Special Interest Session

Implementing forthcoming
Financial Instruments requirements

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Replacing IAS 39 – where are we?

- Classification & Measurement: IFRS 9 (2010) + ED of limited amendments
- Impairment: ED on Expected Credit Losses
- General Hedge accounting*: Review draft complete

* Macro hedge accounting is being deliberated separately from this project.
Limited Amendments

- IFRS 9 is fundamentally sound and operational
- Mindful of efforts to implement IFRS 9
- Three primary objectives:
  1. Improve interaction with accounting for insurance contracts
  2. Address narrow range of application questions
  3. Reduce key differences with FASB
IFRS 9 as proposed

- Business model
  - Amortised cost*
  - FVO for accounting mismatch

- Contractual cash flow characteristics
  - FVOCI*
  - Fair Value (No impairment)

Reclassification required if business model changes

All other instruments:
- Equities
- Derivatives
- Some hybrid contracts
- ...

* Same impairment model

Cash flow characteristics

- Benchmark instrument cash flows
- Actual cash flows

Compare

Satisfies P&I test if effect of modification could not be more than insignificant
Transition – early application choices

Currently

- Classification & Measurement: Financial Assets
- All Classification & Measurement: Financial Assets + Financial
- All Classification & Measurement + General Hedge Accounting

OR

Proposed

- Own Credit requirements
- All Classification & Measurement + Impairment + General Hedge Accounting

Feedback statistics

- 168 comment letters
- More than 60 outreach meetings – Including jointly with the FASB
- Online user survey – Over 40 responses from users
Clarifying solely P&I

- Nearly all welcomed the proposals and agreed ‘modified economic relationship’ can be solely P&I

BUT

- Questions about proposed application guidance
- Proposals do not go far enough
- Regulated rates
- Comments on topics outside the scope of the proposals

Proposed FVOCI category

- The majority of respondents supported FVOCI category
- Views broadly equally split between
  - Support FVOCI category as proposed
  - Support FVOCI with a variation
  - Do not support FVOCI
- Questions about clarity of distinction between business models
- Some questioned whether holding to sell or collect is really a business model
Clarifying ‘hold to collect’

• Many respondents agreed ‘hold to collect’ is clearer

BUT

– Some disagreed with the outcome
– Many challenged particular details of the proposals

• Questions on business model assessment
– Most notably, the emphasis on selling activity
– Treatment of sales to meet regulatory requirements and for credit risk concentration

Transition

• Nearly all supported early application of just ‘own credit’ requirements

BUT

– Requested it to be available before IFRS 9 is completed
  e.g. by incorporating in IAS 39 or IFRS 9 (2010)

• Many asked the IASB to confirm the deferral of the mandatory effective date of IFRS 9 as soon as possible
  – Currently 1 January 2015
Other key themes

• Complexity
  – Many noted increased complexity
  – Some stated added complexity is justified, others stated it contradicts the original objective of reducing complexity

• Convergence
  – Many welcomed greater alignment with the FASB’s model
  – Some encouraged convergence in application guidance
  – Some emphasised changes should only be made if they improve IFRS
The basis for the proposals

- The yield on financial instruments reflects initial credit loss expectations
- When expected credit losses exceed those initially expected an economic loss is suffered
- This was best reflected in the 2009 ED

Proposals reflects this in a more cost effective way by:
- Recognising a portion of expected credit losses initially
- Recognising lifetime expected credit losses when significant deterioration in credit risk occurs

What does it apply to?

- Debt instruments measured at amortised cost
- Debt instruments mandatorily measured at fair value through other comprehensive income (FVOCI)
- Trade receivables and lease receivables
- Other financial instruments subject to credit risk, such as:
  - some loan commitments
  - some financial guarantee contracts

Expected credit losses will be recognised for all of these financial instruments at all times.
Overview of general model

Change in credit quality since initial recognition

Expected credit losses recognised

12-month expected credit losses

Lifetime expected credit losses

Lifetime expected credit losses

Interest revenue

Gross basis

Gross basis

Net basis

Stage 1
Performing

Stage 2
Underperforming

Stage 3
Non-performing

Information used

- Information used to measure expected credit losses and assess changes in credit:
  - Available without undue cost or effort
  - Historical, current and reasonable and supportable forecasts
  - Historical information must be updated
  - Delinquency information may be used

  **Particular measurement methods are not prescribed; nor must PD be explicitly included as an input**

- Information that can be considered includes:
  - Borrower specific
  - Macro-economic
  - Internal default rates and probabilities of default
  - External pricing
  - Credit ratings
Assessment of deterioration in credit quality

Need to assess when significant deterioration has occurred:

• Change in probability of default occurring (not change in expected losses)
• Compared with initial recognition
• Maturity matters
• Operational simplifications:
  – Recognise 12-month expected credit losses if investment grade
  – Rebuttable presumption: significant deterioration when payments are more than 30 days past due
  – Don’t need to assess for trade and lease receivables

Expected credit losses—example

As information emerges over time – entity is able to better distinguish credit quality of loans

Portfolio of home loans originated in a country.

Information emerges that a region in the country is experiencing tough economic conditions.

More information emerges and the entity is able to identify the particular loans that are in default or will imminently default.
### Proposed disclosures

#### Amounts
- Reconciliation of gross carrying amounts and associated losses
- Reconciliation of allowance accounts
- Gross carrying amount per credit risk grades for financial assets and loan commitments
- Information on collateral held, modification

#### Judgements
- Inputs, assumptions and techniques used to estimate expected credit losses (and changes in techniques)
- Inputs, assumptions and techniques used to determine 'objective evidence of impairment'
- Inputs, assumptions and techniques used to determine 'significant deterioration in credit risk'
- Write off policies

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**International Financial Reporting Standards**

**Hedge Accounting**

The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.
Timeline

- December 2010: ED Hedge Accounting
- March 2011: ED redeliberations completed
- September 2011: ED Comment letter deadline
- September 2012: Draft requirements published
- January 2013: IASB discussed outstanding issues
- April 2013: IASB finalises redeliberations
- 2nd half 2013: Publication of final chapter

Major features of the new model

- Greater alignment with risk management including
  - Expansion of risk components for non-financial items
  - Ability to hedge aggregated exposures (combination of derivative and non-derivative)
  - Introduction of ‘costs of hedging’
  - Eligibility criteria based on more economic assessment of hedging relationship
- Enhanced disclosures
- Will be added as a chapter to IFRS 9 (Chapter 6)
Hedged items

**Qualifying hedged item**

- Entire item
- Component

**Risk component** (separately identifiable and reliably measurable)

**Nominal component or selected contractual CFs**

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Hedged items: risk components

<table>
<thead>
<tr>
<th>IAS 39</th>
<th>New model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed element</td>
<td>Fixed element</td>
</tr>
<tr>
<td>Variable element</td>
<td>Variable element</td>
</tr>
<tr>
<td>Benchmark (e.g., interest rate or commodity price)</td>
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</tr>
</tbody>
</table>
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

Transaction related hedged item

Time period related hedged item
Hedge effectiveness

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

Measuring and recognising hedge ineffectiveness

Rebalancing

Discontinuation

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
What happened since the draft requirements were published in 2012?

- **January 2013:**
  - expand the notion of costs of hedging to accommodate FX basis spreads
  - transition for 'own use' contracts as at FVPL on all-or-nothing basis for similar contracts
  - clarification of treatment of 'proxy hedges'

- **April 2013:**
  - provide entities with an accounting policy choice between applying IFRS 9 or IAS 39 hedge accounting
  - permission given to begin balloting

Thank you
Implementing IFRS 9: Hedge accounting

Martin Friedhoff
June 2013

Agenda

► Overview
► Hedged items
► Designation of hedging relationships
► Hedge effectiveness assessment
► Accounting for hedging relationships
► Transition
The new hedge accounting model: implications of the objective

Objective of new hedge accounting model in IFRS 9:

Represent in the financial statements the effect of an entity’s risk management activities

Implications:

► More economic hedging strategies should qualify for hedge accounting
► It should be easier for users of financial statements to understand hedging activities and the accounting consequences
► Some operational simplifications, in particular the hedge effectiveness test

Implementing the new hedge accounting model: overview

Migration of existing hedge accounting
- Operational simplification
- Improve fit to risk management
- Improve stability of hedging relationships

Expansion of hedge accounting
- Economic hedges ineligible under IAS 39 that qualify under IFRS 9
- Hedges for which IAS 39 hedge accounting was too onerous
Hedge accounting: lifecycle

- Hedged item
- Hedging instrument
- Designation & type of hedge
- Accounting for hedging relationship
- Effectiveness assessment
- Discontinuation of hedge accounting

Agenda

- Overview
- Hedged items
- Designation of hedging relationships
- Hedge effectiveness assessment
- Accounting for hedging relationships
- Transition
Implementing risk components: overview

Risk components

Migration of existing hedge accounting
- For risk components of financial hedged items
- Criteria unchanged (separately identifiable & reliably measureable?)
- Check practice (e.g. ‘hypothetical derivatives’)

Expansion of hedge accounting
- For risk components of non-financial hedged items
- Same criteria as for financial hedged items
- Inflation risk component of fixed rate debt?

Contractually specified
- Only designate risk component

Non-contractually specified
- Analyse market structure
- If criteria met, only designate risk component

Risk components of non-financial items: examples

Examples of contractually specified components
- Price of gas contractually linked to gas oil or fuel oil benchmark price
- Price of electricity contractually linked to coal benchmark price
- Price of cans contractually linked to aluminium benchmark price
- Price of coffee purchased on a specific market contractually linked to benchmark price for Arabica coffee

Examples of non-contractually specified components
- Crude oil component in jet fuel
- Components like those listed above, just not contractually specified—if supported by the market structure analysis (e.g. forecast transactions in such markets)
Risk management strategy and risk management objective

**Risk management strategy**
- Established at a high (e.g., entity) level
- Identifies risks (in general) and how entity responds to them
- Typically in place for longer period
- May include flexibility
- Often a formal policy document
- Part of hedge documentation

**Risk management objective**
- Applies at level of particular hedging relationship
- Describes how a particular hedging instrument is used to hedge a particular exposure designated as the hedged item
- Part of hedge documentation
### Examples of risk management strategy and risk management objective

<table>
<thead>
<tr>
<th>Risk management strategy</th>
<th>Risk management objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maintain at least 40% of debt at floating interest rate</td>
<td>Use an interest rate swap to hedge a GBP 100m fixed rate liability (swap fixed to floating)</td>
</tr>
<tr>
<td>Assure medium-term price stability of commodity purchases</td>
<td>Use a coal forward contract to hedge the first 1m tonnes of coal purchases in Nov 2013</td>
</tr>
<tr>
<td>Hedge foreign currency risk of forecast purchases in USD up to 12 months</td>
<td>Designate an FX forward contract to hedge the foreign exchange risk of the first USD10m purchases in Dec 2013</td>
</tr>
</tbody>
</table>

### Why designation matters...

**Example 1: Fair value hedge of a layer**

![Diagram of fair value hedge](image)

- **Proportional**
  - Top layer
  - Fixed rate debt (100)
  - Bottom layer
  - Swap (20)
  - Swap (20)
Why designation matters...
Example 1: Fair value hedge of a layer

- Entity A issues fixed rate debt of 100
- Early repayment at FV contemplated for up to 20

Designation alternatives for fixed-to-float swap of 20:
- Proportional: each repayment is 20% hedged
  - Use if want constant float/fix mix when redeeming early
- Top layer: up to 20 can be redeemed early without interest-related FV gain/loss
  - Use if want to allow early redemption ≈ ‘at par’ (economically)
- Bottom layer: the first 80 that are redeemed early result in gain/loss on derecognition
  - Use if want to retain 20 of floating exposure (and prepay at FV)

Why designation matters...
Example 2: Exposure to variable cash flows

Entity B has cash flow interest rate risk on a nominal amount of 100

Designation alternatives for float-to-fixed swap of 20 for cash flows on existing variable rate debt:
- Proportional: each cash flow is 20% hedged
  - Use if want to retain constant float/fix mix when redeeming early
- Top layer: the first 20 that are redeemed early result in gain/loss on derecognition (CFHR recycling)
  - Use if want to retain 80 of floating exposure (and prepay at FV)
- Bottom layer: up to 80 can be redeemed early without interest-related FV gain/loss
  - Use if want to allow early redemption ≈ ‘at par’ (economically)
Why designation matters...

Example 2: Exposure to variable cash flows

Entity B has cash flow interest rate risk on a nominal amount of 100

Designation alternatives for float-to-fixed swap of 20 for cash flows that are forecast transactions:

- Proportional: relevant?
- Top layer: N/A
- Bottom layer: all amounts above 20 can be redeemed early without interest-related FV gain/loss
  - Use if want to allow early redemption = ‘at par’ (economically) and retain 20 of fixed rate exposure
  - Can also designate other layers above bottom (but not ‘top layer’)
The new hedge effectiveness test: overview

Economic relationship
- Between hedged item and hedging instrument
- Systematic change (opposite direction) in response to same or economically related underlyings

Credit risk does not dominate
- Credit risk does not frustrate economic relationship
- Credit risk can arise from hedging instrument and hedged item

Hedge ratio
- Consistent with actual ratio used by entity
- Different ratio only if accounting outcome would be inconsistent with purpose of hedge accounting
Hedge effectiveness test: implications for implementation

- Only **prospective** test
  - Last testing period no longer ‘at risk’ => *reduces uncertainty*

- **Removal of 80-125% range**
  - Enables use of **materiality** concept
  - Means **qualitative** tests can be appropriate
  - **Avoids** need for ‘**overkill**’ solutions
    - Small changes in value with high percentage mismatch (‘small numbers problem’)
    - Designation of off-market hedges (‘late hedges’)
  - Means can often **use** assessments on which **risk management** decisions are based → also implications for credit risk
  - Overall effect: *reduces uncertainty*

Hedge effectiveness test: implications for implementation

**Implications of new hedge effectiveness test:**

- **Migration** of existing hedge accounting
  - Operational simplification
  - Improve fit to risk management
  - Improve stability of hedging relationships

- **Expansion** of hedge accounting
  - Hedges for which testing was too onerous ?
  - Hedges with basis risk ?
# Agenda

- Overview
- Hedged items
- Designation of hedging relationships
- Hedge effectiveness assessment
- Accounting for hedging relationships
- Transition

## Implementing rebalancing

**Migration of existing hedge accounting**

**Effect:** continue hedge accounting instead of stop & re-start

**Scope: when does rebalancing apply?**

- **No ‘basis risk’**
  - Rebalancing is N/A
- **Basis risk in hedging relationship**
  - Rebalancing required if basis risk *changes* economic relationship
  1. Risk management
     - Establish actually used hedge ratio
  2. ‘Accounting overlay’
     - Check consistency with purpose of hedge accounting (and adjust if necessary)

**NB:** rebalancing is *only* about ‘basis risk’ (*not* the extent of hedging)
Implementing transition

Migration of existing hedge accounting

Default approach: prospective application of IFRS 9 model
- Continue hedge accounting if meet IFRS 9 requirements
- Rebalancing on transition (if applicable) → against profit or loss

Exceptions:
- Items: for ‘risk components’ of derivatives excluded from designation as the hedging instrument under IAS 39
- Time: only for those hedging relationships that existed in earliest balance sheet presented or designated thereafter

Time value of options:
Must apply retrospectively

Forward element of forward contracts
- May apply retrospectively
- All-or-none election

NB: can de-designate any hedging relationship on last day of applying IAS 39!
Thank you
Presentation objectives
From inception to implementation

- Provide an update and overview of the IASB proposals from an operational perspective.
  - Main points of the proposal whilst highlighting changes
  - Next steps and overall timelines

- Focus on WHAT we need to do
  - Categorisation using existing tools and techniques
  - Measurement approaches

- Focus on HOW this will be achieved
  - Differences between corporate and retail
  - Organisation challenges
Overview
The most significant accounting change that banks will face in coming years.

- Impacts all businesses, geographies and products
- Challenges are many and varied
  - Data
  - Models
  - Processes, Policies and standards
  - Central vs. de-centralised
  - Conceptual lifetime and ‘forward look’
  - Financial impacts (size and timing)
  - Multiple internal and external stakeholders
  - Regulatory overlay
  - Governance
  - Impacts on returns and therefore lending

- Typical questions to contend with
  - What’s changed in requirements
  - When
  - How much – impact and cost to implement
  - What needs to change from today

- Requirements are not yet final, despite being several years in development
- Regulators and politicians consider that banks require more allowances, and earlier
- Overriding belief that alignment to risk management creates the most credible results

Timeline is uncertain – but will be short

- Mandatory effective date of IFRS 9 expected to be 1 Jan 2016
  - 31 Dec 2015 switchover
  - 12 months parallel run from 1 Jan 2015
  - 18 months to complete the IFRS 9 programme
  - Classification decisions taking place simultaneously

Pre-implementation
  - Consent window & impact analysis
  - Apr - Jun 2013

No regrets
  - Final IFRS 9 Standard
  - Dec 2013

Design/ Test/ build
  - Comment window & feedback
  - 2014

Fully implemented
  - Go Live
  - 1 Jan 2016
Categorisation: Key steps to follow

- “**Significant deterioration**” is not defined but is earlier than today’s “objective evidence” criteria
- “**Low credit risk**” is not defined – suggested “investment grade”
  - Non investment grade and 30 days are *indicators* not bright lines to be used as backstops as may not be relevant to the exposure in question e.g.
    - 30 days past due not relevant to wholesale
    - Investment vs non investment not relevant in retail
- Banks currently track deterioration in a manner most relevant to their risk management so leverage relevant indicators rather than switch to new ones ‘just for accounting’ (a key strength of the approach)
- Is “**Probability of default**” the same as PD? or is it what you actually use

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**Key challenges to overcome (1)**

To achieve consistent categorisation across businesses, geographies, products

<table>
<thead>
<tr>
<th>IASB</th>
<th>Working Label</th>
<th>Retail</th>
<th>Wholesale</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stage 1</td>
<td>Performing</td>
<td>“Good Book” (New arrears = 0)</td>
<td>“Good Book” Strong (Investment Grade) Satisfactory (BB+ to B-)</td>
</tr>
<tr>
<td>Stage 2</td>
<td>‘Significant Risk’</td>
<td>[30] dpd Change in lifetime PD ‘high risk’ - concessions, forbearance</td>
<td>Watchlist Change in PD ‘high risk’ (CCC+)</td>
</tr>
<tr>
<td>Stage 3</td>
<td>Default</td>
<td>Internal/Regulatory definition of Default [90] days past due</td>
<td></td>
</tr>
</tbody>
</table>
Key challenges to overcome (2)

<table>
<thead>
<tr>
<th>Aspect</th>
<th>Description</th>
<th>Approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>Data, Model, Process and System Development</td>
<td>Existing data to be leveraged as much as possible (e.g. Risk, Basel, Stress Testing and Economic Capital). Challenges where either no data, or models, or both exist</td>
<td>Targeted ‘field testing’ to understand real challenges and gaps. Explore options e.g. modified loss rates, contingent default rates, loss curves, migration matrices, roll rates, DCF, loss component curves.</td>
</tr>
<tr>
<td>Consistency of Judgements</td>
<td>A huge amount of judgement and estimation is required e.g. forecasting data, when lifetime loss is required (B1-B2), discount rates to use if not EIR.</td>
<td>Create a Technical Oversight Committee for interpretations and establish a central library of key decisions, model inputs and assumptions and interpretations of the requirements.</td>
</tr>
<tr>
<td>Level of Allowance</td>
<td>The level of overall allowance is expected to increase significantly, the increase will be unevenly distributed, and will overall be more volatile.</td>
<td>Engage MTP/STP, Capital Planning. Develop scenario analysis modelling capability.</td>
</tr>
<tr>
<td>Mobilisation and Prioritisation</td>
<td>Level of resources likely to be considerable and busy elsewhere (CRD IV, AIRB).</td>
<td>Need to build out team, programme and governance structures. Dedicated resources likely to grow, but may be hard to acquire.</td>
</tr>
<tr>
<td>Global Divergence</td>
<td>Global firms need to implement multiple reporting solutions to comply with the different reporting requirements. Impact is an increase in costs and time to implement.</td>
<td>Engage with various stakeholders early to understand and help shape requirements.</td>
</tr>
</tbody>
</table>

Basel parameters are not identical to IFRS requirements

Provides most sensible starting point for corporate portfolios

- A common language to enable credit deterioration to be monitored
- There is no concept of lifetime Expected Loss in Basel. Maturity information is capped at 5 years
- Even the 12 months Expected Loss for stage 1 (unbiased estimate) is not the same as the12 month regulatory Expected Loss (prudential)
**Governance needs to be defined comprehensively**

Need to manage the project both by business and function to give a coherent whole

- Ownership between CRO and CFO
- Design oversight (Design authority)
- Central project vs business led
- Business specific requirements due to different infrastructure
- Management of functions in each business
  - Models, IT systems, Management Information, Policy, Project Management

**Next steps**

**2013 Objectives**

- The target for this year is:
  1. Analysis of requirements and their financial impacts
  2. Explore implementation options
  3. Develop an Implementation Plan including resource requirements for subsequent phases as these will be significant.

- Work to be undertaken now includes:
  - Estimate profit / Capital Impacts and Inform Capital Planning / Provisioning / Sourcing
  - Identify changes to models / IT systems / Policies and Procedures
  - Engage with auditors to inform internal planning
  - Engage with Regulators to avoid late surprises
  - Confirm approach and build the team