Welcome to the participants of ICAI-Dubai Chapter on IFRS 9 Presentation

By
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Dubai, Date: 15/10/2016

A word About …. CFI

Corporate Finance International

- A Grade 3 Licensee by CBB
- CFI Activities:
  - Risk Governance & Management
  - Corporate Finance & Debt Advisory
  - IFRS 9 – Validation and Implementation
  - Private Equity, Financial Due Diligence & Valuation

Agenda

IFRS 9

- Overview of IFRS 9
- Classification & measurement model
- Impairment
- Hedge Accounting - General
- Moving from incurred to expected credit loss
- Impact on income statement & balance sheet

Overview

The IASB has issued the final version of **IFRS 9 Financial Instruments on 24 July 2014** – Mandatory retrospective application 2018

Classification and Measurement

Impairment

General Hedge Accounting

Macro Hedge Accounting **Separate project**

Transition - Classification and Measurement

New requirements will generally apply retrospectively…

… with some exceptions and practicability accommodations

Business model assessment

- Made on Date of Initial Application (DIA)

SPPI criterion assessment

- Based on facts & circumstances at time of initial recognition

Equity instruments FVTOCI

- Election made based on facts & circumstances at DIA

Fair Value Option

- Re-opened in some cases based on facts & circumstances at DIA

IFRS 9 – **Key components**

Classification & Measurement Model

Financial assets

- Business model for managing financial assets (Business level)
- Contractual cash flow characteristics (Instrument level)

Financial Liabilities

- Financial liabilities same as IAS 39 except treatment of FV changes in own credit risk

Hedge Accounting

- Hedge accounting more aligned with risk management
- Macro hedge accounting still under discussion by IASB & provides options for IAS 39 to continue to be applied or to adopt IFRS 9 model

Expected Credit Loss (ECL) Model

- ECL rather than incurred credit losses
- Account for either 12 month ECL or life time credit losses depending on credit deterioration from origination
- Inclusion of off-balance sheet exposure
- Inclusion of forward looking macroeconomic overlay

IFRS 9 implemented 2018

IFRS 9 – Classification & measurement model at business level

Models for managing financial assets

Amortised cost	Fair value through OCI	Fair value through P&L (FVTPL)
Held-to-collect business model	**Held-to-collect & sell business model**	**Residual**
▪ Objective to collect contractual cash flows over life of loan ▪ Infrequent or insignificant sales incidental to objective of business model ▪ Sales consistent with objective in response to credit deterioration (sale of NPL assets)	▪ Both collecting contractual cash flows & sales are integral to business model ▪ More frequent &/or significant level of sales (not trading)	• Business model is neither Held-to-collect business model nor Held-to-collect & sell business model ▪ Collection of contractual cash flows are incidental to the objective of the model ▪ Trading, managed on a fair value basis, or maximising cash flows through sale
▪ Retail & Business Banking (e.g. Homeloans & Overdrafts, ▪ Corporate loans ▪ Corporate property finance	▪ Originate to distribute (e.g. securitisations) ▪ Sell-down loan books ▪ Liquid asset portfolio - portion sales are made	▪ Trading books (e.g. Global Markets) ▪ Derivatives ▪ Long-term & short-term insurance businesses

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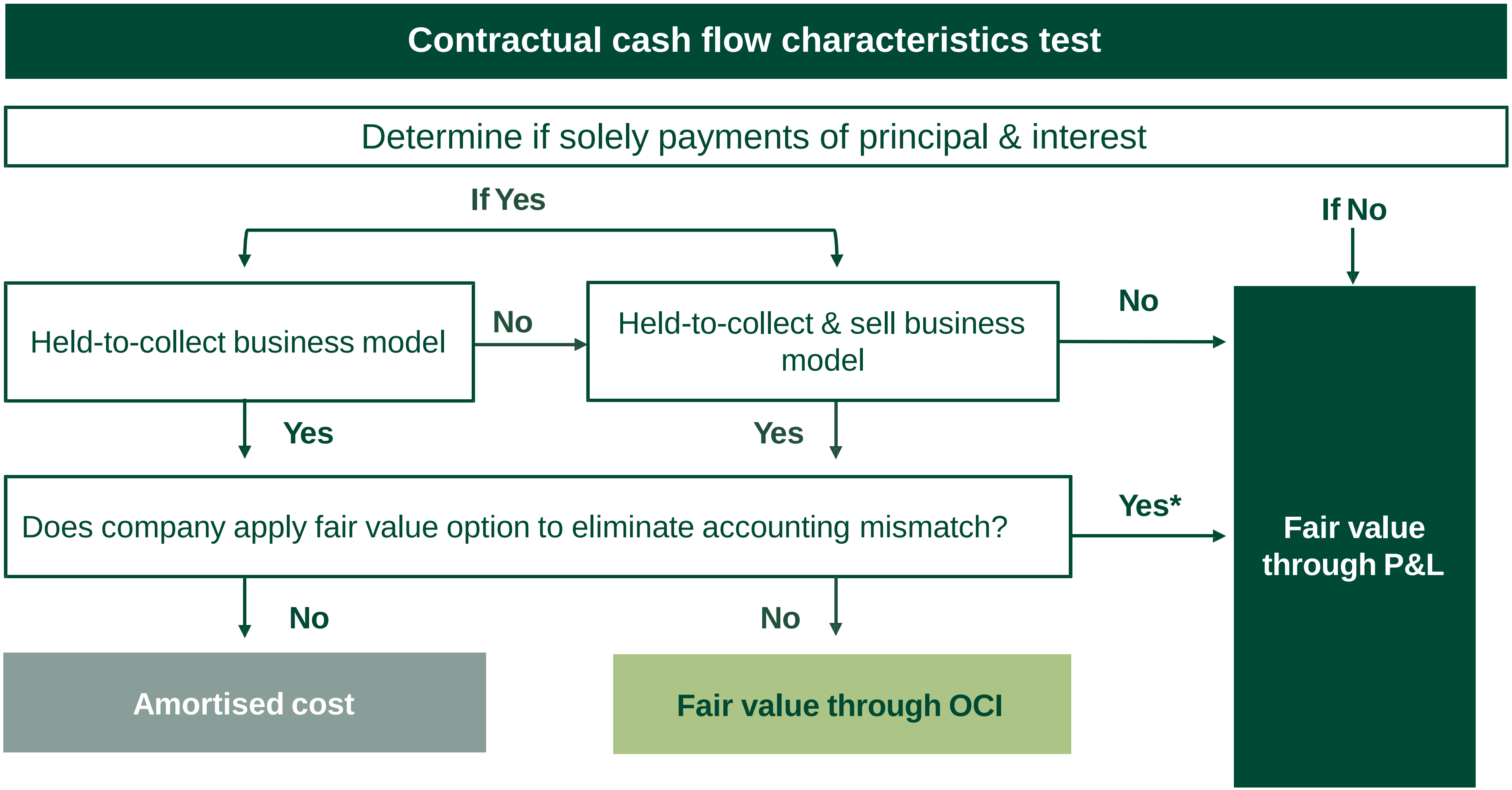
IFRS 9 – Classification & measurement model at financial instrument level



IFRS 9 – **Financial liabilities**

Financial liabilities same as IAS 39 except treatment of FV changes in own credit risk

Financial Liabilities

- **Trading book & derivatives remain FV**
- **Default category for other financial liabilities remains amortised cost, with exception of financial liabilities which is designated at FV (i.e. Fixed rate book)**

Own Credit Risk

- **For financial liabilities designated at FV:**
  - **Marked-to-market to continue & adjustments in FV of 'own credit risk' will be recognised in OCI**
  - **Changes in FV due to other factors (e.g. benchmark interest rate) recognised in P/L**

IFRS 9 – Hedge accounting

Hedge accounting not expected to have material effect

- Current immaterial hedge positions to be in compliance with IAS 39
- Main difference is IFRS 9 eliminates the arbitrary 80% - 125% effectiveness test & aligns hedge designation with risk management practices

IFRS 9 excluded Macro Hedging & allows deferral of hedge accounting

- Macro Hedging allows the hedging of net positions / portfolio positions with derivatives as opposed to current requirements of one-to-one hedging (ie: designated asset/liability and derivative exposure).

- Macro Hedging would be more aligned with risk practices, and could reduce the requirement for designation at fair value of fixed rate book.

- Macro Hedging exposure draft has not been issued and longer road to finalisation

- IFRS 9 allows the deferral of Hedge Accounting (ie continue with IAS 39 principles) until Macro hedging is available so as not to comply with interim measures before Macro Hedging rules are finalised.

IFRS 9 – **Disclosure**

Quantitative

- **Reconciliation of opening to closing amounts of loss allowance showing key drivers of change**
- **Write off, recoveries, & modifications of loan agreements (ie forbearance or restructures)**
- **Reconciliation of opening to closing amounts of gross carrying amounts showing key drivers of change**
- **Gross carrying amounts per individual credit risk grade**

Qualitative

- **Inputs, assumptions & estimation techniques for estimating ECL**
- **Write off policies, modification policies & collateral**
- **Inputs, assumptions & estimation techniques to determine significant increases in credit risk & default**
- **Inputs, assumptions & techniques to determine credit impaired**

- **Significant data required to meet new disclosure requirements**
- **Need to balance between data / compliance reporting vs being useful & meaningful to users of financial statements**
- **Need to consider impacts of OCI movements on key ratios (NAV) & location of fair value reporting in NIR (P/L) & Reserves (OCI).**

IFRS 9 – Alignment to regulatory guidelines

BCBS PRINCIPLES ON ACCOUNTING FOR EXPECTED CREDIT LOSSES

1	A bank's board of directors and senior management are responsible for appropriate credit risk practices, including internal controls to consistently determine allowances
2	A bank should have methodologies for assessing and measuring the level of credit risk on all exposures, with timely measurement of allowances building upon them
3	A bank should have a process in place to appropriately group lending exposures on the basis of shared credit risk characteristics
4	A bank's aggregate amount of allowances, should be adequate as defined by the Basel Core Principles, which is consistent with the objectives of IRFS9
5	A bank should have policies and procedures in place to appropriately validate its internal credit risk assessment models
6	A bank's use of experienced credit judgment, especially in the consideration of forward-looking information and macro-economic factors, is essential to ECL measurement
7	A bank should have, via its credit risk process, a strong basis for common systems, tools and data to assess and price credit risk, and account for ECL
8	A bank's public reporting should promote transparency and comparability by providing timely, relevant and decision-useful information

Source: Basel Committee on Banking Supervision, Consultative Document , *Guidance on accounting for expected credit losses*, paragraphs:
1. 78, 2. A49, 3. A59, 4. 60

IFRS 9 – Practical / system implementation

Changes and enhancements to existing AIRB models, & Data considerations

- Many of the data requirements are similar to that of the Basel models

PD models
- PD term structure to derive lifetime ECL measure
- Calibration periods (prior to macro-economic adjustments) may be shortened to reflect structural changes

High impact

LGD models
- LGD term structure to derive lifetime ECL measure (reflecting future changes in collateral values and EAD)
- Remove downturn adjustments
- Remove costs
- Different discount rates based on effective interest rates
- Balance weighted averages

Impact varies by asset class/product (e.g. high for secured lending)

EAD models
- EAD term structure to derive lifetime ECL measure (reflecting repayments and early settlements)
- Balance weighted averages
- EAD does not need to be floored at current exposure (e.g. instalment products)

Low impact expected

Macro-economic forward looking forecast overlays
(new feature - not allowed for Basel purposes due to TTC/ Downturn regcap requirements)

- Most of the Data requirements are similar
- However, there are some key additional Data requirements for IFRS 9
  - All risk parameters need to be regressed against macro-economic factors to ascertain forward looking macro-economic relationships
  - IFRS 9's lifetime loss feature requires estimates beyond a 12-month time horizon
    - Additional information regarding multi-year default rates or long term depreciation rates (e.g. collateral values for vehicle finance)
  - Other risk information used for (non-Basel) risk management purposes (e.g. clients' prepayment behaviour)

IFRS 9 – Key differences in IFRS 9 requirements

Key parameters	Basel III	IAS 39	IFRS 9
PDs			
Intention of estimate	▪ Average estimate of default within next 12 months	▪ Best estimate of likelihood and timing of credit losses over the loss identification period	▪ **12-month or lifetime ECL** depending on credit quality of the asset (including fully performing loans)
Period of measurement	▪ Long-run historical average over whole economic cycle – TTC	▪ Should reflect current economic conditions – point-in-time (PIT)	▪ Reflects current and **future economic cycles** to the extent relevant to the remaining life of the loan on a PIT basis
LGDs			
Intention of estimate	▪ Average estimate of the discounted value of post-default recoveries	▪ Current estimate of the discounted value of post-default recoveries	▪ Estimate of the discounted value of post-default recoveries. The measurement period is dependent on the relevant performance of the asset
Treatment of collection costs	▪ Recoveries net of direct and indirect collection costs	▪ Recoveries net of direct cash collection costs only	▪ Recoveries net of direct cash collection costs only
Discount rate	▪ Recoveries discounted using the bank's COE	▪ Cashflows discounted using instrument's original effective interest rate	▪ Cashflows are discounted at a discount rate which approximates the original effective interest rate. This discount rate is not changed because of impairment
Period of measurement	▪ Reflects period of high credit losses ▪ dLGDs required	▪ Should reflect current economic conditions – PIT	▪ Reflects current and **future economic cycles** to the extent relevant to the remaining life of the loan ▪ Should reflect current economic conditions (PIT) as well as the expected impact of future macro-economic conditions
EL			
Basis of exposure	▪ **Based on EAD**, which includes unutilised and contingent facilities	▪ Based on actual exposure (on-balance-sheet)	▪ **Based on EAD**, which includes unutilised and contingent facilities

The key difference is moving from a backward-looking "incurred loss" approach to a forward-looking "expected loss" approach

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IFRS 9 – Accounting for the three stage model

Change in credit quality since initial recognition

Stage 1	Stage 2	Stage 3
Recognition of expected credit losses		
12 month expected credit losses (Expected credit losses that result from default events that are possible within 12 months)	**Lifetime expected credit losses** (Lifetime expected credit losses that result from possible default events over the life of the financial instrument)	**Lifetime expected credit losses (100% PD)** (Defaulted loans that result from possible default events over the life of the financial instrument)
Performing (Initial recognition*)	***Underperforming*** (Assets with significant increase in credit risk since initial recognition & not low credit risk*)	***Non-performing*** (Credit impaired assets No significant changes since IAS39)
Portfolio impairments	*Portfolio impairments*	*Specific impairments*
Interest revenue		
Effective interest on gross carrying amount	**Effective interest on gross carrying amount**	**Effective interest on amortised cost carrying amount** (i.e. net of credit allowance)

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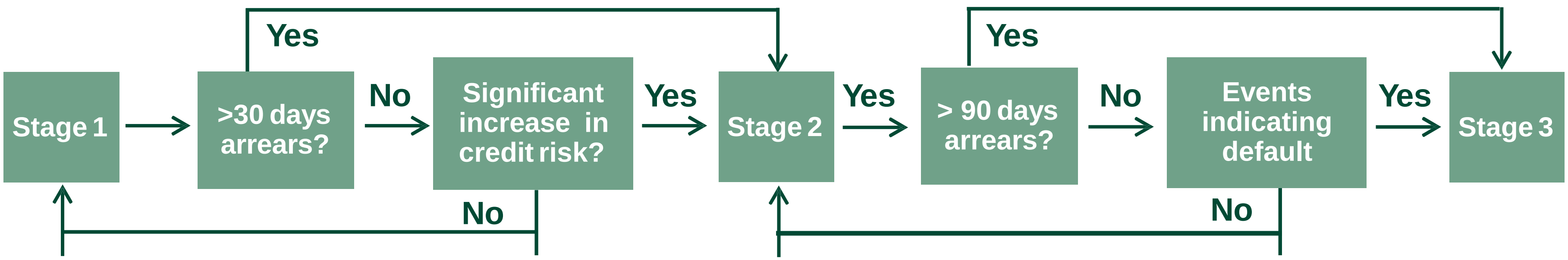
IFRS 9 – **Stage 1 to 2 to 3 migration factors**



Stage 2: Indicators of a significant increase in credit risk

- An increase larger than a specified threshold in the average lifetime PD over the remaining life of the financial instrument
- The lifetime PD shall be adjusted for the macro-economic outlook over the short to medium term (1 to 5 years)
- Credit measures such as warning signals and watch lists in Wholesale result in a reassessment of the credit rating
- A tiered threshold approach based on NGR ratings
- For Retail, delinquency on obligations with Nedbank or on bureau profiles will trigger stage transition

… with 30 days past due rebuttable presumption

Stage 3: Events indicating default

- Bankruptcy or financial reorganisation
- Breach of contract (past due / default)
- Borrower in significant financial difficulty
- Lender concession to borrower
- Disappearance of active market for financial asset
- Purchase of financial asset at deep discount reflecting incurred credit losses

… with 90 days past due rebuttable presumption

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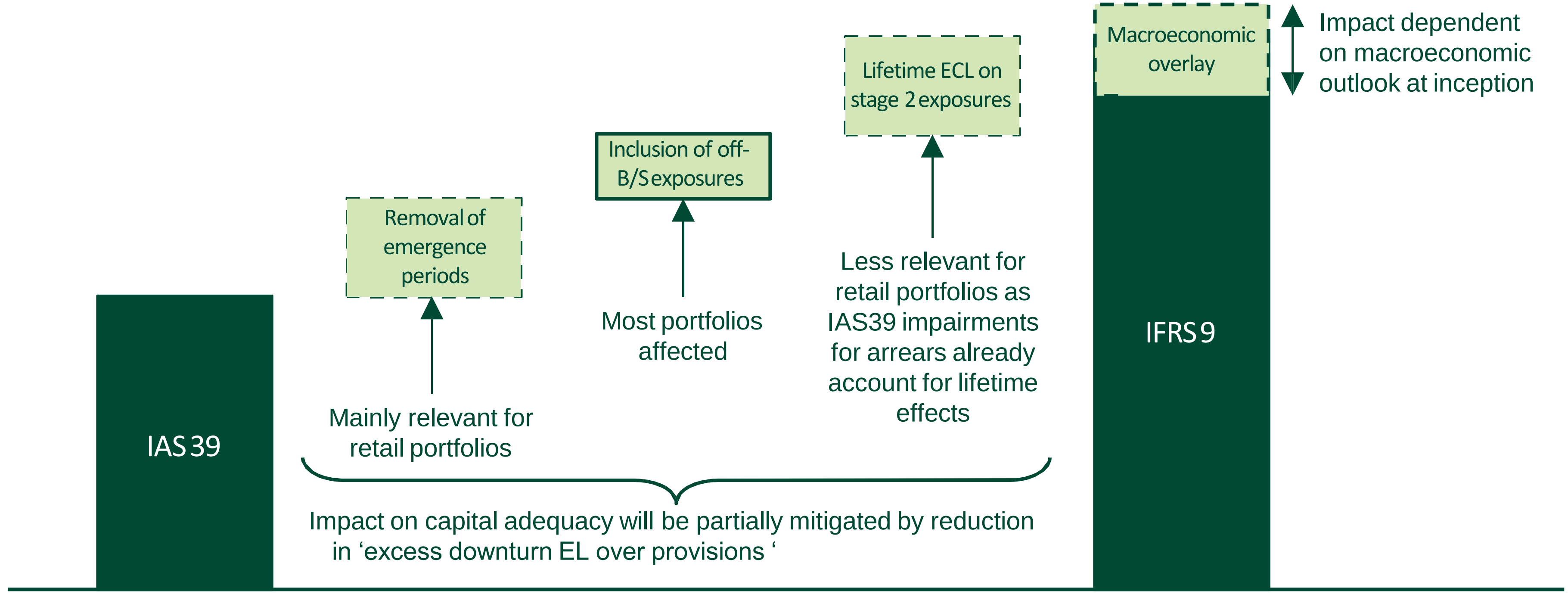
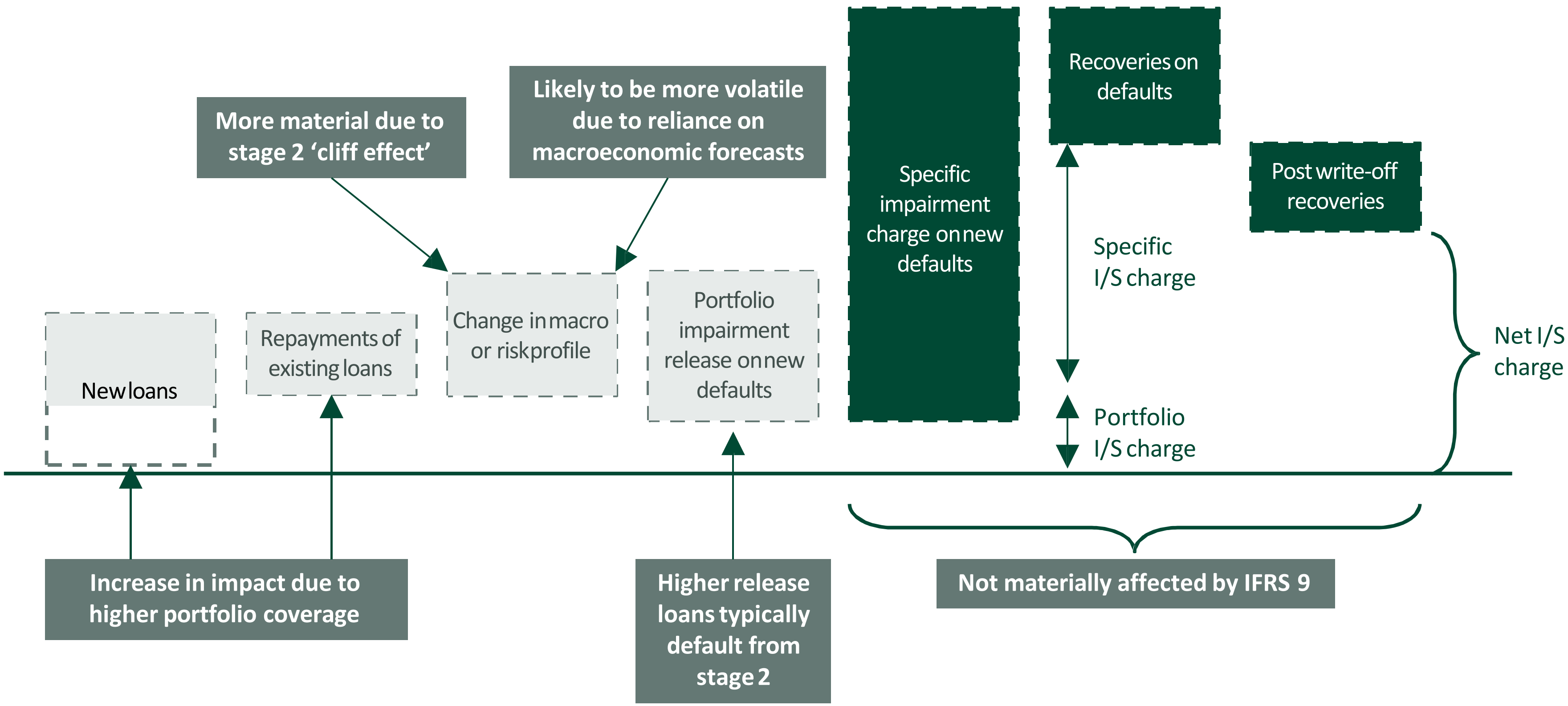
IFRS 9 – Drivers of impact on balance sheet impairments at inception (portfolio impairments)



- IFRS 9 will lead to a general increase in B/S portfolio impairments & hence portfolio coverage
- One-off impact at inception will be taken from reserves such that there is no impact on income statement
- Bank's capital adequacy ratio will only be affected by an increase in balance sheet portfolio impairments in excess of the current capital deduction due to 'excess downturn EL over provisions'
- Actual long run average credit losses will not be affected by IFRS 9 as client defaults & subsequent recoveries are not driven by accounting standards.

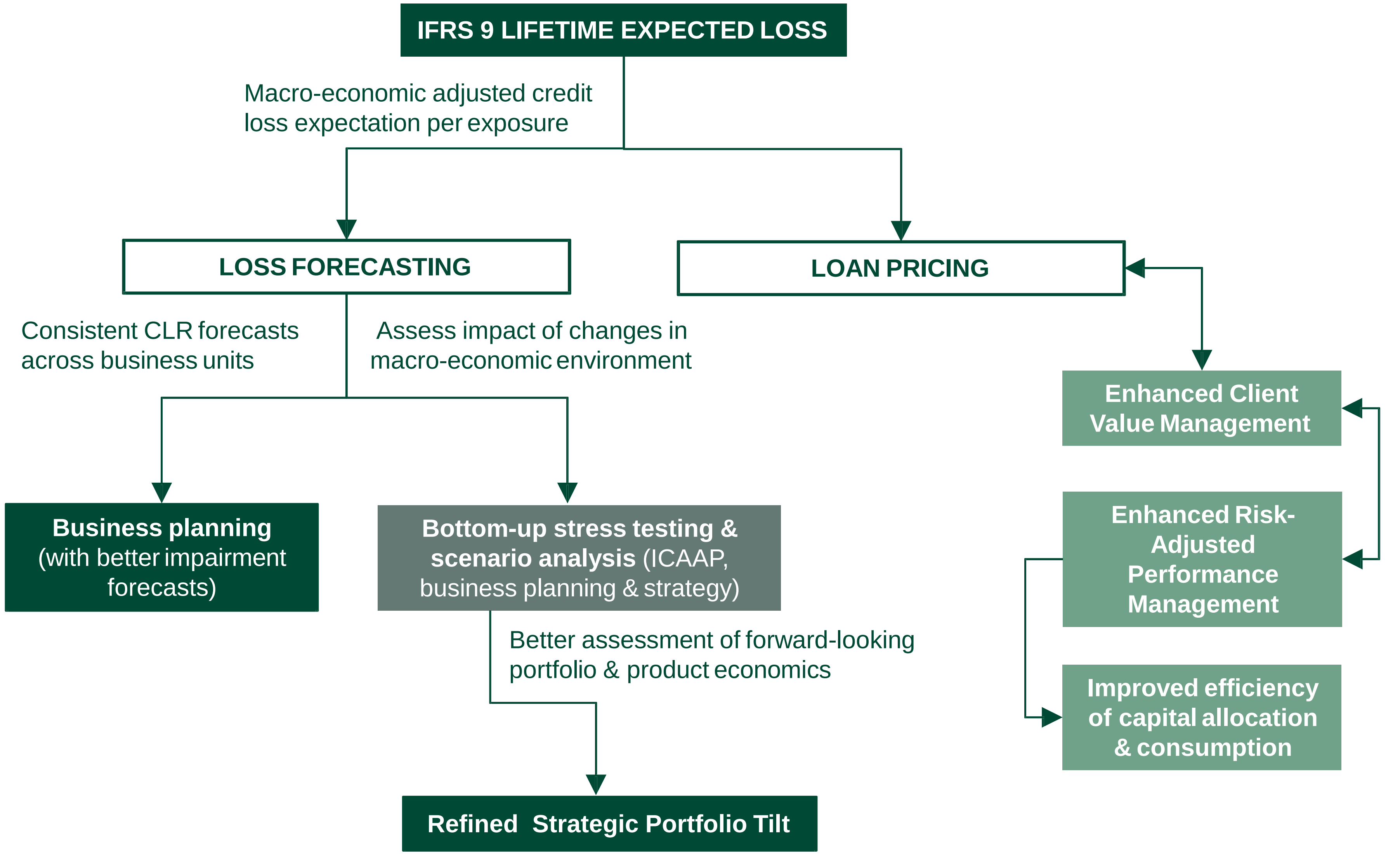
IFRS 9 – Impact on income statement impairments

IAS 39: Build up of annual income statement charge



- Overall income statement impact over life of deal will not change however losses will be recognised earlier with potential increase in earnings volatility
- Some components likely to become slightly more volatile, in particular under changing macroeconomic environments (in both directions).

IFRS 9 – Fundamentally enhance credit risk management & measurement frameworks



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IFRS 9 – **Impairment Focus Areas**

Multiple challenges

1. Impairment Requirements

New general impairment model create the biggest challenge

Change in credit risk

Stage 1 Initial recognition	**Stage 2** Significant increase in credit risk	**Stage 3** Objective Evidence of Impairment

Loss Allowance

1 year EL	**Lifetime EL**

Interest revenue

Gross basis	**Net basis**

Accounting Treatment & Disclosure

Credit risk management

- Assumptions, methodologies, inputs, techniques and policies

Expected credit loss evaluations

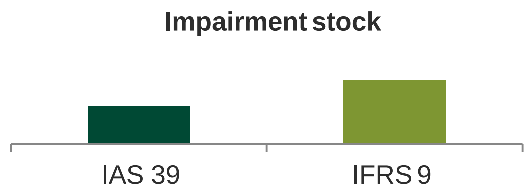
- Movements between stages
- Reconciliations

Credit risk profile

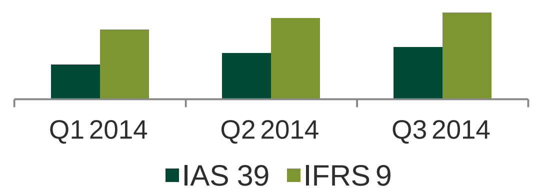
- Increased granularity

2. Financial Impact

Impairment stock anticipated to increase upon transition



Impairment volatility also to significantly increase post transition **Volatility**



Changes require early and ongoing quantitative impact assessment to:

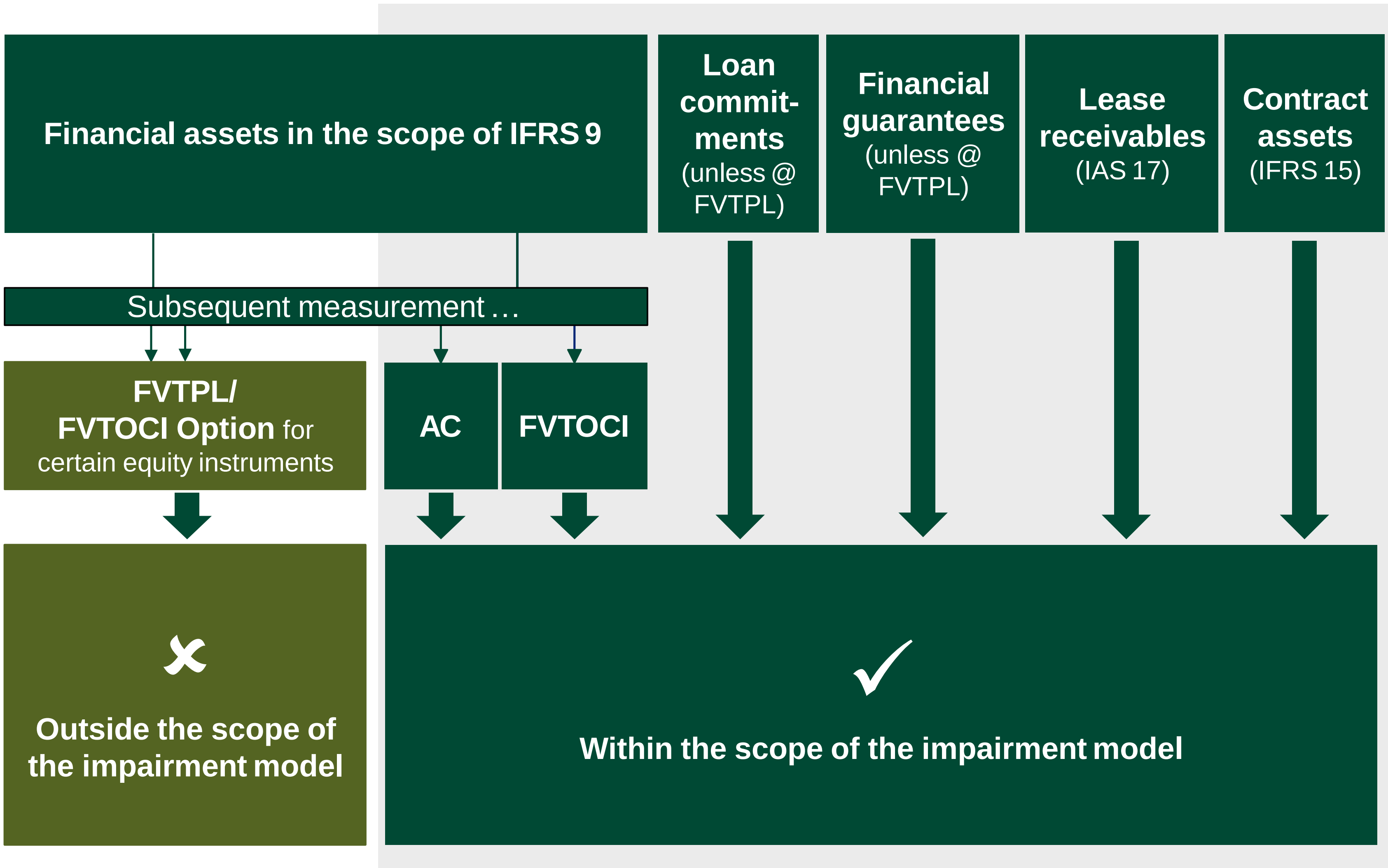
- Prepare communication of change to key stakeholders and
- Inform key design choices including:
  - Model methodology
  - Stage 2 and 3 cut-offs

3. Implementation complexities

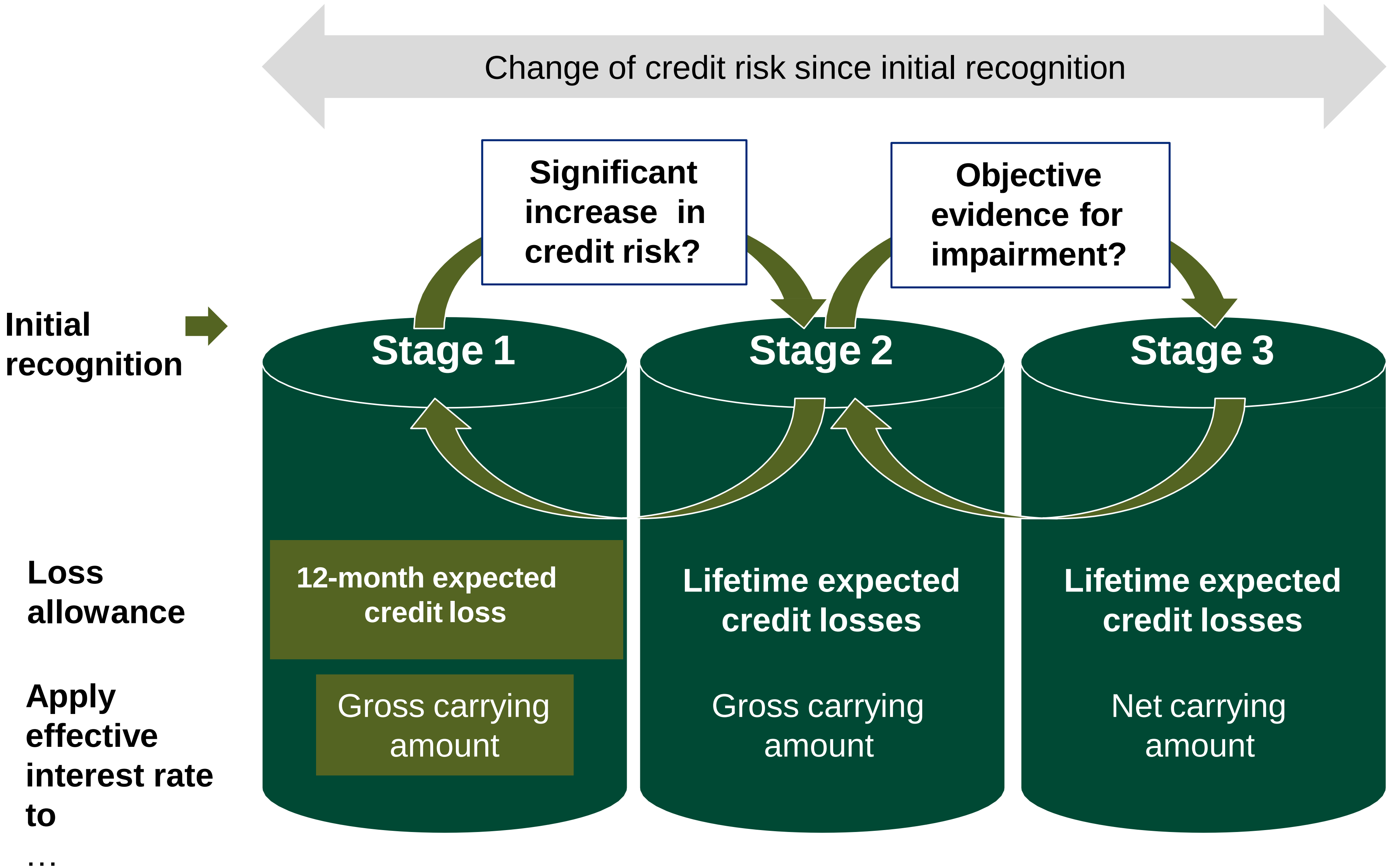
Complex implications across multiple dimensions of the Operating Model.

Models	• Scoring, pricing • PD, LGD EAD • Behavioral lifetime
Data	• Data history • Operational data
IT	• Source systems • Datamarts • Calculators
Controls	• Governance • Model governance • Process controls
Reports	• Internal & external • Quantitative & qualitative
People	• Risk & Finance roles & responsibilities • Skills and resources

IFRS 9 — **Scope**


Financial assets in the scope of IFRS 9
Loan commit-ments (unless @ FVTPL)
Financial guarantees (unless @ FVTPL)
Lease receivables (IAS 17)
Contract assets (IFRS 15)
Subsequent measurement …
FVTPL/ FVTOCI Option for certain equity instruments
AC
FVTOCI
Outside the scope of the impairment model
Within the scope of the impairment model

IFS 9 – Expected Loss Model General impairment model



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IFRS 9 – **Impairment Requirements: Change in credit risk**

Objective Evidence of Impairment - Transfer out of Stage 2

Breach of contract (e.g. past due or default)

Lenders grant a **concession** relating to the borrower's financial difficulty

Significant **financial difficulty** of the borrower

Credit-impaired

= IAS 39

Probable **bankruptcy** or other financial reorganisation

Disappearance of an active market for that financial asset because of financial difficulties

Purchase or origination of a financial asset at a **deep discount** that reflects the incurred credit losses

IFRS 9 – **Impairment Requirements: Loss Allowance**

Measurement of expected credit losses (EL)

Time value of money

Discounted to the reporting date using the effective interest rate at initial recognition or an approximation thereof

Expected value

The estimate shall always reflect:

- The possibility that a credit loss occurs
- The possibility that no credit loss occurs

Cash shortfalls

Shortfalls of principal and interest as well as late payment without compensation

Information

All reasonable and supportable information which is available without undue cost or effort including information about past events, current conditions and forecasts of future economic conditions

Level

Measurement at individual instrument or on portfolio level

Period

Maximum contractual period under consideration (incl. extension options)

IFRS 9 – Impairment Requirements: Loss Allowance

Impairment requirements					
Lifetime .VS. 12 Month ECL					
Years	1	2	3	4	5
Coupon	50	50	50	50	50
Principal					1000
cash flows	50	50	50	50	1050
Effective interest rate	5%	5%	5%	5%	5%
Discount factor	0.95	0.91	0.86	0.82	0.78
LGD	0.60	0.60	0.60	0.60	0.60
EAD	1050	1050	1050	1050	1050
CDS Spreads	1.50%	1.75%	2.00%	2.25%	2.50%
Hazard Rate	2.50%	2.92%	3.33%	3.75%	4.17%
Probability of default	0.025	0.028	0.032	0.034	0.037
Survival probability	0.975	0.947	0.915	0.881	0.844
PD*LGD	1.50%	1.71%	1.89%	2.06%	2.20%
Expected loss	15.75	17.92	19.88	21.62	23.12
PV of EL	15.00	16.25	17.17	17.78	18.11
Life time EL	84.32				
12 Month ECL	15.00				

Impact can be significant for Lifetime ECL

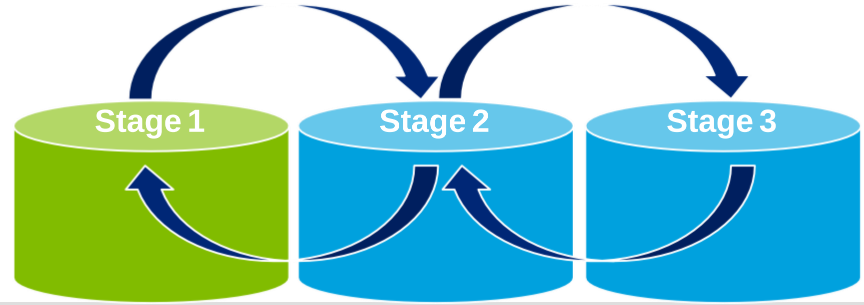
IFRS 9 – **Impairment Requirements: Loss Allowance**

Exemptions from the general model

- Lease receivables
- Contract assets with significant financing component
- Trade receivables with a significant financing component

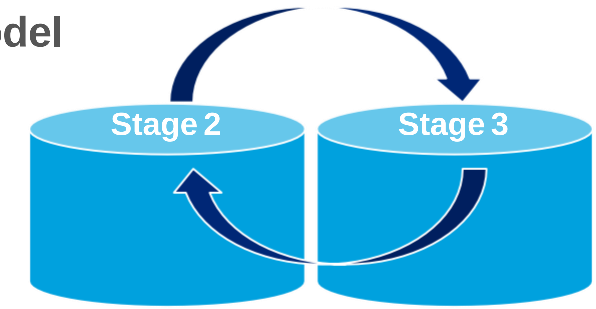
Policy choice

General model



- Contract assets without significant financing component
- Trade receivables without a significant financing component

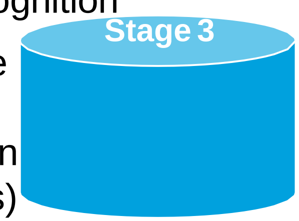
Simplified model



Purchased or originated credit-impaired financial assets

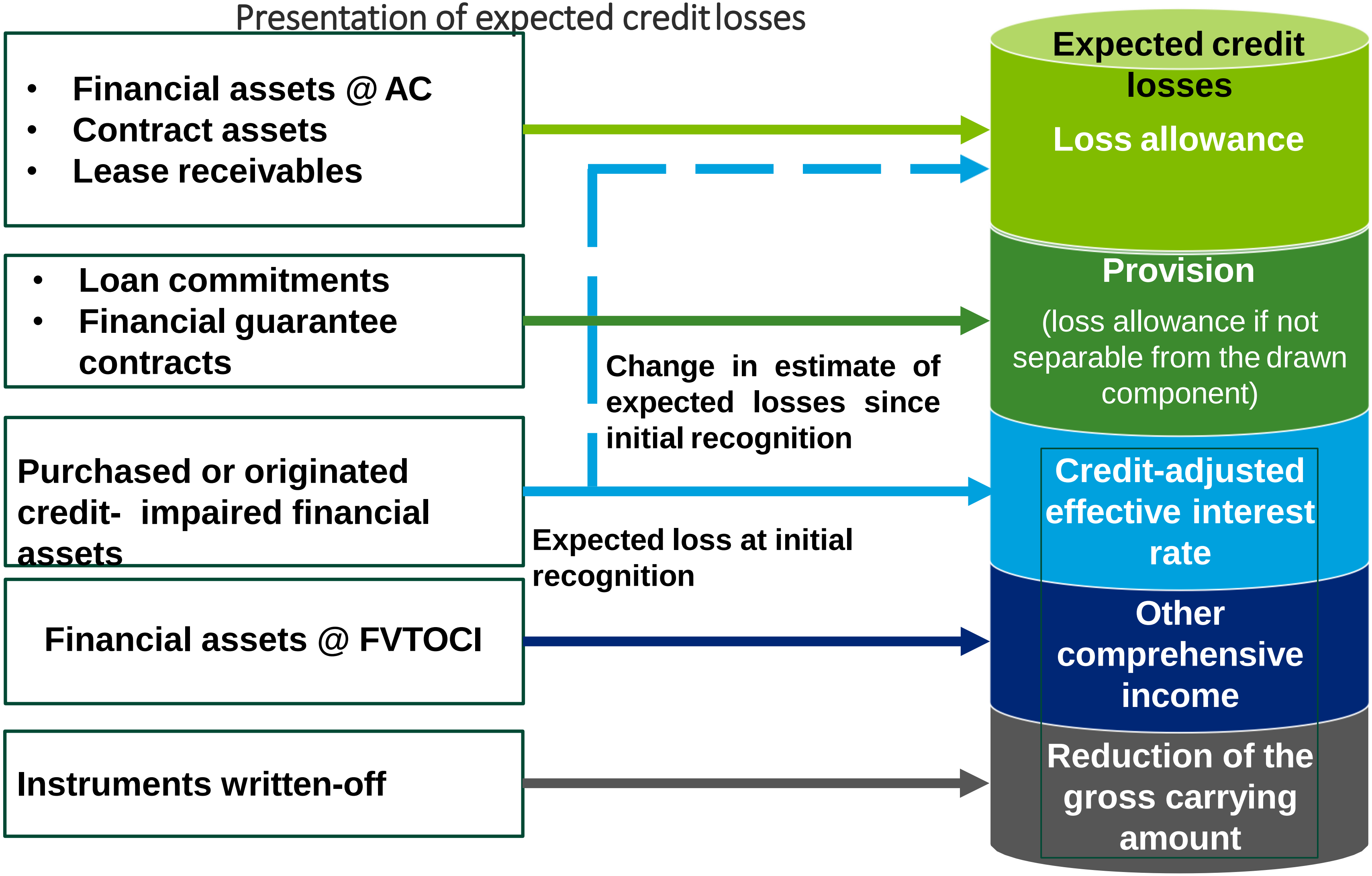
Special provisions

- No loss allowance on initial recognition
- Apply a credit-adjusted effective interest rate (based on the expected cash flows at inception including expected credit losses)



IFRS 9 – **Impairment Requirements: Accounting & Disclosure**

Presentation of expected credit losses



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IFS 9 – Impairment Requirements: Accounting & Disclosure

Impairment requirements					
Lifetime .VS. 12 Month ECL					
Years	1	2	3	4	5
Coupon	50	50	50	50	50
Principal					1000
cash flows	50	50	50	50	1050
Effective interest rate	5%	5%	5%	5%	5%
Discount factor	0.95	0.91	0.86	0.82	0.78
LGD	0.60	0.60	0.60	0.60	0.60
EAD	1050	1050	1050	1050	1050
CDS Spreads	1.50%	1.75%	2.00%	2.25%	2.50%
Hazard Rate	2.50%	2.92%	3.33%	3.75%	4.17%
Probability of default	0.025	0.028	0.032	0.034	0.037
Survival probability	0.975	0.947	0.915	0.881	0.844
PD*LGD	1.50%	1.71%	1.89%	2.06%	2.20%
Expected loss	15.75	17.92	19.88	21.62	23.12
PV of EL	15.00	16.25	17.17	17.78	18.11
Life time EL	84.32				
12 Month ECL	15.00				

	Debit		Credit
	Beginning of the year		
Financial Asset (AC) – B/S	1000		
Cash – B/S			1000
Impairment loss – P/L	15		
Loss Allowance – B/S			15

IFRS 9 – Impairment Requirements:Accounting Disclosure One year later Increase in Credit risk without Lifetime ECL

Impairment requirements				
Lifetime .VS. 12 Month ECL				
Years	1	2	3	4
Coupon	50	50	50	50
Principal				1000
cash flows	50	50	50	1050
Effective interest rate	5%	5%	5%	5%
Discount factor	0.95	0.91	0.86	0.82
LGD	0.60	0.60	0.60	0.60
EAD	1050	1050	1050	1050
CDS Spreads	2.50%	2.75%	3.00%	3.25%
Hazard Rate	4.17%	4.58%	5.00%	5.42%
Probability of default	0.042	0.044	0.046	0.047
Survival probability	0.958	0.914	0.869	0.822
PD*LGD	2.50%	2.64%	2.74%	2.82%
Expected loss	26.25	27.67	28.80	29.64
PV of EL	25.00	25.10	24.88	24.39
Life time EL	99.37			
12 Month ECL	25.00			

	Debit		Credit
	End of the year		
Financial Asset (AC) – B/S	50		
Cash – B/S			50
Impairment loss – P/L	10 =(25-15)		
Loss Allowance – B/S			10

IFRS 9 – Impairment Requirements: Accounting Disclosure
One year later Increase in Credit risk without Lifetime ECL

Impairment requirements				
Lifetime .VS. 12 Month ECL				
Years	1	2	3	4
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Expected loss	26.25	27.67	28.80	29.64
PV of EL	25.00	25.10	24.88	24.39
Life time EL	99.37			
12 Month ECL	25.00			

	Debit		Credit
	End of the year		
Financial Asset (AC) – B/S	50		
Cash – B/S			50
Impairment loss – P/L	84.37 =(99.37-15)		
Loss Allowance – B/S			84.37

IFRS 9 – **Impairment Requirements: Accounting & Disclosure**

The disclosures shall enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows

1

Credit risk management practices and their relation to the recognition and measurement of expected credit losses

2

Evaluation of expected credit loss amounts in the financial statements arising from

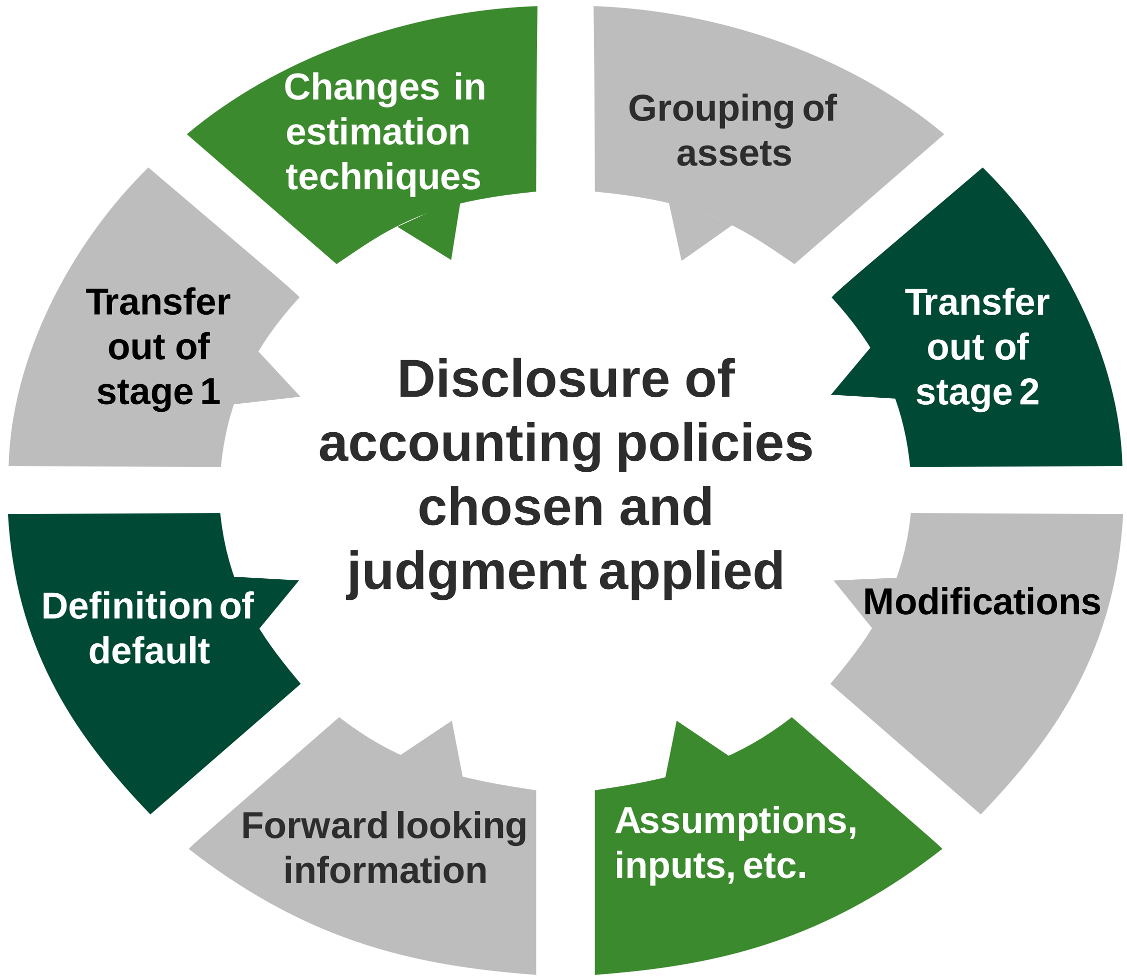
3

Credit risk profile including significant credit risk concentrations

IFRS 9 – Impairment Requirements: Accounting & Disclosure

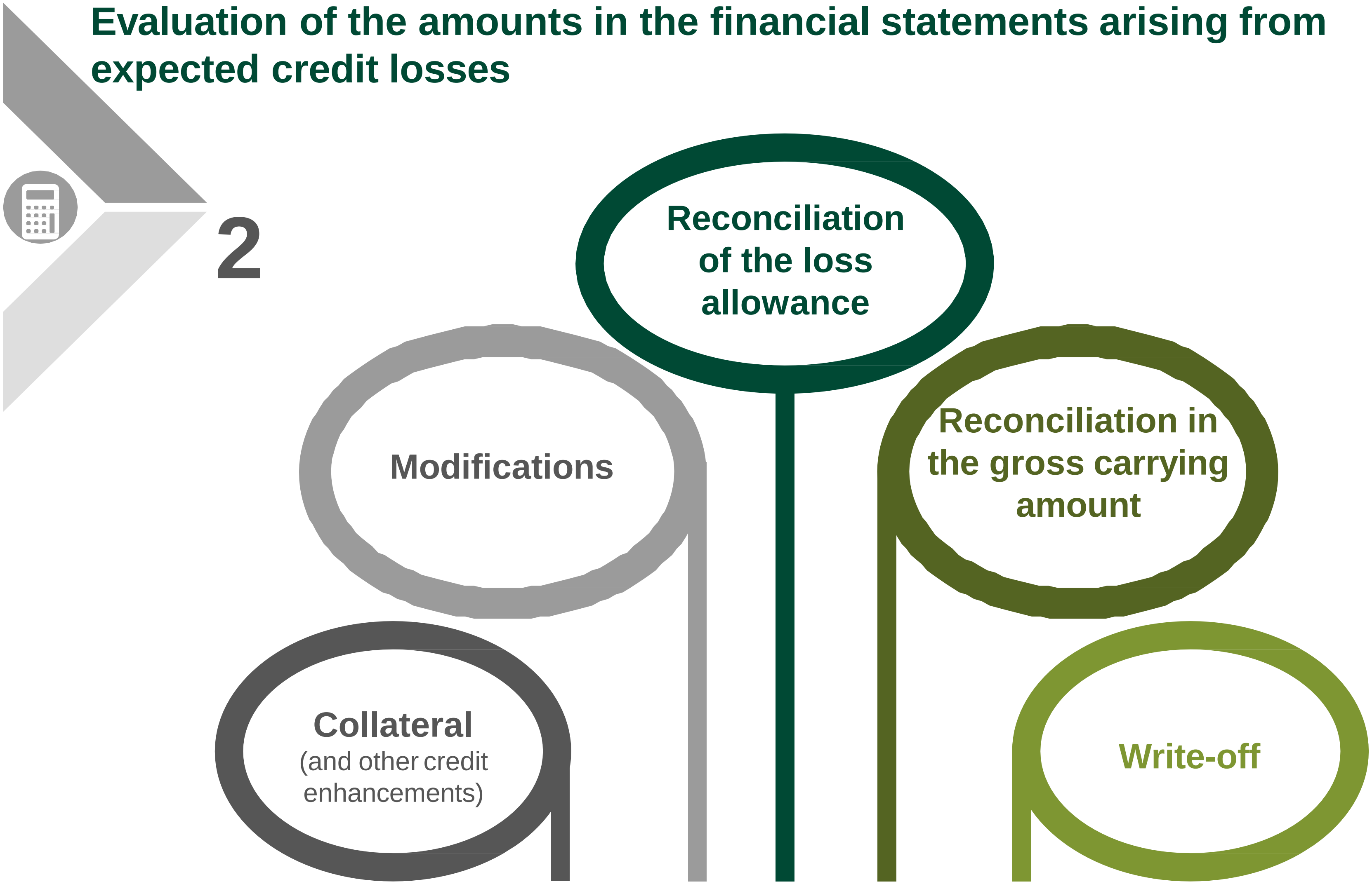
Credit risk management practices and their relation to the recognition and measurement of expected credit losses

1



IFRS 9 – **Impairment Requirements: Accounting & Disclosure**

Evaluation of the amounts in the financial statements arising from expected credit losses



IFRS 9 – Impairment Requirements: Accounting & Disclosure

An entity‘s credit risk profile including significant credit risk concentrations

3

Credit risk exposure

Disclose by credit risk rating grade

- The gross carrying amount of financial assets
- The exposure to credit risk on loan commitments and financial guarantee contracts

Significant concentrations of credit risk by for example:

- Loan-to-value groupings
- Geographical concentrations
- Industry concentrations

IFRS 9 – Impairment Requirements: Accounting & Disclosure

Illustrating the application of the reconciliation of the loss allowance

Mortgage loans - loss allowance	Stage 1 12-month EL	**Stage 2** (collectively assessed)	**Stage 2** (individually assessed)	**Stage 3**
Loss allowance as at 01. January	**X**	**X**	**X**	**X**
Changes du to financial instruments recognised as at 01. January:				
-Transfer to stage 1	X	(X)	(X)	--
- Transfer to stage 2	(X)	X	X	--
- Transfer to stage 3	(X)	--	(X)	X
-Financial assets that have been derecognised during the period	(X)	(X)	(X)	(X)
New financial assets originated or purchased	--	--	--	X
Write-off	--	--	(X)	(X)
Changes in models/risk parameters	X	X	X	X
Foreign exchange and other movements	X	X	X	X
Loss allowance as at 31. December	**X**	**X**	**X**	**X**

Questions & Answers