
# Financial Instruments Update

Insurance working group, 25-26 June 2012

IWG Agenda ref 6


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# Classification and Measurement

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# Overview of classification model in IFRS 9 Financial assets

Business model test

Contractual cash flow characteristics

Amortised cost (one impairment method)

FVO for accounting mismatch (option)

Reclassification required when business model changes

All other instruments:

- Equities
- Derivatives
- Some hybrid contracts
- …

Fair Value (No impairment)

Equities: OCI presentation available (alternative)

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# IFRS 9 Effective date amendment



- IFRS 9 effective date deferred to 1 January 2015
  - Early application permitted
- Restatement of comparative financial statements not required
  - Enhanced disclosures on transition

# Limited modifications to IFRS 9: Why?



- IFRS 9 is sound and operational
- Address specific application issues
- Consider the interaction of IFRS 9 and insurance project
- Seek to reduce key differences with the FASB's classification and measurement model
  - Both are mixed measurement models
  - Both consider characteristics of the instrument and business model
  - Joint deliberations and separate exposure drafts

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# Limited modifications to IFRS 9: Scope



- Clarify the contractual cash flow characteristics test
- Reconsider the need for bifurcation of financial assets
- To address interaction with the insurance project and align with the FASB model, consider:
  - Introducing a third business model
  - Whether some debt instruments should be remeasured through OCI
- Knock on effects, eg interrelated issues for financial liabilities

# Limited modifications to IFRS 9: Scope



Business model test

Contractual cash flow characteristics

Amortised cost (one impairment method)

FVOCI (one impairment method)

FVO for accounting mismatch (option)

**Reclassification required if business model changes**

**All other instruments:**

- Equities
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Fair Value (No impairment)

Equities: OCI presentation available (alternative)

# Contractual cash flow characteristics



- Tentative decision February 2012
- Affirms the principle in IFRS 9
  - If cash flows not solely principal and interest (P&I), measured at FVPL
  - If cash flows are solely P&I, measurement depends on the business model
- Minor change to IFRS 9 to clarify the application of the principle
  - Introduces the notion of modified relationship between principal and interest
  - Determine by comparing with a ‘perfect’ instrument

# Contractual cash flow characteristics

**Contractual cash flow characteristics**

**Contractual terms that give rise to solely payments of**

**Principal**

**Interest**

**Interest =**
Consideration for
• time value of money
• credit risk

**Tentative decision:**

**'Modified' P&I satisfies test IF**

- **Compared with a perfect instrument, difference not more than insignificant**

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# Bifurcation



- IFRS 9
  - Eliminated for financial assets
  - Retained for financial liabilities
- FASB model
  - Retained for financial assets and liabilities
- Tentative decisions April 2012
  - Noted the effect of the revised cash flow test
  - No bifurcation of financial assets
  - ‘Closely related’ bifurcation of financial liabilities
  - No change to IFRS 9

# Business model/strategy



- IFRS 9 business models
  - Held to collect contractual cash flows (amortised cost)
  - Other (FVTPL)
- FASB business strategy
  - Lending business (amortised cost)
  - Investing business (FVOCI with recycling and impairment)
  - Trading business (FVTPL)

# Business model/strategy



- Tentative decisions April 2012 – amortised cost
  - Amortised cost is based on the notion of holding to collect contractual cash flows
  - Minor amendment to when sales are consistent with the ‘hold to collect’ notion
  - Application guidance to support classification at amortised cost

# Business model/strategy



- Tentative decisions May 2012 – FVOCI and FVPL
  - Required FVOCI category for business model that manages assets to both hold to collect contractual cash flows and sell
  - FVOCI will provide fair value information on the balance sheet and amortised cost information in P&L (ie recycling is required)
  - FVPL is a residual; portfolios held for trading and managed on fair value basis will be at FVPL

# Next steps



- Fair value option
- Reclassification mechanics
- Disclosures
- Transition
- Sweep issues

# Questions or comments?



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# Impairment Update

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# 3-Bucket approach: general overview



**Guiding principle: Reflect general pattern of deterioration and improvement of credit quality of financial assets**

- Joint project
- Expected loss (EL) model
- Responsive to changes in information that impact credit expectations
- Inappropriate to recognise full lifetime losses on initial recognition of financial assets priced at market
- Deterioration in credit quality leads to recognition of lifetime losses
- Robust disclosures to support principle and support comparability

# ‘Three-bucket’ approach



**Bucket 1: 12 months expected loss allowance**

All financial assets are initially categorised in this bucket*

→ **Completely *symmetrical* model**

**Bucket 2: Lifetime expected loss allowance**

Evaluation performed on *groups* of financial assets

**Bucket 3: Lifetime expected loss allowance**

Evaluation performed on *individual* financial assets

**Move out of Bucket 1* when:**

1. *more than an insignificant* deterioration in credit quality since initial recognition; <u>AND</u>
2. likelihood of default such that at least *reasonably possible* that all or some contractual cash flows may not be collected.

* Except for purchased credit-impaired assets and trade receivables.

# Purchased credit-impaired assets



- Scope
  - Assets purchased with an ‘explicit expectation of credit losses’
  - Same population as IAS 39 today (IASB)*
- Always outside Bucket 1
- Use credit-adjusted effective interest rate
  - No day 1 allowance balance
  - No day 1 impairment loss recognised
- Allowance balance represents *changes* in lifetime loss expectations

* FASB will consider whether scope should be broadened.

# Trade receivables



- *Without* a significant financing component (short term):
  - – Measure receivable at invoice amount
  - – Always recognise lifetime expected losses (ie categorise outside Bucket 1)
  - – Provision matrix as a practical expedient
- *With* a significant financing component (long term):
  - – Policy election either:
    - – apply general ‘three-bucket’ model or
    - – always recognise lifetime expected losses

# Lease receivables



- Policy election either:
  - apply general ‘three-bucket’ model or
  - always recognise lifetime expected losses

- Parameters:
  - EIR: discount rate used for measurement of the lease receivable
  - contractual CFs: those included in the lease receivable

- Depending on project timing the new model could also be applied in conjunction with IAS 17

# Modifications



- Need to determine whether derecognition applies
- If not derecognised:
  - apply general criteria for allocation to buckets
    → symmetrical, ie also applies to movements up
  - relative criterion: look at original *credit quality*
  - absolute criterion: risk assessed on basis of new terms & conditions
  - gain/loss from modification results in adjustment of gross carrying amount
    => affects basis for interest revenue

# Discount rate



- Rate to discount expected losses:
  - ‘discounting of losses’ needed because the asset’s carrying amount is a PV
  - conceptually right answer: use EIR of asset

- To provide operational relief choice of a rate that is in between:
  - EIR of asset (like under IAS 39); and
  - risk free rate

- Scope:
  - financial assets other than credit impaired purchased ones
  - applies also to lease receivables

# Open topics and timeline



- Loan commitments, financial guarantee contracts, revolvers
- Disclosures
- Transition
- Re-exposure draft in H2 2012

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# Hedge Accounting: General Model

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# Components of the general hedge accounting model



# Hedged items

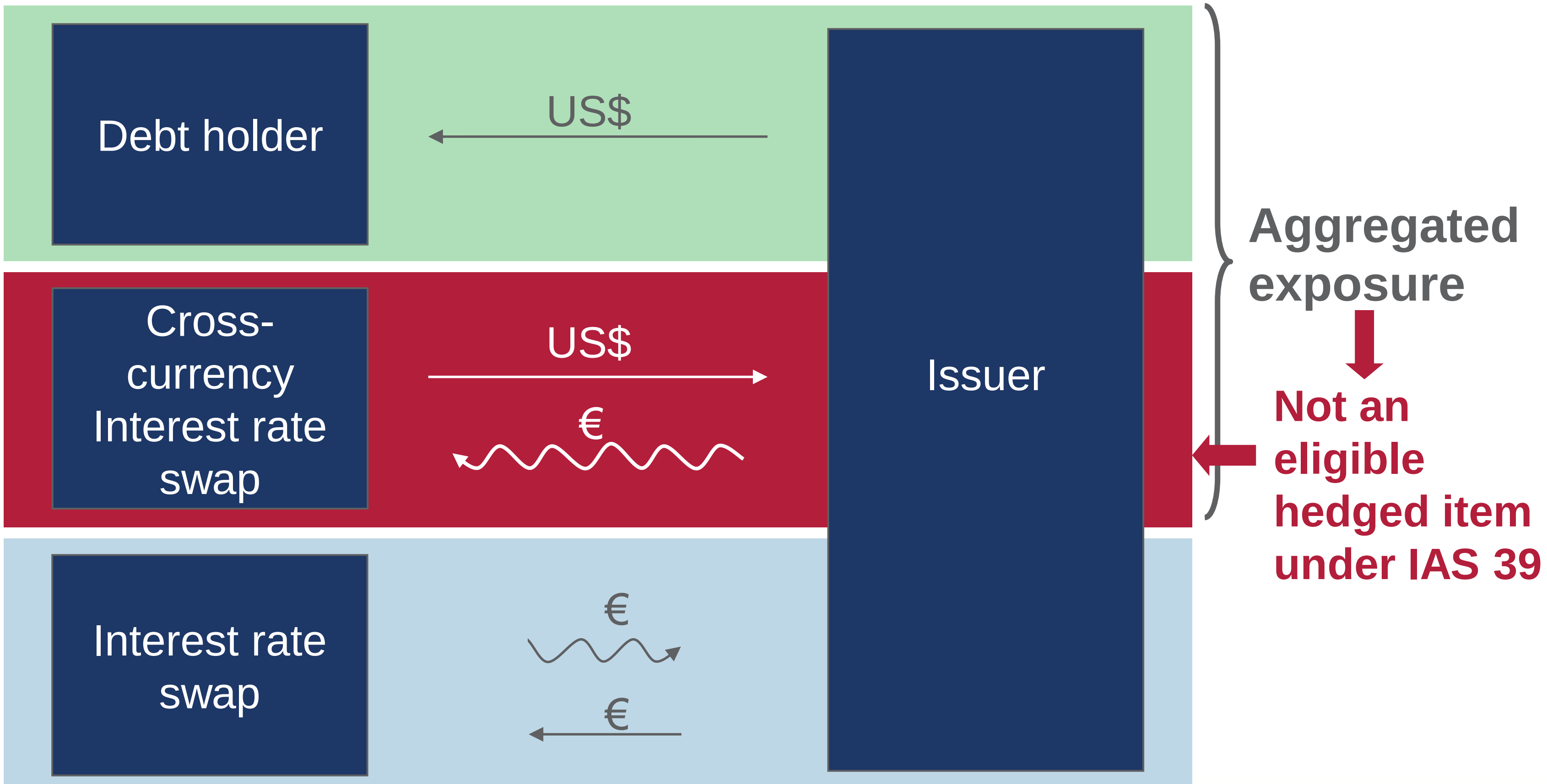


- Qualifying hedged item
  - Entire item
  - Component
    - Risk component (separately identifiable and reliably measurable)
    - Nominal component or selected contractual CFs

# Hedged items: aggregated exposures

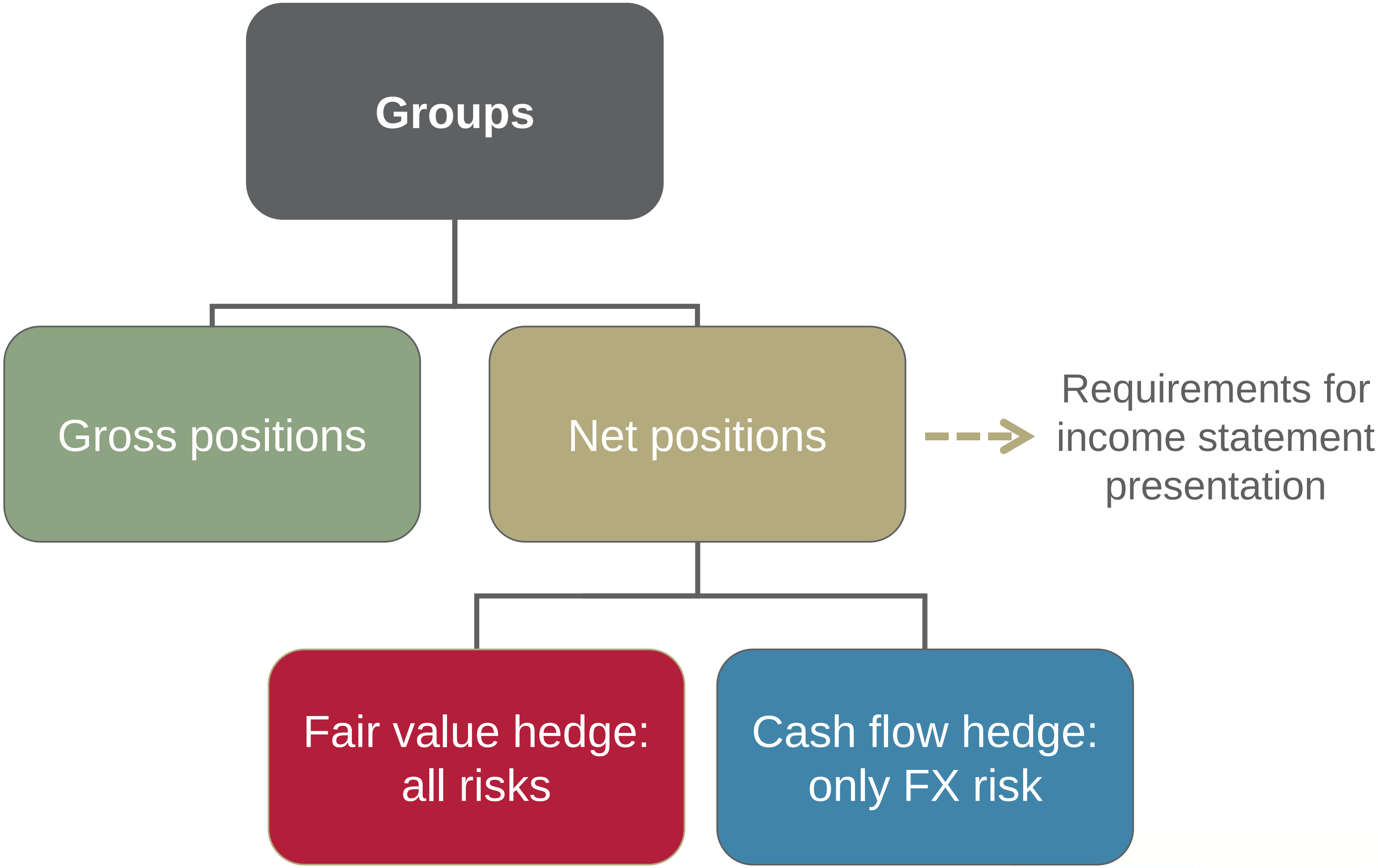


## Example: hedging FX & interest rate risk



# Hedged items: groups of items





# Hedging instruments

**Qualifying hedging instruments**

- Entire item
- Partial designation
  - FX risk component
  - • Intrinsic value
    • Spot element
  - Proportion of nominal amount



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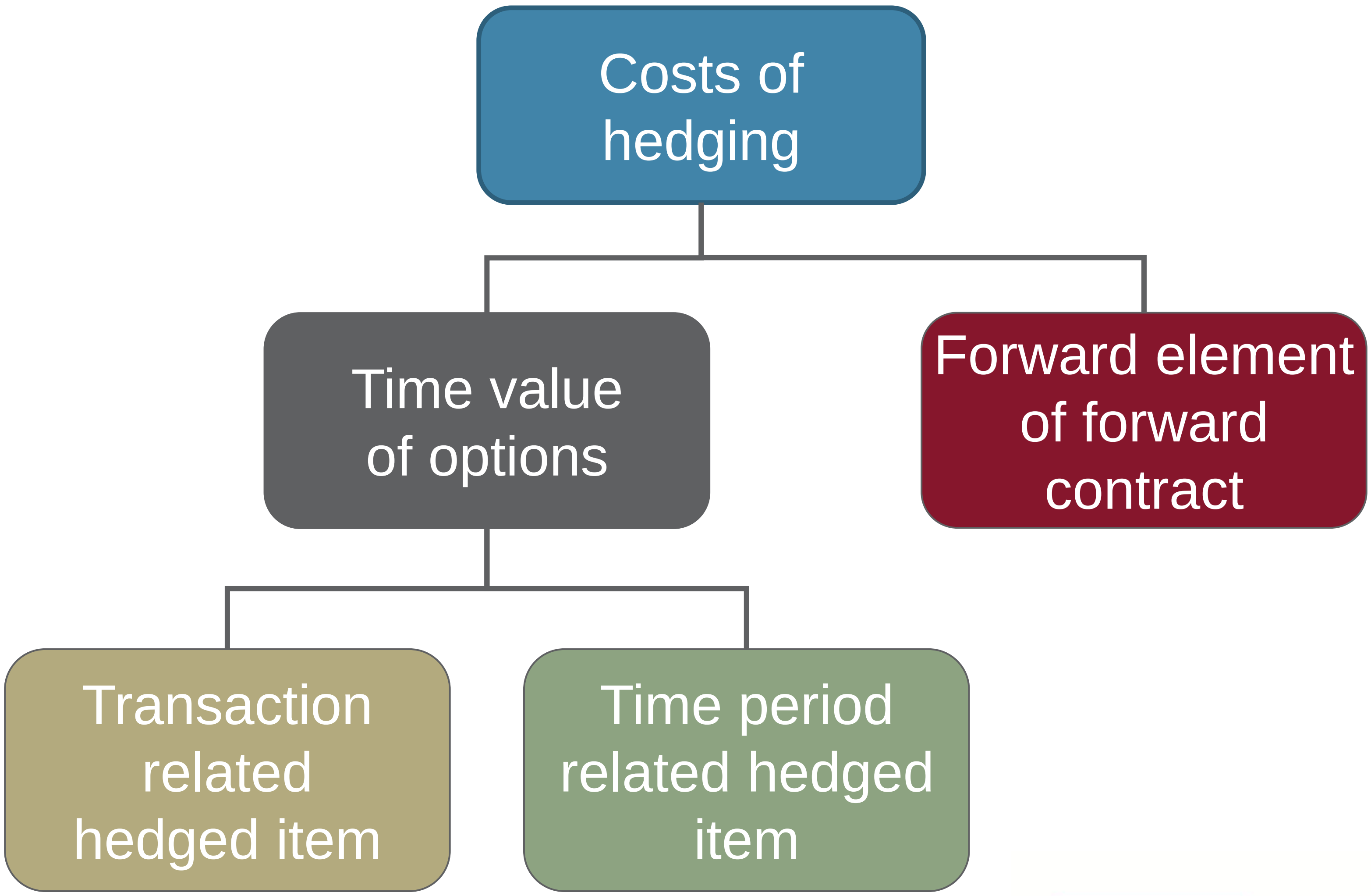
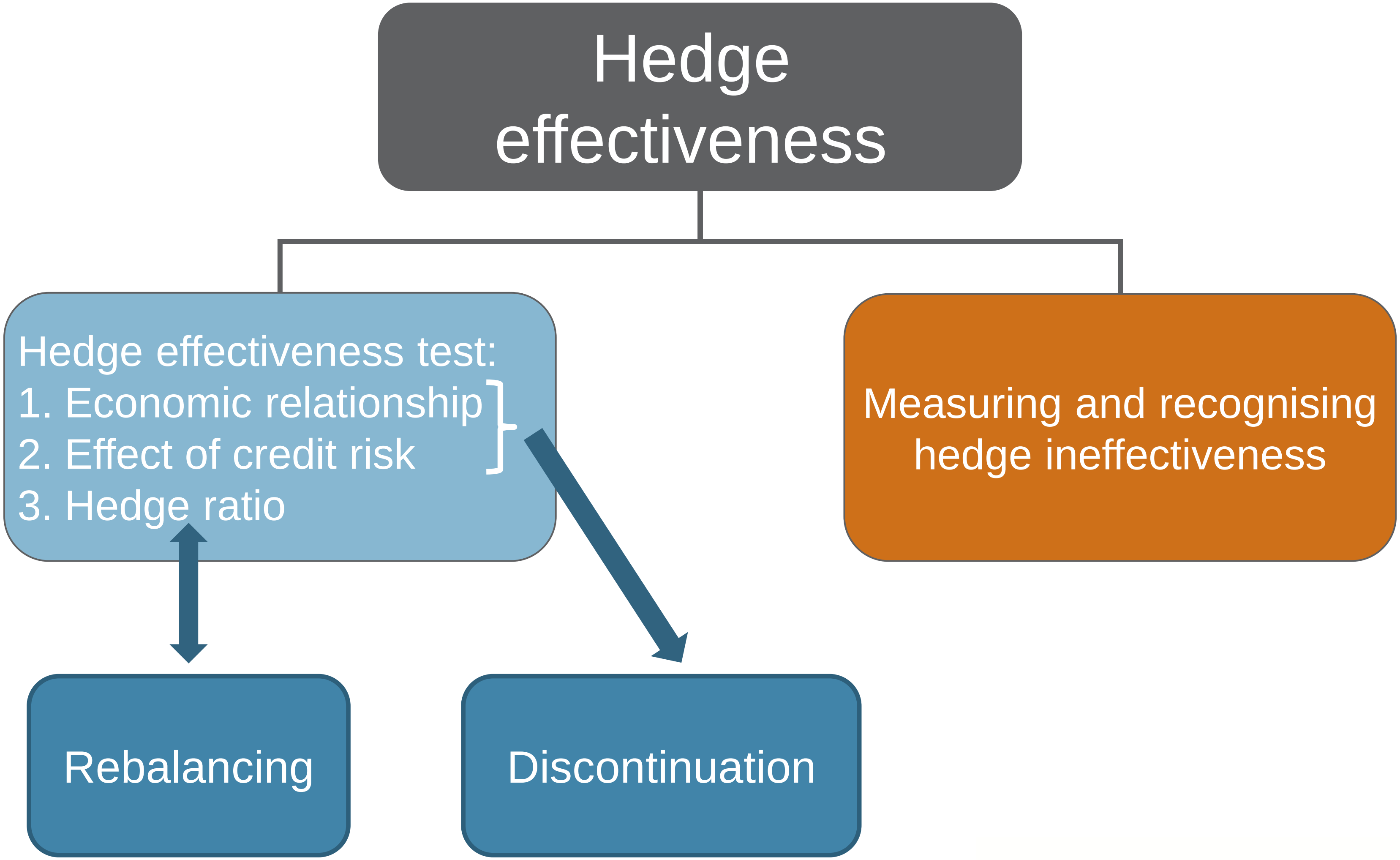
# Costs of hedging



# Hedge effectiveness





# 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

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# Alternatives to hedge accounting



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

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# Hedge Accounting: Macro Model

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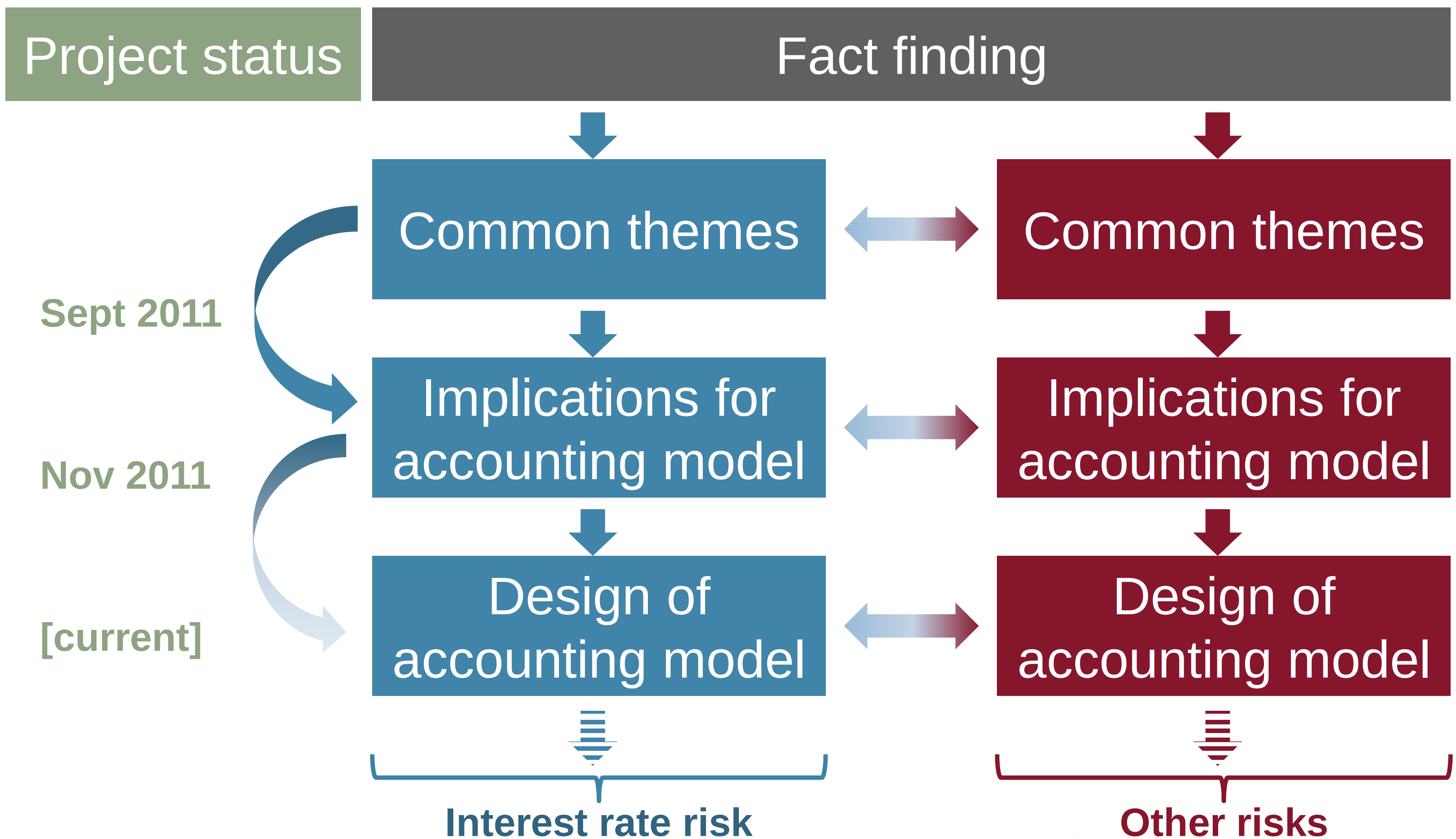
# Status of the macro hedge accounting project



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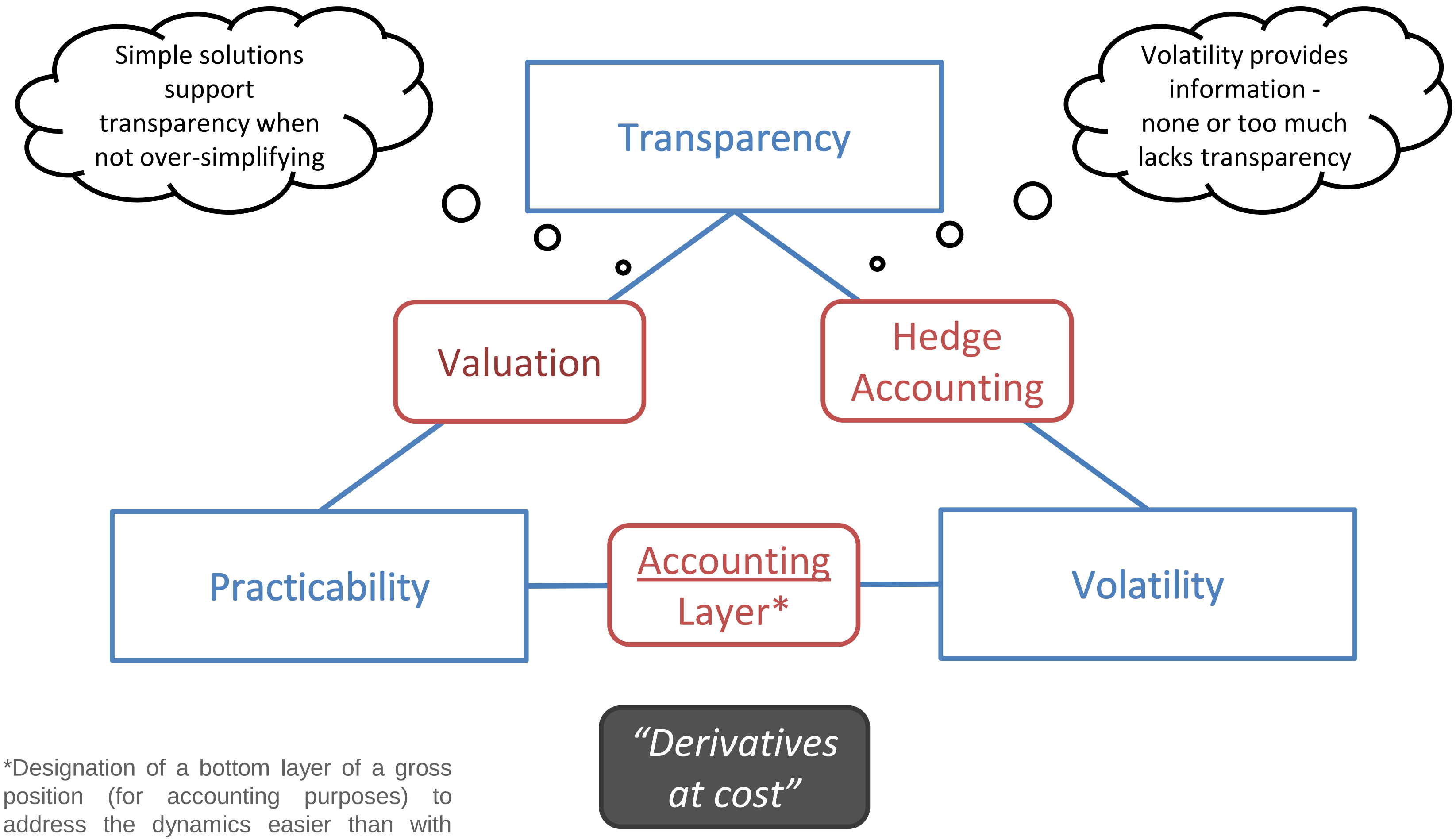
# Accounting alternatives and financial reporting objectives






*Designation of a bottom layer of a gross position (for accounting purposes) to address the dynamics easier than with current hedge accounting approach. The layer is derived from the actual net risk position.

# Decoupling macro hedge accounting from IFRS 9



## Why create a separate accounting standard?

- Developing something very new => extra research and input needed
- Postponing the *entire* financial instruments standard for one issue relevant to entities that do macro hedging is not appropriate
- Demand for IFRS 9 and for a stable accounting basis => IFRS 9 should be available as soon as possible

# Road map



- Continue with IFRS 9 as planned but *exclude* macro hedge accounting from its scope
- Progress macro hedging as a separate project with the objective to prepare a Discussion Paper
- Interim solution:
  - Preparers can keep current accounting for macro hedging strategies
  - Adopt IFRS 9 for all purposes except macro hedge accounting
  - Maintains status quo for those using macro hedging

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