  - Ensure transparency
  - Support for stability/limit pro-cyclicality
- Closer to the provisioning objectives of banking regulators
- IASB decided towards a risk model better aligned with banks credit management systems
- Which addresses partially pro-cyclicality concerns
- Challenges to address the financial instruments impairment issues does not favor timeliness (2009-2018)

From IAS 39 to IFRS 9: Loan Loss Provisioning – A dual perspective



IFRS 9

Objective of the new standard

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

» With a less complex, more principle based standard

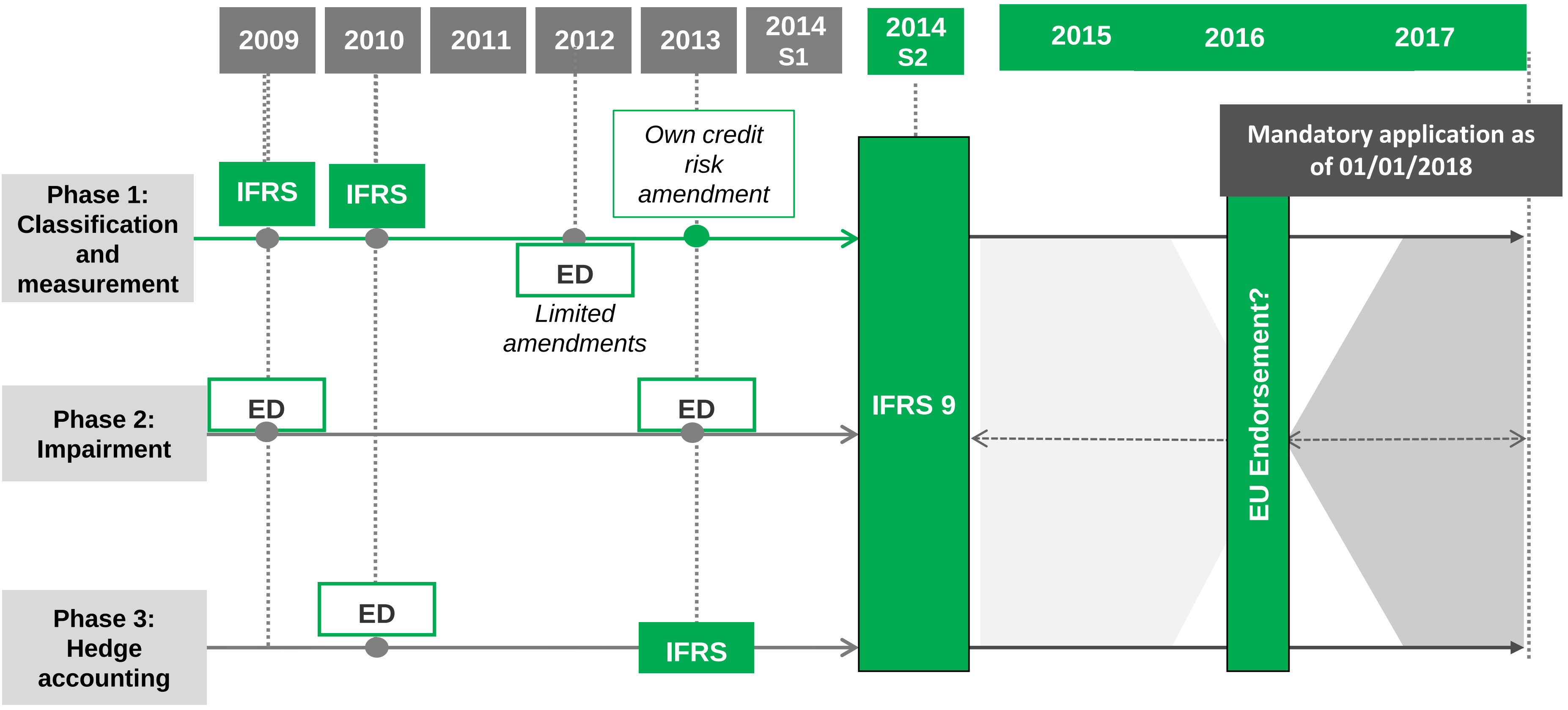
» Have the standard converge with the US GAAP

» Respond to the April 2009 call of the G20 and the recommendation of the FSB

IFRS 9 – The IASB financial instrument project

- A complicated project:
  - 3 phases
  - Issued in four ‘pieces’ over a 5 years period
  - 4 Exposure Draft
  - 9 years to implement a change: 2009-2018
- A challenging context:
  - Changing regulatory environment
  - Convergence with US GAAP
  - Very technical issues with huge implication in terms of equity and P&L for banks

The IFRS 9 project

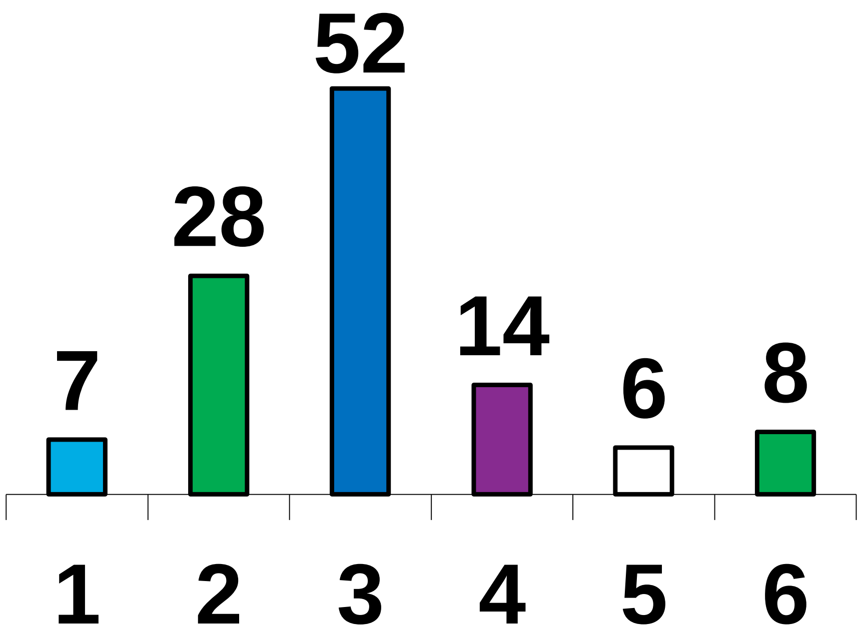


Date of mandatory application

Date of first application of IFRS 9

» In 2013, European banks were asked at a conference organized by a major accounting firms, how much time would they require to implement the IFRS proposals?

1. 0–1 years
2. 1–2 years
3. 2–3 years
4. More than 3 years
5. Does not apply
6. I do not know
7. know



Date of first application of IFRS 9

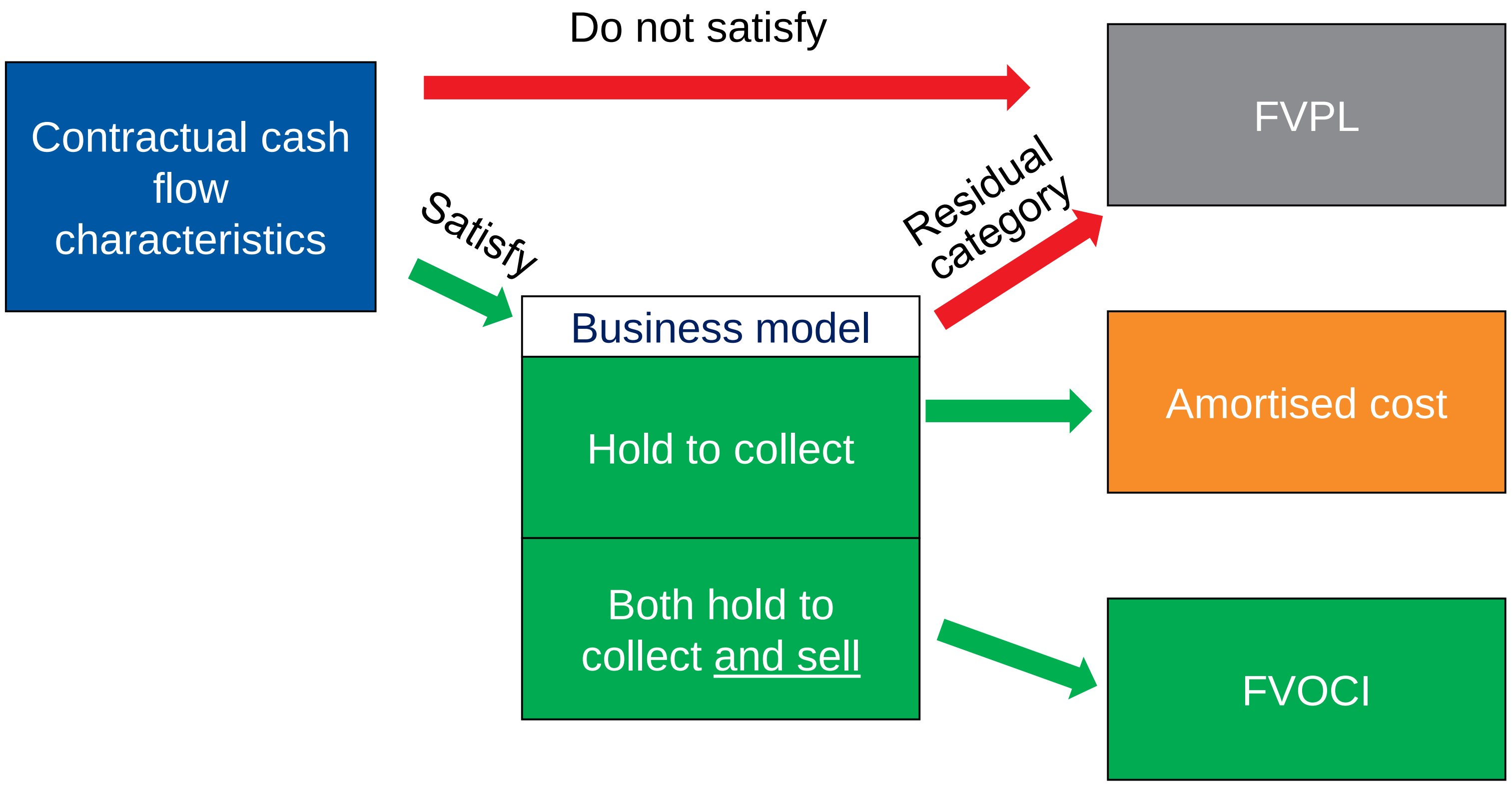
- First date of application is now January 1, 2018 (was 2015)
- For EU countries IFRS 9 need to be endorsed by the European Commission
  - No official endorsement date announced yet (EFRAG Website TBD)
  - EU banks expect IFRS 9 endorsement during 2016
- Earlier versions of IFRS 9 can be used for non Banks that are in non EU member states (classification and measurement)

Business Model – Central feature of IFRS 9

Introduction of business model/strategy

- IFRS 9: 3 business models
  - **Held to collect** contractual cash flows (amortised cost)
  - **FVPTL:** Fair Value Through Profit and Loss
  - **Mixed model:** FVOCI: Fair value Through Other Comprehensive Income
- BM is decided by management

Business model (continued)



Reclassification applies to all business models

Classification & measurement
Impacts on loans and bonds: business model

- Amortized cost : a unique objective “hold to collect”
  - Significant sales must be infrequent (e.g. unanticipated/stress case)
  - Frequent sales must be insignificant both individually and in aggregate
  - Some exceptions: e.g. sales due to deterioration in credit quality in line with a documented investment policy
- An entity should not consider every ‘what if’ or worse-case scenario
- Unanticipated sales :
  - No restatement of prior period financial statements; nor change in the classification of the remaining financial assets in the business model
  - As long as the entity considered all relevant and objective information for initial classification
- Liquidity portfolios :
  - The portion held for extreme stress scenarios may be classified as amortized cost
  - But significant or frequent sales are incompatible with amortized cost (even if the sales are imposed by regulators to demonstrate liquidity)
- Mixed Business model “originate to hold and / or distribute”
  - Granularity of the analysis is key (identification of sub-portfolios)

Classification & measurement
Impacts on loans and bonds: business model

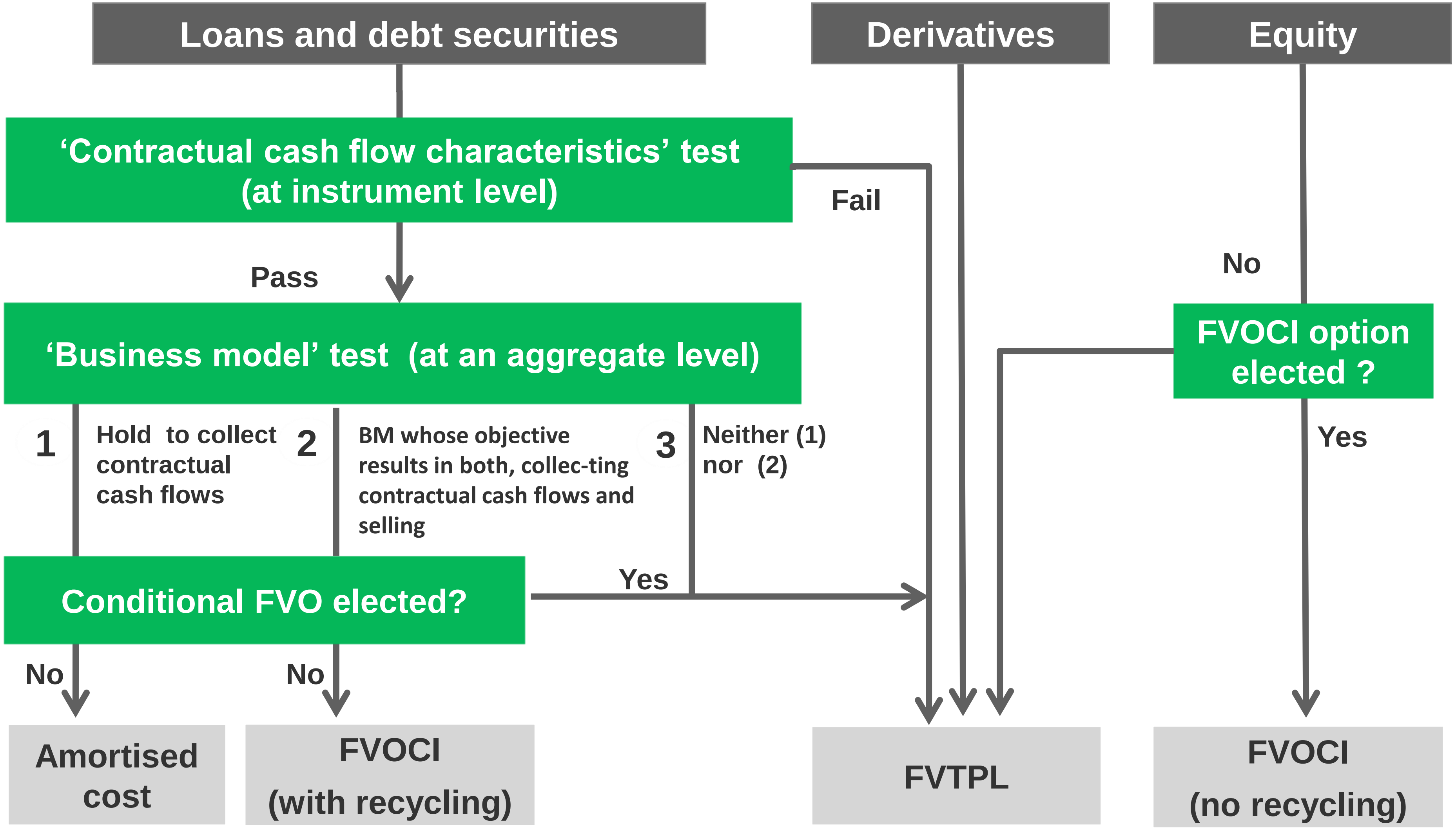
- FVTOCI : a mixed objective "hold to collect AND sell"
  - No threshold for frequency or amount of sales
  - Key Performance Indicators for FVOCI are contractual interest yield, impairment charges and fair value changes
  - Examples :
    - A bank holds financial assets to meet its everyday liquidity needs. The bank typically holds some financial assets to collect contractual cash flows and sells others to reinvest
    - An insurer holds financial assets in order to fund insurance contract liabilities. The insurer also undertakes significant buying and selling activity to rebalance the portfolio of financial assets
- Trading assets + assets managed and assessed at FV should be classified at FVTPL
- Reclassification are prohibited
  - Unless fundamental change in Business Model (very infrequent)
  - That would generally be the case only when the entity has acquired or disposed of a business line.

Measurement and Classification

Classification & measurement: overview

	IAS 39		New classification criteria	IFRS 9
	Categories	**Measurement**		**Measurement categories**
ASSETS	Held-to-Maturity (bonds) Loans & receivables	**Amortised cost** *(with split accounting)*		**Amortised cost**
ASSETS	Available-For-Sale (Equites & bonds)	**Fair Value / OCI <u>recyclable</u>** *(with split accounting)*		**Fair Value / OCI <u>recyclable</u>** (loans & bonds) **Fair Value / OCI <u>non-recyclable</u>** (measurement option for equities)
ASSETS	Fair Value Option Trading	**Fair Value / P&L**		**Fair Value / P&L**
LIABILITIES	Fair Value Option Trading	**Fair Value / P&L**		**Fair Value / P&L** *(FVO: own credit-risk in non-recyclable OCI)*
LIABILITIES	**Amortised cost**			**Amortised cost**

IFRS 9 –criteria for classification and measurement



Impacts on equity

- Equities under IFRS 9: default is FVTPL
- Option to record fair value changes through OCI, with no recycling of gain/loss on disposal
  - Irrevocable choice on an instrument by instrument basis at initial recognition, if not held for trading
  - Only dividends are recorded in profit or loss
  - Extensive disclosures
- AFS Impairment rules – no longer relevant (‘significant and prolonged’ goes away)

IFRS 9 – Fair Value Measurement Hierarchy

- Level 1 - Quoted prices
  - “The best evidence of fair value is quoted prices in an active market”
- Level 2 – Valuation technique making maximum use of maximum of market inputs observable inputs
  - Reference to the current fair value of another instrument that is substantially the same, discounted cash flow analysis, and option pricing models
  - Valuation technique commonly used by market participants and demonstrated to provide reliable estimates of prices obtained in actual market transactions
- Level 3 – Valuation technique with no market observable input

Impairment

IFRS – Financial Instrument Impairment Model

IAS 39 Incurred loss model	IFRS 9 Expected loss model
Current model until 2018 Impairment loss only	Future model from 2018: expected loss
Losses expected as a result of future events, no matter how likely are not recognized	Responsive to changes in information that impact credit expectations
recognized when: trigger (loss) event occurs and impact can be reliably estimated More than one model depending on classification	Expected loss at recognition approach Deterioration in credit quality leads to recognition of lifetime losses
	Robust disclosures to support principle and support comparability

Summary of expected credit loss model: general model

Initial recognition (with exceptions)

Allowance	**12 month Expected Loss** (remeasured subsequently)	**Lifetime Expected Loss** (remeasured subsequently)	
Criterion		**The credit risk has increased significantly since initial recognition** (whether on an individual or portfolio basis)	
			+ Objective evidence of impairment
Interest revenue based on:	**Gross carrying amount**	**Gross carrying amount**	**Net carrying amount**

Change in credit risk since initial recognition

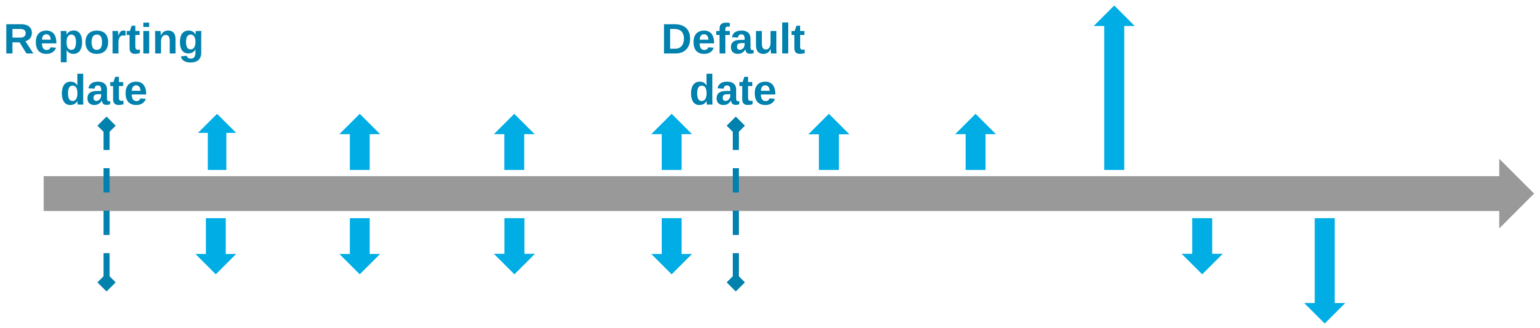
Improvement ← → ***Deterioration***

- Impact on all non impaired exposures (EL 12 mois)
- Impact significance will depend on current provisionning model under IAS 39 (triggers and EL horizon in the impairment allowance)

No impact
(criteria + measure identical to IAS 39)

Defining and measuring 12-month and lifetime ECL

Expected loss = Present Value of Contractual CF – Present Value of CF expected to be recovered



From cash-flows to reporting date

From default to reporting date

From cash-flows to default date

Using the **effective interest rate** at initial recognition (or an approximation)

12 months or lifetime expected loss depending on the bucket	Lifetime expected loss

Defining and measuring 12-month and lifetime ECL

- **Lifetime ECL** = present value of all cash shortfalls expected over the remaining life of financial instrument
  - Σ [PD(year1) x LGD + PD(year 2) x LGD + … + PD(last year) x LGD]
- **12-month ECL** = the portion of lifetime ECL associated with probability of a default occurring in next 12 months after reporting date
  - PD(year1) x LGD(year1)

A probability-weighted outcome

Best available information

Information about past events + **Information about current conditions** + **Reasonable and supportable forecasts**

The time value of money

General Model – Significant deterioration in credit quality

» The magnitude of deterioration must be assessed

» No quantitative trigger set in the standard □ must be determined consistently with risk management practices

» Assessment of deterioration must be made on individual or portfolio basis, for items with similar risks

» Assessment can be made for individual counterparty

Impairment - Operational simplifications

Threshold	Investment grade	Non-investment grade		
Status		No Days Past Dues (DPD)	30 DPD	90 DPD
Allowance	N/A	12-month or lifetime ?	Lifetime	

Analysis of deterioration required

Days past dues are lagging indicators

Use more leading indicators :

- Behavioural scores
- Forebearance
- Negative Credit bureau data
- Loan to values
- Forward looking information

Significant deterioration (rebuttable presumption)

- More than 30 DPD is a backstop (it should identify significant deterioration before default or objective evidence of impairment)
- Use only if forward looking information is not available (neither at individual or portfolio level)
- Presumption can be rebutted (if historical evidence shows no causal link between 30 DPD and significant increase in PD

Defining and measuring 12-month and lifetime ECL

- Default
  - To be defined consistently with an entity's credit risk management practice
  - Must include qualitative indicators of default (e.g., covenant breaches)
  - Rebuttable presumption that default does not occur later than 90 DPD
- Significant deterioration
- Assessment based on the probability of default (does not take into account the collateral)
  - Variation of 12M PD can be used to assess deterioration (except if does not properly reflect deterioration)
  - Regulatory ECL models may form a basis for ECL calculations, but the measurement may need to be adjusted
- Modifications / forebearance
  - Increase in risk must be assessed by reference to credit quality on origination
  - A modification does not automatically result in improvement of the credit quality

Lower risk exception

- Allowance = 12-month EL (automatically, no tracking of deterioration required)
- Credit quality must be consistent with “investment grade”
- Financial instruments are not required to be externally rated
- Not a bright-line trigger to recognize lifetime ECL

Conclusions

Possible impacts

- Context: combined impact of regulatory changes (CRDIV), AQR, IFRS changes, and fines
- Access to the financial market drive banks financial reporting options more that RoE;
  - European banks favor a clean slate, and are looking closely to goodwill (for impairment) and IBNR (rising)
  - IBNR are on the rise; part is linked to avoiding the choc of going from an incurred loss model to and expected loss model
- New prudential and accounting rules are pushing banks out of certain activities and favor shadow banking

The views expressed in this presentation do not necessarily reflect those of the Executive Directors of The World Bank or the governments they represent.

Thank you