IFRS 9 implementation – the Malaysian experience

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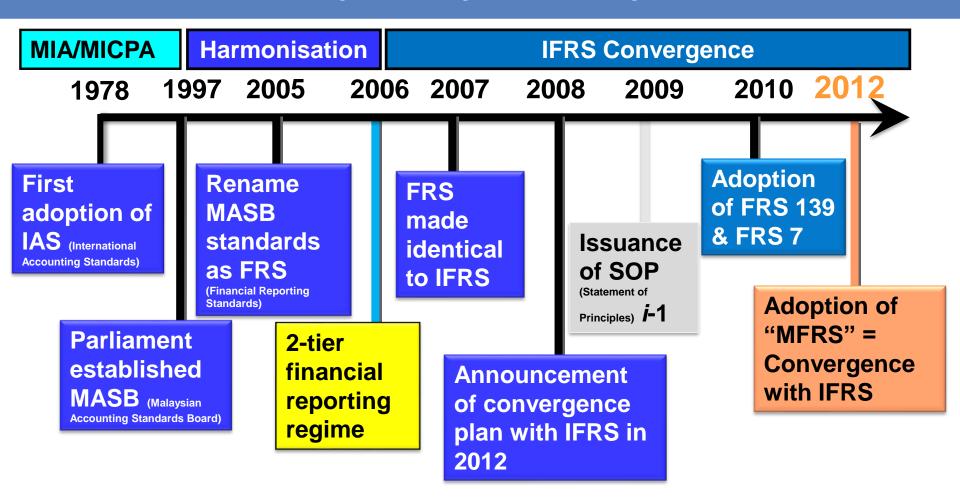
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Agenda

- 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

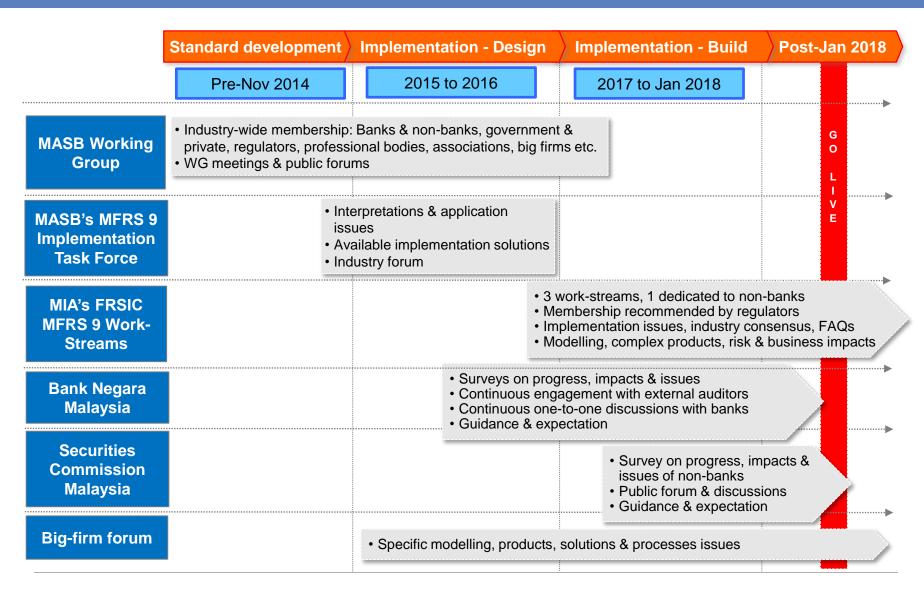
Journey towards convergence with IAS 39 & IFRS 9

Before 2005	2005	2010	2012
 BNM guidelines Loan loss provision Presentation & disclosures Applicable IAS 	 BNM guidelines Loan loss provision by risk buckets, with general provision of 1.5% Investments: In line with IAS 39 requirements Disclosure requirements 	 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 	 Fully converged with IFRS BNM's additional disclosure requirements
	Applicable FRS	disclosure requirements	

[&]quot;BNM": Bank Negara Malaysia, the central bank of Malaysia

IFRS 9 implementation approach

Industry-wide collaboration, coordinated efforts



Entity-level implementation

Accounting policies and reporting

Tax

Business policies and process

IT and systems

People

Project management support

Impact Assessment and Solution Development

Programme Governance

- ▶ Board level project sponsorship and engagement
- Strong senior management ownership of the project setting clear objectives and deadlines
- Typically Finance-leader on Steering Committee (across MFRS 9) but Risk-lead for impairment
- Requires close coordination between Risk, Finance, Business

Financial Impact Assessment

- Determine Impact Assessment methodology and material portfolios for modelling
- Customised modelling approach for material portfolios, with extrapolation for smaller books
- Determine key assumptions per portfolio and sensitivities/stresses to be used
- Provide insights into drivers of financial and capital impact

Gap Analysis

- Assessment of current state: Models, Methodologies and Operating Model
- Review of Data availability and Data quality
- Benchmarking to market / peer practices and how they are evolving
- ► Consideration of in-flight data and reporting programmes

Roadmap

- Prepare multi-year implementation roadmap for senior stakeholders
- Highlight key activities and milestones, stakeholder engagement, market and regulator communications
- Maintain flexibility for possible early adoption. Highlight key dependencies

Build, Test, Deploy

Operating Model

- Document and agree detailed design of "to be" operating model and highlight changes required
- Ensure consistency with overall operating model and interaction of different on and offshore businesses
- Perform a detailed assessment of cost and delivery risk

Model Build & Validation

- Perform a comprehensive review of design options where existing model coverage is misaligned or incomplete
- Assist to design new models. Significant focus on PiT PDs and LGDs and term structures
- Consider internal and external data required for forward looking adjustments /overlays
- Perform model validation

Data/Systems and Controls

- Drive changes to data architecture, focus on known data quality gaps
- Update key controls within the model process, data aggregation process and key finance & risk reconciliations
- Document revised end-to-end processes and ownership matrix

Reporting and Disclosures, Day-One Balances Audit

- ► Analyse and conclude on key accounting judgments
- Design processes to produce required data for risk reporting, Internal management information and financial statements
- ▶ Determine impact on capital and budgets/planning
- Discuss with external stakeholders (BNM etc.)

Go-Live

Parallel / provin

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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

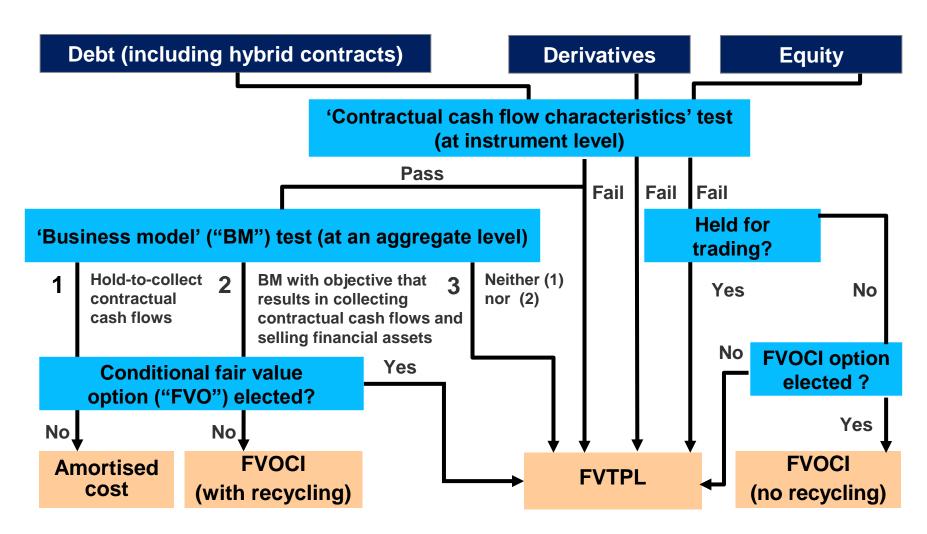


Is the financial asset complex by looking at its underlying *contractual cash flows*?



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

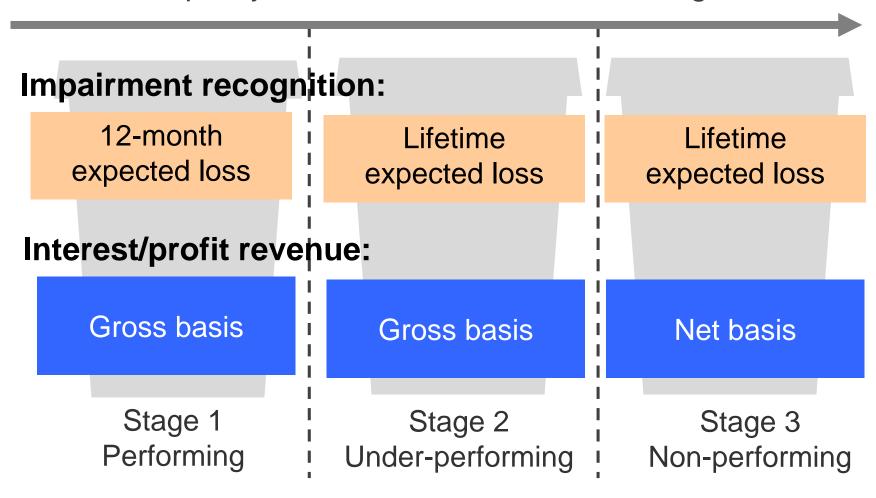
Classification of financial assets



"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

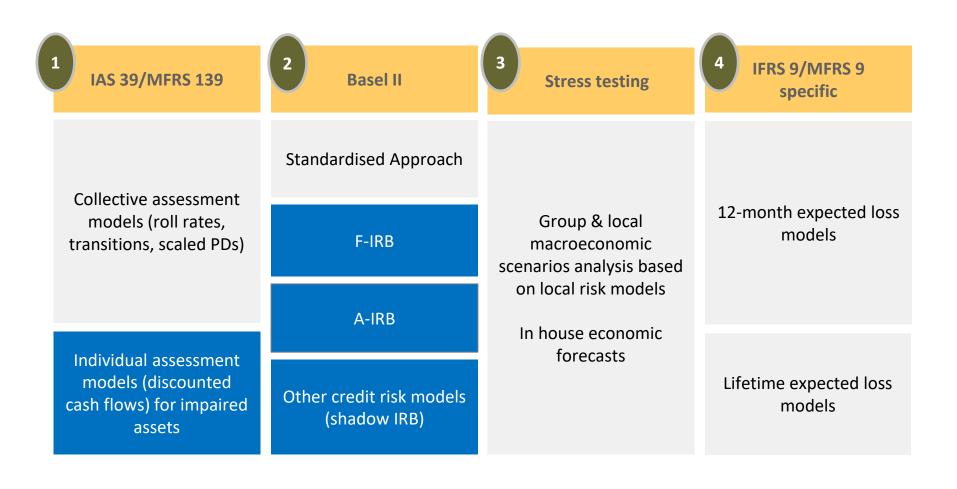
Retail	Non Retail	Treasury	Money Market Instruments	
PD	PD	PD	Internal Rating	
Internal Scoring	Internal Rating	Internal Rating	External Rating	
Collateral Value	Credit Management Approach	Credit Management Approach		
DPD / MIA	DPD / MIA	External Rating		
Modification	Modification	Credit Spread		
Cross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

Steps to decide transfer criteria:

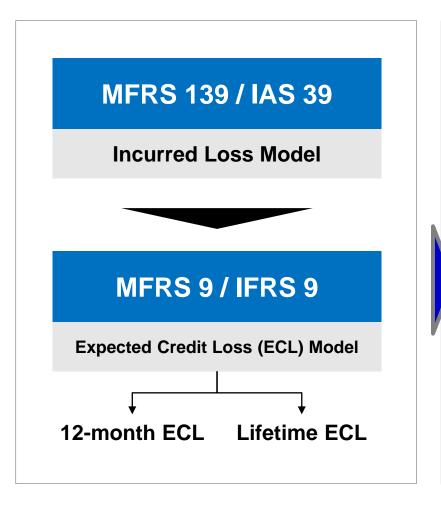
- 1. To confirm which driver(s) are used in the credit risk monitoring & management activities
- 2. Compare the pros & cons to narrow down suitable drivers:
 - By considering guiding principles, simplification & practical expedients, data availability & forward-looking elements
- 3. Design staging scenarios 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

[&]quot;PD": Probability of default; "DPD": Days-past-due; "MIA": Months-in-arrear.

Leveraging existing credit models



Impairment measurement Forward looking factors



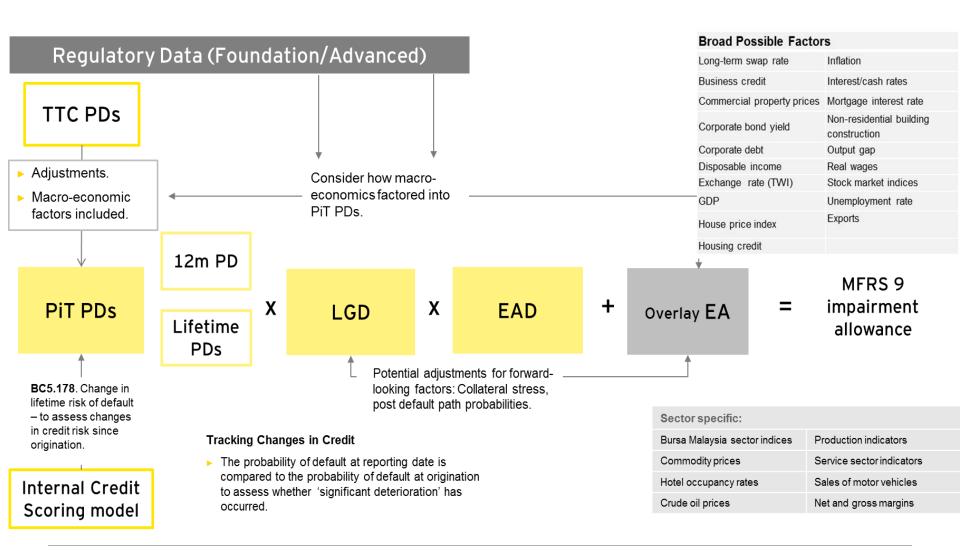
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ECL features:

- ► Forward-looking, time element
- Also sensitive to <u>economic cycle</u>
- 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

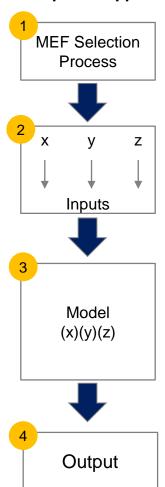
Impacts the entity's provisioning amount

IFRS 9 ECL measurement



Macroeconomic Modelling Process flow

High-level Model Development Approach



- Up to approximately 50 Macroeconomic Factors ("MEFs") considered
- Considered transformation of MEFs
- PD Observe Default Rate ("ODR")
- LGD Cure Rate / Loss Given Loss Rate
- EAD Prepayment rate / credit conversion factor ("CCF") / crytalization rate / utilization at default
- MEFs

Considerations / Analysis:

- i. Seasonality of ODR
- ii. Structure changes impacting ORD
- iii. Correlation of MEFs with PD / LGD / EAD (univariate analysis)
- iv. Clustering analysis and MEF selections

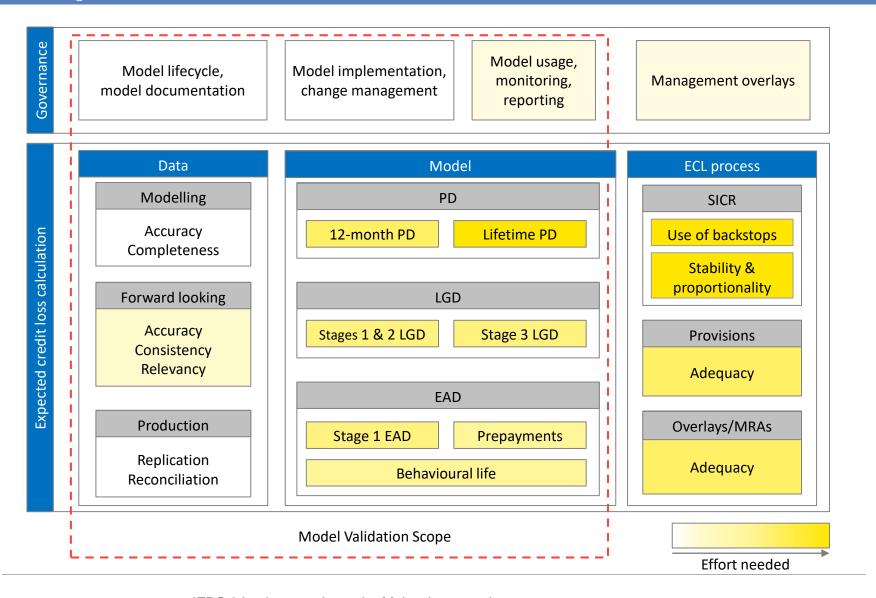
- Regression
- Segmentation

Principle:

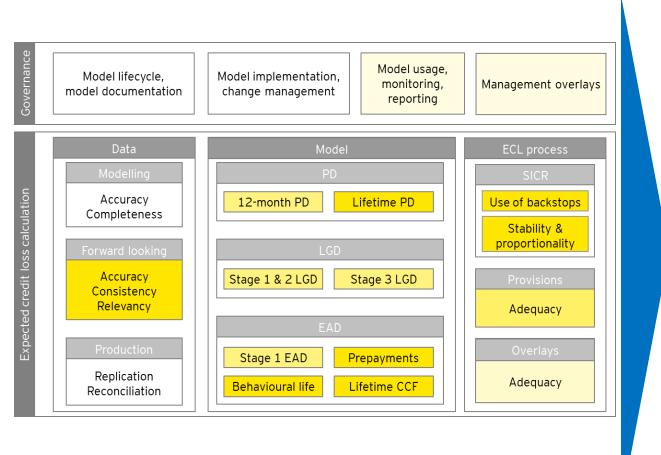
- i. Alignment to Basel models
 - i. Default definition
 - ii. Segmentation
- ii. Modelling iterations
- iii. Model Backtesting based on R-square and P-value (statistics commonly adopted globally)

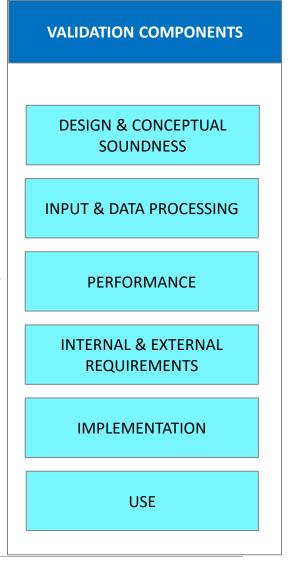
- Business input
- Model refinement

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



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





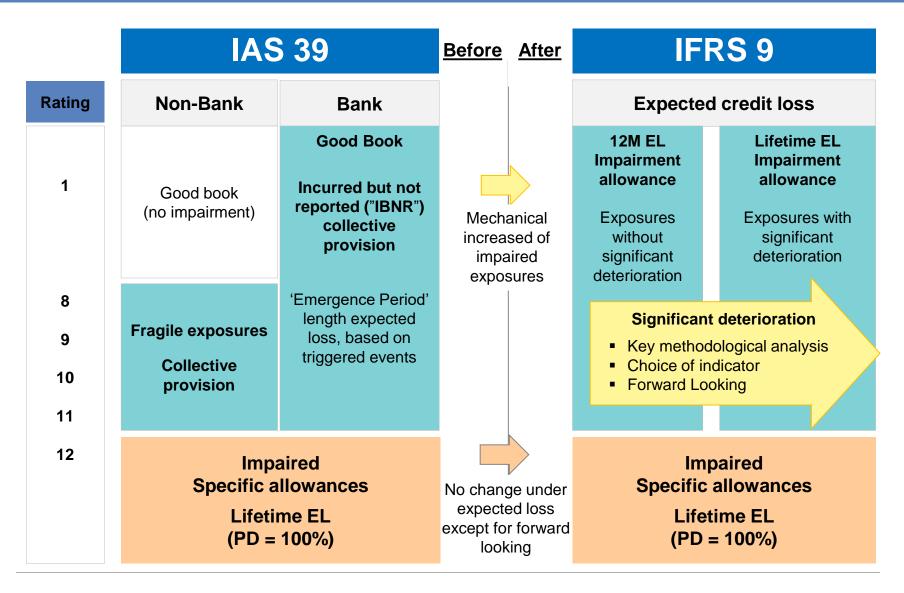
Impairment for non-banks: Use of provision matrix

		Days past due	Current	1-30	31-60	61-90	Over 90	
	Lifetime FOL	Carrying amount	RM15m	RM7.5m	RM4m	RM2.5m	RM1m	
	Lifetime ECL allowance	Lifetime ECL rate	0.3%	1.6%	3.6%	6.6%	10.6%	
allowa	anowance	Lifetime ECL	RM45,000	RM120,000	RM144,000	RM165,000	RM106,000	
		► Portfolio of trade receivables categorised by common risk characteristics						
	Challenges	► Adjusting historical loss rates with forward-looking estimates						

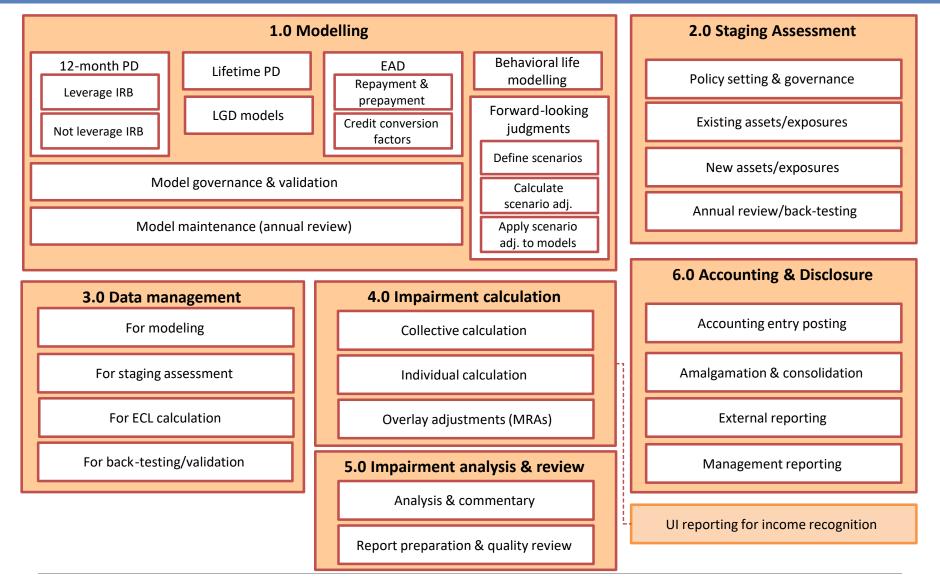
An entity that applies provision matrix needs to consider:

- ► 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!