IFRS 9 Implementation – Korean Experience

16 May 2018

KAI

We bring the finest expertise and insight to our work.
We maintain our independence and fairness.
We are transparent in our decision-making process.
We pursue honesty and integrity.
We trust, communicate openly and cooperate with each other.

Content

Korea Accounting Institute

01 Accounting System in Korea

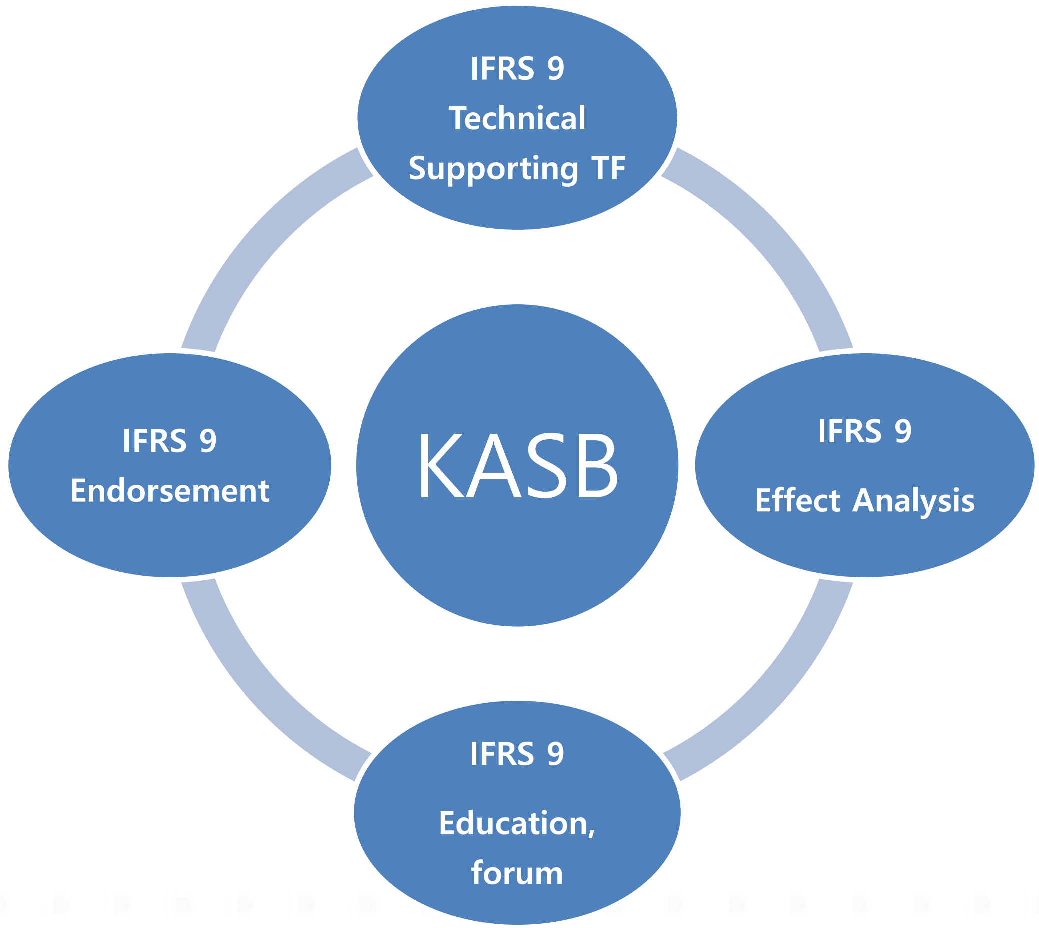
Standard	Tier	External Audit	Related Laws
1. K-IFRS	Listed companies and financial institutions	Mandatory	Act on External Audit of Stock Companies
2. Accounting Standards for Non-Public Entities*	Unlisted but audited companies		
3. SME standards	Unaudited companies	Exempt	Commercial law

3 Tiers

* Unlisted companies are allowed to adopt IFRSs voluntarily instead of Accounting Standards for Non-Public Entities (NPEs).

02 KASB activities for IFRS 9 Implementation

Issuance of IFRS 9 (IASB)



Ⅱ. IFRS Endorsement

01 IFRS Endorsement and Implementation

❖ Before IFRS endorsement: we make efforts to reflect comments of Korean stakeholders

K–IFRS Development process : phase 1 (participation in IFRS development)

Agenda Consultation		Research			Development of standard		Implementation	
Request for information	3–5 Yr interval	Re–search	Discussion Paper	Pro–posal	Exposure Draft	IFRS	Interpretation narrow–scope amendment	PIR*
Comment		Comment			Comment			

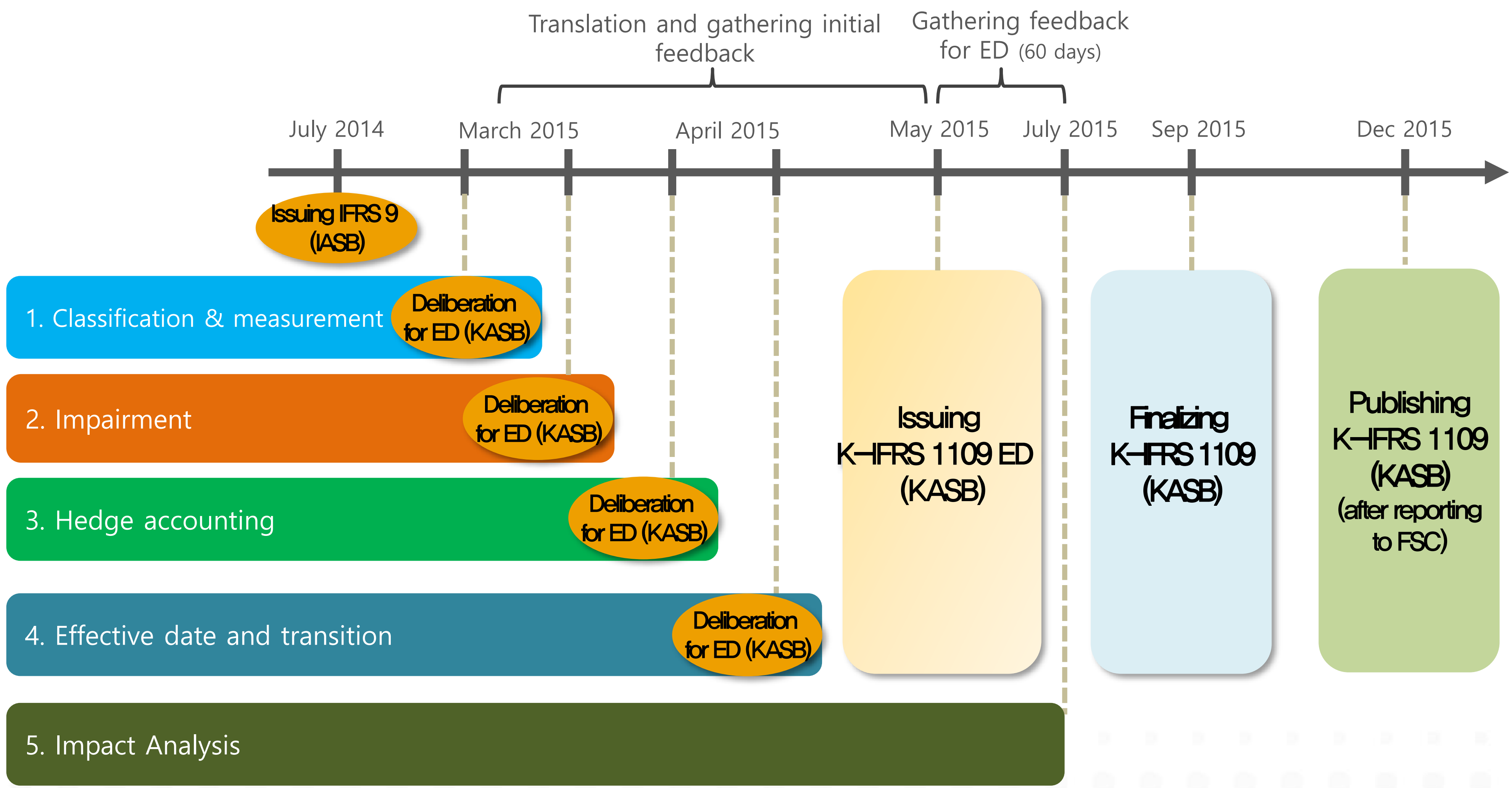
※ PIR=Post Implementation Review

❖ After IFRS endorsement: we actively provide support for successful implementation

K–IFRS Development process : phase 2 (endorsement process including translation)

K–IFRS draft	Public Comment		Development of standard		Implementation	
Plan for standard development & translation	KASB approval	Exposure Draft	KASB approval	Standards	Q&A	Education Seminar …
	Comment				Questions	Participation

02 IFRS 9 Endorsement Process of KASB



Ⅲ. IFRS 9 Technical Supporting TF

01 Purpose and role of IFRS TF

Purpose

- Implementation support for new financial instruments standards (IFRS 9)
- Providing a public forum for stakeholders to learn about the new standards

Role

- Identifying, analyzing and discussing potential issues arising from implementation of the new standards (Anyone can submit issues via KASB website)
- Holding seminar/forums to share discussion results with the public (knowledge transfer)
- Continuously communicating with IASB/IFRIC/ITG and monitoring global discussions of IFRS 9

02 Issues discussed

Issues classified

Separation	Number (%)
Classification/measurement	25 (62.5%)
Impairment	13 (32.5%)
Hedge accounting	2 (5.0%)
Total	40 (100%)

Issues discussed

Separation	Number (%)
1st meeting (Aug 2016)	6 (15.0%)
2nd meeting (Sep 2016)	7 (17.5%)
3rd meeting (Nov 2016)	4 (10.0%)
4th meeting (Dec 2016)	3 (7.5%)
5th meeting (Mar 2017)	6 (15.0%)
6th meeting (Jun 2017)	8 (20%)
7th meeting (Nov 2017)	6 (15%)
Total	40 (100%)

III. IFRS 9 Technical Supporting TF

03 Implementation Issues discussed in IFRS 9 TF

Issues
Classification and measurement • Distinguishing between debt instrument and equity instrument • Identification between CLI and non-recourse loan • SPPI test of various financial assets (Puttable instruments, callable bonds) • Own credit risk of financial liability • Financial assets eligible for the OCI presentation election • Gain or loss from financial instruments measured at FV-PL • Others
Impairment • Determination on indicators for credit risk • Assessment on the date of initial recognition of roll over loan • Practical expedient in accordance with paragraph 5.5.15 of IFRS 9 • Considerations and methodology for determining of IFRS 9 PD • Recognition on accrued interest receivable • Conditional loan commitment • Others
Hedge accounting • Eliminating foreign currency basis spreads of FIs of hypothetical derivative for currency swap • Others

Off-line education

- **Participants**
  - Auditors, preparers and users of FS
  - Anyone who wants to participate

- **Past education**
  - In Dec 2014 (1 time)
  - In June & Dec 2015 (2 times)
  - In May & Sep 2016 (2 times)
  - In Apr, June, July & Sep 2017 (4 times)

Other activities

- **Forum with Hugh Shields (IASB director)**
  - Discuss specific issues in IFRS 9 (Feb 2016)

- **Meeting with SC Bank**
  - Discuss implementation issues (Sep 2017)

On-line education

- **Posting IFRS 9 webcast on KASB website**

분류	2017년
제목	현장강의 K-IFRS 제1109호 금융상품 (1) 분류와 측정
첨부파일	첨부파일이 없습니다.
등록일	2018-03-02

Ⅴ. Expected impacts in Korea*

01 Classification and measurement

* Literature cited **(Expected impacts may be subject to change)**

- ✓ Impact analysis performed by the KASB (Sep 2015)
- ✓ Audit reports of big 4 banks in South Korea (March 2018)
- ✓ Research report from Korea Ratings (April 2018)

● Proportion of FA measured at FV-PL and volatility of PL will increase

- It is expected that there will be no significant impact in adopting IFRS 9 with regard to business model for financial assets
- Financial assets measured at FV-PL is expected to increase due to not meeting SPPI criterion
- According to the audit reports of big 4 banks in South Korea, proportion of all financial assets measured at FV-PL will considerably increase (ex: In case of KB, the percentage of financial assets measured at FV-PL will increase from 1.08% to 3.81%)

● Recognizing entity's own credit risk on financial liabilities designated at FV-PL

- Since it is required to present the effects of changes in the liability's credit risk in OCI, liability valuation-related volatility for PL is expected to decrease
- However, ① financial liabilities designated at FV-PL is not expected to be significant and ② the effects of changes in the liability's credit risk will also not be significant in Korea

V. Expected impacts in Korea (cont'd)

01 Classification and measurement

- Providing more relevant, reliable information

- Entities can classify its financial assets on the basis of the financial assets' characteristics and the entity's substantial business model for managing them
- Since the fair value measurement exemption* for unlisted equity instruments has been removed from IFRS 9, proportion of equity instruments measured at FV-PL is expected to increase

** Para 46 of IAS 39: After initial recognition, an entity shall measure financial assets, including derivatives that are assets, at their fair values, without any deduction for transaction costs it may incur on sale or other disposal, except for the following financial assets: (omit)*

*(c) investments in equity instruments that **do not have a quoted market price in an active market** and **whose fair value cannot be reliably measured** and derivatives that are linked to and must be settled by delivery of such unquoted equity instruments, which **shall be measured at cost***

02 Impairment

Loss allowance will increase under new expected credit loss model

- Loss allowance of Korean banks is expected to increase by about $1 billion as of transition date
- This is **16.3%** of total loss allowance (on separate FS) of all Korean banks as of transition date
- Increasing effects of total increase in loss allowance include effects on all kinds of both loans and debt instruments

Impact of increase in allowance on bank's equity is not expected to be significant

- Coverage ratio(loss allowance / sub-standard loan) increases by an average of **14.9%**. And common equity tier 1 and gross capital ratio decrease by **0.15%** respectively
- Despite the increase in loss allowance resulting from IFRS 9 adoption, the decline of common equity tier 1 and gross capital ratio is not material in Korea
- Korean financial institutions (banking, insurance business, etc.) are required to set aside in its Regulatory Reserve for Credit Losses (appropriation of retained earnings) amount equivalent to the shortfall when credit loss for the accounting purpose is less than the credit loss for regulatory purpose

Ⅴ. Expected impacts in Korea (cont'd)

03 Hedge accounting

● More risk management strategies qualifying for hedge accounting, due to the mitigation of the requirements for hedge accounting

- **Decreased volatility of profit or loss**
  - ✓ IFRS 9 allows more hedging instruments and hedged items to qualify for hedge accounting
  - ✓ More designation of groups of items as the hedged item is possible
- **However, in most Korean banks, as of transition date, the effect of IFRS 9 hedge accounting on the bank's financial statements is not expected to be significant**
  - ✓ In particular, some banks reported that there is no risk management transaction that eligibility conditions for hedge accounting would not have previously satisfied the condition but that condition is now satisfied as a result of applying new requirements for hedge accounting in IFRS 9

Appendix

Korea Accounting Institute

Implementation Issues

1. Determining initial recognition of roll over loan with 1 year maturity
2. Identification for Contractually Linked Instruments
3. Consideration for de minimis and non-genuine in performing SPPI Test
4. Whether non-puttable collective investment vehicle without specified maturity is equity instrument or not
5. Topics discussed with IASB staff in the process of TF operation

1. Determining initial recognition of roll over loan with 1 year maturity

Background

- Determining **initial recognition** is important for **assessing significant increases in credit risk**
- **Stated maturity** of the short-term loan (so called 'roll-over loan') is **1 year**
- When satisfying certain condition(s), the maturity is extended **automatically** or through **banks' minimal procedure** (such as simple credit review, recalculation of interest rate, etc.)
- Legal nature of maturity extension and whether the maturity extension is substantial change or not should be considered

Issue

- With regard to nature of maturity extension for this non callable loan described above, there are differing views: (View 1) This extension is **issuance of a new loan**; or (View 2) It is a **continuation of an existing loan**

1. Determining initial recognition of roll over loan with 1 year maturity(cont'd)

Summary of discussion

- In view of legal nature of maturity extension and change in contractual terms, if it is viewed as a new loan, the extension date is the point of initial recognition of the new loan
- According to legal experts, bank has no legal obligation to extend the maturity on the basis of loan covenant. Therefore, from a legal point of view, this is seen as a new loan
- However, most of the TF members noted that whether a new loan is issued through this maturity extension **may vary** depending on **fact patterns and circumstances** of individual transactions
- Consequently, ① whether **the contractual rights** to an existing loan **have expired** and ② **what procedure the company performed** to extend the maturity should be **collectively considered** to assess whether a new loan is issued

1. Determining initial recognition of roll over loan with 1 year maturity(cont'd)

Implication

- Initial recognition is **a key factor** for assessing significant increases in credit risk
- It is impossible to draw a conclusion regarding whether this is a new loan or an extension of an existing loan at the TF meeting because the conclusion will be varied according **to fact patterns and circumstances on a case-by-case basis**
- IFRS 9 doesn't provide specific requirements regarding definition and scope of changes or modification of financial assets

Questions

- Do you think that IFRS 9 should provide more specific requirements or illustrative examples **for changes(or modification) in financial assets**?
- Have you discussed similar issues with regard to **determining initial recognition**?

2. Identification for Contractually Linked Instruments

Background

- Determining whether a specific loan is **CLI** or **general loan** (including non-recourse loan) is important for **performing SPPI test**
- Entity A gives out a loan to a SPC established for the purpose of operating expressway projects
- In case of default, **entity A is entitled to redeem all property owned by the SPC**. The loan to the SPC is **recourse financial asset**
- The SPC must pay certain fixed interests and repay the principal at maturity **irrespective of cash flows from the expressway operation**

Issue

- Is the loan to the SPC from entity A ❶ a **contractually linked instrument** or ❷ **non-recourse loan** or ❸ **other general loan**?

Summary of discussion

- Most of the TF members noted multiple CLI effect concentrations of credit risk in which payments to holders are prioritized
- The main differences between **waterfall structure**(CLI) **and general loan** are explained in IASB's previous agenda paper (June 2009)

Separation	CLI(waterfall structure)	General FI with credit prioritization
Allocation of loss	**Direct allocation** to **each tranche**	**Allocation** of issuer's asset and liquidation amount **to creditors**
Change in payment	In case of issuer's loss**, the obligation to pay decreases**	In case of issuer's loss, **the obligation to pay does not decrease**
Subordination effect	**default or bankruptcy does not occur**	Missed or incomplete payments are a breach of contract and **default or bankruptcy occurs**

- In Korea, when it come to most loans to SPCs (PF, SOC) such as the one described above, incomplete payments are a breach of contract, and **default or bankruptcy occurs**

Implication

- KASB discussed this issue with IASB staff (Jan 2017)
- Many Korean financial institutions (banks, insurance companies) give out loans to a lot of SPCs related to various development projects(PF, SOC etc.)
- IFRS 9 doesn't provide the **definition of CLI or associated illustrative examples**

Questions

- Do you think that IFRS 9 should provide more specific guidelines or illustrative examples **for CLI**?
- What do you think of the discussions of our TF?
- Have you discussed similar issues with regard to **CLI or non-recourse financial assets** for the purpose of SPPI test?

Background

- In performing the **SPPI test**, it is very important to determine if the **contractual cash flow characteristics** are consistent with the **basic lending arrangement**
- This is about a particular **CD Range Note** (range accrual type) that pays variable interest according to a certain condition*

** If 'benchmark rate at maturity' >= 'benchmark rate at initial recognition', then 1.59%, otherwise 1.58%*

- Probability of occurrence from meeting the stated condition above is set to be **extremely low**

Issue

- When assessing whether the SPPI criterion is met, is the concept of '**de minimis**' and '**non-genuine**' applicable to SPPI testing?

3. Consideration for de minimis and non-genuine in performing SPPI Test (cont'd)

Summary of discussion

- Since IFRS 9 doesn't provide a quantitative standard in applying 'de minimis' concept (Para B4.1.18 of IFRS 9), entities are required to determine the **standard amount** as per **its accounting policy**
- In the case of interest rate of a structured note such as the range accrual type**, time value of money** is not reflected to that interest rate. For this reason, range accrual type note generally does not pass **the SPPI test**
- However, most of the TF members noted that range accrual type note can meet the SPPI criterion if it could have only a **de minimis effect** on the contractual cash flows
- And they noted that if any terms are included in the contract, it will be difficult to say that the term has no **economic substance**. Terms of the contract that are not valid are **very rare** and should only be applied **in exceptional cases**

3. Consideration for de minimis and non-genuine in performing SPPI Test (cont'd)

Implication

- It is important to take into account whether specific terms could have only a **de minimis effect** on the contractual cash flows
- The case to where '**non-genuine provision**' can be applied is a **very rare** in real world situation

Questions

- What do you think of the discussions of our TF?
- Have you discussed similar issues with regard to applying the '**de minimis**' or '**non-genuine**' concept?

4. Whether non-puttable collective investment vehicle without specified maturity is equity instrument or not

Background

- It is very important to distinguish between **debt instrument and equity instrument** In terms of **subsequent measurement** of financial instruments
- According to the law (Capital Market and Financial Investment Business Act), **stated maturity** must be stated on the **articles of incorporation** of non-puttable collective investment vehicle (fund)
- The collective investment business entity of an investment trust or an investment company **shall (if there is no specific method** provided for in the trust contract or the articles of incorporation for guaranteeing realizability, etc. to investors) **list the collective investment securities** within 90 days from the day on which the collective investment securities are initially issued

Issue

- If the maturity is not specified on the article of incorporation subject to listing in the future, can it be regarded as an **equity instrument**?

Summary of discussion

- If the fund does not state a specific method for **guaranteeing realizability** of the investment, the securities must be listed on the securities market
- Most of the TF members noted that **if listing fails**, there will be **an obligation to deliver** cash or other financial assets. Therefore, it is difficult to see that it is an equity instrument **solely due to the fact** that the fund does not have maturity
- And with regard to guaranteeing realizability, **contingent settlement provision** (para 25 of IAS 32) should be considered in assessing whether the instrument is equity instrument or not
- A few TF members noted that **a legal review** will be needed to check whether it is possible not to state maturity in the article
- In a case where distributions to holders of the fund are not at the discretion of the issuer, the fund is financial liability. Therefore **discretion of distribution** should also be considered

Implication

- It would be helpful to look at overseas cases* where a non-puttable collective investment vehicle without stated maturity can be seen as equity instrument

  ** For example, it connects existing holders with new investors (buyers) without a way to put back to issuers (non-callable and no stated maturity)*

- There is no fund to link existing holders with new investors to avoid issuer's repayment obligations in Korea

Questions

- Are there those types of funds (that connect existing holders with new investors)that meet the definition of equity instruments in your country?
- Have you discussed similar issues with regard to determining whether a specific fund meets the definition of equity instrument?

5. Topics discussed with IASB staff in the process of TF operation

Contractually linked instruments (Jan 2017)

- Scope of CLI requirements
- 'Look-through' in paragraph B4.1.22 of IFRS 9

Distinguishing between non-recourse loan and general loan (June 2017)

- Meaning of 'non-recourse financial assets' in paragraph B4.1.16 of IFRS 9
- SPPI test for non-recourse financial assets

Considering fair value of the prepayment feature in performing the SPPI assessment (June 2017)

- SPPI test for conventional callable bond
- The circumstances in which entities must consider the fair value of prepayment feature

Thank You

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