IFRS 9 Financial Instruments: Project Update

Global Preparers Forum: Agenda Paper 5A
8 November 2010

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.
Agenda

- Mandatory effective date and transition
- Hedge accounting
  - General model
  - Macro model
- Impairment
-Offsetting
Mandatory effective date and transition
IFRS 9: Mandatory effective date

• ED proposing to extend the mandatory effective date to 1 January 2015
• Comment period closed on 21 October 2011
• In November 2011, the Board will consider comments received on the ED
• The amendment, if any, would be issued by late November
Hedge Accounting: General Model
Components of the hedge accounting model

- Alternatives to hedge accounting
- Presentation and Disclosure
- Groups and net positions
- Discontinuation and rebalancing
- Effectiveness assessment
- Hedging instruments
- Hedged items
- Objective

Hedge accounting (exposure draft)
Objective

Risk management objective: Seeks to link risk management and financial reporting (top down)

Accounting objective: Seeks to manage timing of recognition of gains or losses (bottom up)
Hedged items

Qualifying hedged item

Entire item

Component

Risk component (separately identifiable and reliably measurable)

Nominal component or selected contractual CFs
Hedged items: risk components

IAS 39

Fixed element

Variable element

Benchmark (eg interest rate or commodity price)

Benchmark (eg interest rate or commodity price)

ED

Fixed element

Variable element

Benchmark (eg interest rate or commodity price)

Benchmark (eg interest rate or commodity price)
Hedging instruments

Qualifying hedging instruments

Entire item

Partial designation

FX risk component

- Intrinsic value
- Spot element

Percentage of nominal amount
Costs of hedging

- Costs of hedging
  - Time value of options
    - Transaction related hedged item
  - Forward element of forward contract
    - Time period related hedged item
Hedge effectiveness

Hedge effectiveness test:
1. Economic relationship
2. Effect of credit risk
3. Hedge ratio

Rebalancing

Discontinuation

Measuring and recognising hedge ineffectiveness
Disclosures: scope

Proposed scope for hedge accounting disclosures

- Total entity risk exposure
  - (no specific disclosure requirements)
- IFRS 7 Disclosure requirements
  - Significance of financial instruments for financial position and performance
- Hedged exposure
  - (Exposure to risks being hedged)
- Entity’s exposure attributable to the hedged risk

Nature and extent of risks arising from financial instruments
Disclosures

Hedge accounting disclosures

- Risk management strategy
- Amount, timing and uncertainty of future cash flows
- Effects of hedge accounting on the primary financial statements
- Specific disclosures for dynamic strategies and credit risk hedging
Alternatives to hedge accounting

- Alternatives
  - ‘Own use’ scope exception in IAS 39
  - Credit derivatives
    - Elective FVTPL
      - At initial recognition or subsequently
      - At discontinuation: amortisation
  - Eligible for FVO in IFRS 9
Transition

• Prospective transition with limited exceptions
  – Retrospective application
    – Required for time value of options
    – Permitted for accounting for forward elements (if elected, applies to all such hedging relationships)
  – Practical expedients
    – Allowed to consider the moment IAS 39 ceases to apply and the moment from which the new model applies as one point in time
    – For rebalancing, the starting point will be the hedge ratio used under IAS 39 (any gains or losses will be recognised in profit or loss)
  – Hedging relationships that qualified under IAS 39 and qualify under the new model will be treated as continuing hedging relationships
General hedge accounting: timetable

- Exposure Draft on general hedge accounting published December 2010
- Redeliberations started in March 2011—completed in September 2011
- Staff draft of final general hedge accounting requirements available on website in Q4 2011 (for about 3 months)
- Effective date will be aligned with other phases of IFRS 9
  - Annual periods beginning on or after 1 January 2013/2015* with earlier application permitted
  - All existing IFRS 9 requirements must be adopted at the same time (or already have been adopted)
Hedge Accounting: Macro Model
Status of the Macro Hedge Accounting Project

Fact finding

Common themes

Implications for accounting model

Design of accounting model

Interest rate risk

Project status

Common themes

Implications for accounting model

Design of accounting model

Other risks

Sept 2011

2011 November | IFRS 9 Update
Insights from the project so far

Asset Liability Management (ALM)

- Margin (Bid-Offer Spread of Transfer Prices)
- Repricing Risk / Yield Curve Risk / Basis Risk
- Use of Risk Limits for Management
- Volatility in net profit and loss due to:
  - Differences in timing of cash flows
  - Basis differences
  - Amount differences (vintage)
  - Open positions

Internal Transactions (Derivatives)

Influence on risk limit and target cash flow profile

Transfer (Benchmark) Prices - Component

- Margin: contractual market rate vs. internal transfer price
- Impairment Risk/Prepayment Risk/Market Rate Risk
- Volatility in profit or loss due to:
  - Uncertainty regarding impairment and prepayment (model risk)
  - Margin for new business dependent on market forces

Treasury

Trading Unit

- Management within predefined risk limits.
- Trading Unit takes and manages the counterparty risk of the entire derivative position.

Equity

- Capital Protection
- Dividend targets

Demand Deposits
Time Deposits

Other Liabilities

Consumer Loans
Mortgage Loans
Commercial Loans

Demand Deposits
Time Deposits

Other Liabilities
Applicability to other industries
‘Three-bucket’ approach

Guiding principle: Reflect the general pattern of deterioration of credit quality of financial assets.

- Pattern of deterioration of credit quality is captured through a three-bucket approach
- Deterioration at some point leads to recognition of lifetime losses
- Based on expected credit losses (EL)
- Responsive to changes in information impacting credit expectations
- Builds on credit quality differentiation in joint Supplementary Document (SD)
- Robust disclosures to support principle of the model and to ensure comparability
- Model to be applicable for various types of financial assets and various types of entities.
‘Three-bucket’ approach

<table>
<thead>
<tr>
<th>Bucket 1</th>
<th>Bucket 2</th>
<th>Bucket 3</th>
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</thead>
<tbody>
<tr>
<td>Deterioration in credit risk</td>
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<tr>
<td>Transfer between Buckets 1 - 3</td>
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</table>

- All financial assets are initially classified in this bucket
- Financial assets that deteriorated in credit quality since initial recognition
- Financial assets that deteriorated in credit quality since initial recognition

Acknowledges link between pricing and credit risk and inappropriateness of recognising full lifetime losses on loans priced at market.
Three-bucket’ approach

Allowance balance

Bucket 1 | Bucket 2 | Bucket 3
---|---|---
Less than lifetime expected losses | Full remaining lifetime expected losses

- The boards have not yet decided on the measurement of Bucket 1 allowance.
- Measurement of Bucket 1 allowance shall be based on a principle.
‘Three-bucket’ approach

Next steps

Boards to further discuss:

– Principle that underpins the measurement attribute of the credit allowance for financial assets in Bucket 1
– Principle and indicators for when recognition of lifetime expected losses becomes appropriate
– Application of the model for various types of financial assets and various types of entities
– Implication for purchased financial assets
– Scope of Bucket 2 and Bucket 3 (ie what is to be captured in Bucket 3)
– Disclosures
Offsetting
Amendments to IAS 32 and disclosures

Criteria

IASB
- Retain basic IAS 32 offsetting requirements
- Add application guidance to improve consistency of application regarding:
  - the meaning of ‘currently has a legally enforceable right of set-off’; and
  - that some (non-simultaneous) gross settlement systems would be considered equivalent to net settlement
- Next steps
  - Final document planned for Q4 2011
  - Retrospective application
  - Effective for all periods beginning on or after 1 January 2013

FASB
- Continue to allow netting for particular derivatives / collateral with conditional rights of set-off
**Amendments to IAS 32 and disclosures**

Disclose information about rights of set-off and related arrangements associated with financial assets and financial liabilities to enable users to understand the effect of those rights and arrangements on the entity’s financial position.

- Applies only to instruments under an enforceable master netting agreement or similar arrangement (e.g., derivatives, sale and repurchase agreements, reverse sale and repurchase agreements, securities lending arrangements)

<table>
<thead>
<tr>
<th>Category</th>
<th>Financial instruments</th>
<th>Collateral</th>
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<tbody>
<tr>
<td>Derivatives</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Repos and similar arrangements</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>Other</td>
<td>X</td>
<td>X</td>
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</tbody>
</table>

Columns d and e could be shown by category of instrument or by counterparty

- Final document planned for Q4 2011
- Retrospective application
- Effective for interim and annual periods beginning on or after 1 January 2013
Questions or comments?

Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.