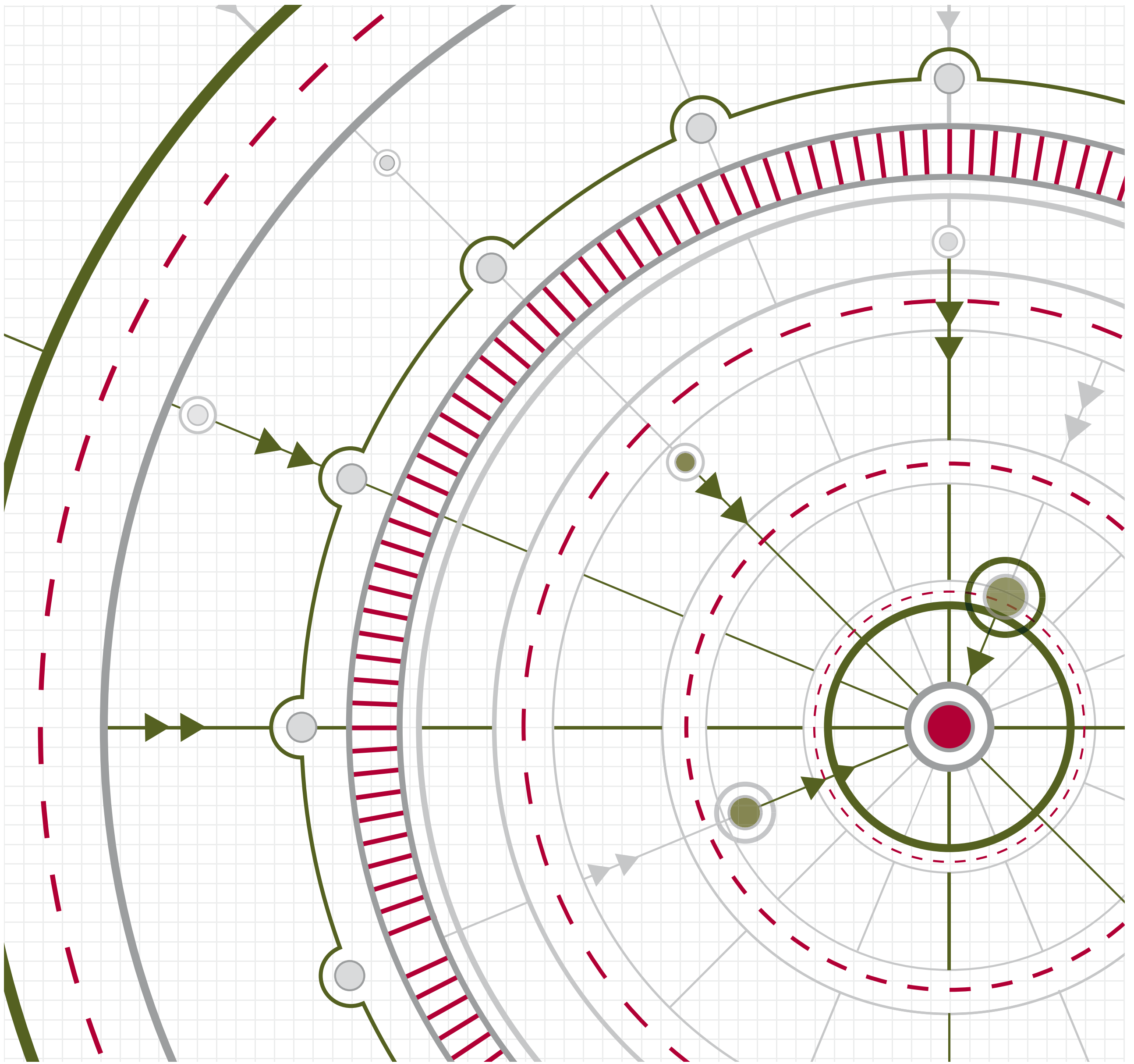
Monday 28 and Tuesday 29 September 2015
The Grange City Hotel (London, UK)

Meeting documentation: IFRS 9 *Financial Instruments*

2015 World Standard-setters Meeting



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World Standard-setters Meeting

Monday 28 and Tuesday 29 September 2015

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 project to replace IAS 39

2014 International Financial Reporting Standard® IFRS 9 Financial Instruments IASB IFRS

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*	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 assets;
  - typically observable through activities that the entity undertakes; and
  - 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; and
  - 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; and
  - for example, liquidity needs, interest yield management, asset/liability management.
- Reclassify only if business model changes.

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SPPI characteristics

- Contractual cash flows are consistent with a basic lending arrangement (simple instruments).
- Interest is consideration for:
  - time value of money and credit risk;
  - basic lending risks (for example, liquidity risks);
  - other associated costs (for example, administrative costs); and
  - a profit margin.
- 'Principal' is the fair value of the financial asset at initial recognition:
  - the amount transferred by holder (fair value).

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SPPI characteristics

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- Exceptions for regulated rates:
  – government or regulatory authority establishes interest rates where the TVM element does not provide consideration for only the passage of time;
  – the regulated rate may be a proxy for the TVM element; and
  – the rate should not provide exposure to risks or volatility that is inconsistent with a basic lending arrangement.
- Simplified the test for a modified economic relationship:
  – the TVM element is not perfect, for example, the rate is referenced to an average of short- and long-term rates;
  – the effect of the modification cannot result in cash flows that are significantly different from benchmark cash flows; and
  – a qualitative or quantitative assessment.

Alternative classifications

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- **Financial assets – fair value option**
  – available in cases of 'accounting mismatches'.
- **Equity investments – FVOCI alternative**
  – available for investments in equity instruments that are **not held for trading**.
  – features:
    - instrument by instrument;
    - dividends recognised in P&L;
    - no recycling; and
    - no impairment.

Embedded derivatives

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- No longer applies to financial assets:
  – entire contract must be assessed in accordance with the business model and the contractual cash flows criteria; and
  – no separation required.
- Still applies to:
  – non-financial hosts; and
  – financial liabilities.

Financial liabilities – 'own credit'

designated under the fair value option (FVO)

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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

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- 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 in which they are managed.
- Improved reclassification rules consistent with management:
  – financial assets reclassified between measurement categories only when the business model for managing them changes in which.
- 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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Benefits of the expected loss model

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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 a more timely recognition of expected credit losses (ECLs); and
  - elimination of the IAS 39 threshold.
- Builds on existing systems to balance costs and benefits:
  - approximates the 2009 ED in a more operational manner.
- Single model reduces the complexity of multiple approaches.
- Enhanced disclosures:
  - illustrate how an entity has applied the requirements; and
  - show assets that have significantly increased in credit risk.

Overview of the general model

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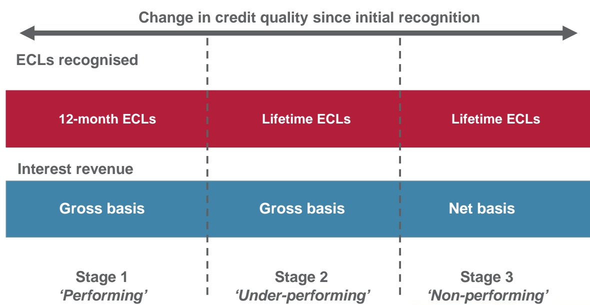

12-month ECLs

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When to recognise 12-month ECLs?

- Performing assets, ie:
  - no significant increase in credit risk has been determined; and
  - a low credit risk simplification can be used to make this determination (for example, 'investment grade').

12-month ECLs are a portion of the lifetime ECLs – they are not the expected cash shortfalls over the next 12 months.

Lifetime ECLs

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When to recognise lifetime ECLs?

- Underperforming assets, ie:
  - a significant increase in credit risk has been determined; and
  - 30 days past due rebuttable presumption.
- Non-performing assets, ie:
  - asset is credit impaired; and
  - 90 days past due rebuttable presumption.

Exceptions to the general model

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Trade receivables and contract assets

- Trade receivables and contract assets that do not contain a significant financing component => must always recognise lifetime ECL.
- Trade receivables and contract assets that contain a significant financing component => accounting policy choice to always recognise lifetime ECL.

Lease receivables

- Accounting policy choice to always recognise lifetime ECL.

Purchased or originated credit impaired financial assets

- Must always recognise lifetime ECL.
- Interest revenue calculated on a net basis.

Determining whether credit risk has increased significantly

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- Change in credit risk over the life of the instrument (ie risk of a default occurring):
  - compared to credit risk at initial recognition;
  - relative rather than an absolute assessment; and
  - need to determine what is meant by 'default'.
- Maturity matters.
- Not changes in ECLs.
- Can be done on an individual or a collective basis.
- Does not require a mechanical assessment but need to use **reasonable and supportable** information.

Measuring ECLs

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ECLs need to reflect:

- the probability weighted outcome:
  - must consider the possibility that default will/will not occur.
- the time value of money:
  - discount at the effective interest rate or an approximation thereof.
- reasonable and supportable information:
  - available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

Particular measurement methods are not prescribed.

Reasonable and supportable information

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- Borrower-specific factors:
  - changes in operating results of the borrower, technological advances that affect future operations, changes in collateral supporting the obligation.
- Macro-economic factors:
  - house price indexes, GDP, household debt ratios.
- The data sources could be:
  - internal data – credit loss experience and ratings; and
  - external data – ratings, statistics or reports.

Historical information can be used as a base but must be updated to reflect current conditions and future forecasts.

Disclosures

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Quantitative	Qualitative
Reconciliation of allowance accounts showing key drivers for change	Inputs, assumptions and techniques used to estimate ECLs (and changes in techniques)
Explanation of gross carrying amounts showing key drivers for change	Inputs, assumptions and techniques used to determine a 'significant increase in credit risk' and 'default'
Gross carrying amount per *credit risk grade or delinquency*	Inputs, assumptions and techniques used to determine 'credit-impaired'
Write-offs, recoveries, modifications	Write-off policies, modification policies, collateral

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Hedge accounting

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Accounting and risk management

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Feedback on IAS 39 *Financial Instruments: 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.

Major improvements

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- 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 the effect of hedging.

A new approach to how accounting interacts with risk management.

Hedged items

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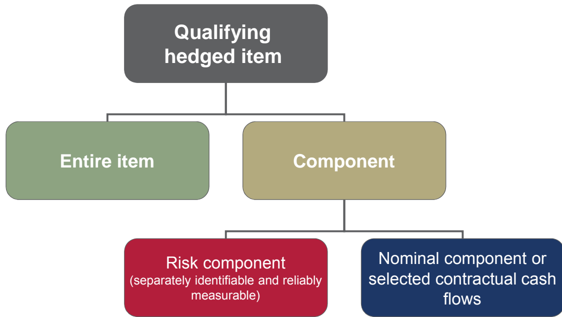

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Designating risk components

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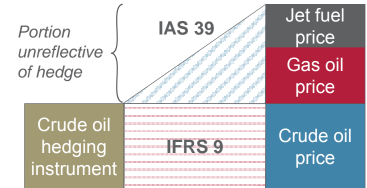
Example – hedging a component of a non-financial item

Measuring the success of hedging jet fuel contracts with crude oil futures



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Hedging instruments

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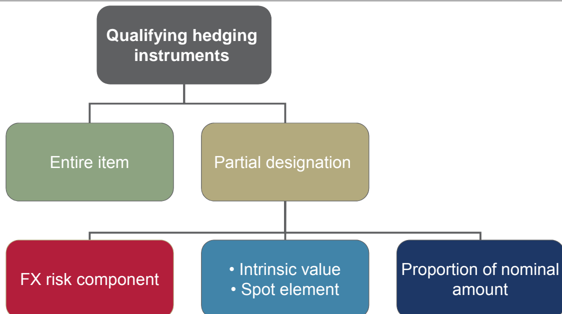

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Costs of hedging

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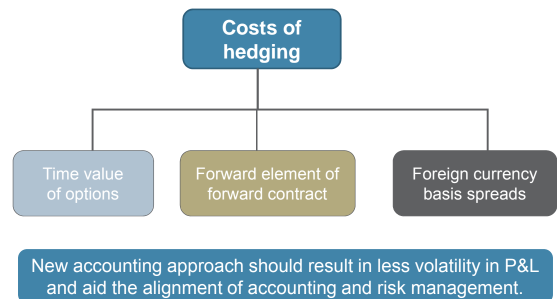

New accounting approach should result in less volatility in P&L and aid the alignment of accounting and risk management.

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Hedge effectiveness

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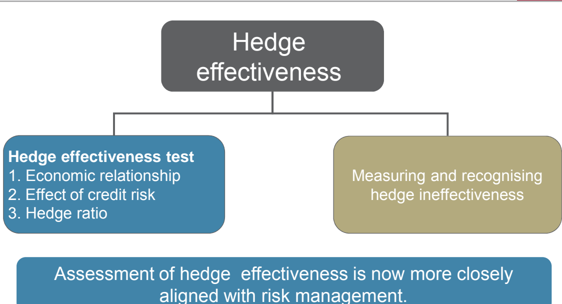

Assessment of hedge effectiveness is now more closely aligned with risk management.

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Disclosures

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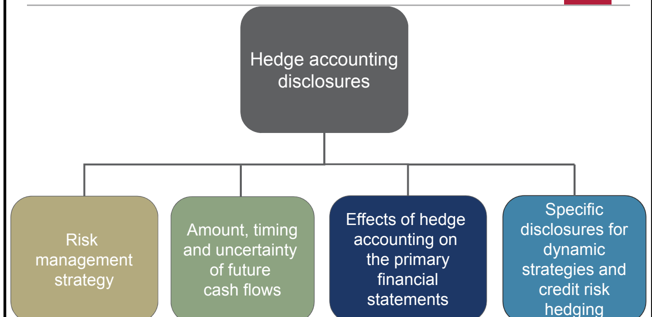

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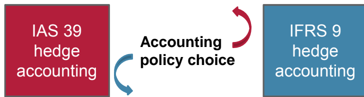
Project does not address macro hedging

Even if IFRS 9 is applied, the specific portfolio hedge accounting requirements in IAS 39 can still be used.

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).

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).
- EU Endorsement Status – EFRAG has issued a draft endorsement advice letter, which:
  - concludes that the preliminary assessment is that IFRS 9 satisfies the criteria for endorsement for use in the EU; and
  - advises that the IASB should defer the effective date of IFRS 9 for insurance businesses.

Questions and comments