IFRS 9 Financial Instruments and research opportunities

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# Overview

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IFRS 9 at a glance

- Effective 1 January 2018
- Replaced IAS 39
- First stage of post-implementation review starting now

**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
Research opportunities

**IFRS 9 brings many changes to accounting for financial instruments**

We are looking for evidence from studies:

- About the impact of these changes that use a range of methods.

**Pre and post application**
- What changes in accounting practice are observed?
- What are the financial impacts of the changes?

**Market effects**
- What are the effects for market participants of the changes?
- What market outcomes are observed?
Classification and measurement
Classification of debt financial assets

Objective

Useful information about future cash flows

Approach

Business model + Contractual cash flows

A large portion of financial assets in a traditional banking business continue to be measured at amortised cost
## Classification of debt financial assets

<table>
<thead>
<tr>
<th>Cash flows</th>
<th>Business model</th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Solely payments of principal and interest (SPPI)</td>
<td>Hold to collect</td>
<td>Amortised cost</td>
<td>FVOCI</td>
<td>Other</td>
</tr>
<tr>
<td>Other</td>
<td>Hold to collect and sell</td>
<td>FVPL</td>
<td>FVPL</td>
<td>FVPL</td>
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</table>

- Can also be measured at FVPL if elect fair value option at initial recognition due to an accounting mismatch.
## Business model assessment

<table>
<thead>
<tr>
<th>How are cash flows generated?</th>
<th>Typically observed through activities undertaken, eg business plans, manager compensation</th>
</tr>
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<tbody>
<tr>
<td>Not about intent for individual asset</td>
<td>Determined on a level that reflects how financial assets are managed</td>
</tr>
<tr>
<td>Sales information in isolation does not determine the business model</td>
<td>However, it does provide evidence about the business model</td>
</tr>
<tr>
<td>Reclassify only if business model changes</td>
<td>It is a significant event and thus is expected to be uncommon</td>
</tr>
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Solely payments of principal and interest

Features consistent with a basic lending arrangement:
### Solely payments of principal and interest

<table>
<thead>
<tr>
<th>Financial asset</th>
<th>SPPI?</th>
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<tbody>
<tr>
<td>Bond with stated maturity date. Pays a variable market interest rate. That rate is capped</td>
<td>✔</td>
</tr>
<tr>
<td>Full-recourse loan secured by collateral</td>
<td>✔</td>
</tr>
<tr>
<td>Bond convertible into fixed number of equity instruments of the issuer</td>
<td>✗</td>
</tr>
<tr>
<td>Loan that pays floating interest rate that is inverse to market rate</td>
<td>✗</td>
</tr>
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</table>
### Investment in equity instruments

All equity instruments must be measured at fair value, but there is a presentation alternative to present fair value changes in other comprehensive income (OCI).

#### Scope
- Must be equity as defined in IAS 32
- Not eligible if held for trading

#### Features
- Irrevocable election at initial recognition
- Instrument by instrument election
- Dividends recognised in P&L
- No recycling of gains and losses in P&L
- No impairment

Not ‘AFS’ accounting and not the same as the FVOCI classification for debt instruments.
Classification of financial liabilities

Financial liability accounting essentially unchanged from IAS 39, except for own credit on financial liabilities designated under the fair value option.

<table>
<thead>
<tr>
<th>Financial statements – IFRS 9</th>
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<tbody>
<tr>
<td><strong>Balance sheet</strong></td>
</tr>
<tr>
<td>Financial liabilities – FVO</td>
</tr>
<tr>
<td>Full FV</td>
</tr>
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* Not recycled

Required by IFRS 9 for financial liabilities under FVO
There is no available for sale (‘AFS’) category for equity instruments (ie no impairment and recycling)

- what is the significance and characteristics of investments affected by this change?
- how has this affected entities investment decisions (ie nature and type of investment)?
- how prevalent is the use of the OCI presentation election?
- how do investors respond to choices made?

Reclassification of financial assets due to **changes in business model** are expected to be rare

- under what circumstances have entities reclassified financial assets due to a change in business model?
- is the information disclosed about a reclassification useful to investors?
Only financial assets with cash flows that are SPPI are eligible for amortised cost or FVOCI (depending on the business model)

- do any financial assets that would generally have been considered as basic lending arrangements not meet SPPI? Why?
- do these two criteria (SPPI and business model) result in the most useful information being provided for particular financial assets?

For financial liabilities designated under the fair value option, changes in the fair value of an entity’s own credit risk are recognised in OCI rather than profit or loss

- is the information provided about an entity’s own credit useful to investors?
Questions?
Impairment
Impairment—an expected loss model

- Responds to calls from the G20 and others
  - Forward-looking model
  - Responsive to changes in credit risk

Single model reduces complexity of multiple approaches

Broader range of information required to be considered
- more timely recognition of expected credit losses
- IAS 39 threshold eliminated

Builds on existing systems to balance costs and benefits

Enhanced disclosures
- illustrate how entity has applied requirements
- show assets which have significantly increased in credit risk

Builds on existing systems to balance costs and benefits
Scope of impairment requirements

- Financial assets measured at FVOCI
- Financial assets measured at amortised cost
- Lease receivables
- Trade receivables and contract assets
- Loan commitments and financial guarantee contracts not measured at FVPL
Overview of general impairment model

Change in credit risk since initial recognition

ECL recognised

12-month expected credit losses  
Lifetime expected credit losses  
Lifetime expected credit losses

Interest revenue

Gross basis  
Gross basis  
Net basis

Stage 1  
Stage 2  
Stage 3

'Performing'  
'Underperforming'  
'Non-performing'/Credit-impaired
Main judgements and estimates

- Determining whether there is a significant increase in credit risk since initial recognition
- Determining whether a collective or individual assessment is needed for portfolios of shared risk characteristics
- Measuring expected credit losses (ECL)
  - determining whether loans will be paid as due – and, if not, how much might be recovered and when
  - probability-weighting different scenarios
- Appropriately incorporating forward-looking information into assessment of changes in credit risk and measurement of ECL
- Determining the appropriate period over which to measure ECL for revolving credit facilities
Determining significant increases in credit risk

• Change in credit risk over the life of the instrument – ie risk of default occurring (not changes in expected credit losses)
  – no definition of default, but rebuttable presumption that no later than 90 days past due
  – maturity matters

• Compare to credit risk at initial recognition
  – consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk

• Financial instruments that have low credit risk at the reporting date
  – may assume credit risk has not increased significantly

• More than 30 days past due
  – rebuttable presumption that credit risk has increased significantly since initial consideration
Assessment of increase in credit risk

As information emerges over time an entity is able to better distinguish credit risk of loans

Portfolio of home loans originated in a country

Information emerges that one region is experiencing tough economic conditions

More information emerges and entity can identify particular loans in default or that will imminently default

Stage 1
Stage 2
Stage 3
Measuring expected credit losses

ECL needs to reflect:

- **Probability-weighted outcome**
  - Must consider at least possibility that default will/will not occur

- **Time value of money**
  - Discount at 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 – designed to accommodate different information availability
Information set

**Historical**

- Need to ensure historical information is relevant (may need to be adjusted)

**Current**

- Emphasis on forward looking information, but if nothing more forward-looking is available, delinquency information may be used
- Expect move to stage 2 before delinquent

**Reasonable and supportable forecasts of future economic conditions**

Available without undue cost or effort
Reasonable and supportable information

Objective

Consider all reasonable and supportable information, including forward-looking information, that is relevant and available without undue cost or effort.

- Information with these characteristics is used in both assessment of significant increases in credit risk and in measurement of expected credit losses.
- Will require judgement.
- Information should not be excluded simply because:
  - the event has a low or remote likelihood of occurring; or
  - the effect of that event on credit risk or the amount of expected credit losses is uncertain.
Reasonable and supportable information (cont’d)

**Borrower-specific factors**
- Changes in operating results of borrower
- Technological advances that affect future operations
- Changes in collateral supporting obligation

**Macroeconomic factors**
- House price indexes
- GDP
- Household debt ratios

**Data sources could be**
- **Internal**
  - Credit loss experience and ratings
- **External**
  - Ratings, statistics or reports

Information does not need to flow through statistical model or credit-rating process to determine whether it is reasonable and supportable and relevant.
Disclosures—objective

Enable users to understand the **effect of credit risk** on the **amount, timing and uncertainty** of future cash flows.

- Entities’ **credit risk management practices** and how they relate to recognition and measurement of ECL
- Quantitative and qualitative **information** to evaluate amounts in the financials arising from ECL
- Entities’ **credit risk exposure** including significant credit risk concentrations
Transition to IFRS 9—impairment

- Retrospective application required
- Reliefs available
  - low credit risks simplification
  - 30 days past due rebuttable presumption
  - undue cost or effort to determine credit risk at initial recognition

Retrospective application

- Impracticable to apply
- Use of hindsight
- Undue cost or effort
Research opportunities—impairment

**New expected credit loss model**
- what is the impact on reported numbers and financial ratios?
- how do entities’ calculations relate to economic conditions?
- how do entities, industries and countries compare in their application of the model?
- in the long term, how does better measurement of impairment contribute to goals such as financial stability?

**Transition choices**
- what transition approaches have entities adopted?
- what are the characteristics of entities making various choices?
- are any market impacts observable in relation to these choices?
Research opportunities—impairment

Objective-based *disclosure requirements* were included in IFRS 7 for ECL

- can researchers observe changes in entities’ disclosures, and the quality thereof, because the drafting of disclosure requirements is different?
- what factors are associated with better ECL disclosures?
- are regulatory effects observed?
- are costs or benefits of better disclosure observable?
Questions?
IASB Research opportunities

See News on our Academic page https://www.ifrs.org/academics/

• Webinars:
  – IFRS 9 *Financial Instruments*
    Thursday 21 January, 09:00-10:00 and Thursday 21 January, 15:00-16:00
  – IFRS 16 *Leases*
    Friday 22 January, 09:30-10:30 and Friday 22 January, 15:00-16:00
  – IFRS 15 *Revenue from Contracts with Customers*
    Monday 8 February, 09:00-10:00 and Monday 8 February, 15:00-16:00

• Journal special issues
• Upcoming conferences, including IASB Research Forum 2021
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Relevant materials

IFRS 9 overview and access to Standard
Project Summary
Supporting materials

Articles

Big changes ahead: accounting for financial instruments

IFRS 9: a complete package for investors