IFRS Foundation

IFRS Conference

Thursday 29 and Friday 30 May 2014
Marina Bay Sands Hotel, Singapore

Special Interest Session

Implementing IFRS 9 Financial Instruments

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IFRS Foundation: Special Interest Sessions

Morning of Thursday 29 May 2014—Marina Bay Sands Hotel in Singapore

Implementing forthcoming Financial Instruments requirements

To assist you to prepare for the implementation of IFRS 9 Financial Instruments*, the IFRS Foundation will hold an intensive half-day session immediately before the IFRS conference, on the morning of 29 May 2014.*

09:00 ***Registration and refreshments***

09:30 ***Introduction and requirements***
Sue Lloyd
Member
IASB

10:15 ***Advisor's perspective***
Chen Voon Hoe
Partner
PwC

10:45 ***Preparer's perspective***
Fraser Marriott
Head of Technical Accounting Group and UK Regulatory Policy, Asia Pacific
Barclays

11:15 ***Round-table Q&A***
Chair: **Sue Lloyd,** *Member,* **IASB**

Panellists:

- Chen Voon Hoe
- Fraser Marriott

11:55 ***Concluding comments***
Sue Lloyd
Member
IASB

12:00 ***Close session***

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International Financial Reporting Standards

IFRS 9
Financial Instruments

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Finalisation of the IASB's response to the global financial crisis

Classification and measurement
A logical, single classification approach driven by cash flow characteristics and how it's managed

Impairment
An urgently needed and strongly supported forward-looking 'expected loss' model

Hedge accounting
An improved and widely welcomed model that better aligns accounting with risk management

A unified Standard to improve accounting for financial instruments

- IFRS 9 is the IASB's response to the financial crisis to improve the accounting for financial instruments
- We expect the benefits of IFRS 9 to outweigh the costs.
- IFRS 9 (2014) is a single package of requirements

Classification and measurement | Impairment | Hedge accounting

IFRS 9 Financial Instruments

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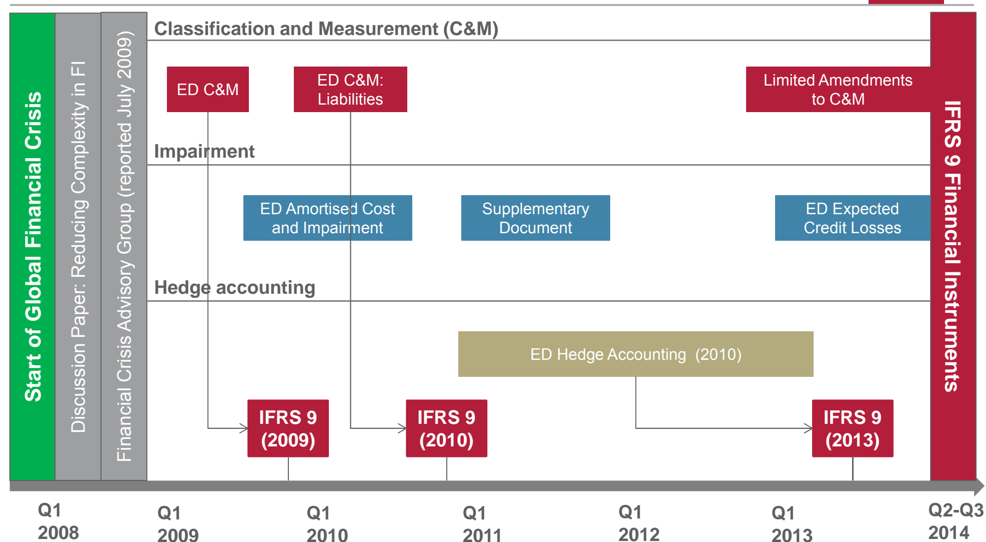
An extensive reworking of the accounting for financial instruments



When will IFRS 9 be effective?

Annual periods beginning on or after 1 January 2018

- A mandatory effective date consistent with stakeholder requests (a 3-year lead time)
- Entities permitted to early apply the completed (whole) version of IFRS 9
- Previous versions of IFRS 9 phased out:
  - Not permitted to early apply a previous version if date of initial application is more than 6 months after completed IFRS 9 is issued
- 'Own credit' requirements have been available for early application, in isolation, since the publication of IFRS 9 (2013)

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Classification and measurement

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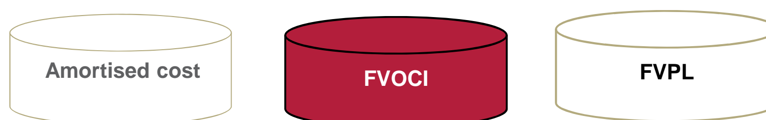
The IFRS 9 classification model for assets

	Business model is hold to collect	Business model is hold to collect and sell	Other business models
Cash flows are solely payments of principal and interest (P&I)	Amortised cost	FVOCI (NEW)	FVPL
Other types of cash flows	FVPL	FVPL	FVPL

*Excludes equity investments. Can elect to present in OCI.

Limited amendments



- Introduces new business model
- Assets managed with the objective of both:
  - Collecting contractual cash flows; and
  - Selling financial assets
- Addresses a business model some felt was missing
- Furthermore addresses potential accounting mismatches due to interaction with accounting for insurance contract liabilities

Limited amendments (cont.)

- Clarified the principal and interest concept so that a broader range of instruments are eligible for amortised cost
  - More aligned with what constituents view as 'simple instruments'
- Contractual cash flows must be solely P&I but time value of money and credit risk not only components of interest
- Time value of money is just consideration for passage of time
- Exception for instruments with regulated rates to be eligible for amortised cost measurement
  - Particularly important in some jurisdictions, eg France and China

Financial liabilities – 'own credit'

designated under fair value option (FVO)

Financial statements – IFRS 9			
Balance sheet		*P&L*	
Financial liabilities – FVO	Full FV	Gain or loss	all FV Δ except own credit
		OCI	
		Gain or loss	FV Δ due to 'own credit'*

* Not recycled

- Otherwise, **P&L gain when 'own credit' deteriorates**, loss when it improves
- ***Required* by IFRS 9** for liabilities under the FVO
- **IFRS 9** allows the 'own credit' requirements to be applied before the rest of IFRS 9

Improved approach to classification and measurement

- Principle-based, unified model with a logical structure and rationale for classification and measurement of financial assets
  - measurement categories and use of business model reflect nature of cash flows and how they are managed
- Improved reclassification rules consistent with changes in management
- Addresses 'own credit' concerns
  - P&L volatility will no longer result from changes in own credit, while information on own credit will still be available for users
- Single approach eliminates complex bifurcation requirements and multiple impairment approaches
- Elimination of IAS 39 tainting rules

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Impairment

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A thoroughly considered response on accounting for impairment

ED: Amortised Cost and Impairment (2009)

- Integrated measurement
- Conceptually most appropriate
- Significant operational challenges

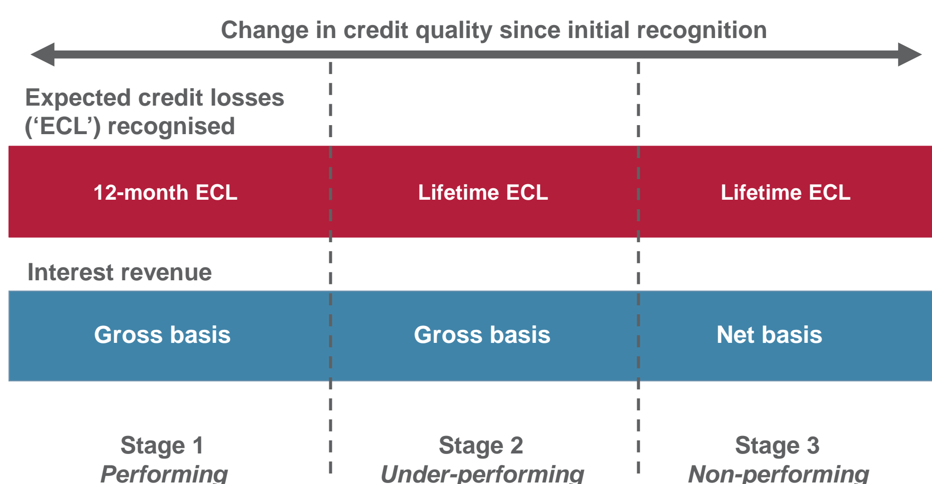
Supplementary Document: Impairment (2011)

- 'Decoupled' expected credit losses from effective interest rate to address operational concerns
- Based on 'good book' or 'bad book'
- Model still lacked support
- Not a basis to converge

ED: Expected Credit Losses (2013)

- Balances costs and benefits
  - Approximates outcome of 2009 ED in more operational manner
- Ensures more timely recognition of expected credit losses
- Identifies assets that have significantly deteriorated

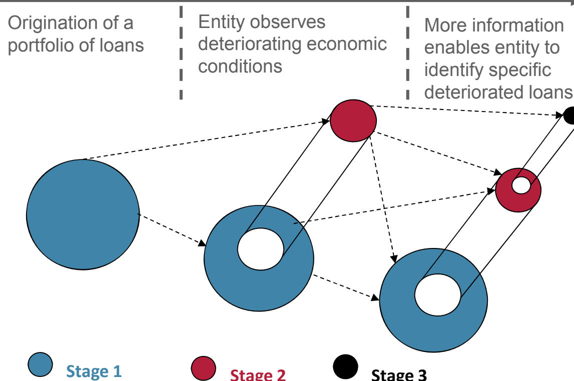
Overview of the finalised model



Key changes from current accounting

A responsive, forward-looking expected credit loss model

- Meets the calls of the G20 and others
- Responds to delayed recognition concerns and provides timely information about ECL
- Single model reduces the complexity of multiple approaches in IAS 39
- Robust disclosures to understand changes in ECL and credit risk



Feedback on 2013 ED

- Substantial support
  - For recognising lifetime ECL after significant deterioration
  - Avoids excessive front loading of ECL
  - Pragmatic reflection of economics of lending (12-month ECL)
- Consider the model operational
  - Can build on credit risk management systems

An appropriate balance of costs and benefits

Feedback requested additional clarifications

Some key responses to the feedback

Multiple clarifications and improvements to address concerns

- Clarified objective and information to be used to ensure responsiveness of the model to increases in credit risk
- Provided solutions to noted operational concerns:
  - Assessment compared to initial maximum credit risk on homogeneous portfolios
  - Counterparty assessment if within objectives of model
- Rebuttable presumption of 90 days past due for default
- Can use the behavioural life for revolving credit facilities
- Modified disclosures to resolve key operational challenges while retaining usefulness of information

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Hedge accounting

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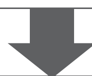
A better link between accounting and risk management

Feedback on IAS 39: *Recognition and Measurement*

- Lack of an overarching principle; complex and rule-based
- Inability for **preparers** to reflect hedges in financial statements
- Hard for **users** to understand risk management practices



Solutions in IFRS 9: *Financial Instruments*

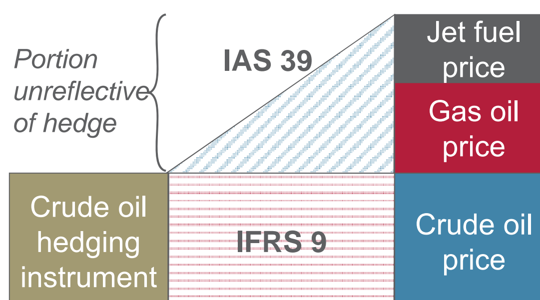
- Align accounting treatment with risk management activity
- Enable **preparers** to better reflect hedging in financial statements
- Provide disclosures to help **users** understand risk management and its impact on the financial statements

Key changes from current accounting

This has been a comprehensive review of hedge accounting

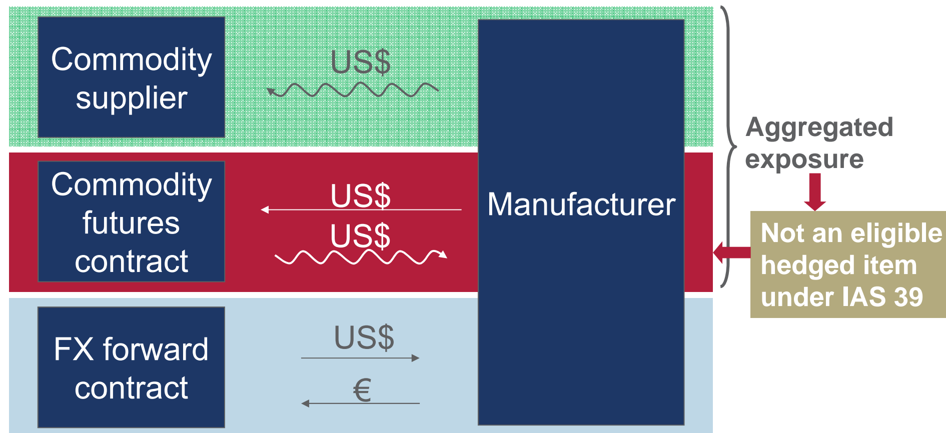
- Links economics of risk management with accounting treatment
- Significantly reduces accounting considerations that affect risk management decisions
- Ability to account for more hedges of non-financial items

Example: Measuring the success of hedging jet fuel contracts with crude oil futures



Superior hedging for ‘aggregate exposures’

Example: hedging commodity price & FX risk



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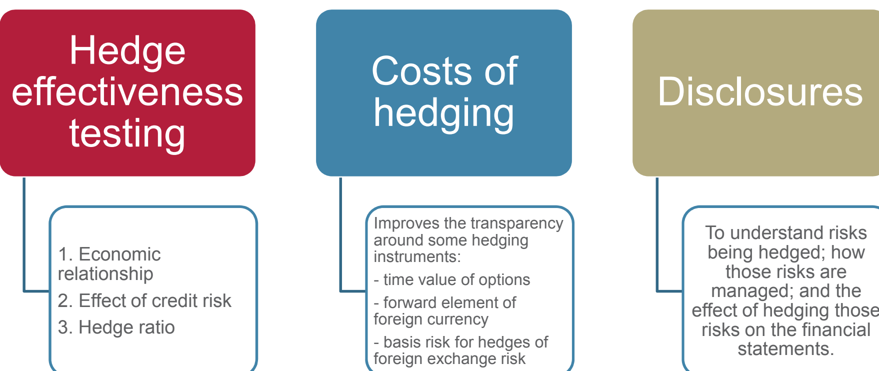
Other core improvements



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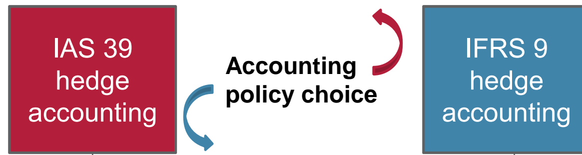
Project doesn't address macro hedging

Even if apply IFRS 9 can still use specific portfolio hedge accounting requirements in IAS 39



IAS 39 hedge accounting

Accounting policy choice

IFRS 9 hedge accounting

Some banks may not make any changes to their hedge accounting at this time

- The IASB is simultaneously working on a specific project to consider accounting for macro hedges (Discussion Paper published)

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Conclusion

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Where are we in terms of publication?

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- IASB staff are currently balloting both:
  - Limited amendments to classification and measurement
  - Impairment of financial assets
- Balloting process includes multiple drafts and a detailed fatal flaw review to ensure quality and clarity of drafting
- On track for publication around **June/July**
- Next version published will be the complete IFRS 9

IFRS 9 is a package, hence it is important these requirements be made available quickly and simultaneously

Convergence with the FASB

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The lack of convergence has been disappointing for all of us.

Strong attempts have been made, but the starting points were already different.

We developed limited amendments to the existing IFRS 9 C&M model, whereas for the FASB it was an entirely new model

Multiple attempts to converge on various impairment models

Hedge accounting has been an IASB-only project

Questions and comments

- We are pleased to be finalising our response to the financial crisis, and expect that IFRS 9 will provide a new stage of reliability in financial reporting

More information available at www.ifrs.org

www.pwc.com

Implementing IFRS 9 Financial Instruments

pwc

IFRS 9 Financial Instruments

- Classification and measurement
- Impairment
- Hedge accounting

Phase 1 – Classification and Measurement

Classification and measurement - Key impact and challenges

Impact to processes and systems

- Define business models for various portfolios e.g. liquidity portfolios held by financial institutions
- Evaluation of solely payments of principal and interest. Challenge with contractually linked instruments.
- New chart of accounts including remapping of the effects depending on the new classification requirements

Impact to financial statements

- The criteria for financial assets and liabilities may lead to potential accounting mismatch
- No recycling of gains or losses upon disposal for equity instruments classified as fair value through OCI
- Unquoted equity instruments may need to be measured at fair value

***Classification and measurement** – some audit consideration*

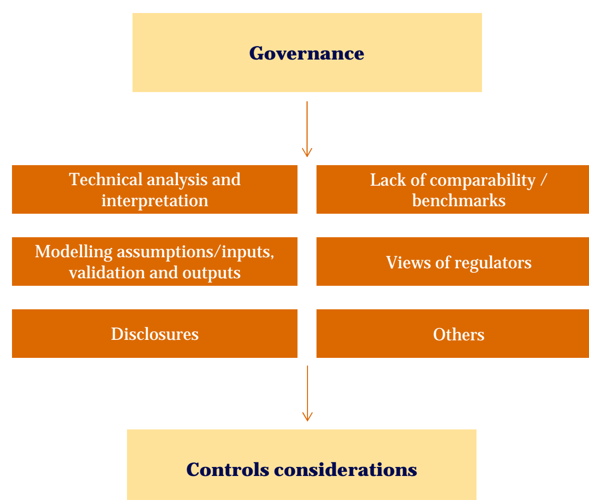
- Adequacy of documentation of business model
- Assessment of changes in business model
- Assessment of frequency of sales to evaluate the business model test
- Evaluation of cash flows to fulfil the solely payments of principal and interest and availability of data

Phase 2 – Impairment

Impairment: *Implementation challenges*

Components	Implementation challenges
Portfolio segmentation	• Determine segmentation criteria. • Consider existing models and data availability for various portfolios • Criteria for low credit risk
Transfer criteria	• Definition of trigger events • Significant deterioration in credit
Maturity	• Contractual term Vs behavioral • Consideration of prepayments and others
Expected loss modeling	• Determination of models for 12 month and lifetime expected loss • Discount rate
Forward looking data	• Economic overlay

Impairment: *Key audit considerations*

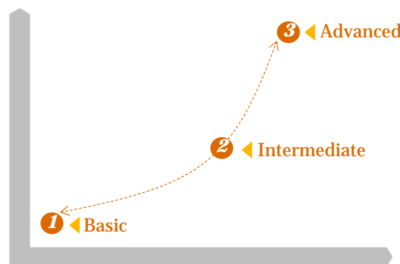


Impairment : *Models to be developed*

Audit considerations

- Has the entity appropriately segmented its portfolios?
- How do we test if the various models are appropriate?
- How strong is the model governance framework?
- Is there a consistent basis for model development, validation and documentation?
- Is there an appropriate benchmark?

Impairment : *Level of modelling*



3 Advanced approach

- Robust models to incorporate forecasts of macroeconomic conditions used to adjust loss curves.
- Loss curves exist for PD, LGD and EAD and are updated both by internal and external data

Specific issues

- Challenging to explain to senior management and investors
- Consistence roll out of economic scenarios
- Significant overheads

1 Basic approach (?)

- A simplified approach to ECL by using management judgment to determine provision rates

Specific issues

- How to evaluate that management judgment is accurate and correlated to historical data
- Is it acceptable under the standards and with the regulators ?

2 Intermediate approach (?)

- Model PD using simple statistical averages.
- LGD assumptions are flat
- Loss curves are generated using external benchmarks
- Economic forecasts included as a management overlay

Specific issues

- Substantiate economic overlays
- Insufficient details in development of PD

Impairment : *Leveraging existing credit infrastructure*

Banks will consider leveraging existing infrastructure
- Improves efficiency and minimise rework
- Align with regulatory model

Specific issues and audit concerns

Transfer criteria

- Significant deterioration

- What is considered as significant credit deterioration ?
- How can you demonstrate consistency of watch lists?
- What are the controls over application of significant deterioration?

Term structures

- Development of lifetime EL, term structure for PD, LGD and correlation

- How to model life time PD and LGD leveraging on existing regulatory and credit models?
- How to perform back testing with limited availability of data ?

Economic overlays

- Consider economic forecasts based on past events, current conditions and reasonable forecasts of future events

- How to determine what economic overlays to be applied ?
- How do you judge and evidence the "right economic conditions" and forecasts of the future?

Impairment *- Leveraging existing Basel methodologies*

	IFRS 9	Basel III
Probability of Default ('PD')	• PD estimated over 12-month horizon for Stage 1; Lifetime loss calculation for Stages 2 and 3 • PD estimates are 'point-in-time' measures • Definition of default - may adopt regulatory definitions • Considers forward looking estimates at balance sheet date	• 12-month PD estimation • PD estimates is mostly based on 'through-the-cycle' measures • Regulatory overrides • Routine use of stress testing and scenario analysis to calibrate
Loss Given Default ('LGD')	• Current LGD • Discount rate should be at effective interest rate • Collateral valuation and disclosures for financial instruments with inherent objective evidence of impairment.	• Downturn LGD estimates • Consideration of certain costs and LGD floors • Discount rate based upon weighted average cost of capital or risk-free rate • Treatment of collateral is subject to detailed rules, haircuts etc

Impairment – *Data requirements*

- Identify the new data requirements
- Which systems will the data come from - existing finance reporting systems and others?
- Data sourcing from different systems may not be subject to same level of controls and governance
- Identification of appropriate data from right systems

Key considerations
How has firm developed processes to collate data from the other systems?
Has finance engaged with other business unit to understand the data impact?
Has the firm determined the level of automation required to produce the required disclosures in the financial statements ?
Has the firm considered the controls over systems typically outside the statutory audit ?
How to develop process to maintain and update the newly required qualitative/assumption disclosures ?
How comfortable is the firm with the completeness and accuracy of loan level data?

Impairment - *Control and governance considerations*

Business model	• Business models reflect the impact of the IFRS 9 • ECL models feedback into other strategic processes (e.g. capital management, pricing, stress testing, etc).
Systems	• Alignment of risk and finance systems? • Remapping of lines and accounts within the general and sub ledgers • Common chart of accounts and data definitions across all parts of the business.
Data quality	• Single data source at required granularity, with full drill down capability and validation of data • Frequent testing and maintenance of new data models • Automation of data controls
Process	• Fully defined processes for identifying the provisions and how they relate to the business units, product pricing and strategy. • New credit risk monitoring processes to incorporate system solution to the generation of accounting information.
Controls and Governance	• Circulation of management reports in a timely manner • Governance and controls over areas not currently subject to statutory audit (e.g. Risk and regulatory data)

Phase 3 – Hedge accounting

Hedge accounting - Potential impact and challenges

Impact to processes and systems

- Linking hedge accounting with risk management
- Develop a process to rebalance and determine the frequency
- Additional need for information due to new disclosure requirements
- Voluntary de-designation is not permitted

Impact to financial statements

- Reduced volatility in profit and loss due to treatment of time value of purchased options
- Reduced ineffectiveness due to separation of risk components in case of non-financial items
- Reduced volatility in profit and loss as swap differential and FX basis risk is considered as costs of hedging

***Hedge accounting** - Potential audit considerations*

- Assessing the effectiveness of the hedge without the bright line 80% to 125%
- Validating market data for hedge effectiveness testing including rebalancing and basis risk
- Identifying risk components that are separately identifiable and reliably measurable if no specific criteria explicitly stated in the contract
- Controls and governance over availability of data to comply with additional disclosure requirements regarding an entity's risk management and hedging activities

Thank you

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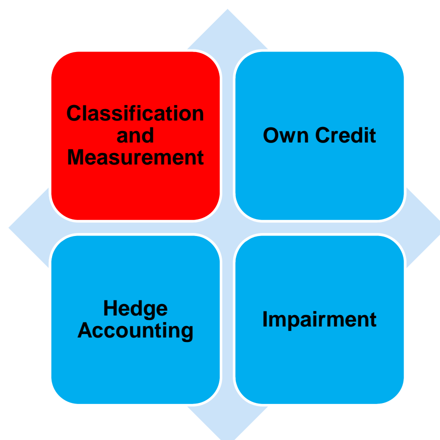
Implementing IFRS 9 Financial Instruments
A Preparer's Perspective

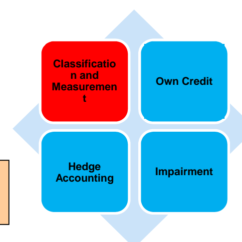
Fraser Marriott
Head of Technical Accounting and UK Regulatory Policy, AsiaPac
IFRS Conference: Singapore - 29 May 2014

Agenda

- Each of the IFRS 9 elements in focus:



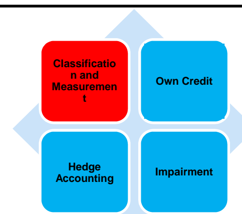
Classification and Measurement: the Barclays' historical context



Previously went about as far as any European financial institution:
Parallel reporting late 2010 / early 2011 despite EU uncertainty

- Brief period in early 2011 where weren't clear if would be reporting under IAS 39 or IFRS 9
- Financial markets and financial institutions' balance sheets were in a very different state from today – potential for larger impacts
- Draw on some of our experiences from that exercise – although the interim proposed amendments negate certain changes by bringer IFRS 9 closer to IAS 39 (especially the 3rd FVTOCI business model which is helpful for accounting, but in the interim the associated regulatory "protection" has been lost under Basel III)

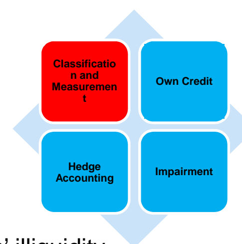
Most significant challenges encountered



The 2011 Headline Impact:
More Barclays Group Assets at Fair Value thru P+L

Challenge	Key Points
Portfolio Definition	• Granularity / disaggregation • Perceived "tight" sales rules at the time
Evolving Business Models	• Rapidly changing financial markets and regulation • Original vs. current vs. possible future intent (legacy assets, core vs. non-core)
Historical Sales Analysis	• Objective evidence / clarity of rationale • Management intent vs. management actions • "Acceptable" levels/types of sales?
Securitisation "Look-Through"	• Data limitations, especially with "re-securitisations"
Valuation	• Increased proportion of non-traded portfolio measured at fair value in illiquid market environment • Increased use and importance of unobservable inputs

Commercial / strategic implications



The 2011 Headline Impact:
More Barclays Group Assets at Fair Value thru P+L

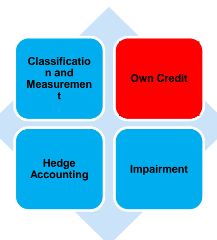
Transition Date:

- **Potentially significant transition impact** – given financial markets' illiquidity, with an important link to regulatory capital calculations
- **Non-recognition of economic gains and losses** – consideration for the impacted amortised cost and available for sale portfolios

Post-Transition:

- **Increased earnings volatility going forward** – perceived impact on cost of capital, coupled with existing incurred loss model
- **Reduced liquidity of certain issuance platforms** – in particular IFRS-reporting clients forced to fair value our structured notes
- **New challenges emerging –** classification and structuring of "bail-in" instruments (CoCos)

Own Credit – we would like to, but…



In fact, Barclays was at the forefront of industry lobbying…

FINANCIAL TIMES

Barclays calls for clarity on fair value debt

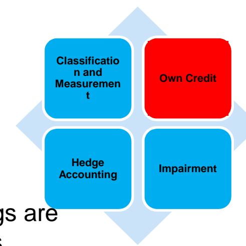
November 14, 2011

"The financial crisis prompted calls from G20 and many others for an overhaul of financial instruments accounting. Nevertheless, 4 years after crisis began, European companies still have to report large unrealised gains/losses though income from revaluing own debt. We urge the European Commission, the IASB and regulators to consider taking the straightforward step of amending current requirements in IAS 39."

Income Statement

- Adjusted profit before tax was down 5% to £1,693m driven by a reduction in Investment Bank income, in particular FICC, and currency movements partially offset by a reduction in operating expenses of 16% to £4,435m
- Statutory profit before tax improved 18% to £1,812m, including an own credit gain of £119m (Q113: loss of £251m)

Other complications posed by current own credit rules



Taxation

- As a UK tax payer, own credit revaluations booked through earnings are taxable / deductible – complicating the forecasting / planning process.

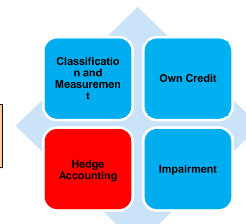
Operational Risk

- The need to firstly calculate own credit and then back it out from earnings in different ways for different metrics increases operational risk.

Bank of America Announces Adjustment to Estimated Regulatory Capital Ratios:

April 28, 2014 - Company Will Suspend Previously Announced Capital Actions and Resubmit 2014 Capital Plan; Proposed Revised Capital Actions Expected to be Less Than Previously Announced. *Downward revision to company's previously disclosed regulatory capital amounts due to an incorrect adjustment related to treatment of certain structured notes assumed in the Merrill Lynch & Co., Inc. acquisition in 2009.*

New hedge accounting model



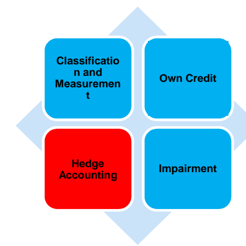
Model Adoption Question:
Largely theoretical for Barclays, and unlikely to be strategic

- EU endorsement an ongoing practical adoption constraint
- Own credit currently viewed as key IFRS 9 benefit and can be separately adopted
- Impairment implementation timelines
- New hedge accounting rules unlikely to have strategic impact. Should there be a model adoption timing question, will be driven by operational considerations

General Model - Implementation Ask:
Principally changes to designation model documentation and ongoing procedures

- Ensure all existing designations are aligned to applied risk management strategies
- Simplify and modify existing hedge effectiveness testing processes, incorporating hedge ratio changes / credit risk guidance
- Still to fully assess impact of removal of voluntary de-designation

New hedge accounting model



Commercial Perspective:
Popular with our FICC business as current "inflexible" rules can impede sales

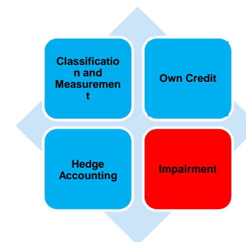
- **Commodities** - Individual risk components can now be hedged
- **Commodities** – Can now fair value "own use" contracts to offset derivative revaluations
- **Rates –** Ability to designate foreign issuance and CCIRS as combined hedged item
- **Cross Asset Class –** Option time value, FX forward points and CCIRS basis spreads can be treated as amortised costs of hedging

Discussion Paper - Dynamic Risk Management – Portfolio Revaluation Approach

- In the process of digesting
- First thoughts - good response to requests, closer link between accounting and risk mgmt
- But significant operational challenges , especially around retaining and tracking original hedged exposure information

BARCLAYS

Impairment implementation project: progress to date



Deferral to 2018 is welcome, its crucial we are given (but must utilise) sufficient lead time

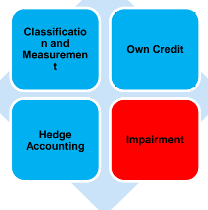
Key initiatives to date:

- Joint risk / finance workshops across data, modeling and systems to assess what's required and what can be leveraged (e.g. capital reporting where possible)
- High-level implementation approach agreed for model development and data and systems implementation
- Project cost estimates determined and factored into medium-term budgets
- Estimated 3 year workplan, including a 12-month parallel run

Model development to continue in background for rest of year, but focussed data, systems and process work will not commence until 2015

BARCLAYS

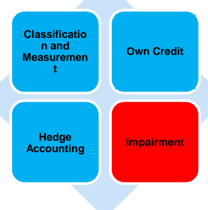
Impairment implementation project: Key challenges and critical success factors



Most significant accounting change that banks will face in coming years – impacts all business, geographies and products

Challenge	Description / Proposed Approach
Data, Model, Process and System Development	• Leverage existing platforms and information to extent possible. Some fit for purpose, others not.
Framework consistency across businesses	• Retail vs. wholesale – very different metrics and management approaches. Central Technical Oversight Committee.
Interpretation risks	• Early engagement with peers, auditors, IASB and regulators. • Consistent approach desirable, but should reflect entity's applied risk management practices.
Consistency of Judgments	• Huge amount of judgment and estimation required (e.g. long-dated forecasting data and LTL migration points). Central Technical Oversight Committee.

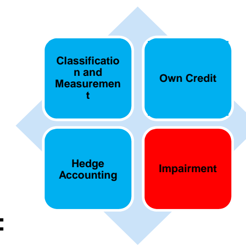
Impairment implementation project: Key challenges and critical success factors



Most significant accounting change that banks will face in coming years – impacts all business, geographies and products

Challenge	Description / Proposed Approach
Allowance levels	• Expected to increase significantly and unevenly distributed. • Engage MTP / Capital Planning early • Develop scenario modeling capabilities
Mobilisation and Prioritisation of Resources	• Competing objectives in cost constrained environment • Need to build out specialist teams, but skillsets scarce • Dependence on key individuals
Internal Collaboration	• Importance of senior sponsorship • Multiple dependencies across departments • Collaborative approach, but clear ownership critical
Retain flexibility	• Desire to define end-state as early as possible, but need to be flexible in an uncertain regulatory environment.

Our thoughts on the model



We are supportive – better aligned to financial reporting objectives and applied credit risk management practices

Although not without some residual concerns and uncertainties:

- EU endorsement timing?
- Level playing field? (vs. US peers and potentially even within Europe – more on next slide)
- Convergence - possibility that may even need to prepare 3 separate impairment calcs
- Increased volatility
- Longer-dated forecasting
- “Sandbagging”
- Disclosure challenges
- Comparatives

Regulatory context – a key uncertainty

Bank of England Financial Policy Committee identifies £25bn capital shortfall

March 27, 2013 – Honest assessment of hidden losses *sparks row with business secretary Vince Cable. FPC said that losses over 3 years on high-risk loans could exceed provisions by £30bn. FPC is also creating a dilemma for UK banks which under accounting rules must provide for bad loans on losses they are certain will occur –* ***while the FPC wants information about losses they can realistically estimate will occur.***

- Expectation that Basel Committee will issue its own IFRS 9 implementation guidance in effort to promote consistency and “ensure high quality implementation”
- Possibility that certain national regulators may issue their own supplementary guidance
- Technically no legal / regulatory standing, but…
- Enthusiasm for numbers at the earliest
- Importance of the impact on regulatory capital calculations

Questions?