Tuesday 30 September 2014
The Grange City Hotel (London)

Meeting documentation

World Standard-setters Meeting

Education session: IFRS 9 *Financial Instruments*

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Education session:
IFRS 9 *Financial Instruments*

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International Financial Reporting Standards

IFRS 9
Financial Instruments

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Finalisation of the IASB's response to the global financial crisis

Classification and measurement
A logical, single classification approach driven by cash flow characteristics and how it's managed

Impairment
A much needed and strongly supported forward-looking 'expected loss' model

Hedge accounting
An improved and widely welcomed model that better aligns accounting with risk management

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Classification and measurement

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The IFRS 9 classification model for assets

	Business model = hold to collect	Business model = hold to collect and sell	Other business models
Cash flows are solely payments of principal and interest (SPPI)	Amortised cost	FVOCI* (NEW)	FVPL
Other types of cash flows	FVPL	FVPL	FVPL

*Excludes equity investments. Can elect to present FV changes in OCI.

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Business model test

- Factual assessment based on how assets are managed:
  - Not based on intent for individual asset
  - Typically observable through activities that the entity undertakes
  - Anchor is how cash flows are realised
- Hold to collect (amortised cost)
  - Generate value by collecting contractual cash flows
  - Consider past sales information and future expectations
  - Some sales may be consistent if infrequent or insignificant
- Hold to collect and sell (FVOCI)
  - Achieve objective by collecting contractual cash flows and selling
  - Involves greater frequency and volume of sales
  - eg liquidity needs, interest yield management, asset/liability management
- Reclassify if business model changes

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Clarifications to cash flow characteristics

- Clarifies the principal and interest concept
  - More aligned with what constituents view as 'simple instruments'
- Interest – not only time value and credit risk
  - Notion of a basic lending arrangement
- Exception for regulated rates
- 'Principal' = amount transferred by holder (fair value)
- Simplified the test for a modified economic relationship
  - Now 'significant' rather than 'insignificant' difference compared to benchmark
  - Qualitative or quantitative

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Financial liabilities – 'own credit'
designated under the fair value option (FVO)

Financial statements – IFRS 9		
Balance sheet	*P&L*	
Financial liabilities – FVO — Full FV	Gain or loss	all FV Δ except own credit
	OCI	
	Gain or loss	FV Δ due to 'own credit'*

* Not recycled

- Otherwise, **P&L gain when 'own credit' deteriorates**, loss when it improves
- ***Required*** **by IFRS 9** for liabilities under the FVO
- **IFRS 9** allows the 'own credit' requirements to be early applied in isolation

Treatment of financial liabilities is carried forward from IAS 39 essentially unchanged

A superior approach

- Principle-based, unified model with logical structure/rationale
  - measurement categories and use of a business model approach reflect the nature of their cash flows and the way they are managed
- Improved reclassification rules consistent with management
  - financial assets reclassified between measurement categories only when the business model for managing them changes
- Solution to 'own credit' concerns
  - P&L volatility will no longer result from changes in own credit, while information on own credit will still be available for users
- Single approach eliminates complex bifurcation requirements and multiple associated impairment approaches
- Elimination of IAS 39 tainting rules

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Impairment

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At a glance

Forward-looking model that is responsive to changes in credit risk and responds to the calls of the G20 and others

- Broader range of information required to be considered
  - Ensures more timely recognition of expected credit losses
  - Elimination of IAS 39 threshold to recognise expected credit losses
- Builds on existing systems to balance costs and benefits
  - Approximates 2009 ED in a more operational manner
- Single model reduces complexity of multiple approaches
- Shows assets that have significantly increased in credit risk
- Robust disclosures to illustrate estimates and credit risk

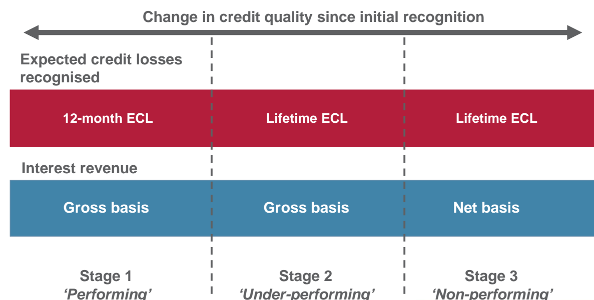
The basis for the model

- The yield on financial instruments reflects initial credit loss expectations
- When expected credit losses exceed those initially expected an economic loss is suffered
- This was reflected in the 2009 ED

Model reflects this in a more cost effective way by:

- Recognising a portion of expected credit losses initially
- Recognising lifetime expected credit losses when significant increase in credit risk occurs

Overview of the requirements



12-month Expected credit losses

When to recognise 12-month expected credit losses?

- When the financial instrument is recognised initially
- No significant increase in credit risk; or
- Low credit risk (for example, 'investment grade')

Expected credit losses will be recognised for *all* financial instruments at *all* times.

12-month Expected credit losses (ECL)

What are 12-month expected credit losses?

Full lifetime expected credit losses that would result from default *multiplied by* the probability of default in the next 12 months

- Expected cash shortfalls in next 12 months
- Credit losses on assets expected to default in next 12 months

Assessment of deterioration in credit quality

- Change in credit risk over the life of the instrument (ie probability of a default occurring)
  - Not changes in expected losses
  - Compared to credit risk at initial recognition
- Maturity matters
- Use information that is available without undue cost or effort

Expected credit losses are updated at each reporting date for new information and changes in expectations even if deterioration is not significant

Measuring expected credit losses

Expected credit losses need to reflect:

- Probability weighted outcome
  - Must consider possibility that default will/will not occur
  - Must define default for purposes of determining risk of default
- Time value of money
  - Discount at effective interest rate or an approximation thereof

Information used to measure expected credit losses and assess changes in credit:

- Available without undue cost or effort
- Historical, current and reasonable and supportable forecasts
- Historical information must be updated
- Delinquency information may be used
  - 30 days past due rebuttable backstop

When to calculate net interest

When assets are 'credit impaired'

- Interest is usually calculated on the gross carrying amount (ie before the loss allowance)
- Change to calculation on a net basis (ie on the amortised cost amount that is net of the loss allowance) when IAS 39 criteria for impairment are satisfied
- Consistent with population considered impaired under IAS 39 today (excluding IBNR)

Disclosures

Quantitative

- Reconciliation of allowance accounts showing key drivers for change
- Explanation of gross carrying amounts showing key drivers for change
- Gross carrying amount per *credit risk grade or delinquency*
- Write-offs, recoveries, modifications

Qualitative

- Inputs, assumptions and techniques used to estimate expected credit losses (and changes in techniques)
- Inputs, assumptions and techniques used to determine 'significant increase in credit risk' and 'default'
- Inputs, assumptions and techniques used to determine 'credit-impaired'
- Write off policies, modification policies, collateral

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Hedge accounting

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Accounting and risk management

Feedback on IAS 39: *Recognition and Measurement*

- Lack of an overarching principle; complex and rule-based
- Inability for **preparers** to reflect hedges in financial statements
- Hard for **users** to understand risk management practices

Solutions in IFRS 9: *Financial Instruments*

- Major overhaul of hedge accounting
- Align accounting treatment with risk management activity
- Enable **preparers** to better reflect hedging in financial statements
- Provide disclosures to help **users** understand risk management and its impact on the financial statements

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Major improvements

- Designate risk components of non-financial instruments
- Ability to hedge aggregated exposures (combinations of derivatives and non-derivatives)
- Introduction of 'costs of hedging' to improve the transparency around some hedging instrument
- A principle-based hedge effectiveness assessment to achieve hedge accounting
- Disclosures that meet the objectives of understanding the hedged risks; how those are managed; and effect of hedging

A new approach to how accounting interacts with risk management

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Hedged items

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

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Hedging instruments

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

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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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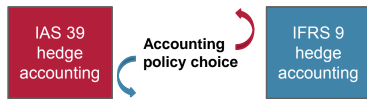
Project does not address macro hedging

Even if apply IFRS 9 can still use specific portfolio hedge accounting requirements in IAS 39

For now entities can choose to keep using IAS 39 hedge accounting



Some banks may not make any changes to their hedge accounting at this time

- The IASB is simultaneously working on a specific project to consider accounting for macro hedges (Discussion Paper published)

'Macro cash flow hedging'

Until the completion of the project on 'macro hedging', entities can account for their macro hedging activities using the specific model in IAS 39 for portfolio hedges of interest rate risk

In the case of cash flow hedge accounting, so-called 'proxy hedging' is still an eligible way to designate a hedged item in accordance with IFRS 9 as long as the designation reflects risk management

This in effect maintains the position that existed prior to IFRS 9

Implementation of IFRS 9

Annual periods beginning on or after 1 January 2018

- Mandatory effective date consistent with stakeholder requests
- Entities permitted to early apply the completed (whole) version of IFRS 9
- Previous versions of IFRS 9 phased out:
  - Not permitted to early apply a previous version unless the relevant date of initial application is before 1 February 2015
- 'Own credit' requirements available for early application, in isolation, until the mandatory effective date
- Transition Resource Group for Impairment of Financial Instruments (ITG)

Questions and comments

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