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 23 June 2014.

09:00  **Registration and refreshments**

09:30  **Introduction**
Sue Lloyd  
*Member, IASB*

09:35  **Classification and measurement**
Brief overview of the requirements: Yulia Feygina, *Senior Technical Manager, IASB*
Implementation advice—corporates: Andrew Spooner, *Partner, Deloitte*

10:10  **Impairment model**
Brief overview of the requirements: Riana Wiesner, *Senior Technical Manager, IASB*
Implementation experience—banks: Mark Robbins, *Portfolio Analytics & Reporting Director Retail & Consumer Credit Risk, Lloyds Banking Group*
Implementation advice—including corporates: Colin Martin, *Partner, KPMG*

10:45  **Hedge accounting model for corporates**
Implementation advice: Martin Friedhoff, *Executive Director, EY* and Kush Patel, *Director, Deloitte*

11:25  **Round-table Q&A**
*Chair: Sue Lloyd, Member, IASB*
Panellists including:
- Yulia Feygina
- Martin Friedhoff
- Colin Martin
- Kush Patel
- Mark Robbins
- Andrew Spooner
- Riana Wiesner

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

12:00  **Close session**
Special Interest Session

Implementing forthcoming Financial Instruments requirements

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Member
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Senior Technical Manager
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MARTIN FRIEDHOFF
Executive Director
EY

COLIN MARTIN
Partner
KPMG

KUSH PATEL
Director
Deloitte

MARK ROBBINS
Portfolio Analytics & Reporting Director
Retail & Consumer Credit Risk
Lloyds Banking Group

ANDREW SPOONER
Partner
Deloitte

RIANA WIESNER
Senior Technical Manager
IASB
The IFRS 9 classification model for assets

<table>
<thead>
<tr>
<th>Business model is hold to collect</th>
<th>Business model is hold to collect and sell</th>
<th>Other business models</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash flows are solely payments of principal and interest</td>
<td>Amortised cost</td>
<td>FVOCI (NEW)</td>
</tr>
<tr>
<td>Other types of cash flows</td>
<td>FVPL</td>
<td>FVPL</td>
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<tr>
<td></td>
<td>FVPL</td>
<td>FVPL</td>
</tr>
</tbody>
</table>
Limited Amendments to IFRS 9

- Defined category
- Better reflects how financial assets are actually managed
  - Business model that involves both collecting contractual cash flows and selling financial assets
- Addresses potential accounting mismatches due to interaction with accounting for insurance contract liabilities
- Provides fair value and amortised cost information
- Supported by the majority of respondents, including users

Limited Amendments to IFRS 9

- 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’
- Exception for instruments with regulated rates to be eligible for amortised cost measurement
  - Particularly important in some jurisdictions, eg France and China
- Simplified the test for assessing a modified economic relationship
  - Now ‘significant’ rather than ‘insignificant’ difference in contractual cash flows compared to benchmark
Financial liabilities at FVO – ‘own credit’

<table>
<thead>
<tr>
<th>Financial statements – IFRS 9</th>
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</thead>
<tbody>
<tr>
<td><strong>Balance sheet</strong></td>
</tr>
<tr>
<td>Financial liabilities – FVO</td>
</tr>
<tr>
<td>Full FV</td>
</tr>
<tr>
<td><strong>P&amp;L</strong></td>
</tr>
<tr>
<td>Gain or loss</td>
</tr>
<tr>
<td>all FV ( \Delta ) except own credit</td>
</tr>
<tr>
<td>OCI</td>
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<tr>
<td>Gain or loss</td>
</tr>
<tr>
<td>FV ( \Delta ) due to ‘own credit’*</td>
</tr>
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</table>

* Not recycled

- Otherwise, **P&L gain when ‘own credit’ deteriorates**, loss when it improves
- **Required by IFRS 9** for financial liabilities designated under the FVO – the only change to the IAS 39 model for financial liabilities
- **Limited amendments** allowed the ‘own credit’ requirements to be applied before the rest of IFRS 9

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Thank you
Implementation challenges for corporates

Classification assessment and designations

• Requirement to assess classification for all financial assets and liabilities

• However, in many cases measurement basis will be the same (though impairment will differ)

• Assessment of business models
  – Treasury portfolios: consideration of holding horizon, motivations for purchase and sale
  – Due consideration to FVTOCI for equity instruments given no recycling

• Transition is crucial
  – making elections (FVTOCI for equity instrument, FVTPL (‘fair value option’) at the ‘date of initial application’)
  – Assess whether previous fair value elections can still stand (noting the changing in qualifying criteria)
  – Decision on whether to restate comparatives
Implementation challenges for corporates

Fair valuing credit risk

Assets

• If loans/receivables/debt securities have embedded derivatives that are separated out under IAS 39 then IFRS 9:
  – Assess classification of the whole instrument
  – Reasonable likelihood that the whole instrument will be FVTPL (but no hard and fast rule)
  – Need to fair value interest rate, liquidity and credit risk on the debt host previously measured at amortised cost
  – Robust valuation required

Liabilities

• If issued debt has been designated at FVTPL under the fair value option
  – Presentation of changes in own credit in OCI (rather than P&L)
• If had not previously used the fair value option for issued debt it is now potentially more appealing
  – Potential as a surrogate for fair value hedging fixed rate debt
Overview of general approach

Change in credit risk since initial recognition

- Expected credit losses recognised
- 12-month expected credit losses
- Lifetime expected credit losses
- Lifetime expected credit losses
- Interest revenue
- Gross basis
- Gross basis
- Net basis

Stage 1: Performing
Stage 2: Underperforming
Stage 3: Non-performing
**Interaction between FVOCI and impairment**

1. Acquire a debt instrument to be measured at FVOCI for CU1,000

<table>
<thead>
<tr>
<th>FVOCI</th>
<th>Cash</th>
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<tbody>
<tr>
<td>1,000</td>
<td>1,000</td>
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2. Recognise 12-month expected credit losses of CU50

<table>
<thead>
<tr>
<th>P&amp;L</th>
<th>OCI</th>
<th>Retained earnings</th>
</tr>
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<tbody>
<tr>
<td>50</td>
<td>50</td>
<td>50</td>
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3. FV increased to CU1,500

<table>
<thead>
<tr>
<th>FVOCI</th>
<th>OCI</th>
<th>Retained earnings</th>
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<td>1,000</td>
<td>50</td>
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**Modification of contractual cash flows**

Gross carrying amount (based on contractual cash flows)

- Gross carrying amount prior to modification (original contract)
- Less
- Gross carrying amount after modification (modified contract) discounted at original EIR

\[
= \text{Modification gain or loss recognised in P&L}
\]

Loss allowance – based on expected cash flows

- Credit risk at initial recognition
- Compared to
- Credit risk after the modification

\[
= \text{Change in credit risk used to assess whether there is a significant increase in credit risk}
\]
Thank you
IFRS9 IMPAIRMENT MODEL
IMPLEMENTATION EXPERIENCE

Presented By:
Mark Robbins - Portfolio Analytics & Reporting Director,
Retail & Consumer Credit Risk, Lloyds Banking Group
23 June 2014

KEY CHALLENGES

FIRM SPECIFIC CHALLENGES
• SIGNIFICANT INCREASE IN CREDIT RISK
• FORWARD LOOKING VIEW

INDUSTRY CHALLENGES
• TRANSPARENCY & COMPARABILITY

IMPLEMENTATION CHALLENGES
• DATA & SYSTEMS
• STAKEHOLDER ENGAGEMENT
• REGULATORY UNCERTAINTY
FIRM SPECIFIC CHALLENGES: TRANSFER CRITERIA

HOW TO DETERMINE A SIGNIFICANT INCREASE IN CREDIT RISK?

STAGE 1
12 month Expected Credit Losses

STAGE 2
Lifetime Expected Credit Losses

STAGE 3
Lifetime Expected Credit Losses

TWO MAIN APPROACHES:

PD TRACKING
model driven measurements of both origination and current likelihood of default

OPERATIONALLY BASED MEASURES
Watchlists, days past due (DPD) & other operational measures / customer metrics

ADVANTAGES

• Single view of risk through alignment with capital metrics
• Alignment with Pillar 3 disclosures by credit rating grades
• Simplified approach permitted, using initial maximum credit risk for a portfolio
• Meets regulatory expectations

CONSIDERATIONS

• Definition of PD to be used
• Impact of PD recalibrations & unwanted volatility
• Origination threshold
• Granularity of PD model

FIRM SPECIFIC CHALLENGES: FORWARD LOOKING

HOW TO APPLY A FORWARD LOOKING VIEW?

STAGE 1
12 month Expected Credit Losses

STAGE 2
Lifetime Expected Credit Losses

STAGE 3
Lifetime Expected Credit Losses

What does a forward looking view provide?

• Movement of accounts across Stages from / to LEL and 12m EL
• Changes in expected loss rates

PD based and Delinquency + approaches present similar issues

Challenges in determining a forward looking view

• Determining the drivers of credit risk
• Use of hybrid model - account level assessment + (sub) portfolio measures
• The Granularity Trade Off
• Selection and weighting of macro economic scenarios
• Application of other forward looking expectations
• Pro-cyclicality versus spurious volatility – challenges in calling the ‘tipping point’
**INDUSTRY CHALLENGES: COMPARABILITY**

IDENTIFYING & UNDERSTANDING FIRM SPECIFIC APPROACHES

**Significant increases in credit risk**
- Each bank can determine its own measures.
- Similar portfolios may be assessed in different ways.

**Forward looking view**
- Subjective – Banks’ selection of scenarios and their application
- **Granularity of Assessment**
  - Determination of the assets that should be subject to a lifetime loss measurement
  - High Level Assessment versus granular disclosure

**Potentially wide range of approaches may hamper interpretation and comparability**

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**IMPLEMENTATION CHALLENGES**

PRACTICAL ISSUES TO CONSIDER

**Data & Systems**
- Changes to existing impairment models
- Bringing together finance and credit risk data across multiple systems
- Disclosure Requirements and measurement of Significant Deterioration are key drivers

**Stakeholder engagement**
- Impact assessments to understand the drivers of and movements in impairment over time
- Understand potential consequential impacts, for example:
  - Product Profitability
  - “Optical” impacts on coverage, net assets and other balance sheet disclosures
  - Changes to capital resources
- Communicating the size of the task / creating a sense of urgency

**Regulatory Uncertainty**
- Potential Augmentation / clarification of Accounting Standard by BCBS / PRA
- Pressure for Early Adoption?
2018 IS NOT SO FAR AWAY

The planning work has established that for banks the complexity and cost of the IFRS 9 implementation is likely to be second only to the Basel II implementation, and broadly equivalent to the entire first time adoption of IFRSs in 2005.**

There are many reasons for this period of implementation (3 years) including the size and complexity of the necessary changes to systems and processes, the volume of data required by the model, the limited pool of skilled resources required for the implementation available in the market, the need for guidance to develop on the interaction with regulatory capital requirements and the need to inform market expectations of the accounting, regulatory capital and business impacts in advance of the final standard coming into force.

**Source: British Banker’s Association letter to the IASB on 5th November 2013
IFRS Foundation Conference

23rd June 2014
Implementing IFRS 9 – Impairment for Corporates

Agenda

- Corporates
  - Wide spectrum of sophistication
  - Current approaches to trade debtor impairment
  - Data requirements

- Non trade debtor financial instruments

- Disclosure

- Potential concerns?
Thank you

Presentation by Colin Martin