Joint ICAEW and IFRS Foundation Financial Institutions IFRS Conference

Monday 08 December 2014, 08:30–16:30
Chartered Accountants’ Hall, London, EC2R 6EA
## Joint ICAEW and IFRS Foundation
### Financial Institutions IFRS conference
**8 December 2014—Chartered Accountants’ Hall, One Moorgate Place (London, United Kingdom)**
*An one-day IFRS event for financial institution executives and others interested parties*

### Conference Programme

<table>
<thead>
<tr>
<th>Time</th>
<th>Event Description</th>
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<tbody>
<tr>
<td>08:30</td>
<td><strong>Registration</strong></td>
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<tr>
<td></td>
<td>Light refreshments</td>
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<tr>
<td>09:15</td>
<td><strong>Welcome</strong></td>
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<tr>
<td></td>
<td>Michael Izza, CEO, ICAEW</td>
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<tr>
<td>09:30</td>
<td><strong>Panel discussion: accounting for the financial crisis</strong></td>
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<tr>
<td></td>
<td><em>Chair: Simon Nixon, Chief European Commentator of the Wall Street Journal</em></td>
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<td></td>
<td><strong>Panellists:</strong></td>
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<tr>
<td></td>
<td>- IASB staff: Hugh Shields, <em>Executive Technical Director</em>, IASB</td>
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<td></td>
<td>- IASB Vice-Chairman: Ian Mackintosh</td>
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<td>- Regulator: Sir Winfried Bischoff, <em>Chairman</em>, FRC (UK)</td>
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<td>- Director: Mike Ashley, <em>Chairman of the Audit Committee</em>, Barclays</td>
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<td>- Investor: Vincent Papa, <em>Director, Financial Reporting Policy</em>, CFA Institute</td>
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<tr>
<td>11:00</td>
<td><strong>Refreshment break</strong></td>
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<tr>
<td>11:30</td>
<td><strong>IFRS implementation break-out sessions:</strong></td>
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<tr>
<td></td>
<td><em>Choose one of the following:</em></td>
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<tr>
<td></td>
<td>1. <strong>Financial instruments: classification and measurement</strong></td>
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<tr>
<td></td>
<td><em>Chair: Sue Lloyd, IASB member</em></td>
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<td><strong>Panellists:</strong></td>
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<tr>
<td></td>
<td>- Mary Tokar, IASB member</td>
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<td></td>
<td>- Maria Nordgren, <em>Global Technical Director, Accounting Policy and Advisory Group</em>, Deutsche Bank</td>
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<td></td>
<td>- Andrew Spooner, <em>Partner</em>, Deloitte</td>
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<td></td>
<td>2. <strong>Financial instruments: impairment</strong></td>
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<tr>
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<td><em>Chair: Stephen Cooper, IASB member</em></td>
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<td></td>
<td><strong>Panellists:</strong></td>
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<td></td>
<td>- Darrel Scott, IASB Member</td>
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<td></td>
<td>- William Hayward, <em>Director, Group Risk</em>, Barclays</td>
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<td></td>
<td>- Sandra Thompson, <em>Partner, Global Accounting Consulting Services Group</em>, PwC</td>
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<tr>
<td>13:30</td>
<td><strong>Lunch</strong></td>
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<td>14:30</td>
<td><strong>IASB project break-out sessions:</strong></td>
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<td><em>Choose one of the following:</em></td>
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<tr>
<td></td>
<td>1. <strong>Financial Instruments: accounting for macro hedging</strong></td>
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<tr>
<td></td>
<td><em>Sue Lloyd, IASB member</em></td>
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<tr>
<td></td>
<td><em>Yuji Yamashita, Visiting Fellow</em></td>
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<td></td>
<td>2. <strong>Insurance contracts</strong></td>
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<tr>
<td></td>
<td><em>Darrel Scott, IASB member</em></td>
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<tr>
<td></td>
<td><em>Milena Lacheta, <em>Technical Associate</em>, IASB</em></td>
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<td>3. <strong>Leases</strong></td>
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<td><em>Philippe Danjou, IASB member</em></td>
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<td><em>Roberta Ravelli, Seconded to the IASB</em></td>
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<td>16:00</td>
<td><strong>Keynote address</strong></td>
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<td>David Wright, <em>Secretary General</em>, International Organisation of Securities Commissions (IOSCO)*</td>
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<tr>
<td>16:30</td>
<td><strong>End of conference</strong></td>
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</tbody>
</table>
Panel discussion: accounting for the financial crisis

SIMON NIXON  
*Chief European Commentator*  
*Wall Street Journal*

MIKE ASHLEY  
*Chairman of the Audit Committee*  
*Barclays*

SIR WINFRIED BISCHOFF  
*Chairman*  
*FRC (UK)*

IAN MACKINTOSH  
*Vice-Chairman*  
*IASB*

VINCENT PAPA  
*Director, Financial Reporting Policy*  
*CFA Institute*

HUGH SHIELDS  
*Executive Director*  
*IASB*
IFRS implementation break-out session:

Financial instruments: classification and measurement

SUE LLOYD  
Member  
IASB

MARIA NORDGREN  
Global Technical Director, Accounting Policy and Advisory Group  
Deutsche Bank

ANDREW SPOONER  
Partner  
Deloitte

MARY TOKAR  
Member  
IASB
Classification and measurement
A single, logical 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
Classification of financial assets—IFRS

<table>
<thead>
<tr>
<th>Business model</th>
<th>Amortised cost*</th>
<th>FVO for accounting mismatch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Contractual cash flow characteristics</td>
<td>FVOCI*</td>
<td>Equities: OCI presentation available (alternative)</td>
</tr>
<tr>
<td>All other instruments:</td>
<td>Fair value (No impairment)</td>
<td></td>
</tr>
<tr>
<td>• Equities</td>
<td></td>
<td></td>
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<tr>
<td>• Derivatives</td>
<td></td>
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<tr>
<td>• Some hybrid contracts</td>
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</tr>
</tbody>
</table>

* Same impairment model for amortised cost and FVOCI

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International Financial Reporting Standards

What changed in redeliberations?
Classification and Measurement – Business model

- Confirmed ‘hold to collect and sell’ business model – How objective of business model is achieved (how cash flows are generated)
- Sought to reduce emphasis on selling activity as determinant of business model
- Confirmed that a single portfolio may have more than one business model

<table>
<thead>
<tr>
<th>Hold to collect</th>
<th>Hold to collect and sell</th>
<th>Residual</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Held for trading</td>
</tr>
</tbody>
</table>

Classification and Measurement – SPPI

- Solely principal and interest contains:

<table>
<thead>
<tr>
<th>Principal</th>
<th>Interest</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Time value</td>
</tr>
</tbody>
</table>

- Must be consistent with a basic lending arrangement
- If time value modified determine if can be more than significantly different from unmodified cash flows
  - Quantitative or qualitative assessment
- Regulated interest rates proxy for time value if
  - Broadly consistent with passage of time and
  - Not inconsistent with a basic lending arrangement
Financial liabilities – ‘own credit’
designated under the fair value option (FVO)

**Financial statements – IFRS 9**

<table>
<thead>
<tr>
<th>Balance sheet</th>
<th>P&amp;L</th>
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</thead>
<tbody>
<tr>
<td>Financial liabilities – FVO</td>
<td>Gain or loss</td>
</tr>
<tr>
<td></td>
<td>OCI</td>
</tr>
<tr>
<td></td>
<td>Gain or loss</td>
</tr>
</tbody>
</table>

* 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 early applied in isolation

Treatment of financial liabilities is carried forward from IAS 39 essentially unchanged

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**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)
Questions or comments?

Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.
Deutsche Bank
Group Finance

IFRS 9 Classification and Measurement
A preparer’s perspective

Maria Nordgren
Global Technical Director Deutsche Bank
8 December 2014

Contents

- DB IFRS 9 Project Approach
  - Timeline from IAS 39 to IFRS 9
  - Project Governance and Set Up

- Challenges of implementation
  - Key Interpretive issues
  - Timeline and prioritisation

- Lessons learned
Deutsche Bank is an international bank operating in 73 countries.

Universal bank with diverse businesses such as investment banking, transaction banking, private and business clients and asset management.

While a large part of our financial instruments is already at Fair Value through profit and loss (EUR900bn or 68% of all financial instruments of EUR 1.325 trillion), we still have considerable amortised cost and AFS portfolios requiring analysis under IFRS 9 (EUR425bn or 32%).

Thus IFRS 9 classification and measurement is a critical standard for us.

Timeline from IAS 39 to IFRS 9
In fact, we only have two years for implementation.

- External Parties’ Request for Information of Impacts (Regulators, Analysts)- must manage the form and timing of communication.
- A ‘parallel run’ period will allow DB to test/embed systems and processes, including disclosures.
- More importantly, the finance information from the parallel run will allow us to understand numbers and sensitivities and enable business to make pricing and strategic decisions.
Initial observations

- While the categories under IFRS 9 are similar to IAS 39, the routes to the classifications are entirely different.

- There is much work required to assess and document how we arrive at the conclusions; this should not be underestimated.

- There is a perception that C&M may (or may not) lead to more FV through PNL and will have relatively less impact than impairment.

- All of the above may translate to less resources allocated to this part of the project and less senior management focus.
Key interpretive and implementation issues

- How to split portfolio into AC and FVOCI categories
- Regulatory Impact
- Data limitations for re-securitisations and old securitisations
- Are purchased distressed loans considered to be SPPI?
- What limitations should we put on the business’ use of this restrictive category?
- Possibly increased use of FV for non-traded/illiquid portfolio

Financial transparency

Lessons learned

- IFRS 9 Phase 1 has areas of significant judgment and policy choices
- Therefore important to bottom out the issues early
  - Analyse the issue, evaluate alternatives and understand impacts
  - Cross Check for industry comparability
  - Run key decisions through an appropriate governance process internally
  - Engage external auditors fully at each stage of the process
  - Document decisions and carefully record baselines (e.g. De minimis threshold, acceptable level of sales) and rationale in an auditable format
  - Disseminate decisions widely and stored in a central intranet location so that all users have access
  - Consider how to embed into processes and businesses
  - Use of standardised templates and guidance for documentation of the business model test and SPPI test
IFRS 9 – C&M
Some reactions from an auditor
Andrew Spooner 8 December 2014

Classification & measurement of financial assets

- **Business model test**
  - Objective of entity’s business model is to hold financial asset in order to collect contractual cash flows

- **Contractual cash flow characteristics**
  - Contractual terms give rise solely to principal and interest on principal

- **Amortised cost** (only debt instruments)

- **Recategorization if change in the business model**

- **Fair value option for accounting mismatch**

- **Business model test**
  - Objective of entity’s business model is to hold financial asset in order to collect contractual cash flows and to sell

- **Contractual cash flow characteristics**
  - Contractual terms give rise solely to principal and interest on principal

- **Fair value through OCI** (only debt instruments)

- **Recategorization if change in the business model**

- **All other instruments**
  - Equity investments
  - Derivatives
  - Complex hybrids

- **Fair value through profit or loss except if investment in equity securities designated at FVTOCI**

- **Equities: FVTOCI option (Divs in P&L)**
Classification and measurement of assets

Business model assessment

- Forces a need for a better understanding of business models (front versus back half)
- Liquidity portfolios - understanding the motivation for holding and selling
- Concern that portfolios are designed simply for accounting purposes

Reclassification

- Reclassification required when there is a change in business model – expected to be rare
- Unknown how these requirements will be applied in stress

Disclosure

- How do expected credit losses used for impairment measurement correspond with credit risk for fair valuation purposes?
  - Relevant for measurement at FVTOCI
  - Relevant for disclosure of fair value for amortised cost financial assets

Classification & measurement of financial assets

Contractual cash flows assessment

- Modified time value
  - When is a modified time value element regarded as too different that it breaches a return of principal and interest on the principal outstanding?
  - Comparison of undiscounted cash flows on instrument with the ‘perfect’ instrument
  - Consideration whether difference could be ‘significant’ over ‘reasonably possible scenarios’
  - No bright line
- Contingent factor changing timing or amount of cash flows
  - The nature of the contingent event is ‘not determinative’, though it is relevant in understanding the risks of the instrument
  - More heavily structured instruments derived from non-basic lending risks likely to fail
- Do not assume for financial assets that:
  - non-closely related embedded derivatives in IAS 39 will lead to FVTPL treatment in IFRS 9; or
  - closely related embedded derivatives in IAS 39 will lead to amortised cost or FVTOCI in IFRS 9
Classification & measurement of financial assets

Fair value option (FVTPL) – whole instrument, debt instruments
- Fair value option (FVTPL)
  - Potentially more desirable for financial liabilities given own credit volatility in OCI
  - Potentially more desirable given impairment model for debt instrument financial assets
  - Reminder: not applicable to derivatives
  - Potentially more discipline needed in separating the own credit component
- Election applied to financial assets in combination with Insurance Phase II
  - Effective date of Phase II

Option for FVTOCI – whole instrument, equity instruments
- Not common in frequency, perhaps common if significant in size (and strategy)
- Need to determine return on investment versus return of investment
- Potentially sensitive disclosures

Quasi fair value option – whole instrument, or proportion, as an alternative to hedge accounting counterparty credit risk
- Not restricted to initial recognition – restrictive, e.g. name matching
- Two-way street (on and off if economic hedging ceases)
- Given expected credit loss model how much offset will be achieved with applying the election versus not (and given ‘jump’ to fair value if originally measured at amortised cost)

Classification & measurement of financial assets
Planning for transition

Assess business model as at date of initial application

Fair value option and FVTOCI option for equities may be applied at date of initial application

Shall/may revoke previous fair value option

Restatement of equities previously measured at cost taken to opening reserves

Retrospective application
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IFRS implementation break-out session:

Financial instruments: impairment

STEPHEN COOPER  
Member  
IASB

WILLIAM HAYWARD  
Director, Group Risk  
Barclays

SANDRA THOMPSON  
Partner, Global Accounting Consulting Services Group  
PwC

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

International Financial Reporting Standards

IFRS 9
Financial Instruments:
Impairment

Thorough review

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
- Based on ‘good book’/‘bad book’
- Model still lacked support

ED: Expected Credit Losses (2013)
- Balances costs and benefits
  - Approximates outcome of 2009 ED but more operational
- Ensures more timely recognition of expected credit losses
- Identifies assets that have significantly deteriorated
**Deterioration model**

Credit quality deterioration since initial recognition

- **Impairment recognition**
  - 12 month expected loss
  - Lifetime expected loss
  - Lifetime expected loss

- **Interest revenue**
  - Gross basis
  - Gross basis
  - Net basis

- **Stage 1**
  - Performing

- **Stage 2**
  - Under-performing

- **Stage 3**
  - Non-performing

---

**Implementation**

Annual periods beginning on or after 1 January 2018

- A **mandatory effective date** consistent with stakeholder requests, but permitted to **early apply** the completed version of IFRS 9
- **Previous versions** of IFRS 9 phased out
- ‘**Own credit**’ **requirements** have been available for early application, in isolation, since publication of IFRS 9 (2013)
- **Transition Resource Group** for Impairment of Financial Instruments (ITG)
  - First administrative meeting held 3 December 2014
  - No technical issues discussed as of date
12-month Expected credit losses (ECL)

What are 12-month expected credit losses?

- Full lifetime expected credit losses that would result from default multiplied by probability of default in next 12 months

- Expected cash shortfalls in next 12 months
- Credit losses on assets expected to default in next 12 months
When to calculate net interest

• Interest is usually calculated on the gross carrying amount (ie before the loss allowance)
• Change to calculation on a net basis (ie on the amortised cost that is net of the loss allowance) when IAS 39 criteria for impairment are satisfied
• Consistent with population considered impaired under IAS 39 today (excluding IBNR)

Measuring expected credit losses

Expected credit losses need to reflect:
• Probability weighted outcome
  – Must consider possibility that default will/will not occur
  – Must define default for purposes of determining risk of default
• Time value of money
  – Discount at effective interest rate or an approximation thereof

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
  – 30 days past due rebuttable backstop
Measuring expected credit losses

What information could be considered in measuring forward-looking ECL?

- Particular measurement methods are not prescribed
- **Borrower specific:**
  - changes in *operating results* of borrower
  - technological advances that affect future operations
  - changes in *collateral* supporting obligation
- **Macro-economic:**
  - house price indexes, GDP, household debt ratios
  - Internal default rates and probabilities of default
  - External pricing, eg credit rating agency information

Assessment

*Significant increase in credit*

- Recognise *lifetime ECL* on a significant increase in credit risk
- Change in credit risk over the life of the instrument (ie probability of a default occurring)
  - Not changes in expected losses
  - Compared to credit risk at initial recognition
- Doesn’t require mechanical assessment of probability of default statistics
- Use information that is available without undue cost or effort

ECL updated at each reporting date for new information and changes in expectations even if deterioration is not significant
Assessment

**Deterioration in credit quality**

Is it possible to assess a significant increase in credit risk on a portfolio/collective level?

- In general, assessment made on individual level
- Collective assessment if the same outcome as individual assessment, ie same risk characteristics, such as
  - Credit risk ratings
  - Industry
  - Geographical location of borrower
  - Remaining term to maturity
- Grouping changes as time reduces uncertainty of outcome
- Objective is to recognise lifetime ECL on instruments for which credit risk has increased significantly

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**Low credit risk**

- Operational simplification for high quality financial instruments (for example, investment grade)
- Choice to assume that a financial instrument considered low credit risk would remain in stage 1
- Therefore, no need to assess whether changes in credit risk have been significant
- Still need to update expected credit losses for changes in expectations even if in stage 1

But

- Not a hair-trigger – if the credit quality falls below investment grade, need to assess whether deterioration is significant (ie normal model applies)
Delinquency—rebuttable presumption

- Objective is to act as a backstop or latest point to identify significant deterioration
- Rebuttable presumption when payments are more than 30 days past due
- This is a lagging indicator, but should identify before default
- Proxy for significant deterioration if no other borrower-specific information
- Can be rebutted if days past due are not associated with a significant change in credit risk
- However, cannot ignore information that suggest significant deterioration prior to 30 days delinquency

Disclosures

Quantitative
- Reconciliation of allowance accounts showing key drivers for change
- Explanation of gross carrying amounts showing key drivers for change
- Gross carrying amount per credit risk grade or delinquency
- Write-offs, recoveries, modifications

Qualitative
- Inputs, assumptions and techniques used to estimate expected credit losses (and changes in techniques)
- Inputs, assumptions and techniques used to determine “significant increase in credit risk” and “default”
- Inputs, assumptions and techniques used to determine “credit impaired”
- Write off policies, modification policies, collateral
IFRS 9: Impairment
-What we will cover

Overview of Model

Significant increase in credit risk

Measuring Expected Loss

Interaction with Regulatory Capital

Questions and Answers

Other considerations
**IFRS 9: Impairment**

**- Overview**

Change in credit quality since initial recognition

**Recognition of expected credit losses**

<table>
<thead>
<tr>
<th>12 month expected credit losses</th>
<th>Lifetime expected credit losses</th>
<th>Lifetime expected credit losses</th>
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**Interest revenue**

<table>
<thead>
<tr>
<th>Effective interest on gross carrying amount</th>
<th>Effective interest on amortised cost carrying amount (i.e. net of credit allowance)</th>
</tr>
</thead>
</table>

**Stage 1**

*Performing (Initial recognition)*

**Stage 2**

*Underperforming (Assets with significant increase in credit risk since initial recognition)*

**Stage 3**

*Non-performing (Credit impaired assets)*

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**Impairment**

General model – significant increase in credit risk

**Key Judgements and Implementation Issues**

**Considerations when using Forward Looking and Macro Economic Information**

- "Undue cost or effort"?
- Where is data generated from?
- Consistency with budgeting / capital planning / stress tests?
- Overlay to model vs embed in model?
- How many scenarios modelled?
- How do you turn macro economic data into EL?
IFRS 9: Impairment
- Key Judgements and Implementation Issues:
  (i). Significant increase in credit risk (cont.)

Top down versus bottom up
Level of segmentation /granularity
Basel PDs vs IFRS 9 PDs
Mapping internal and external credit grades

Regulatory PD
Through the cycle ('TTC')
IFRS 9 PD
Point in time ('PIT')

Hard to reconcile!

December 2014
**IFRS 9: Impairment**
- **Key Judgements and Implementation Issues:**
  (i). Significant increase in credit risk (cont.)

**Use of simplifications**
- Top down versus bottom up
- Level of segmentation /granularity
- Basel PDs vs IFRS 9 PDs
- Mapping internal and external credit grades

**Simplifications**
1. Low credit risk – "investment grade"
2. 30 days past due 'backstop'
3. Use 12 month PD as an approximation
4. Assessment at counterparty level
5. Set transfer threshold by maximum initial credit risk
6. Collective assessment based on shared credit risk characteristics

---

**Simplifications**
- Low credit risk – "investment grade"
- 30 days past due 'backstop'
- Use 12 month PD as an approximation
- Assessment at counterparty level
- Set transfer threshold by maximum initial credit risk
- Collective assessment based on shared credit risk characteristics
IFRS 9: Impairment
- Key Judgements and Implementation Issues:
  (ii). Measuring Expected Loss

Forward looking and macro economic information

What happens outside of an explicit forecast period?

Life of revolving credit facilities

Definitions –
• Default
• 90 days past due

Estimation of lifetime EL metrics

Empirical PD Rate

1. PIT PD Rate

2. TTC PD

3. PIT/TTC Mean Reversion

4. Economic Scenario/TTC Means

Projections
IFRS 9: Impairment
- Key Judgements and Implementation Issues:
  (ii). Measuring Expected Loss

- Forward looking and macro economic information
- What happens outside of an explicit forecast period?
- Life of revolving credit facilities
- Definitions –
  • Default
  • 90 days past due

IFRS 9: Impairment
- Key Judgements and Implementation Issues:
  (iii). Other Considerations

- Governance over models and data sources
- Multi-disciplinary project team
- ‘Bolt on’ vs bespoke model
- Keeping the model up to date and re-segmentation
- Dialogue with supervisor and auditor
- Reporting: Giving information to the market ahead of 2018
Thank you
Overview of key implementation considerations

Status and Progress

- Planning can commence against finalised rules - IFRS 9 final standard issued 24 July 2014.
- Regulators to issue Implementation Guidance (SCRAVL) – expected Q1 2015.
- Regulators to issue final capital model – expected once US rules are final.
- Regulators require high quality, robust and consistent implementation.
- Two years to implement / one year of parallel run.

Main Impacts to Address

- **New LEL Risk Models** – joined up approach to model design and development across Regulatory and IFRS 9 models.
- **Data, Infrastructure** – confirm target operating model.
- **Reporting** – more granular including legal entity and portfolio level and time series.
- **Governance** – enhanced governance as move from Incurred Loss to Expected Loss which is more forward looking and judgement based.
- **Financial Impacts** – external demand for early sight of capital impacts e.g. Regulators, Analysts, Investors.
- **Alignment to Firms’ risk management** – some enhancement of risk processes required.
Implementation Activities

Three blocks of activities to be considered:

<table>
<thead>
<tr>
<th>Implementation Activities</th>
<th>Business and Capital Planning</th>
<th>Engagement Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assess data and infrastructure changes required – confirm target operating model.</td>
<td>Manage Capital and Business Impacts - plan and source required capital / reflect in business plans.</td>
<td>Other Banks – to develop industry wide consensus on best practice and to solutions to implementation issues.</td>
</tr>
<tr>
<td>Develop new LEL Risk Models – joined up approach to model design across regulatory and IFRS 9 models</td>
<td>Managing Competing Priorities – several major regulatory transformation programmes at the same time.</td>
<td>Audit Firms – audit approval will be required / important to reach early agreement on approaches.</td>
</tr>
<tr>
<td>Modify Reporting - more granular including legal entity and portfolio level and time series.</td>
<td></td>
<td>Standard Setters – to help develop final guidance.</td>
</tr>
<tr>
<td>Enhance surrounding Governance - as move from Incurred to Expected Loss.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Period Programme Models Data/Systems Engagement

2014 Build teams, Confirm Approach, “No regrets” work

H1 2015 Develop Plans, Identify Key Risks and “Show-stoppers”

H2 2015 –17 Build commences

2017 Parallel Run - commences 1 January 2017

2018 GO LIVE 1 January 2018

* Only 2 years for high quality implementation.
Regulator Expectations to Meet

- Regulators have communicated that they:
  - Will set a very high bar for firms in identifying their risk drivers in their models and approaches with increased emphasis on the governance on how judgement is applied, including at Board level.
  - Require high quality, robust and consistent implementation of a forward looking expected loss model with timely and appropriate recognition of credit losses.
  - Consider implementation of IFRS 9 as much to do with a change in the culture (spirit and letter) as it is a mechanistic calculation to satisfy accounting rules.
  - Implementation should reflect firms risk management, but firms should not assume that their current risk management will be sufficient to satisfy all requirements.
  - Expect as much attention to be given to data and systems to ensure that the results are auditable and explainable.
  - Expect consistency within firms and period to period rather than consistency being solely applied across firms and geographies and expect greater use of benchmarking to explain differences between firms.
  - Expect significant deterioration thresholds to be applied 'not in a restrictive manner' to include more factors that firms typically use today (e.g. more than just days past due for retail, greater segmentation, more use of forward looking factors where risk evolves, stronger link to pricing).

Managing Competing Priorities

Competing and complimentary initiatives

- Regulatory and other priorities are impacting by creating demand which requires use of the same people to make changes to processes and infrastructure in overlapping time periods creating resource strain.
- Timescales and scope are not perfectly aligned.
- It is important to develop a clear line of sight to dependencies as well as the target future state to minimise areas of underlap or duplication.
Other points to consider

- **Policy Interpretations** – need Finance and Risk policy teams to work together. Need to
- **Significant deterioration** – develop meaningful criteria applicable to firm’s risk management practices and approach (which may need to be modified).
- **Consistency** – opportunity to harmonise approaches across firm, asset class/product/customer. Important to benchmark approaches within geography and across regions.
- **Models only part of the answer** – Requires judgement and strong governance especially for forward looking information.
- **Robust and comprehensive documentation** – auditors will require clear documentation of model choices, policy interpretations (across finance and risk), risk drivers, levels of segmentation/aggregation, trade offs, model sensitivities.
- **Data** – need to confirm golden sources, granularity, levels of aggregation, time series data, stock and flow details, model and reporting requirements.
- **Practical expedients** – limited use bearing in mind it’s more than 30 days, use of low default is not a safe harbour.
- **‘Spirit and letter’** – greater alignment of accounting and risk management, leading to improved transparency and clarity over firm’s risk management capabilities.
- **Resources** – need the right people to join it together and make it work.
IASB project break-out session:

Financial instruments: accounting for macro hedging

SUE LLOYD
Member
IASB

YUJI YAMASHITA
Visiting Fellow
IASB
Overview of Discussion Paper
Why do a project on accounting for DRM?

- For dynamic risk management, existing accounting requirements (i.e., hedge accounting) do not work well.
  - ‘patchwork application’ of HA
  - inability to accommodate ‘behaviouralisation’
- Exploring an approach to better reflect DRM in entities’ financial statements.
- The Discussion Paper sets out the Portfolio Revaluation Approach (PRA).
  - Aims to better reflect DRM in financial statements
  - Operational feasibility was considered

Dynamic interest rate risk management in banks

The purpose of dynamic RM is usually to manage Net Interest Income.
Banks’ profit source and interest rate risk management

- **Customer margin** is the responsibility of Business Units (branches).
- In this example, if variable funding rate increases (decreases), Net Interest Income (NII) decreases (increases). Interest rate risk for current and future NII is dynamically managed by ALM using derivatives (e.g., Interest Rate Swaps).

---

The Portfolio Revaluation Approach (PRA)

- Exposures within open portfolios are revalued with respect to the managed risk (for example, interest rate risk).
- Not a full fair value model.
The PRA—continued

- Net effect of the revaluation adjustment of the managed exposures and the fair value changes of the risk management instruments (for example, interest rate swaps) is reflected in profit or loss.

Information arising from PRA (Actual Net Interest Income presentation)

What is the effect of dynamic interest rate RM in the entity's current NII?

<table>
<thead>
<tr>
<th>Leading indicator for future NII</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revaluation</strong></td>
</tr>
<tr>
<td>Positive</td>
</tr>
<tr>
<td>Negative</td>
</tr>
</tbody>
</table>
Behaviouralisation (core demand deposits)

- ‘Contractually’ the demand deposits have a variable rate and can be withdrawn at any time.
- But at a portfolio level, the ‘sticky’ nature of demand deposits leads to the identification of a stable portion in the amount outstanding.
- These core demand deposits are deemed to be fixed rate deposits with longer maturities for risk management purposes (behaviouralisation).

Hedge accounting and the managed portfolios in DRM

What is included in banks’ dynamic interest rate RM

Eligible hedged items under FV Hedge Accounting
- Recognised assets (e.g., loans) and liabilities (e.g., deposits)
- Firm commitments (e.g., loan commitments)

Core demand deposits
Equity model book
Pipeline transactions
Scope of the application of the PRA

Alternative approach–PRA through OCI

• Included as an alternative approach. The net effect of the revaluation of the managed portfolios and FV changes of risk management instruments recognised in OCI rather than in P&L

• BUT important conceptual and practical issues:
  - breaks assumption in DP that all risk management instruments measured at FVTPL;
  - gross presentation of internal derivatives no longer net to zero in P&L; and
  - recycling from OCI to P/L will not happen if managed exposures are sold or derivatives are terminated.
Overview of feedback from outreach

High level feedback summary – from outreach

Overall document
- DP perceived as describing dynamic risk management issues in a comprehensive manner.

Scope
- **Preference for scope focused on risk mitigation** particularly by banks.
- Some prefer a solution to current issues when dealing with open portfolios in IAS 39/IFRS 9 instead of fully reflecting DRM in financial statements.
- Some concerns raised about combination of IAS 39/IFRS 9 with this scope alternative (doesn’t provide comprehensive picture)
- **Focus on DRM**—concerns about having to revalue the managed exposures that an entity has decided to leave unhedged.
### Feedback from users of financial statements

- Generally saw real progress in usefulness of the information.
- Particularly valued the information provided by:
  - the net interest from DRM line in the actual net interest income (NII) presentation (allows users to understand the effect of DRM activities on an entity’s NII);
  - the scope with a focus on DRM provides holistic picture of DRM activities (ie the effect of hedging and leaving positions unhedged); and
  - the stable net interest income presentation would allow users to understand the performance of the business unit and the performance of ALM.
- Divergence in views about whether revaluation effect should be recognised in primary statements or only through disclosures.

### Behaviouralisation, core demand deposits, pipeline transactions and EMB

- **Consideration of behavioural aspects** generally welcomed.
- Generally more **support for core demand deposits** than Equity Model Book (EMB) and pipeline transactions.
- Some happy to include pipeline transactions and EMB if part of DRM – others think should depend on business model. Others think need to include pipeline transactions and EMB otherwise can’t reflect risk management activities.
- Concerns raised by some about interaction with the **Conceptual Framework**. Trade off with need to consider risk management comprehensively.
- Some concerned about **comparability**. Some users concerned about the opportunity for **earnings manipulation**.
- **Disclosures** considered important. Some preparers concerned information is commercially sensitive.
IASB project break-out session:

Insurance contracts

DARREL SCOTT  
Member  
IASB

MILENA LACHETA  
Technical Associate  
IASB
The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

International Financial Reporting Standards

Insurance Contracts

Project Update

Why?

The need for change
Need for a global insurance standard

IFRS 4 Insurance Contracts is an interim Standard

- IFRS 4 permits continuation of a wide variety of diverse practice
- IFRS 4 includes a ‘temporary exemption’ from the general requirement that accounting policies should be relevant and reliable

IFRS 4 does not provide transparent information about the effect of insurance contracts on financial statements

- The new standard will provide transparent information about:
  - The effect of insurance contracts on financial performance
  - The way an entity makes profits or losses through underwriting activity and investing premiums from customers
  - The nature and extent of risks from insurance contracts

Existing accounting makes comparisons difficult between products, companies and across jurisdictions.

- The new standard will replace the huge variety of accounting treatments that depend on type of contract and type of company that issues the contracts
- The new standard will make it easier to make comparisons between insurance contracts and other types of contracts

Improvements to accounting

**Existing issues**

- Variety of accounting treatments depending on type of contract and type of company that issues the contracts
- Estimates for long duration contracts not updated
- Discount rate based on estimates of investment returns does not reflect economic risks of insurance contract
- Lack of discounting for measurement of some contracts
- Little information about economic value of embedded options and guarantees

**How our proposals improve accounting**

- Consistent accounting for all insurance contracts by all companies (not just insurance companies)
- Estimates updated to reflect current market-based information
- Discount rate reflects characteristics of the cash flows of the contract
- Measurement of insurance contract reflects discounting where significant
- Measurement reflects information about full range of possible outcomes
How?
Project history and consultation

1997
- IASC starts project on insurance contracts

2004
- March 2004: IFRS 4 Insurance contracts
- ‘Phase I’ completed: Interim standard on insurance contracts issued

2007
- 162 comment letters received

2010
- July 2010: Exposure Draft Insurance Contracts
- 253 comment letters received

2013
- June 2013: Exposure Draft Insurance Contracts
- 194 comment letters received

2015
- Late 2015: Expected publication IFRS x Insurance contracts
Extensive consultation

- Consultation documents issued
  - 2007 Discussion Paper *Preliminary Views on Insurance Contracts*
  - 2010 Exposure Draft *Insurance Contracts*
  - 2013 Exposure Draft *Insurance Contracts*
- Extensive outreach with investors, analysts, preparers, regulators, accounting firms and standard-setters, in all regions with significant insurance industry
- Three rounds of field work focused on assessing operability of the proposals

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What?
The IASB’s proposals
Current balance sheet measurement provides up-to-date view of entity’s obligations

Contractual service margin reflects the entity’s obligation to provide insurance coverage. Measured as the difference between the risk-adjusted present value of expected inflows and outflows at inception, updated to reflect changes in future service-related estimates.

Fulfilment cash flows is a probability-weighted estimate of cash inflows and outflows that will arise as the entity fulfils the contract. Estimated in a way that incorporates all possible scenarios and calculated using current estimates, including current discount rates and risk adjustment.

The IASB has sought to address concerns about the effect of changes in current value measurement

- Many believe that not all changes in estimates should be considered current period performance. Some estimates viewed as causing “unwarranted volatility”
- The IASB has sought to address these concerns by tentatively deciding:
  - Changes relating to future service affect profit or loss in future periods through adjustment to contractual service margin (so-called ‘unlocking’)
  - Entities can choose whether to present effects of interest rate changes in OCI or profit or loss
  - Entities can use ‘top-down’ approach to determine discount rate. Significantly reduces accounting mismatches caused by credit spread changes by reflecting this in both asset and liability measurement.
Changes in estimates
Non-participating contracts

Contractual service margin
(Expected contract profit)

Future cash flows: expected cash flows from premiums and claims and benefits

Risk adjustment: an assessment of the uncertainty about the amount of future cash flows

Discounting: an adjustment that converts future cash flows into current amounts

‘Fulfilment cash flows’

Profit or loss: underwriting result

Release of contractual service

Changes in cash flows related to past and current services

Release of risk adjustment relating to current and past periods

Interest expense at locked-in discount rate

Effect of changes in discount rates

Other comprehensive income

Changes in estimates

- Risk adjustment
- Discounting
- Future cash flows

Non-participating contracts

Statement of Comprehensive Income

<table>
<thead>
<tr>
<th>20XX</th>
<th>Insurance contracts revenue</th>
<th>X</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Incurred claims and expenses</td>
<td>(X)</td>
</tr>
<tr>
<td></td>
<td>Operating result</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>Investment income</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>Interest on insurance liability</td>
<td>(X)</td>
</tr>
<tr>
<td></td>
<td>Investment result</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>Profit or loss</td>
<td>X</td>
</tr>
<tr>
<td></td>
<td>Effect of discount rate changes on insurance liability (optional)</td>
<td>(X)</td>
</tr>
<tr>
<td></td>
<td>Total comprehensive income</td>
<td>XX</td>
</tr>
</tbody>
</table>

Interest expense is either current or ‘locked-in’, depending on accounting policy choice

If interest expense is ‘locked-in’, effect of difference between current and locked-in rates is presented in OCI
The IASB has sought to reduce complexity where possible

Practical expedients and simplifications proposed by the IASB:

- Pragmatic scope exceptions to avoid imposing costs with no significant benefits
- Optional premium allocation approach to simplify measurement
- Contracts are not recognised until the coverage period begins, unless onerous
- Contracts may be aggregated for accounting purposes
- Limited unbundling of components within insurance contracts
- Measurement includes renewal cash flows when there is a substantive obligation to provide coverage determined at a portfolio, rather than the contract level
- Discount rates can be determined using top-down or bottom-up approach
- Simplified transition requirements allow more entities to approximate retrospective application

However, significant complexity arises as a result of the decisions taken to disaggregate current period performance from other changes in current value measurement
Support for many key features (1)

Scope

• Consistent accounting for all types of insurance contracts, with pragmatic exceptions made on cost-benefit grounds

• Limited unbundling of components of insurance contracts

• Simplified accounting for straightforward insurance contracts

Support for many key features (2)

Current measurement approach

• Measurement based on the assumption that the entity fulfils the contract

• Incorporates all available information about expected cash flows, especially effect of options and guarantees embedded in insurance contracts

• Reflects time value of money using a rate that reflects only the characteristics of the cash flows

• Explicit measurement of the uncertainty inherent in the expected cash flows, based on the entity’s assessment of risk after the effects of diversification benefits

• Elimination of Day 1 gains

• Effects of service-related estimates recognised in period service is provided (through unlocking)
Support for many key features (3)

**Presentation and disclosure**

- Consistency in presentation of revenue and expense between insurance and other types of contracts
- Segregation of the effects of changes in discount rate in profit or loss or OCI according to accounting policy choice
- Reconciliation of changes in the components of the insurance contracts measurement
- Information about the nature and extent of risks arising from insurance contracts

---

Mixed views in some areas (1)

<table>
<thead>
<tr>
<th>Topic</th>
<th>Reason for IASB view</th>
<th>Differences in views</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>Comparable revenue and expenses between different types of insurance contracts and with all other types of contract</td>
<td>Some suggest that the costs of determining revenue do not justify the benefits of comparable information.</td>
</tr>
<tr>
<td>Transition</td>
<td>Comparable accounting for contracts written before and after the date of transition, at a reasonable cost</td>
<td>Some believe it inappropriate to require contracts written many years ago to be accounted for using the new standard.</td>
</tr>
<tr>
<td>Level of aggregation</td>
<td>Allow aggregation provided that doing so approximates the results if contracts were measured individually</td>
<td>Some are concerned that the combination of the IASB’s proposals and regulatory constraints may result in recognition of losses that would not be recognised under existing accounting methods.</td>
</tr>
</tbody>
</table>
### Mixed views in some areas (2)

<table>
<thead>
<tr>
<th>Topic</th>
<th>Reason for IASB view</th>
<th>Differences in views</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determining CSM using locked-in</td>
<td>Consistency with Day 1 measurement of the CSM, consistency with revenue recognition, and to avoid the CSM reflecting cash flows discounted using discount rates from different dates</td>
<td>Some would prefer using current rate for unlocking and accreting interest to reduce operational complexity. Some would prefer to remeasure CSM to reflect current rates.</td>
</tr>
<tr>
<td>discount rates</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Allocation of CSM</td>
<td>To recognise the CSM as the entity provides insurance coverage, which is provided according to the passage of time. Insurance coverage is distinct from the bearing of risk, which is reflected in the risk adjustment.</td>
<td>Some believe that the provision of insurance coverage should instead reflect the pattern of release from risk or the occurrence of claims and benefits.</td>
</tr>
<tr>
<td>Reinsurance CSM at inception</td>
<td>Gains arising from reinsurance contracts, and the expense of purchasing reinsurance, recognised over coverage period</td>
<td>Some believe that, for some reinsurance contracts, some gains and losses ought to be recognised in profit or loss immediately.</td>
</tr>
</tbody>
</table>

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**Work in progress**

Decisions still to be made on participating contracts
Decisions still to be made

• IASB still considering appropriate accounting for contracts with participating features.

• Critical issues are:
  – Accounting for entity’s share of underlying items, including the effect of options and guarantees
  – Allocation of the CSM in profit or loss
  – Determining ‘locked-in’ interest expense for profit or loss

Approach to participating contracts

Extending the general model

Consider what adaptations are needed to general proposals

Fulfilment cash flows
  • Measure on basis of all cash flows that arise in fulfilling the contract
  • Include all cash flows that arise from policyholder rights to share in return on underlying items
  • Discount using rates that reflect the characteristics of the cash flows
  • No special adaptations for risk adjustment needed

Contractual service margin (CSM)
  • ED proposals:
    • Determined to eliminate any Day 1 gain at initial recognition
    • Subsequent to initial recognition, adjust the CSM to reflect changes in estimates of future services
    • Payment of investment returns is not a service
    • Adaptations being considered:
      • Adjust to reflect changes in entity’s share of underlying items
      • Allocation pattern

Interest expense in profit and loss
  • ED proposals:
    • Determined at the date when the contract was initially recognised, updated when changes in returns on underlying items result in changes in expected cash flows.
    • Adaptations being considered:
      • Alternative approaches to determining locked-in interest rates
**Critical issue: Reporting changes in entity's share of returns**

- In participating insurance contracts, the entity:
  - Provides policyholder with share in the returns on underlying items held by the entity (policyholder’s share)
  - Retains a share of the returns on the underlying items held by the entity (entity’s share)

**Issue: how should changes in entity's share be reported?**

- Consistent with applicable standard for the underlying item. Changes would be recognised in comprehensive income **OR**
- As a change in the value of the obligation to provide service, ie by adjusting the CSM.

---

**Critical issue: Example: Entity’s share**

- Entity A receives premium of €100 and promises to pay:
  - €1,000 if policyholder B dies; and
  - Return of premium plus 90% share of returns A earns from investing the premium at the end of 5 years
- A invests premium in financial assets, and expects to earn 5%, ie assets worth 100 x 1.05^5 = 128 at end of 5 years.
- At beginning of contract, A expects B will not die, and that it will:
  - pay B 100+90% of 28=125 (policyholders’ share)
  - retain 10% of growth, ie 3. (entity’s share)
- Expectations change immediately, A now expects 7%, then:
  - Assets would be worth 100 x 1.07^5= 140 at end of 5 years
  - A would pay B 100 + 90% of 40 = 136.
  - A would expect to retain 10% ie 4.
Critical issue:
Allocation of CSM

Issue: what guidance should be provided to ensure consistency in how entities recognise the contractual service margin in profit or loss?

- Objective: to allocate CSM on a reasonable and systematic basis that reflects the service provided by a contract.
- Questions the IASB needs to address are:
  - What services are provided by insurance contracts with participating features?
  - What is the pattern of provision of those services?
  - How to address situations in which there is more than one service provided in more than one pattern?

Critical issue:
Determining locked in interest rate

Issue: How to report a ‘cost’ based interest expense on the insurance contract?

- A par contract includes cash flows that vary as a result of changes in interest rates, so segregation changes in discount rate from other changes need to be modified.
- The IASB is considering two possible modifications:
  - A “book yield” approach - Interest expense in profit or loss mirrors investment income on underlying items.
  - An “effective yield” approach - Interest expense in profit or loss based on yield that discounts estimated cash receipts through the expected life of the contract to the net carrying amount of the contract.
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When?
Next steps and interaction with IFRS 9

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Next steps

Consultations continue throughout 2014
Deliberations continue into early 2015
Final standard expected 2015
IASB to consider need for testing and how to support implementation
Timing

Interaction with IFRS 9 Financial Instruments

IFRS 9 Financial Instruments

• Applies to all entities with financial instruments
• Provides:
  – A logical classification approach
  – A much needed forward-looking ‘expected loss’ model for impairment
  – An improved hedge accounting model that is better aligned with risk management

Insurance Contracts Standard

• Applies to all entities that issue insurance contracts
• Expected to provide:
  – Comparable accounting for insurance contracts
  – Transparent information about how insurance contracts affect an entity’s financial position and performance

Many are concerned that IFRS 9 will be applied before the insurance contracts standard

• IFRS 9 was issued on 24 July 2014 and is effective for accounting periods beginning on or after 1 January 2018
• The Insurance Contracts Standard is expected to be issued in late 2015 and is not expected to be effective until at least 1 January 2019

Accounting mismatches between insurance contracts and financial assets can be avoided
• Entities permitted to choose to present the effect of changes in discount rate in profit or loss, or OCI
• We expect to confirm that entities can address new accounting mismatches by refreshing elections in IFRS 9 for relevant financial assets
• Insurance contract liabilities or associated assets could be hedged items for some risks in accordance with IFRS 9
• Limited interaction with macro-hedging project: not directly relevant to insurance contracts which would already be measured on a current basis

IASB will consider ways to ensure entities applying the insurance contracts standard are not disadvantaged

• IFRS 9 will allow adequate time for implementation
• Aware of potential disruption if there were to be two significant changes in successive years

IASB will consider implementation period as it finalises the insurance contracts standard
For more information…

Stay up to date
• Visit our website:
  – www.ifrs.org
  – go.ifrs.org/insurance_contracts
• Sign up for our email alert

Ask questions or share your views
• Email us: insurancecontracts@ifrs.org
• Comment on our proposals: go.ifrs.org/Exposure-Drafts

Resources on IASB website
• IASB Update
• Project podcasts and webcasts
• Effect of redeliberations on the 2013 ED
• Investor resources
• High level summary of project
• Feedback statement

Thank you
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International Financial Reporting Standards

Appendix: Tentative decisions to date on the 2013 ED

The 2013 Exposure Draft built on previous consultations, focussed on five targeted areas

Measurement proposals

1. Unlocking
   Changes in estimates of cash flows relating to future service recognised over remaining coverage period

2. Mirroring
   Measurement and presentation exception when no economic mismatch is possible

Presentation proposals

3. Revenue
   Align to presentation of revenue required for other types of contracts with customers

4. OCI proposals
   Interest expense is amortised cost-based in profit or loss, current value - on the balance sheet

Approach to transition

5. Transition
   Apply Standard retrospectively if practicable, or with specified simplifications if not practicable
Who we heard from

- 194 comment letters
- 187 outreach meetings, including discussion forums in 18 countries
- Third round of field work
  - 17 entities outside European Union directly
  - 13 entities within European Union, co-ordinated with EFRAG and European standard-setters
- Comment letter summaries discussed in January 2014 and redeliberations began in March 2014

Summary of feedback on the 2013 ED

+ Welcome progress made since 2010 Exposure Draft
  - Acknowledgement that IASB has responded to concerns raised on the 2010 Exposure Draft
  - Widespread agreement with direction of proposals relating to:
    - unlocking of contractual service margin
    - transition
  - Support at a conceptual level for insurance contract revenue

- Overarching concern about extent of accounting mismatches. As a result:
  - concern about scope of mirroring
  - concern about mandatory OCI
- Significant concerns that mirroring:
  - cannot be made operational
  - does not sufficiently address accounting mismatches overall to justify the complexity
  - would require options and guarantees to be reported in profit or loss
IASB has substantially completed redeliberations for contracts with no participating features

**Measurement proposals**

1. Unlocking
   Changes in estimates of cash flows and risk adjustment relating to future service recognized over remaining coverage period
   Favourable changes in estimates in profit or loss to the extent that they reverse losses that relate to future services

2. Mirroring
   Not applicable to non-participating contracts. The IASB has not made decisions on participating contracts.

**Presentation proposals**

3. Revenue
   Align to presentation of revenue required for other types of contracts with customers
   Prohibit presentation of non-revenue premium information in the statement of comprehensive income

4. OCI proposals
   Effect of changes in discount rates presented in either profit and loss or in OCI as accounting policy choice for contracts within a portfolio

**Approach to transition**

5. Transition
   Retrospective application unless impracticable
   When impracticable, apply a specified simplified approach
   When the simplified approach is impracticable, determine CSM using fair value

IASB has addressed some issues raised that were not targeted for input in the 2013 ED

1. Option to include fixed fee service contracts within scope of insurance contracts standard
2. Additional guidance on use of judgement in making any necessary adjustments to observable inputs to determine the discount rate
3. Recognise contractual service margin in profit or loss in a way that reflects the passage of time and the expected number of contracts in force
4. Symmetrical treatment for changes in estimates of fulfilment cash flows for a reinsurance contract and the underlying direct insurance contract
5. Contracts acquired in settlement period should be accounted for as if issued by entity at the date of portfolio transfer or business combination
6. Clarified objectives relating to level of aggregation
7. Clarify that significant insurance risk only occurs when there is a possibility that an issuer will incur a loss on a present value basis
8. Confirm use of locked-in rate for accreting interest and for determining the amount that unlocks the contractual service margin
IASB project break-out session:

Leases

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

International Financial Reporting Standards

Leases Project
Break-out session
December 2014

Project status

In May 2013 the boards publish a revised Exposure Draft (2013 ED)

In November 2013 the boards discuss a summary of feedback received on the 2013 ED

Re-deliberations continue

Comment period ends 13 September 2013; the boards received over 640 comments letters

In January 2014 the boards start the joint re-deliberations

Publication of the new Leases Standard (Effective date TBD)

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The need for change

- Leases create assets and liabilities
- Most leases are not reported on the balance sheet
- Leverage of heaviest users of operating leases(1) understated by:
  - 20% Europe
  - 23% N America
  - 46% Asia Pacific
- Huge variation across and within industries

(1) 950 companies in Europe, North America and Asia Pacific each with estimated operating lease liabilities of >$300M (discounted basis). Data obtained from financial data aggregators that may contain errors; this information should, therefore, be used with a degree of caution.

A lack of comparability

<table>
<thead>
<tr>
<th></th>
<th>Industry entity 1</th>
<th>Industry entity 2</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Reported</td>
<td>Proposals (1)</td>
</tr>
<tr>
<td>Total property, plant and equipment</td>
<td>16,908</td>
<td>19,926</td>
</tr>
<tr>
<td>Non-current liabilities</td>
<td>13,232</td>
<td>16,567</td>
</tr>
<tr>
<td>Equity</td>
<td>6,719</td>
<td>6,402</td>
</tr>
<tr>
<td>Ratio of non-current liabilities to equity</td>
<td>2.0:1</td>
<td>2.6:1</td>
</tr>
</tbody>
</table>

(1) Proposals are estimates using various assumptions about the discount rate and average lease term of leases held by each entity.
And a lack of information

<table>
<thead>
<tr>
<th>Retailers that went into liquidation</th>
<th>Operating lease commitments (undiscounted) (1)</th>
<th>Reported debt (1)</th>
<th>Operating lease commitments as % of reported debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Circuit City (US)</td>
<td>$4,537M</td>
<td>$50M</td>
<td>90.74%</td>
</tr>
<tr>
<td>Borders (US)</td>
<td>$2,796M</td>
<td>$379M</td>
<td>73.8%</td>
</tr>
<tr>
<td>Woolworths (UK)</td>
<td>£2,432M</td>
<td>£147M</td>
<td>165.4%</td>
</tr>
<tr>
<td>HMV (UK)</td>
<td>£1,016M</td>
<td>£115M</td>
<td>88.3%</td>
</tr>
<tr>
<td>Clinton Cards (UK)</td>
<td>£652M</td>
<td>£50M</td>
<td>112.4%</td>
</tr>
</tbody>
</table>

(1) Based on averaged published financial statements data available in the 5 years before the company entered Chapter 11 (US) or liquidation (UK).

Most investors make estimated adjustments

- Use rough estimation techniques (eg multiple of rent expense)
- Liabilities of individual companies often overstated but some understated

<table>
<thead>
<tr>
<th>950 companies (1)</th>
<th>Reported</th>
<th>Adjusted on present value basis</th>
<th>Adjusted on multiple of 8 basis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Long-term (LT) debt (in millions of dollars)</td>
<td>5,623,307</td>
<td>7,080,412</td>
<td>7,673,513</td>
</tr>
<tr>
<td>LT debt to total assets</td>
<td>16%</td>
<td>19%</td>
<td>20%</td>
</tr>
<tr>
<td>LT debt to equity</td>
<td>56%</td>
<td>71%</td>
<td>77%</td>
</tr>
</tbody>
</table>

(1) 950 companies in Europe, North America and Asia Pacific each with estimated operating lease liabilities of >$300M (discounted basis). Data obtained from financial data aggregators that may contain errors; this information should, therefore, be used with a degree of caution.
Companies also provide lease-adjusted information—a sample

<table>
<thead>
<tr>
<th>Airlines</th>
<th>Retail</th>
<th>Hotels</th>
<th>Transport and courier</th>
</tr>
</thead>
<tbody>
<tr>
<td>Air France – KLM</td>
<td>Ahold</td>
<td>Accor</td>
<td>A.P. Moller – Maersk Group</td>
</tr>
<tr>
<td>Alaska Airlines</td>
<td>Foot Locker</td>
<td>Home Retail Group (Argos, Homebase)</td>
<td>Deutsche Post</td>
</tr>
<tr>
<td>Delta Airlines</td>
<td>Kingfisher (B&amp;Q, Castorama)</td>
<td>Nordstrom</td>
<td>Oil and gas</td>
</tr>
<tr>
<td>Easyjet</td>
<td>Sainsbury’s</td>
<td>Shell</td>
<td>Construction</td>
</tr>
<tr>
<td>Emirates</td>
<td>Whole Foods</td>
<td>Statoil</td>
<td>Hochtief</td>
</tr>
<tr>
<td>SAS Airlines</td>
<td></td>
<td></td>
<td>Travis Perkins</td>
</tr>
</tbody>
</table>

Investor support for the project

- Extensive outreach
  - In 2013, 270 investors and analysts around the world
- Majority support recognition on balance sheet—measured to reflect contractual commitments
- Disclosure is not enough(1)

**Substantial convergence with the FASB**

- **Converged decisions**
  - Leases reported on-balance sheet
  - Definition of a lease
  - Measurement of lease liabilities

- **Different**
  - Lease expenses in income statement and cash flows in cash flow statement*

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- **In practice, little difference in amounts reported for many companies**
  
  * For some leases only

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**IASB’s rationale for a single lessee model**

- **Useful information**
  - Most investors think leases create debt-like liabilities
  - Link between balance sheet and income statement important for analyses, eg. return on capital

- **Strong conceptual basis**
  - All leases contain rights of use
  - Financial liability, if payments are made over time

- **Cost and complexity**
  - IASB model
    - No lease classification
    - Can use fixed asset systems for lease asset
  - No difference in liability measurement caused by difference in lease expense
**Benefit of separating interest expense**

- Many investors adjust the income statement using rough estimation techniques (e.g., interest = 1/3 rent expense, depreciation = 2/3 rent expense; or focus on EBITDAR)
- Estimated effects of IASB lessee model on operating profit:

<table>
<thead>
<tr>
<th>950 listed companies⁽¹⁾</th>
<th>Increase in operating profit margin %</th>
</tr>
</thead>
<tbody>
<tr>
<td>62%</td>
<td>&lt; 1%</td>
</tr>
<tr>
<td>19%</td>
<td>1 – 2%</td>
</tr>
<tr>
<td>13%</td>
<td>2 – 5%</td>
</tr>
<tr>
<td>4%</td>
<td>5 – 10%</td>
</tr>
<tr>
<td>2%</td>
<td>&gt; 10%</td>
</tr>
</tbody>
</table>

⁽¹⁾ 950 companies in Europe, North America and Asia Pacific each with estimated operating lease liabilities of >$300M (discounted basis). Data obtained from financial data aggregators that may contain errors; this information should, therefore, be used with a degree of caution.

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**Illustration—lessee model**

Three companies lease an identical truck for the same 4-year period:
- Company 1—pays €50,000 upfront
- Company 2—pays €60,000 in equal amounts over 4 years
- Company 3—pays €53,000 at the end of year 1

Difference in total payments relates solely to difference in timing of payments.
Decisions to reduce cost and complexity

IASB responding to feedback in redeliberations:

- Single lessee model
- Exemption for short-term and small asset leases
- Portfolio application
- Simplified measurement of liability
  - Exclude variable payments and most optional payments
- Simplified separation of lease and non-lease payments
- In essence, no change to existing lessor accounting

Lessor accounting

- Feedback on 2013 ED
  - Existing lessor accounting is not broken
  - Concerns about cost and complexity
- Redeliberations: enhanced disclosures
  - Information about the residual value risk
  - Operating leases: separate disclosures for leased assets and assets used by a lessor
  - Finance leases: separate disclosure of lease receivable and unguaranteed residual value
**Definition of a lease**

- 2013 ED model confirmed in redeliberations with various clarifications
- Clear principle: control
- Leases different from service / executory contracts
  - Asset not obtained at start of typical service / executory contract
- Vast majority of cases—straight forward

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**Going forward**

- IASB and FASB will continue to re-deliberate jointly
- Main topics yet to be discussed
  - Lessee disclosures
  - Transition requirements
  - Effective date
- Publication of final standard—H2 2015
Thank you