

IFRS 9 implementation – the Malaysian experience

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The views expressed in this presentation are the presenter, not necessarily those of the Malaysian Accounting Standards Board or the Financial Reporting Foundation.

Agenda

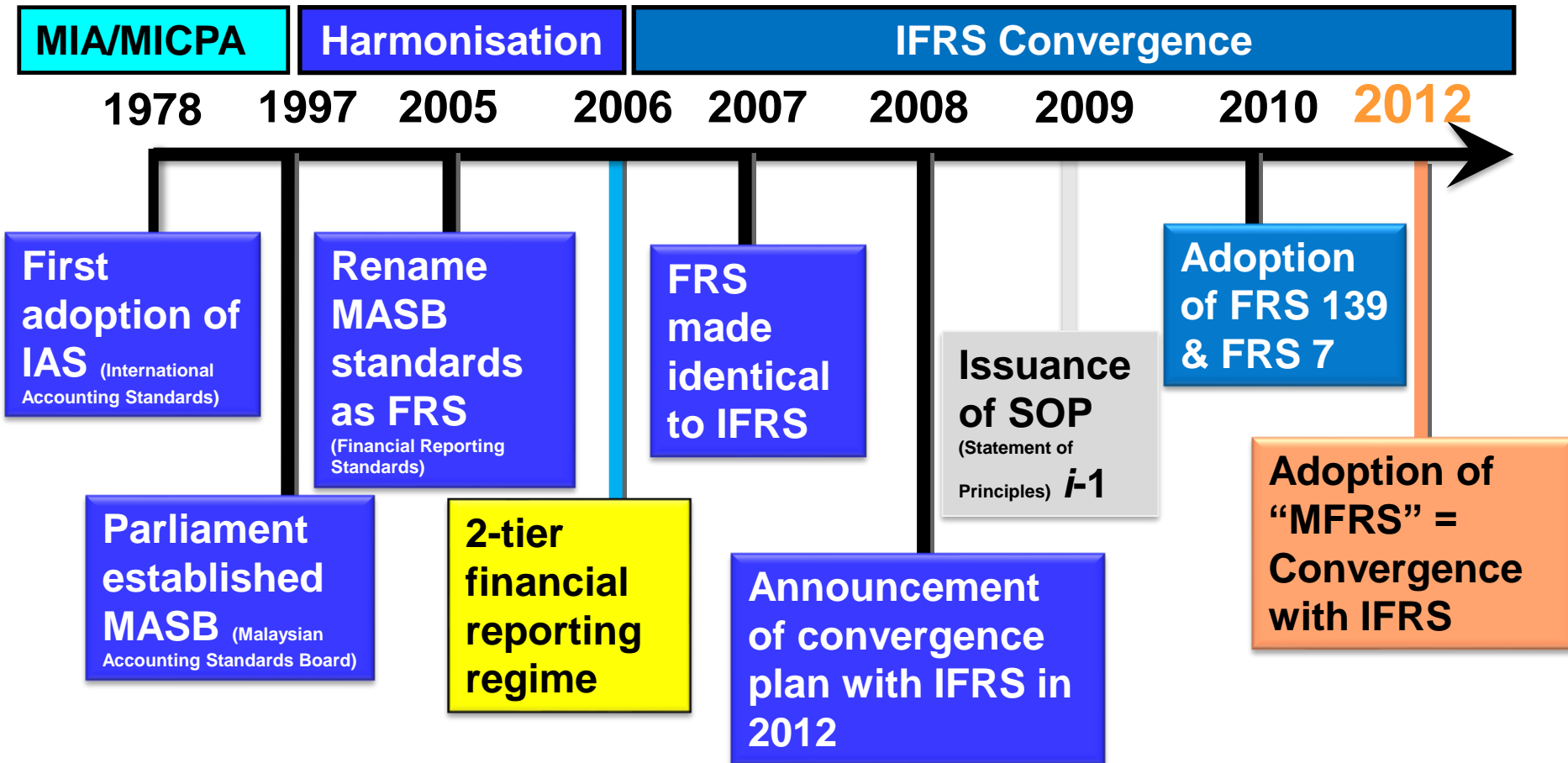
1 Accounting for financial instruments in Malaysia

2 IFRS 9 implementation approach

3 Key issues, practices & business implications

Accounting for financial instruments in Malaysia

Convergence of IFRS & MFRS – the journey in Malaysia



"MIA": Malaysian Institute of Accountants; "MICPA": Malaysian Institute of Certified Public Accountants

"MFRS": Malaysian Financial Reporting Standards

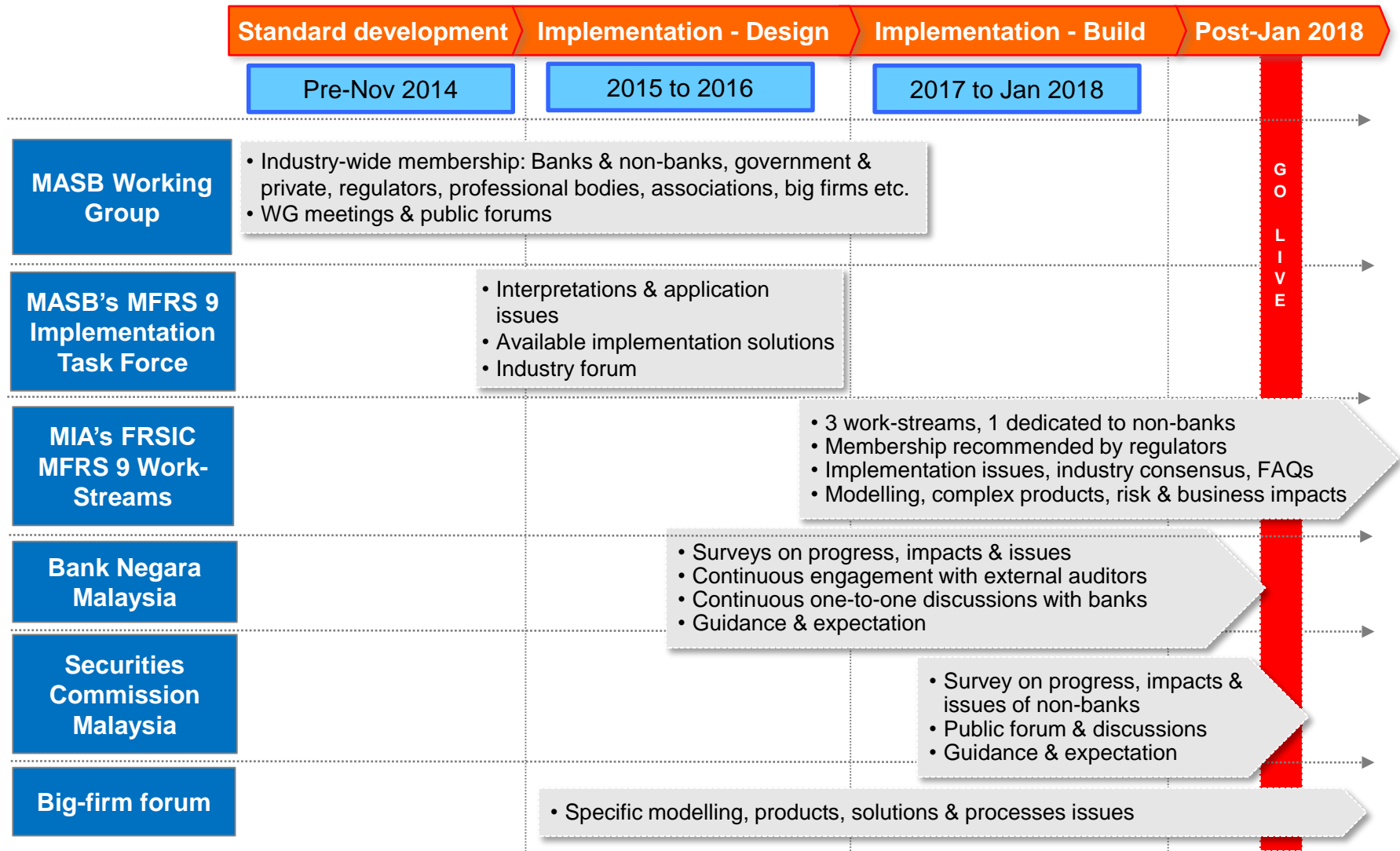
Journey towards convergence with IAS 39 & IFRS 9

Before 2005	2005	2010	2012
<ul style="list-style-type: none"> • BNM guidelines <ul style="list-style-type: none"> - Loan loss provision - Presentation & disclosures • Applicable IAS 	<ul style="list-style-type: none"> • BNM guidelines <ul style="list-style-type: none"> - Loan loss provision by risk buckets, with general provision of 1.5% - Investments: In line with IAS 39 requirements - Disclosure requirements • Applicable FRS 	<ul style="list-style-type: none"> • Adoption of FRS 139 & FRS 7 (principally IAS 39 & IFRS 7) • Transition provision for banks on collective assessment (minimum of 1.5% allowance) • BNM's additional disclosure requirements 	<ul style="list-style-type: none"> • Fully converged with IFRS • BNM's additional disclosure requirements

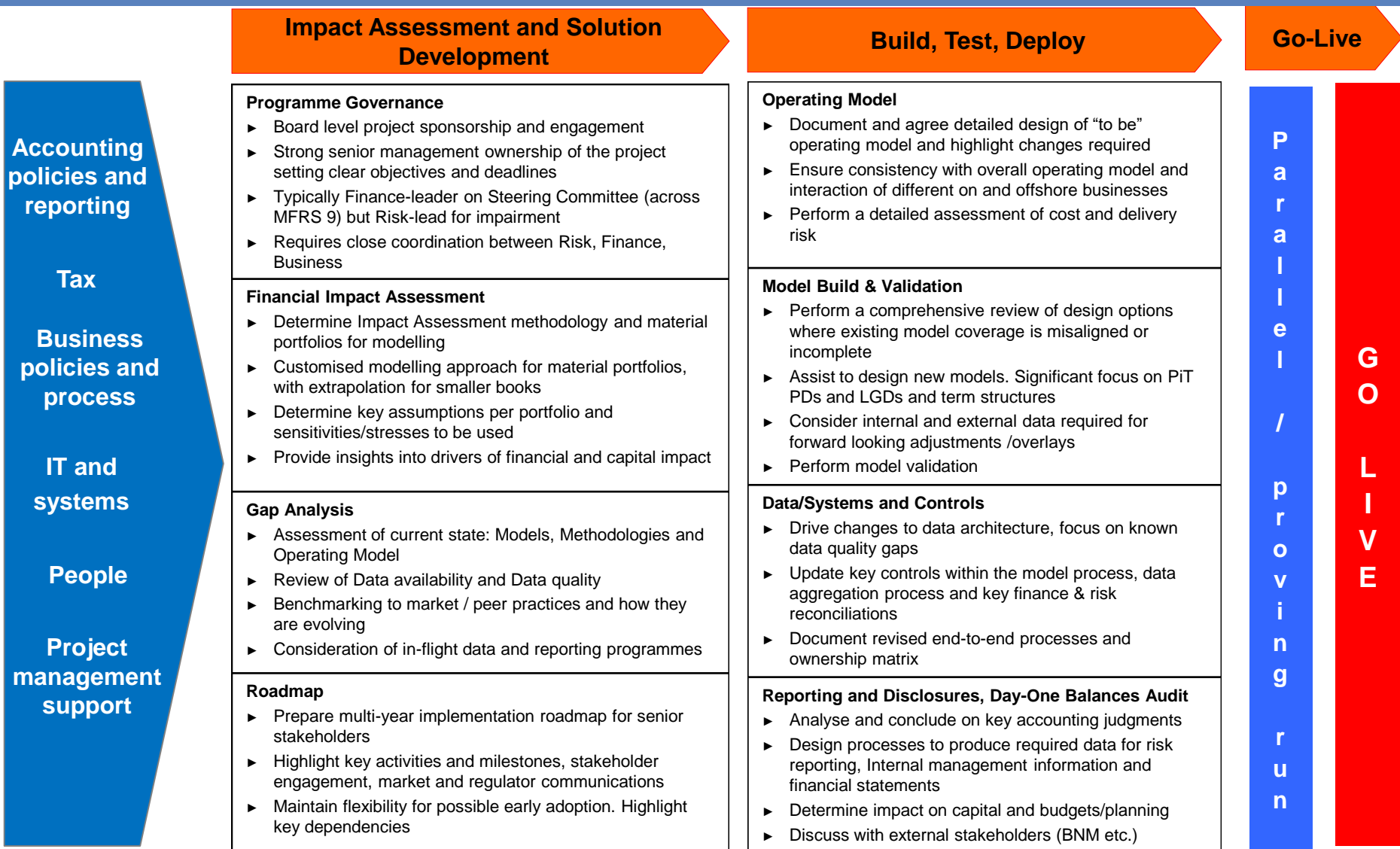
“**BNM**”: Bank Negara Malaysia, the central bank of Malaysia

IFRS 9 implementation approach

Industry-wide collaboration, coordinated efforts



Entity-level implementation



Key issues, practices & business implications

Overview of IFRS 9/ MFRS 9

Why the replacement of IAS 39/ MFRS 139 ?

Benefits

Attention on pricing

- ▶ Otherwise may result in day-1 gain or loss

Governance

- ▶ Upfront or early analysis of financial impact before any major transactions
- ▶ Both for internal management and for customers in some cases

Transparency

- ▶ More items measured at fair value e.g. all equity instruments and derivatives
- ▶ Timing of recovery will affect provisions for bad debts

Challenges

Complex and difficult to understand

- ▶ Substance over form?
- ▶ *Bright lines* or rule-based in many instances
- ▶ Many exceptions to underlying principles

Fair value determination rules

- ▶ Market-based approach
- ▶ Pro-cyclical
- ▶ Judgmental at times

Impairment assessment

- ▶ Different measurement models for different items
- ▶ “Too little too late”

Classification of financial assets

Two key questions asked in classifying financial assets

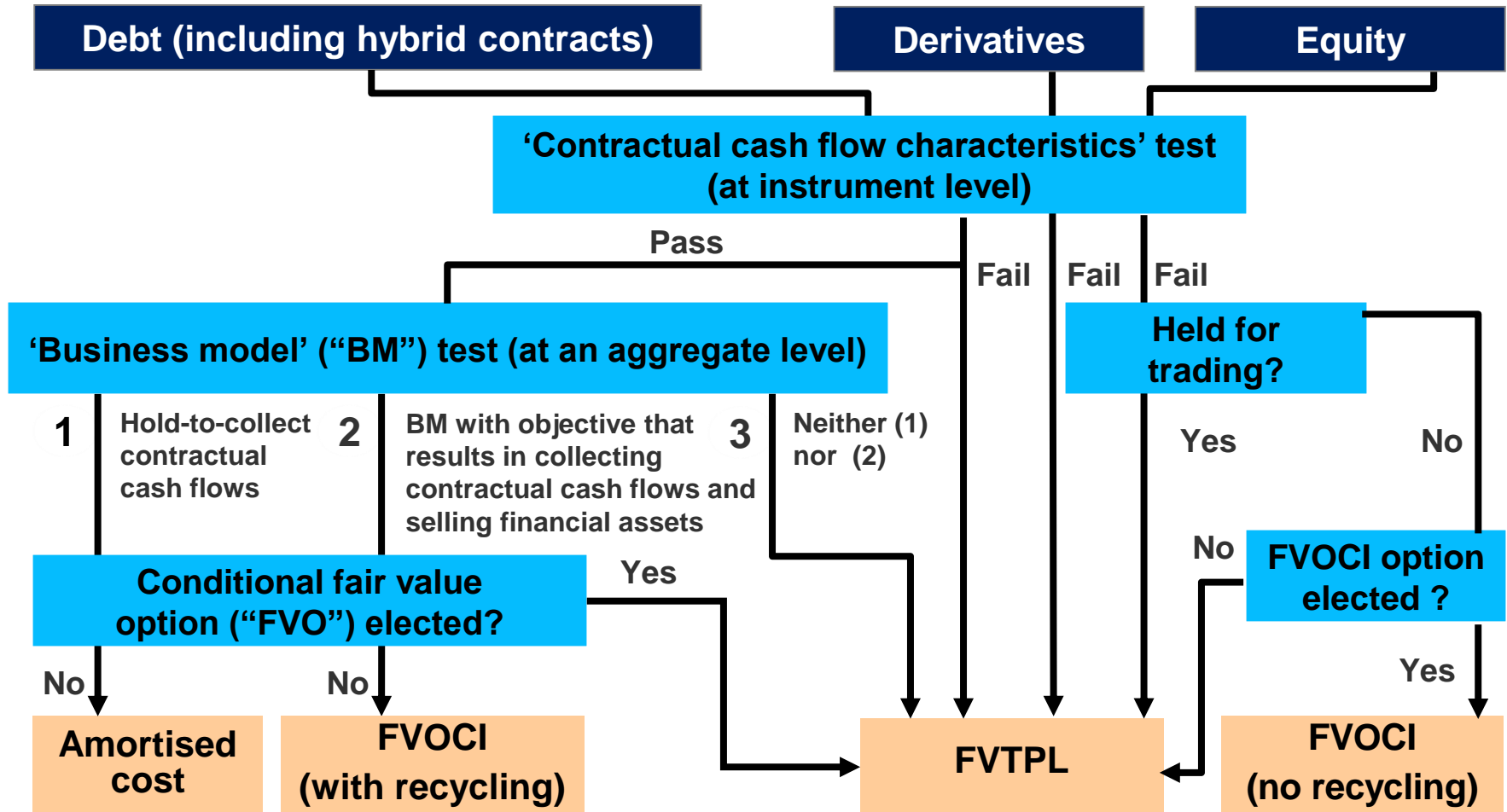
Q1

Is the financial asset complex by looking at its underlying **contractual cash flows**?

Q2

How is the asset used to generate cash flows/profits for the business (“**business model**”)?

Classification of financial assets

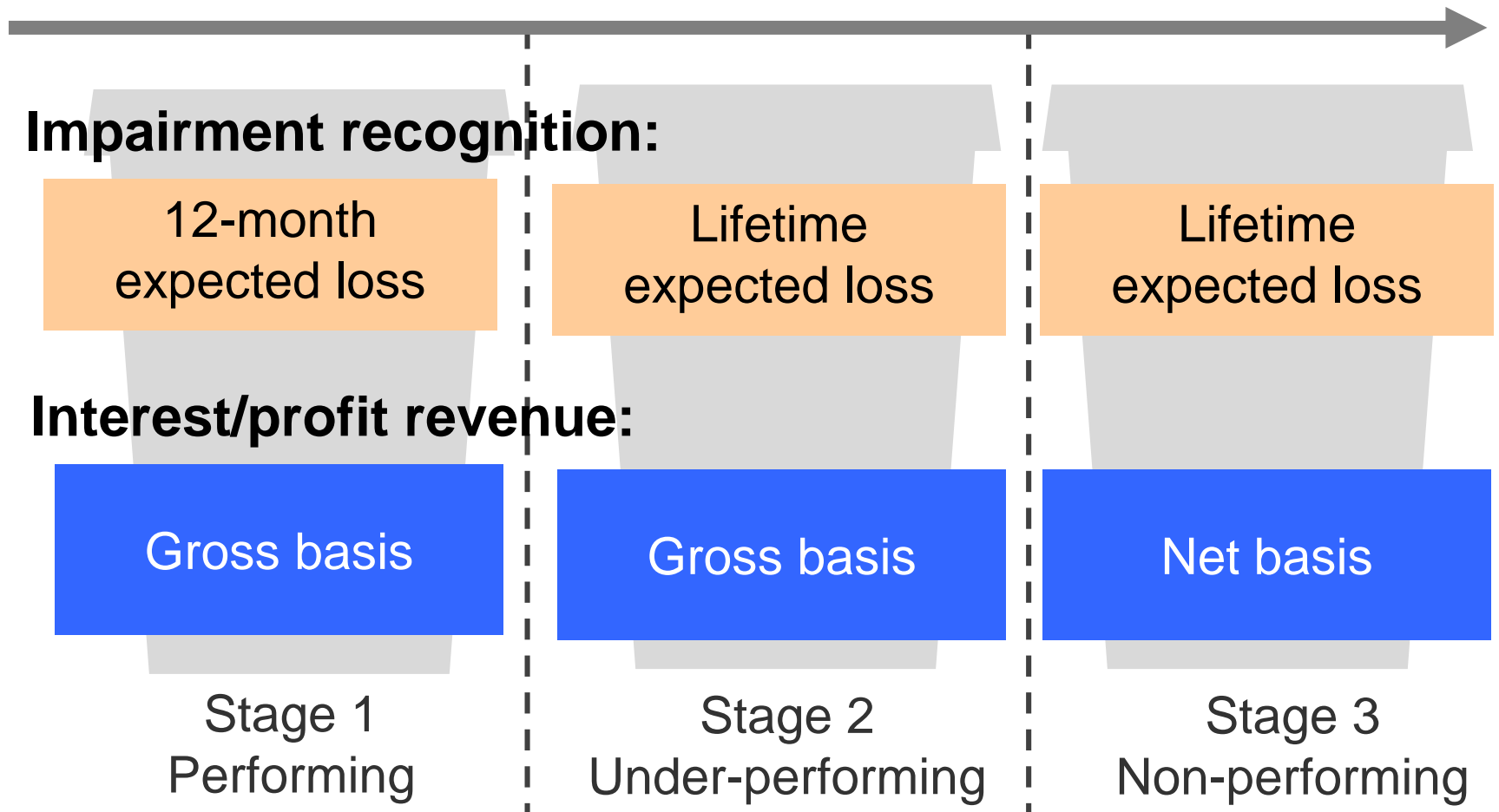


“FVOCI”: Fair value through other comprehensive income; “FVTPL”: Fair value through profit or loss

Expected credit loss (ECL)

Deterioration model

Credit quality deterioration since initial recognition:



Common drivers considered/used by banks in Malaysia

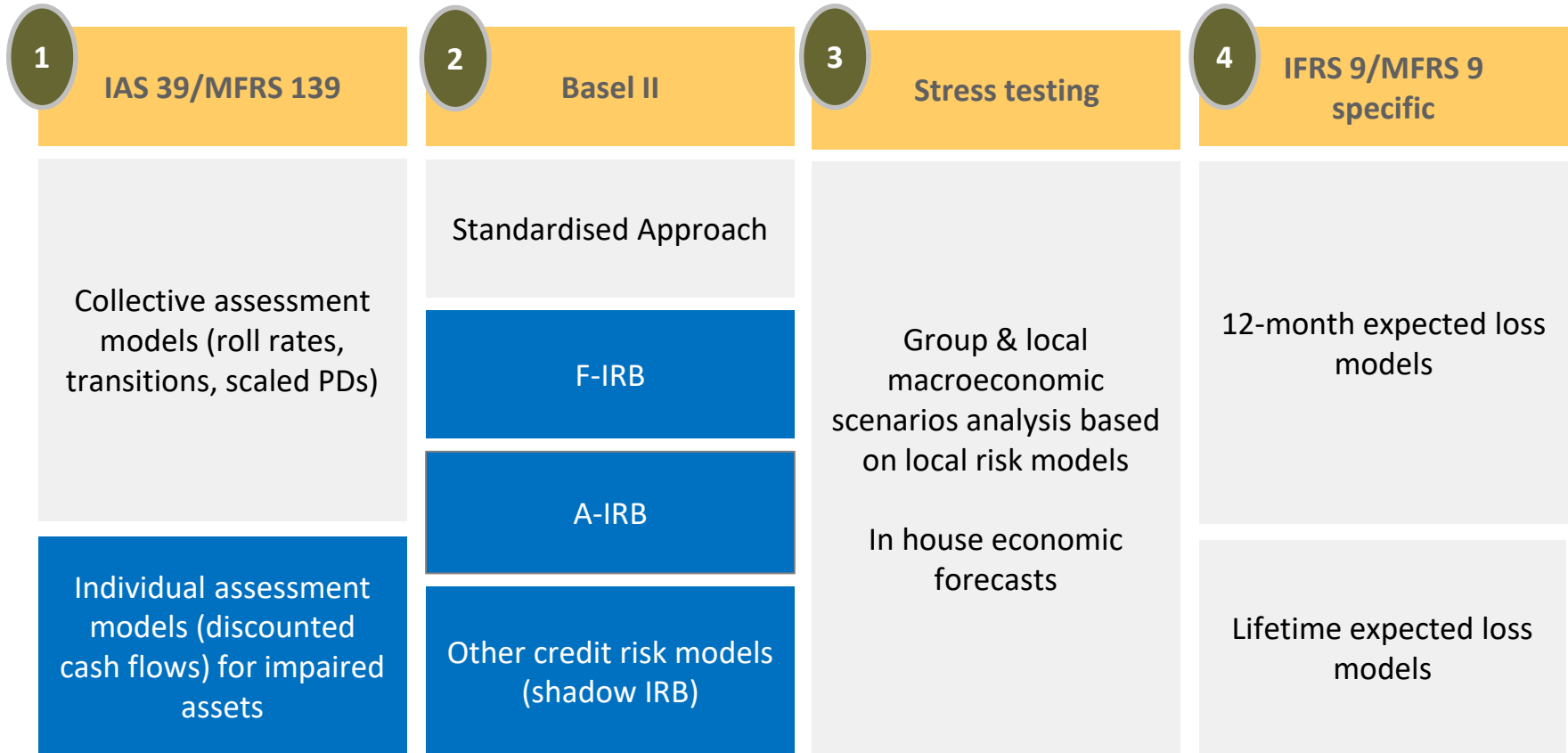
Retail	Non Retail	Treasury	Money Market Instruments
PD	PD	PD	Internal Rating
Internal Scoring	Internal Rating	Internal Rating	External Rating
Collateral Value	Credit Management Approach	Credit Management Approach	
DPD / MIA	DPD / MIA	External Rating	
Modification	Modification	Credit Spread	
Cross Default	Cross Default/Staging		

Steps to decide transfer criteria:

1. To confirm which driver(s) are used in the credit risk monitoring & management activities
2. Compare the pros & cons to narrow down suitable drivers:
 - By considering guiding principles, simplification & practical expedients, data availability & forward-looking elements
3. Design staging scenarios using suitable drivers
4. Run scenarios using historical data to analyze portfolio distribution & its stability
5. Decision on suitable drivers to be used as IFRS 9 transfer criteria.
6. Determine tolerable thresholds for staging using rating/scoring
7. Back-testing – qualitative & quantitative

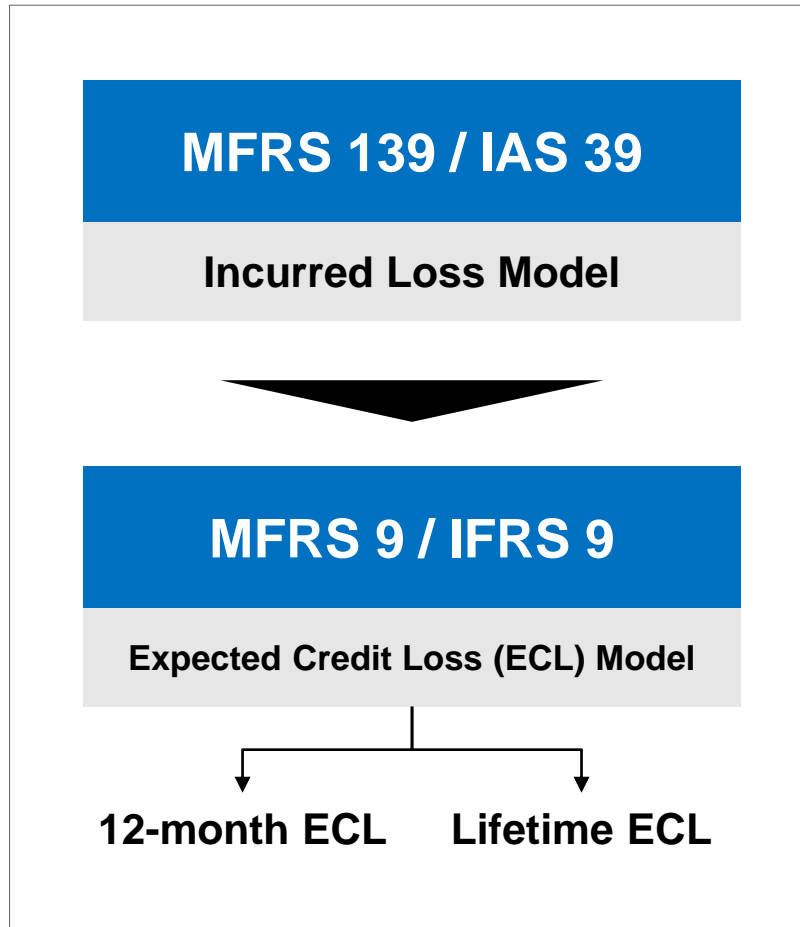
“**PD**”: Probability of default; “**DPD**”: Days-past-due; “**MIA**”: Months-in-arrear.

Leveraging existing credit models



Impairment measurement

Forward looking factors



1

ECL features:

- ▶ Forward-looking, time element
- ▶ Also sensitive to economic cycle

2

Measurement of ECL reflects a probability-weighted outcome:

- ▶ Time value of money
- ▶ Best available forward-looking information (e.g. oil price, purchasing power index, GDP)
- ▶ At least 2 scenarios are considered

3

Impacts the entity's provisioning amount

IFRS 9 ECL measurement

Regulatory Data (Foundation/Advanced)

TTC PDs

- ▶ Adjustments.
- ▶ Macro-economic factors included.

Consider how macro-economics factored into PiT PDs.

Broad Possible Factors

Long-term swap rate	Inflation
Business credit	Interest/cash rates
Commercial property prices	Mortgage interest rate
Corporate bond yield	Non-residential building construction
Corporate debt	Output gap
Disposable income	Real wages
Exchange rate (TWI)	Stock market indices
GDP	Unemployment rate
House price index	Exports
Housing credit	

12m PD

Lifetime PDs

PiT PDs

BC5.178. Change in lifetime risk of default – to assess changes in credit risk since origination.

Internal Credit Scoring model

Tracking Changes in Credit

- ▶ The probability of default at reporting date is compared to the probability of default at origination to assess whether 'significant deterioration' has occurred.

LGD

Potential adjustments for forward-looking factors: Collateral stress, post default path probabilities.

EAD

Overlay EA

MFRS 9 impairment allowance

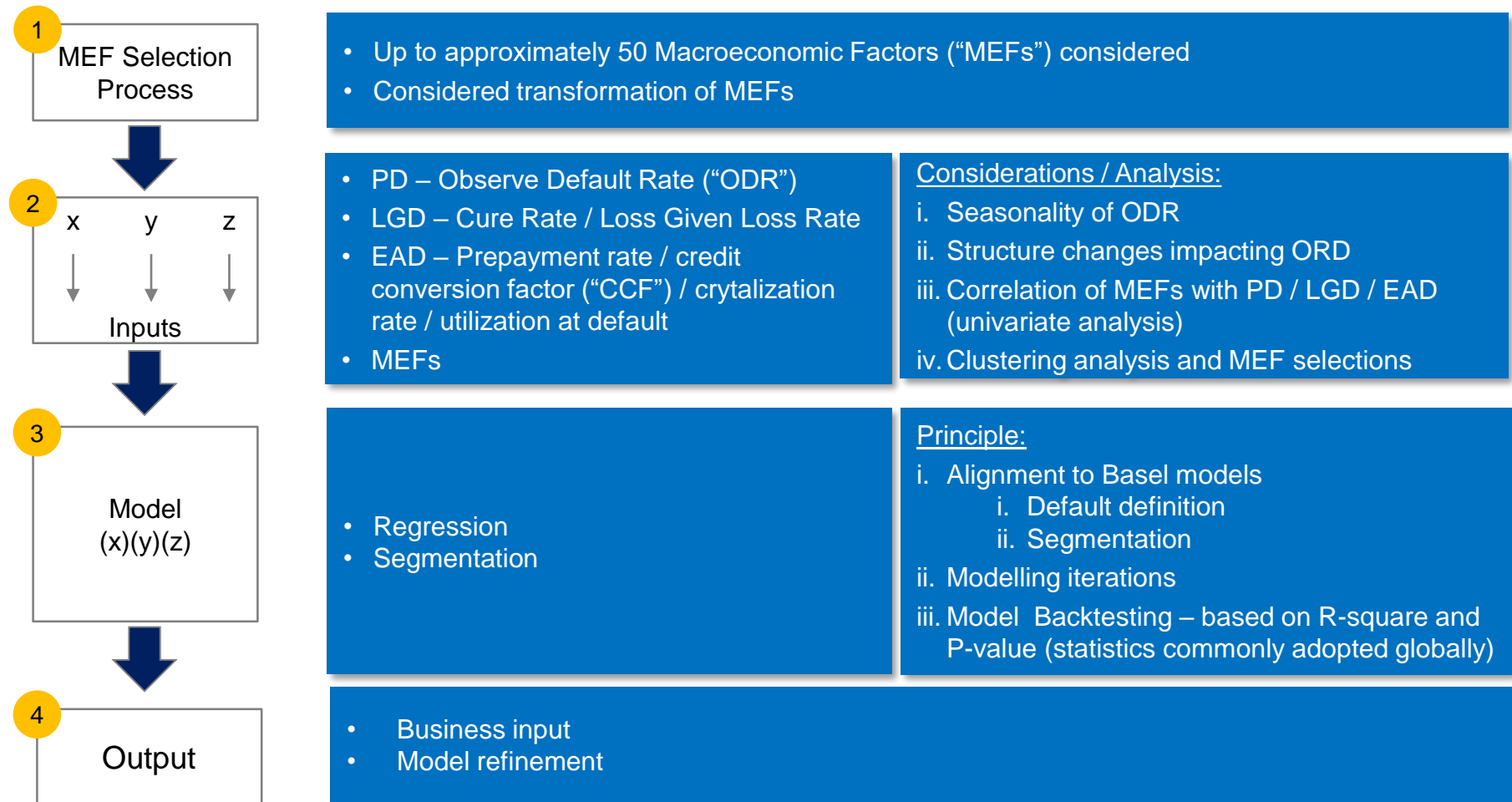
Sector specific:

Bursa Malaysia sector indices	Production indicators
Commodity prices	Service sector indicators
Hotel occupancy rates	Sales of motor vehicles
Crude oil prices	Net and gross margins

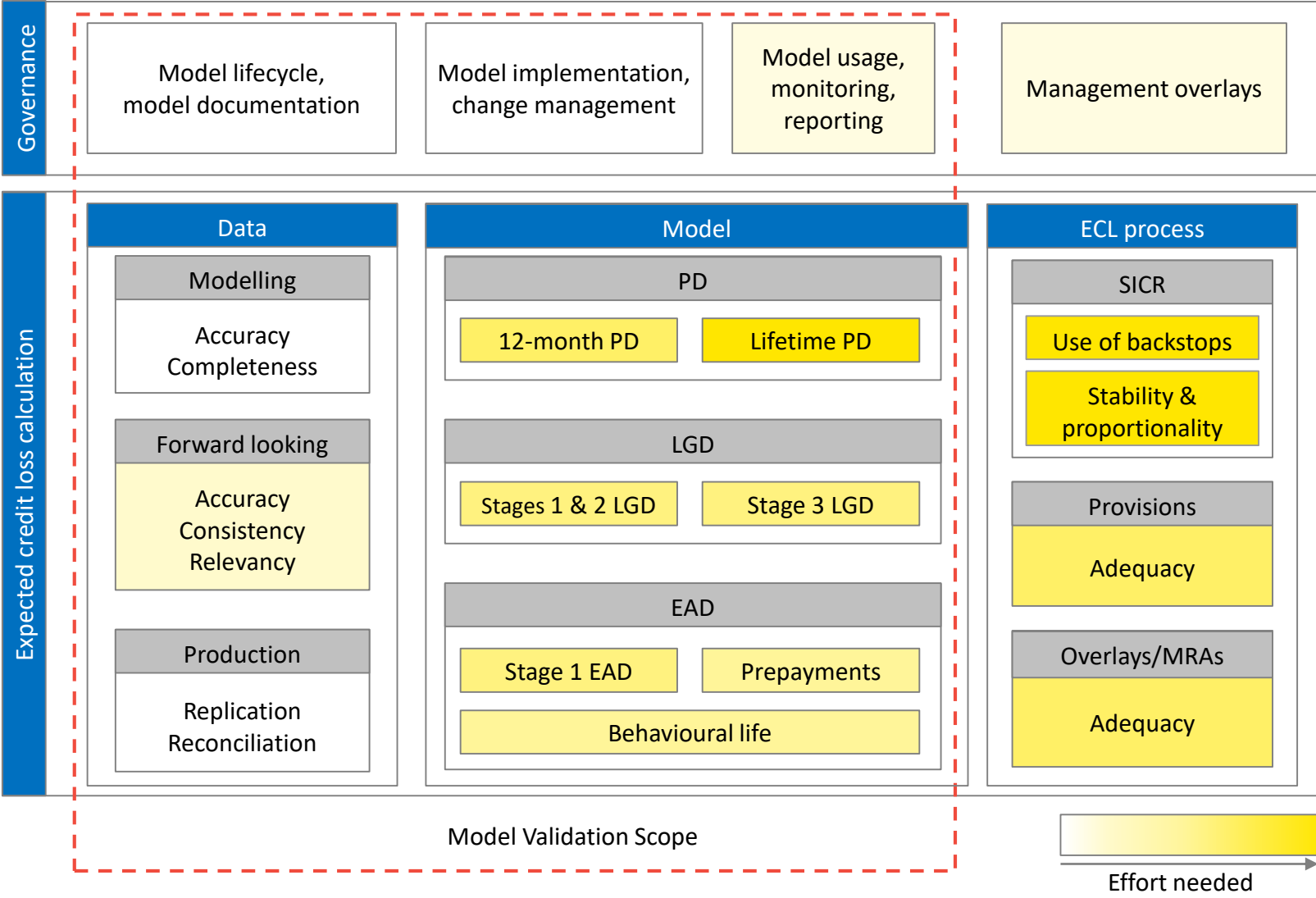
Macroeconomic Modelling

Process flow

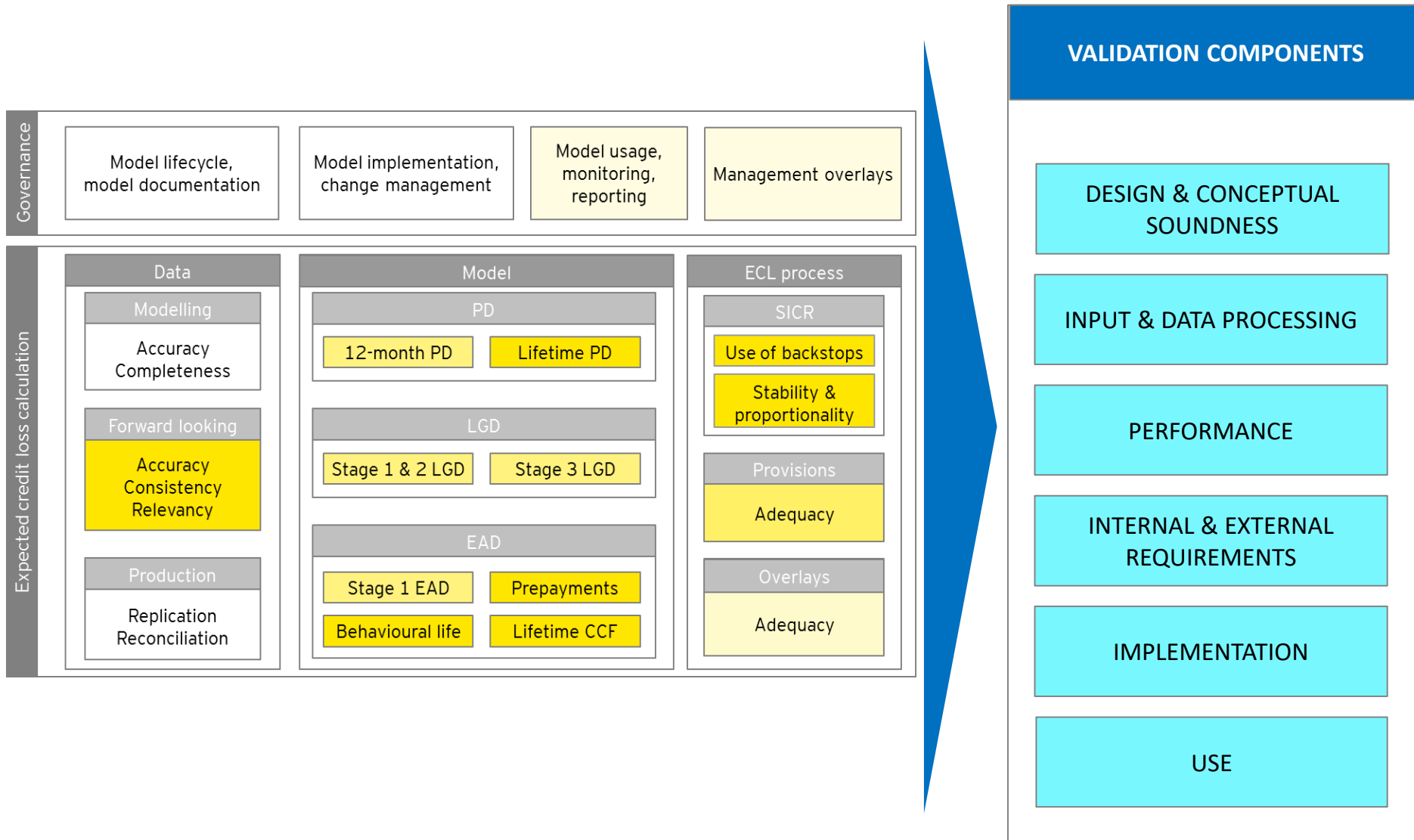
High-level Model Development Approach



More effort is required to review MFRS 9 as compared to Basel models



Whilst the model validation components are the same as Basel validation.....



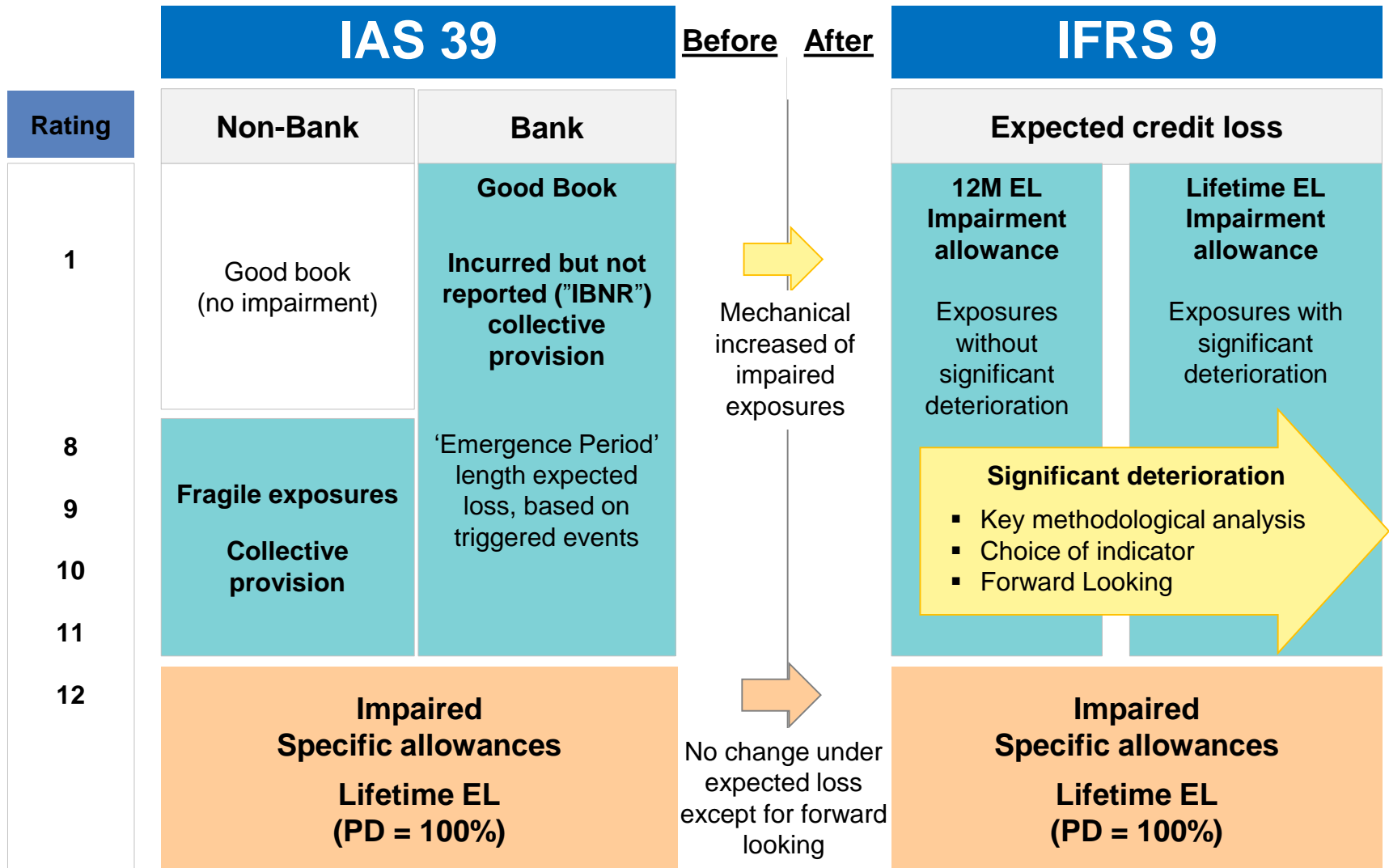
Impairment for non-banks : Use of provision matrix

Lifetime ECL allowance	Days past due	Current	1-30	31-60	61-90	Over 90
	Carrying amount	RM15m	RM7.5m	RM4m	RM2.5m	RM1m
	Lifetime ECL rate	0.3%	1.6%	3.6%	6.6%	10.6%
	Lifetime ECL	RM45,000	RM120,000	RM144,000	RM165,000	RM106,000
Challenges	<ul style="list-style-type: none"> ▶ Portfolio of trade receivables categorised by common risk characteristics ▶ Adjusting historical loss rates with forward-looking estimates 					

An entity that applies provision matrix needs to consider:

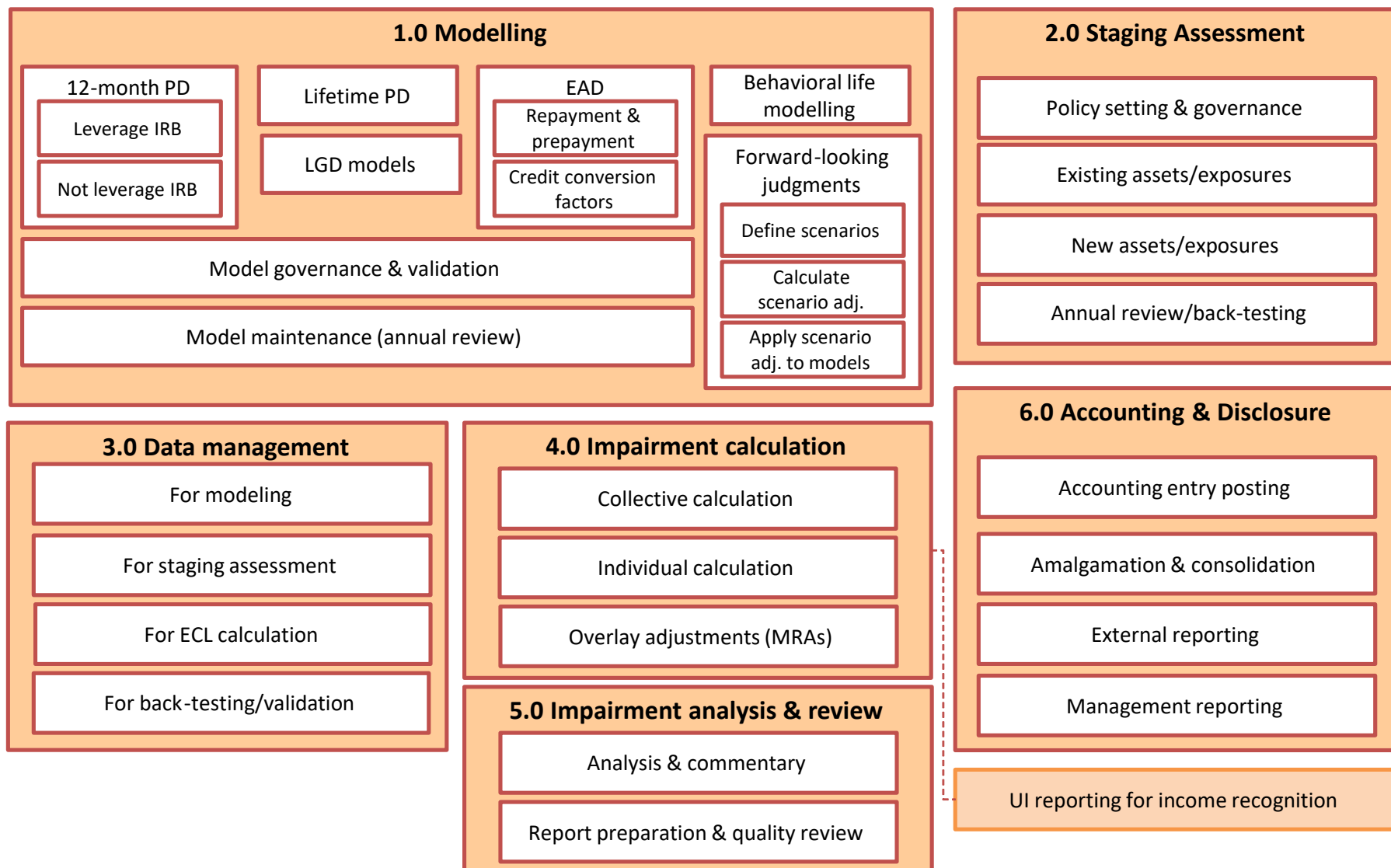
- ▶ **Segmentation of trade receivables portfolio e.g.:**
 - ▶ Corporate vs individual
 - ▶ Large entities vs medium & small entities
 - ▶ Recurring clients vs new clients
 - ▶ Geography etc.
- ▶ **Length of historical loss experience**
- ▶ **Adjustment of historical loss experience to incorporate current & forward looking conditions e.g.:**
 - ▶ Unemployment rates
 - ▶ Industry trends
 - ▶ GDP

From MFRS 139 to MFRS 9



IFRS 9 impairment target operating model (TOM)

– Functional capabilities



Implications from applying the new IFRS 9

- ▶ Raising the bar, again ...
 - ▶ *Challenges* to the Boards & management
 - ▶ Are the *people* sufficiently knowledgeable?
 - ▶ Are the *financial impacts*, effects to *capital requirements* & other *KPIs* understood?
 - ▶ Are the *processes* updated & the *controls* are adequate?
 - ▶ Are the *systems* ready?
 - ▶ Have we managed *stakeholder* expectations?

Business impacts to banks

Expected credit losses (ECLs) recorded on day-1 / Capital Impact

Increase price?

Changes in product mix, client mix & overall risk appetite

Strengthen underwriting standards

Monitor / reduce undrawn components

Shorten maturity?

Tightening pre-arrears collection & recovery processes

Increase IRB coverage

Improve data quality

Enhance system capabilities

Industry key issues raised and discussed

Classification & measurement:

- Performance guarantee
- Determining 'insignificant in value' & 'infrequent'
- Non-viability & loss absorption clauses of capital instruments
- Islamic financial instruments under Shariah concepts of Musharakah & Mudharabah
- Securitisation of financial assets
- Fair value of unquoted equity instruments
- Classification of Sustainable Responsible Investment (SRI) Sukuk
- Credit card portfolio vis-à-vis regulatory requirements
- Interest-free loans
- Factoring business & trade receivables – SPPI test & business model
- Trade vs. non-trade receivables
- Loans to subsidiary (under MFRS 9/IFRS 9 or MFRS 127/IAS 27)

Industry key issues raised and discussed (cont'd)

Impairment:

- Aging (MIA or DPD) as transfer criteria
- Validation of IFRS 9/MFRS 9 models
- Incorporation of forward looking information into PD, LGD & EAD
- Forward looking factors beyond the range of forecast/projection
- Forward looking factors & share-margin financing
- ECL for client & broker balances
- ECL for deposits & placements with local & foreign banks
- ECL for sovereign exposures
- Lifetime – contractual vs. behavioral
- Modification of financial assets
- ‘Reasonable’ & ‘supportable’ forward looking information

Industry key issues raised and discussed (cont'd)

Impairment (cont'd):

- Forward looking formation vis-à-vis information available subsequent to balance sheet date
- ECL for interest portion of financial assets
- Treatment for possibility of cancellation for lease receivables

Industry key issues raised and discussed (cont'd)

Hedge accounting:

- Transitional provision for hedge accounting

Regulatory:

- Tax treatment
- Regulatory capital treatment for costs of hedging

Thank you!