October 2015

International Financial Reporting Standards

AP4
IFRS 9
Expected losses – a paradigm shift

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Agenda

1. Key facts about IFRS 9 - Impairment
2. How important is impairment and how big will the change be?
3. Some details on the new approach in IFRS 9

The illustration of the potential impact of IFRS 9 included in this presentation does not necessarily reflect the views of the IASB

Key Facts about IFRS 9

- Whose financial statements are affected?
  - Expect banking and insurance sectors to be most affected
  - Other corporates with large investment portfolios could be affected as well.
- When does IFRS 9 become effective?
  - Mandatory beginning 1.1.2018
  - Final step in Europe is Endorsement by EU Parliament
- But it’s not just watching and waiting…
  - Early application seen in Australia (eg NAB)
  - Canada’s large banks will “early” apply to align with global peers
  - Suggestions that the UK regulator (PRA) may include IFRS 9 in capital assessments earlier
  - Enhanced Disclosure Task Force (EDTF) is looking at disclosure options

Jargon Busting

Variety of Terms	P&L Expense	Balance Sheet Allowance
IFRS	Impairment expense Impairment gain/loss	Loan Loss Allowance
Financial Media & Investment Research	Loan Loss Provisions Loan Loss Charges Bad Debt Expense Provisioning Charge Impairments	Loan Loss Reserve Provisions Impairment Allowance Allowance for Loan Losses

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How big is the change?

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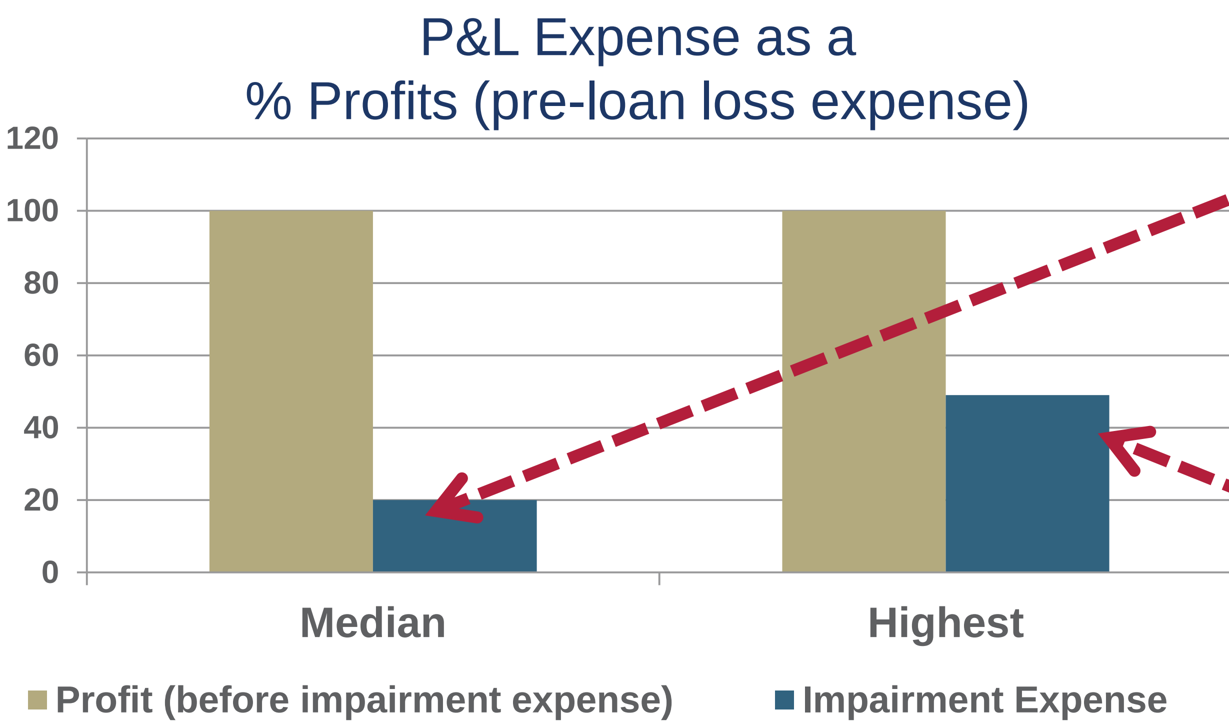
P&L expense is key to banks' earnings

- Loan loss P&L Expense is frequently the single biggest expense item in a bank's P&L



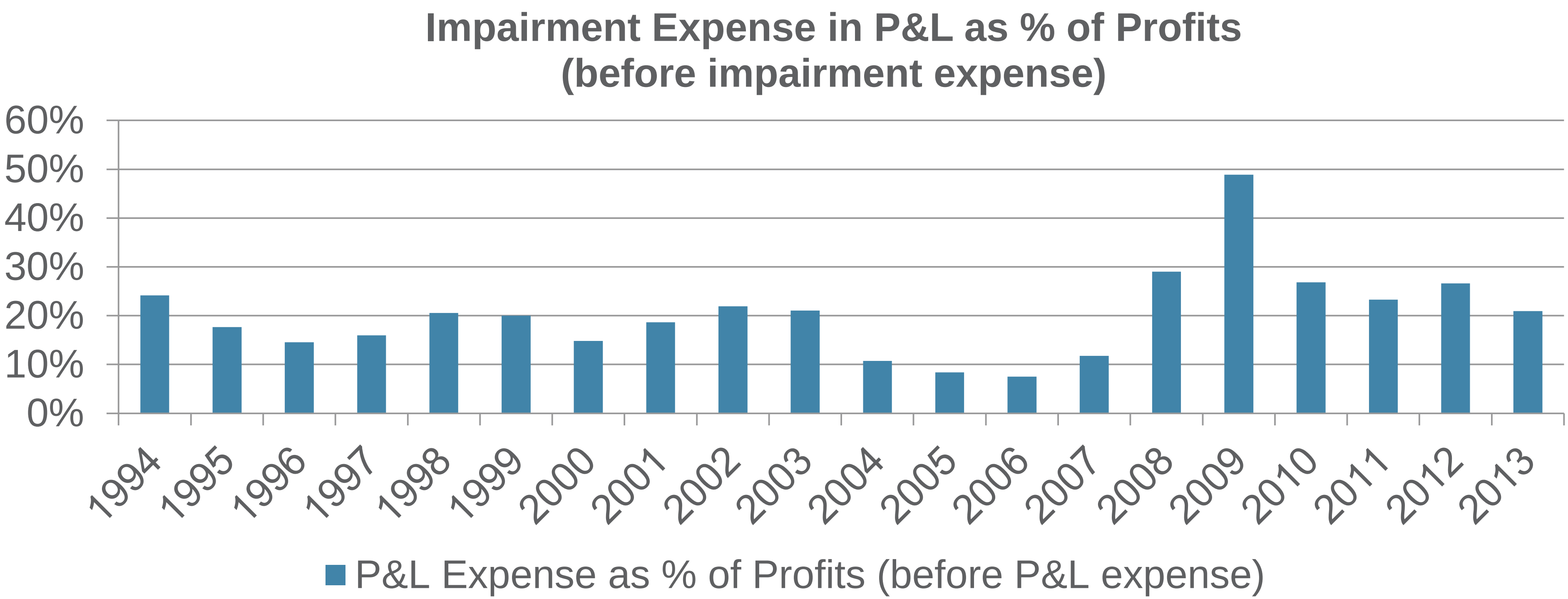
During 1994-2013:
P&L expense consumed
20% of profits (before P&L expense)

The median was as high as c50% in the most severe years

*Source: IASB, Capital IQ, 1994-2013, sample of 31 banks currently reporting under IFRS

P&L expense is key to banks' earnings

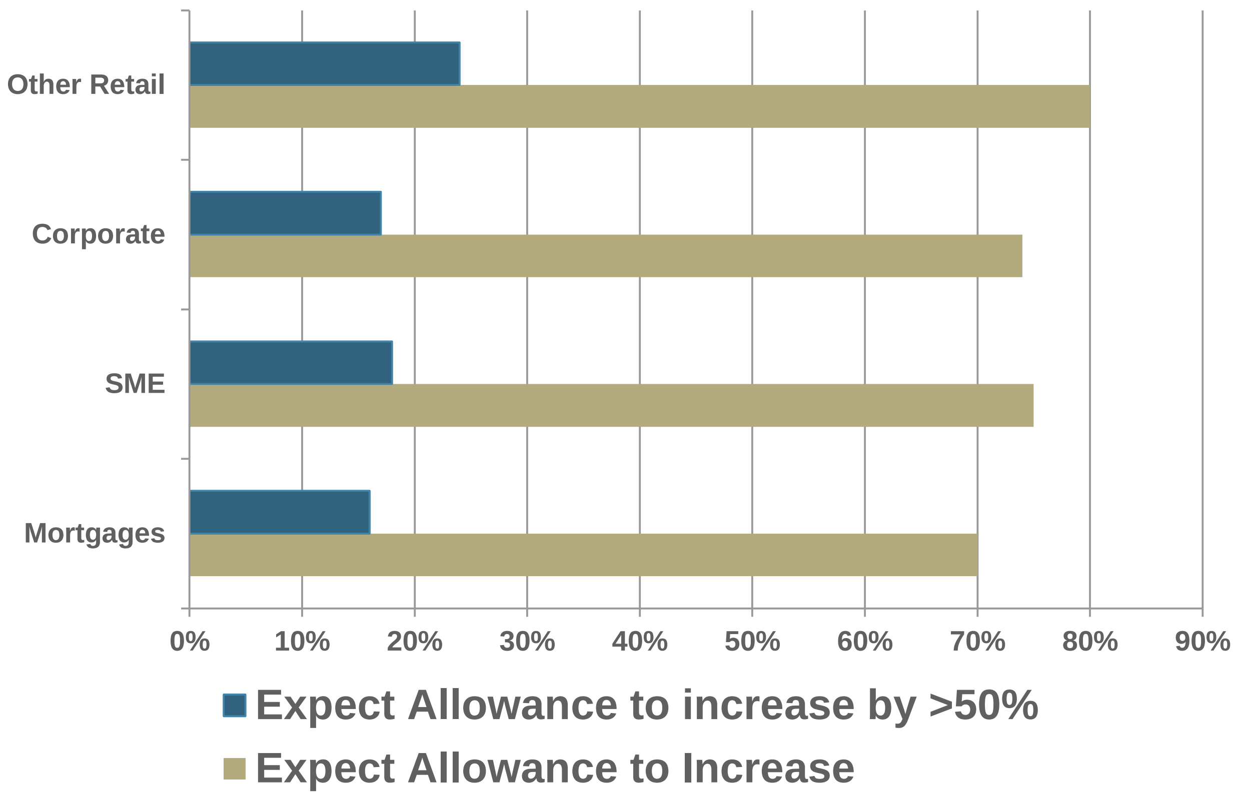
- Impairment Expense is a key determinant of bank profits



*Source: IASB, Capital IQ, 1994-2014, Chart plots the median of a sample of 31 banks currently reporting under IFRS

Balance Sheet allowances are likely to rise

How will balance sheet allowances change when IFRS 9 is implemented?



- Majority of large banks surveyed expect balance sheet allowance to increase at 1st time application
- Many expected allowances to increase by > 50%

Source: "Fourth Global IFRS Banking Survey" by Deloitte, June 2014

3 Stage Impairment Model

IFRS 9 Impairment: Expected Credit Loss Model

3-Stage model	Stage 1: performing	Stage 2: Under-performing	Stage 3: Non-performing
Balance Sheet Allowance	**12-month ECL**	**Lifetime ECL**	**Lifetime ECL**
Criterion	**No significant increase in credit risk**	**Credit risk increased significantly.**	**Credit risk increased significantly & objective evidence of impairment**
Interest Revenue based on:	**Gross Carrying Amount**	**Gross Carrying Amount**	**Net Carrying Amount**

Change in Credit Risk

Why not lifetime losses at all times?

- IASB concluded this doesn't reflect the economics of the situation
- A "day-1" lifetime losses approach would produce undesirable reporting consequences:
  - Booking full lifetime losses distorts the value of the loan book
  - Artificially depresses book value per share or earnings per share
  - Poorer information set for investors by removing the signalling achieved by separating performing from under and non performing loans.
- A "day-1" lifetime losses approach could potentially produce undesirable business consequences:
  - Banks can sell loans or run down the loan book to release large allowances and book gains – these can mask real economic losses
  - In bad times, banks could be incentivised to cut off liquidity to the system by lending less and lending for shorter durations.

And shareholders equity will decline

An increase in balance sheet allowances under IFRS 9 can result in a material reduction in shareholders' equity

Impact of Transition to IFRS 9 from IAS-39: Effect on Common Shareholders' Equity*							
	Increase existing balance sheet allowance by:						
	10%	20%	30%	40%	50%	75%	100%
Decline in Shareholders' Equity	-2%	-5%	-7%	-10%	-12%	-18%	-24%

*Source: IASB estimates, Capital IQ database

- 27 banks reporting under IFRS
- FY-2013 data Capital IQ database
- Comparison of Balance Sheet Allowance (aka Loan Loss Allowance) to (reported) Common Shareholder's Equity
- Range of assumptions is for illustrative purposes only.

How do Expected Losses Affect Regulatory Capital Today (IAS-39)?

Issue to monitor: Will the status quo change as IFRS-9 gets implemented?

If Balance Sheet Allowance (IAS 39) is Smaller than Expected Loss (EL)

Common Equity Tier 1 Before Regulatory Adjustment		1000
Memo:		
Expected Loss	300	
Balance Sheet Allowance	200	
Excess of EL over Provision	100	-100
Other (unrelated) deductions		-50
CET1		**850**
Tier 2 Capital		350
Total Capital		**1200**

Balance Sheet Allowance (IAS 39) is Larger than Expected Loss (EL)

Common Equity Tier 1 Before Regulatory Adjustment		900
Other (unrelated) deductions		-50
CET1		**850**
Tier 2 Capital		350
Memo:		
Expected Loss	200	
Balance Sheet Allowance	300	
Deficit of EL over Provision	-100	
Add Back to Tier 2*		100
Total Capital		**1300**

?

Accounting "Deficit" *reduces* CET1 and *reduces* Total Regulatory Capital

Accounting "Surplus" *reduces* CET1 but *increases* Total Regulatory Capital*

Source: IASB estimates

*Assumptions: The Tier-2 add-back does not exceed 0.60% of RWA

Effect on regulatory capital ratios

- If balance sheet allowances increase by >40%...
  - then core Tier-1 capital ratios for many banks would be materially affected.
- All else equal, this assumes that the impact from accounting transition flows directly to regulatory capital.

Average decrease (%) in core Tier 1 ratio if balance sheet allowance increases by:							
	10%	20%	30%	40%	50%	75%	100%
Canada Banks	-0.10%	-0.19%	-0.29%	-0.38%	-0.48%	-0.72%	-0.96%
Western Europe banks	-0.53%	-1.06%	-1.59%	-2.12%	-2.65%	-3.97%	-5.30%
EEMEA banks	-0.17%	-0.33%	-0.50%	-0.67%	-0.84%	-1.26%	-1.67%
Asia-Pacific banks	-0.16%	-0.32%	-0.47%	-0.63%	-0.79%	-1.19%	-1.58%
Latin America banks	-0.35%	-0.69%	-1.04%	-1.39%	-1.74%	-2.60%	-3.47%

Source: Standard & Poor's report ""Could Ballooning Loss Reserves From New Accounting Rules Deflate Bank Capital Ratios?" & Capital IQ

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What might prudential regulators do?

- Prudential regulators will consider how to respond to changed accounting

Scenarios	If Accounting Allowance Is Larger Than Regulatory Expected Loss	If Accounting Allowance Is Smaller Than Regulatory Expected Loss
No Change to Regulatory Capital Treatment	**Excess amount of allowance:** • No adjustment of Core Tier-1 Capital • Added to Tier-2 Capital*	**Allowance deficit :** • Deducted from Core Tier-1 Capital
Symmetrical Treatment	**Excess amount of allowance:** • Added back to Core Tier-1 Capital	**Allowance deficit :** • Deducted from Core Tier-1 Capital
Accept accounting allowance	No adjustment to Core Tier 1 Capital	• No adjustment to Core Tier 1 Capital

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IFRS 9….will we see a pattern of early application?

Basel III requirements are not yet live…

Yet disclosures are very common

New Disclosures	Q1-2014 % of banks reporting a ratio or regulatory threshold guidance	Full Compliance Date
Basel leverage ratio / Supplementary Leverage Ratio	74%	2019
Liquidity Coverage Ratio (LCR)	60%	2019
Net Stable Funding Ratio (NSFR)	29%	2019
Fully-loaded Basel III Core Tier 1 / Tier 1 Common	100%	2019

The EDTF has already started work to look into what, if anything, banks might be encouraged to disclose earlier

Source: Enhanced Disclosure Task Force (35 large global banks featured in the sample)

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What does the new approach look like?

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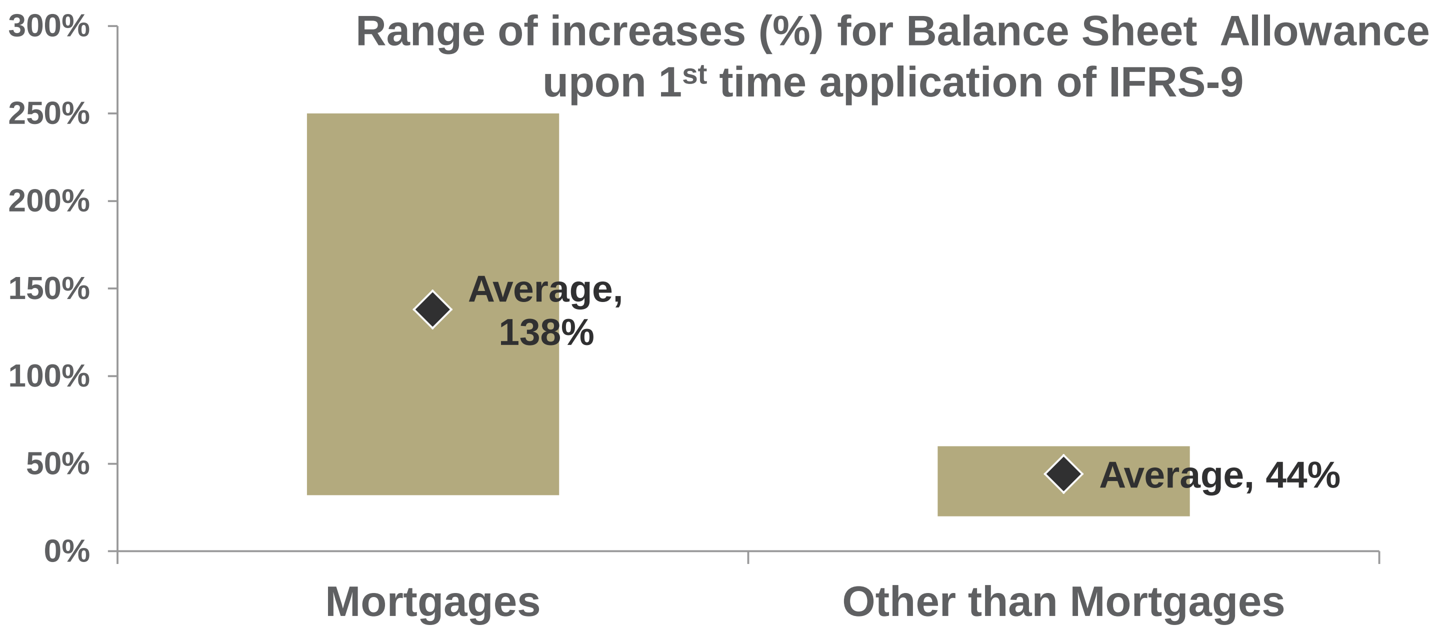
What can we expect when IFRS 9 is first applied?

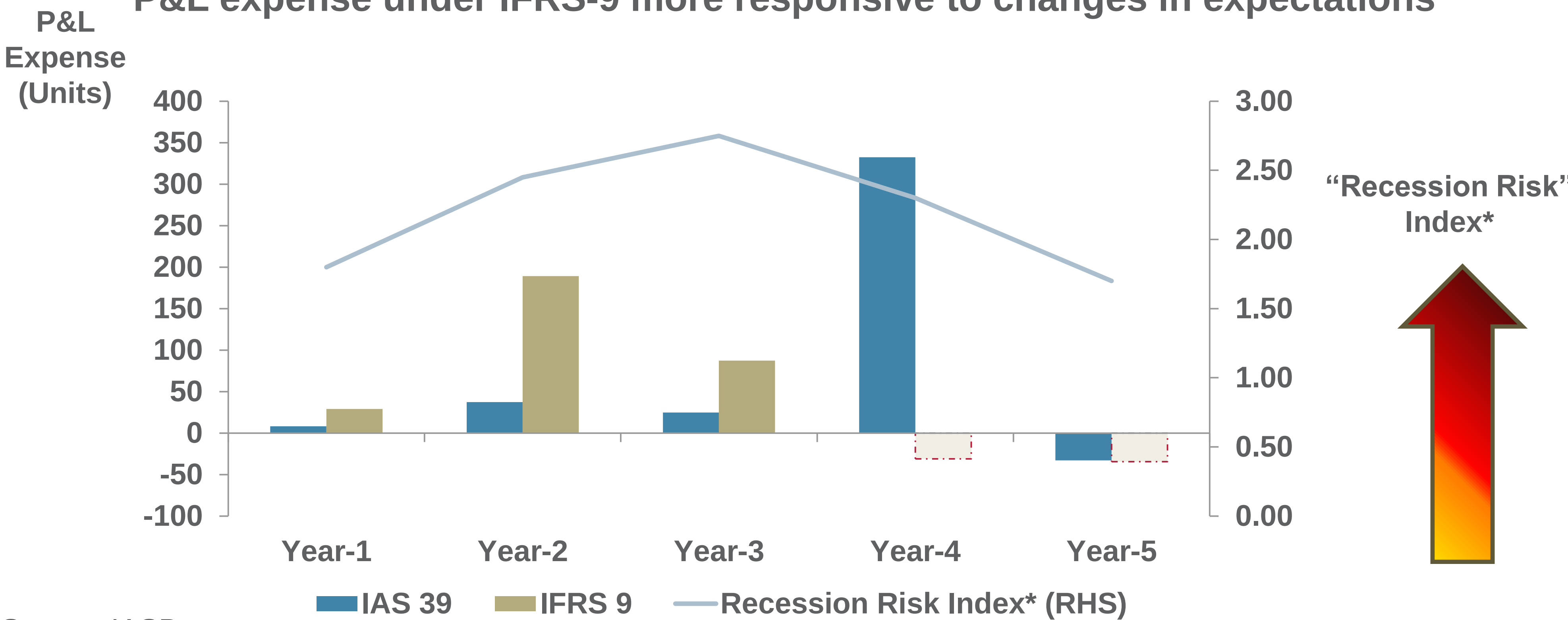
- **Expect Balance Sheet Allowances to increase under IFRS-9 relative to IAS 39**
- **Allowances could increase:**
  - **Between 30% and 250% for mortgage portfolios**
  - **Between 25% and 60% for non-mortgage portfolios**



Source: IASB field work analysis

What can we expect over time?
Illustration in a volatile environment

P&L expense under IFRS-9 more responsive to changes in expectations



Source: IASB

- *Index comprised of various economic variables, solely used for illustrative purposes.
- Higher readings increased expectations of economic recession
- Year 4 & 5 Caveat: IFRS 9 shading differs, example illustrates the direction of P&L expense without being definitive about the amounts.

What drives allowance balances?

Change in Volume of Lending

Change in Credit Risk Expectations

Disclosure Objectives aimed at investors

Credit Risk Disclosure Objectives	Comments
The Big Picture	Enable investors to understand the effect of credit risk on the: • Amount of future cash flows • Timing and uncertainty of future cash flows
Key Concepts & Details	**Information to be provided by disclosures**
1. Credit Risk Management Practices	Information about these practices and how they relate to measuring ECL (methods, assumptions, information used)
2. Evaluating the amounts of ECL	Quantitative and qualitative information to evaluate the amounts of ECL in financial statements (changes in amount of ECL, reasons for the change)
3. Entity's Credit Risk Exposure	Information about credit risk inherent in financial assets and commitments, including significant credit risk concentrations.

Note: IFRS 7 *Financial Instruments: Disclosures* in paragraphs 35A-35N states the requirements in detail.

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New Disclosures, new insights

Quantitative Information	Judgements
Reconciliation of balance sheet allowance and gross carrying amount (significant changes)	Inputs, assumptions and techniques used to - estimate expected credit losses - determine “significant increase in credit risk” - determine objective evidence of impairment - how forward looking information has been incorporated
Gross carrying amount by credit risk rating grades	Default definition
Maximum credit risk disclosure (net of collateral) and collateral for credit impaired financial assets	
Modifications to contractual cash flows	Modifications to contractual cash flows
Contractual amount outstanding for assets written off but still subject to enforcement activity	Write off policy

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New Disclosure: reconciliation of the loan loss balance sheet allowance

- Insights into how the balance sheet allowance changed due to:
  - (i) the economic environment
  - (ii) loan book growth

	Total Balance Sheet Allowance	of which: Stage 1 12 month ECL	of which: Stage 2 Lifetime ECL	of which: Stage 3 Credit Impaired
Loan Loss Allowance Balance at start of year (Year 1)	**5,910**	**2,160**	**2,250**	**1,500**
Changes due to Financial Instruments recognised at beginning of year (Organic Loan Book):				
Transfer to lifetime ECL	2,250		2,250	
Transfer to Credit impaired financial assets	3,500			3,500
Transfer to 12-month ECL	-613	-613		
Financial assets that have been derecognised				
Sub-total	**11,047**	**1,547**	**4,500**	***5,000***
New financial assets originated or purchased (New Loans)	1,500	1,500		
Write offs	-500			-500
Changes in model/risk parameters	0			
FX and other	0			
Loan Loss Allowance Balance at end of year (Year 2)	**12,047**	**3,047**	**4,500**	**4,500**

P&L Expense recognises the YoY change in the allowance

Source: IASB
Note: Hypothetical figures above are used for illustrative purposes only.

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Disclosure details: How does loan book growth affect balance sheet provisions?

Analyse how Loan Portfolio Balances migrate across the 3-stages

	Loan Book Balance	of which: Stage 1 12 month ECL	of which: Stage 2 Lifetime ECL (Collectively Assessed)	of which: Stage 2 Lifetime ECL (Individually Assessed)	of which: Stage 3 Credit Impaired
Gross Carrying Amount as at 1 January (Year-1)	**250,000**	**240,000**	**7,500**		**2,500**
Individual financial assets transferred to lifetime ECL		-10,500	10,500		
Individual financial assets transferred to Credit Impaired			-5,000		5,000
Individual financial assets transferred from Credit Impaired					0
Financial Assets Assessed on collective basis		-2,000	2,000		
Sub-total	250,000	227,500	15,000		7,500
New financial assets originated or purchased (New Loans)	113,636	113,636			
write offs	-500				-500
changes due to modifications that did not result in derecognition	0				
Other changes	0				
Gross Carrying Amount at end of year (Year-2)	**363,136**	**341,136**	**15,000**		**7,000**

Source: IASB

Note: Hypothetical figures above are used for illustrative purposes only.

Analysing credit-quality migration over time

- Over time, these disclosures may provide investors with new insights into the accuracy of management's predictions/expectations
- Compare banks results over time: balance sheet allowances /Loans by impairment stage.

Allowances/ Loans by Stage	Year-1	Year-2
Stage-1	0.9%	0.9%
Stage-2	30.0%	30.0%
Stage-3	60.0%	64.3%
Total Loan Book	2.4%	3.3%

- Compare banks results over time: loan book mix by different stages.

Loan Book Mix (%)	Year-1	Year-2
Stage-1	96%	94%
Stage-2	3%	4%
Stage-3	1%	2%

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Additional reference

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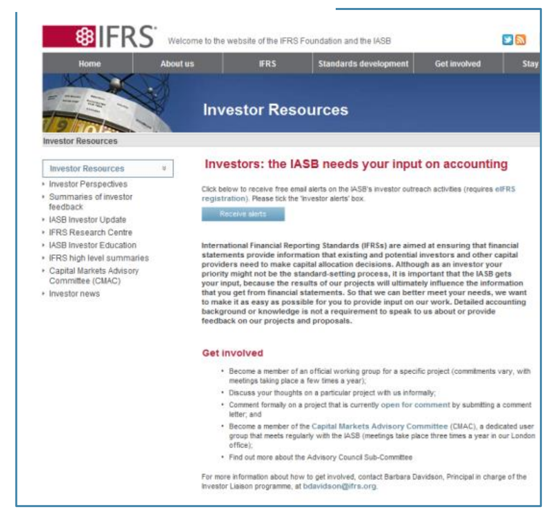
Why did the IASB issue IFRS 9?

- Complexity and opacity
  - Different allowance balances for same assets just due to accounting classifications
  - Not enough information about credit risk and risk management
- Responding to Global Financial Crisis
  - Improve investors understanding of the amounts, timing and uncertainty of future cash flows
  - Delayed recognition of credit losses on loans was a weakness – new model more responsive

Where can you find more?

IASB Has Resources for Investors

- IASB Articles for investors
  - Investor Perspectives
  - Project Snapshot
  - Investor Update newsletter
- On the web:
  - go.ifrs.org/Investor-Centre
  - https://twitter.com/IFRSinvestors



Glossary of terms

- IAS 39 is *Financial Instruments: Recognition and Measurement*
- IFRS 9 is *Financial Instruments*
- ED = Exposure Draft
- AC = Amortised Cost
- ECL = Expected Credit Losses
- FV = Fair Value
- FVOCI = Fair Value through Other Comprehensive Income
- FVPL = Fair Value through Profit or Loss
- FVO = Fair Value Option
- RE = Retained Earnings
- OCI = Other Comprehensive Income
- AOCI = Accumulated OCI
- Balance sheet jargon: LLA = Loan Loss Allowance same as LLR = Loan Loss Reserve
- P&L jargon: LLP = Loan Loss Provision same as LLC = Loan Loss Charge

Thank you

We welcome your feedback

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