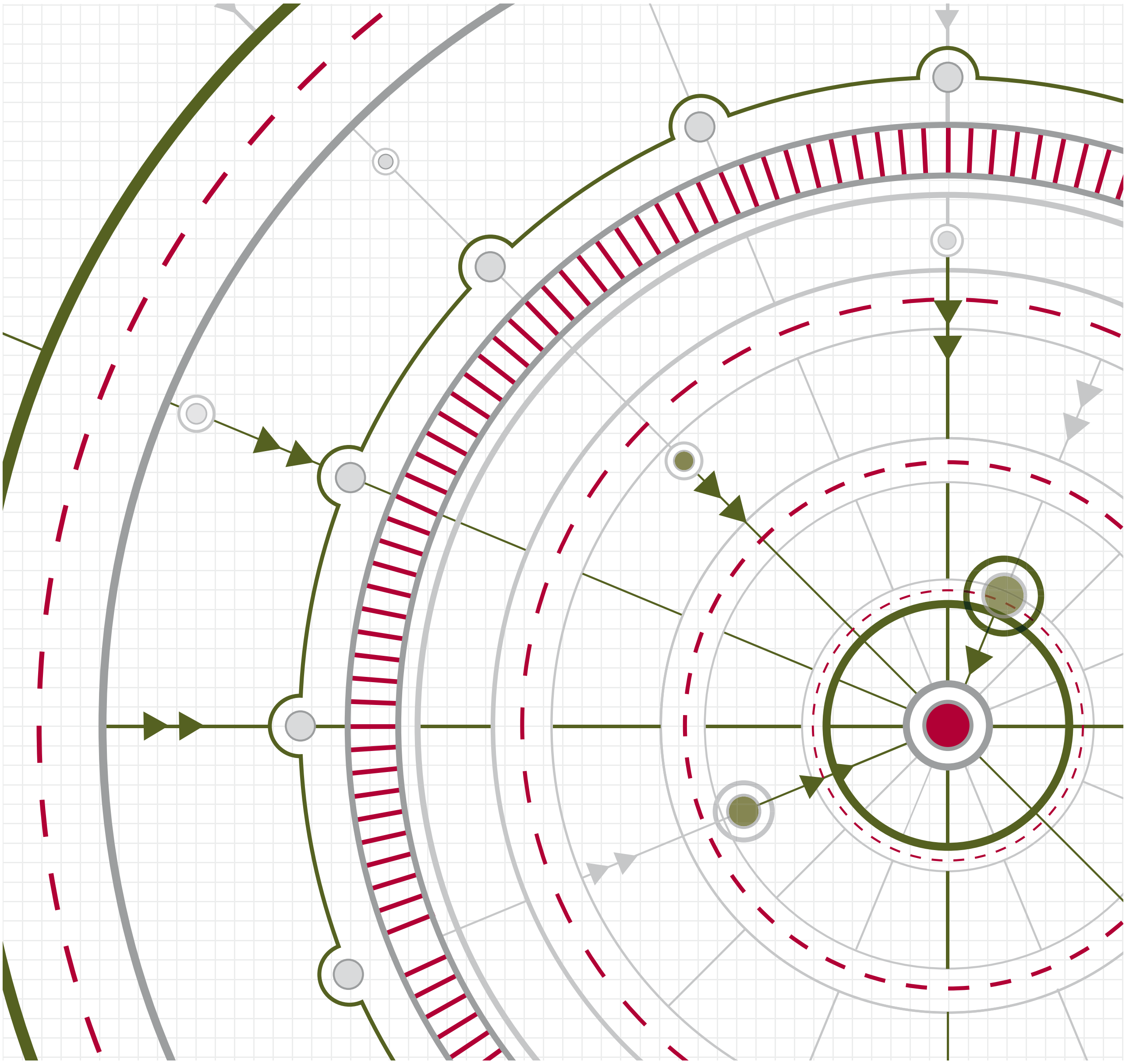
Monday 26 September 2016
The Grange City Hotel (London, UK)

Conference documentation: IFRS 9 *Financial Instruments*

2016 World Standard-Setters Conference



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World Standard-Setters Conference

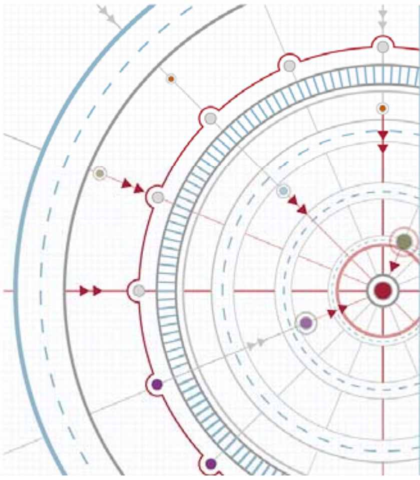
Monday 26 and Tuesday 27 September 2016

Education session:
IFRS 9 *Financial Instruments*

Kumar Dasgupta
Technical Director
IASB

Uni Choi
Practice Fellow
IASB

IFRS® Foundation



IFRS 9
Financial Instruments

Uni Choi, Practice Fellow

The views expressed in this presentation are those of the presenter, not necessarily those of the International Accounting Standards Board (the Board) or IFRS Foundation.

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Agenda

- Project background
- History of the project
- IFRS 9 *Financial Instruments*
    - Classification and measurement
    - Impairment
    - Hedge accounting
- Implementation
- Convergence with the FASB

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Project background

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- IFRS 9 replaces IAS 39, one of the Standards that the IASB inherited when it began its work in 2001.
- The requirements for the accounting of financial instruments were considered complex by preparers, auditors and users.
- The reform of the accounting for financial instruments was one of the areas identified in the Norwalk Agreement in 2002 between the IASB and US Financial Accounting Standards Board (FASB).
- Work on IFRS 9 was accelerated in response to the financial crisis.
- In particular, interested parties such as the G20 highlighted the areas below as areas in need of consideration:
  - the timeliness of recognition of expected credit losses;
  - complexity of multiple impairment models; and
  - own credit.

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Project background—*continued*

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- Throughout the life cycle of the project, the IASB has consulted widely with constituents:
  - the IASB has received over 1,000 comment letters;
  - six Exposure Drafts were published, one Supplementary Document and a Discussion Paper;
  - the IASB has conducted an extensive programme of outreach, including hundreds of meetings with users, preparers of financial statements and others.

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History of the project

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Date	History		
March 2008	Publication of the Discussion Paper *'Reducing Complexity in Reporting Financial Statements'*. Subsequently, the IASB decided to divide the project into 3 phases		
	Phase 1—Classification and Measurement	**Phase 2—Impairment**	**Phase 3—Hedge accounting**
November 2009	IFRS 9 (2009): Requirements for financial assets		
October 2010	IFRS 9 (2010): Requirements for financial liabilities		
November 2013			IFRS 9 (2013)
July 2014	IFRS 9 (2014): Clarified a narrow range of application issues and added a third measurement category (FVOCI)	IFRS 9 (2014)	IFRS 9 (2014): All requirements in IFRS 9 (2013) were carried forward.

This slide includes the publication of the different versions of IFRS 9. Publication of Exposure Drafts and other due process documents are not included.

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IFRS 9 *Financial Instruments*

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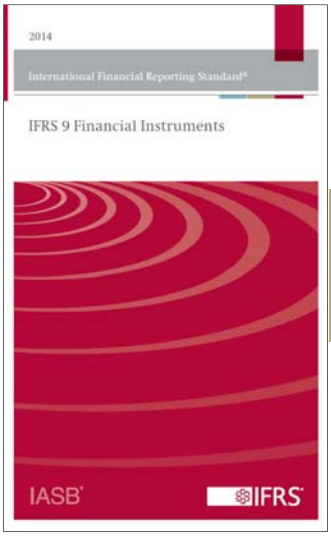

Classification and measurement
- A logical, single classification approach driven by cash flow characteristics and how it is managed.

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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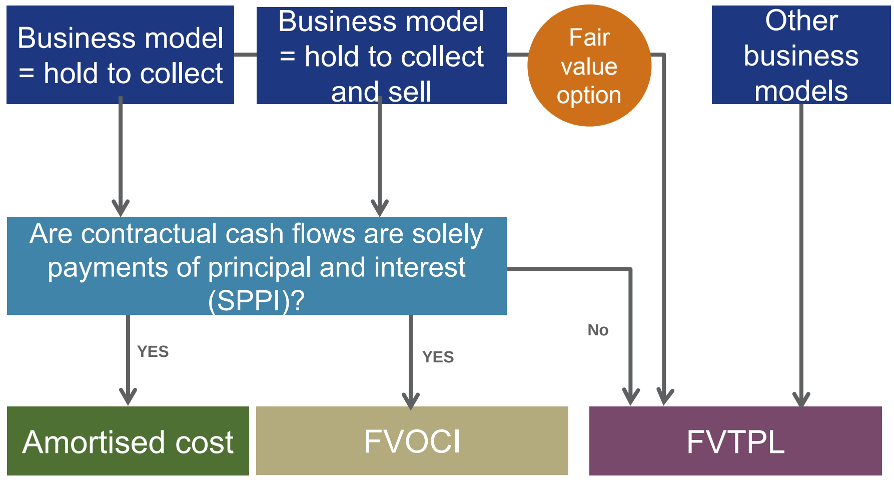
Classification and Measurement

Background

- IAS 39 contained many different classification categories and associated impairment models.
- Many of the application issues that arose with IAS 39 were related to the classification and measurement of financial assets.
- On the basis of feedback received, the Board decided that the most effective way to address such issues and improve the ability of users of financial statements to be better understand the information about the amounts, timing and uncertainty of future cash flows is replace the existing classification and measurement categories for financial assets.

The IFRS 9 classification model for assets*



*Debt instruments only

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What is a business model?

- A business model refers to **how** an entity manages its financial assets in order **to generate cash flows**—by collecting contractual cash flows, selling financial assets or both.
- The business model should be determined on a level that reflects how financial assets are managed to achieve a particular business objective.
- A business model can typically be observed through the activities that an entity undertakes to achieve its business objective. As such, a business model is a matter of fact rather than an assertion.
- Objective information, such as **business plans**, how managers of the business are **compensated** and **the amount and frequency of sales activity** should be considered. Judgement needs to be used when assessing a business model. That assessment should consider all relevant available evidence.

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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.

Solely payments of principal and interest (SPPI) characteristics

- Contractual cash flows are consistent with a basic lending arrangement.
- 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).

SPPI characteristics—*continued*

- Modified time value of money
- Contractual terms that change the amount and timing of the cash flows. For example:
  - Variable interest rate
  - prepayment option
  - extension option
- Non-recourse loan
- Contractually linked instruments
- Hybrid instruments with embedded derivatives

Alternative classifications

- **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**.
  - Key features:
    - instrument by instrument
    - dividends recognised in P&L
    - no recycling
    - no impairment.

Embedded derivatives

- 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)

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 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.
- 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

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
- Builds on existing systems to balance costs and benefits
  - Approximates 2009 ED in more operational manner
- Single model reduces complexity of multiple approaches
- Enhanced disclosures:
  - Illustrate how an entity has applied the requirements
  - Show instruments which have significantly increased in credit risk

The basis for the proposals

- The yield on financial instruments should reflect initial credit loss expectations.
- When expected credit losses exceed those initially expected, an economic loss is suffered.
- We reflect this by measuring impairment considering *changes* from inception.

Overview of the general model

Change in credit quality since initial recognition

ECLs recognised

12-month ECLs	Lifetime ECLs	Lifetime ECLs

Interest revenue

Gross basis	Gross basis	Net basis
Stage 1	Stage 2	Stage 3

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12-month expected credit losses

Expected shortfall in all contractual cash flows given probability of default occurring in next 12 months

- *NOT*: - Expected cash shortfalls in next 12 months
  - Credit losses on instruments expected to default in next 12 months
- *Example:*
  - Portfolio of 10m loans
  - 2% probability of a default occurring in next 12 months
  - Entire loss that would arise on default is 10%
  - 12-month expected credit losses = 20,000 (2%x10%x10m)

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Lifetime expected credit losses

When to recognise lifetime expected credit losses?

- Assets in stage 2, ie:
  - A significant increase in credit risk since initial recognition has been determined
  - 30 Days Past Due rebuttable presumption
- Assets in stage 3, ie:
  - Asset is credit impaired

Exceptions to the general model

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

- Change in credit risk <u>over the life</u> 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.
- <u>Not</u> 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.
- Rebuttable presumption ‘30 days past due’

Determining whether credit risk has increased significantly—Practical expedients

- Financial instruments that have low credit risk at the reporting rate
  - if a financial instrument is determined to have low credit risk at the reporting date, an entity may assume that the credit risk of the financial instrument has not increased significantly since initial recognition.
  - an example of a low credit risk instrument is one that has an investment-grade rating.
- Using 12 months risk of default occurring as a proxy of that of lifetime.

Measuring ECLs

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.

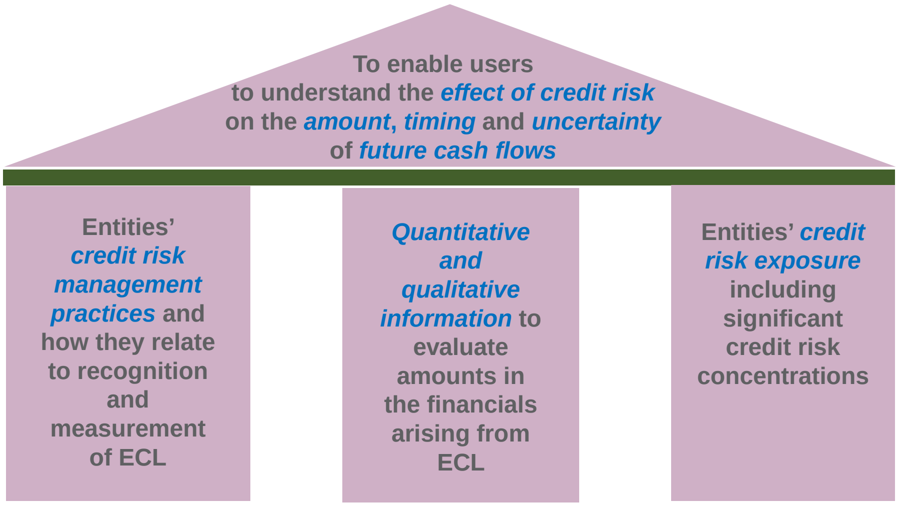
Particular measurement methods are not prescribed.

Reasonable and supportable information

- Borrower-specific factors:
  - changes in operating results of the borrower, technological advances that affect future operations, changes in collateral supporting the obligation.
- Macroeconomic 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 - objectives



Impairment Transition Resource Group (ITG)

- The ITG was established to provide support for the IASB's stakeholders who are implementing the new expected credit loss requirements:
  - Forum for questions regarding implementation
  - Make the IASB aware of implementation issues – any actions required would follow normal due process
  - Educational role
  - Limited life during the transition period
  - Will not publish any guidance
- No further meetings have been scheduled:
  - need to balance the provision of implementation support without creating uncertainty that could delay implementation; however
  - the group will remain in place and further meetings will be convened if circumstances warrant it.
- All ITG agenda papers and meeting summaries can be found on the following web page: http://www.ifrs.org/About-us/IASB/Advisory-bodies/ITG-Impairment-Financial-Instrument/Pages/Meetings.aspx

Hedge accounting

Background

- The hedge accounting requirements in IAS 39 were developed when hedging activities were relatively new and not as widely understood as they are today.
- As a result of the increased use and sophistication of hedging activities, the IASB decided to undertake a fundamental overhaul of all aspects of hedge accounting.

Accounting and risk management

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

- 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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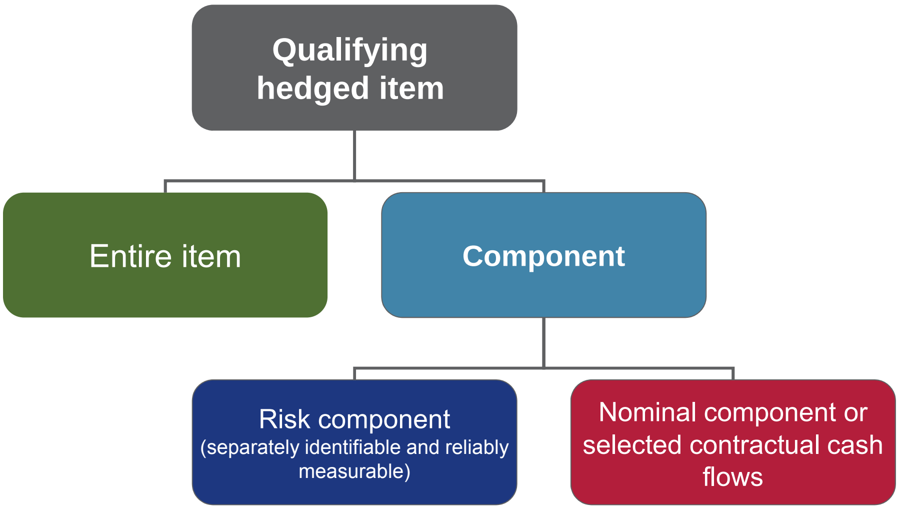

Designating risk components

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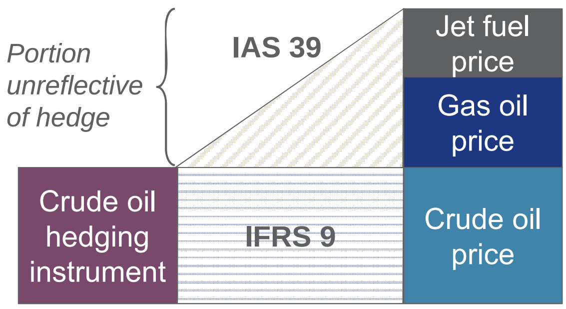
Example – hedging a component of a non-financial item

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



Hedging instruments

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

Costs of hedging

- **Costs of hedging**
  - Time value of options
  - Forward element of forward contract
  - Foreign currency basis spreads

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

Hedge effectiveness

Hedge effectiveness

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

Measuring and recognising hedge ineffectiveness

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

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

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

IAS 39 hedge accounting

Accounting policy choice

IFRS 9 hedge accounting

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

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

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Implementation of IFRS 9

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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 – On 27 June 2016, the Accounting Regulatory Committee (ARC) voted in favour of endorsing IFRS 9 'Financial Instruments' for use in the European Union.

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Interpretations Committee activities

Completed Interpretations Committee activities relating to IAS 39/IFRS 9 are as follows:

Status	Item
Completed	**IFRS 9 *Financial Instruments*** ➢ Transition for hedge accounting (January 2016) ➢ Determining hedge effectiveness for net investment hedges (March 2016) ➢ Derecognition of modified financial assets (May 2016) **IAS 39 *Financial Instruments: Recognition and Measurement*** ➢ Separation of an embedded interest rate floor from a floating rate host contract in a negative interest rate environment (January 2016) ➢ Classification of a hybrid financial instrument by the holder (September 2014) ➢ Accounting for term-structured repo transaction (March 2014) ➢ Income and expenses arising on financial instruments with a negative yield-presentation in the statement of comprehensive income (January 2015) ➢ Accounting for embedded foreign currency derivatives in host contracts (January 2015)

http://www.ifrs.org/Current-Projects/IFRIC-Projects/Pages/IFRIC-activities.aspx

Interpretations Committee activities—*continued*

For the following items relating to IAS 39/IFRS 9, the Interpretations Committee has published tentative agenda decisions:

Status	Item
Tentative agenda decisions	**IFRS 9 *Financial Instruments* and IAS 39 *Financial Instruments: Recognition and Measurement*** ➢ Fees and costs included in the '10 per cent' test for the purpose of derecognition

http://www.ifrs.org/Current-Projects/IFRIC-Projects/Pages/IFRIC-activities.aspx

Convergence with the FASB

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Convergence with the FASB

- An important consideration throughout the project
- Lack of convergence - disappointing for all of us
- Ultimately, the Board decided that it was most important to improve IFRS Standards on a timely basis.
- IFRS 9 is a complete package, which includes:
  - a logical, single classification approach for financial assets including improvements to own credit
  - a single and more forward-looking impairment model for financial instruments and
  - a hedge accounting model that aligns risk management more closely with accounting.

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Convergence with the FASB

- Current Status of the FASB Financial Instruments related projects:

Project	Current Stage	Completion
Classification and Measurement	Completed	January 2016
Hedge Accounting	Exposure Draft	September 2016
Impairment	Final Standard	June 2016

IFRS 9 adoption

- **Australia[1]**

One of the first major banks globally to early adopt IFRS 9 is Australian. National Australia Bank (NAB) adopted IFRS 9 on 1 October 2014 and in March 2015 they released a detailed investor presentation explaining the impact of making the transition from IAS 39 to IFRS 9.

- **Canada[1]**

Canadian Domestic Systemically Important Banks ('D-SIBs') are required by the Office of Superintendent of Financial Institutions ('OSFI') to adopt the requirements of IFRS 9 as at 1 November 2017, with published IFRS 9 figures to be produced as at 31 January 2018, the first quarter of IFRS 9 adoption. In anticipation of this, the Canadian D-SIBs are well on their way through the assessment phase of the impact from IFRS 9 and related Standards.

- **Europe**

Major European banks have started their IFRS 9 implementation project with the aim to ensure a high quality implementation of the Standard with a 2017 parallel run.

(1) Source: Fifth Global IFRS Banking Survey, Deloitte, September 2015

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