IFRS 9 - NEW ACCOUNTING MODEL FOR FINANCIAL INSTRUMENTS
(To Replace IAS-39)

Venue: Crystall Ball Room – Marriott Hotel Karachi
11th February 2019

Arslan Khalid
February 2019
Agenda

► Reasons for replacement of IAS-39

► IFRS-9 – Classification and Measurement of financial instruments

► IFRS 9 Impairment Model for Financial Assets

► Basel III- Regulatory treatment of accounting provisions

► IFRS 9 Governance and Implementation - Challenges and Guidance
The criticism on IAS-39, in brief:

- **Fair value accounting** was said to have created cycles of accounting write downs and distressed selling of assets during the Crisis.

- The application of IAS-39 impairment model for loan loss provisions results in delayed recognition of credit losses.

- The **over complexity of IAS-39** such as mixed valuation models, multiple impairment approaches, complicated category transfer rules and hedge accounting requirements.
In view of above criticism, IASB received calls to reduce the complexity of accounting standards for financial instruments from G-20, the Financial Stability Board, the European Union and regulators and other stakeholders from around the world.

The work on IFRS 9 started in 2009 and after 5 years of extensive technical work and stakeholders consultations, the final standard was issued in July 2014.
Adoption of IFRS 9 in Pakistan

► As per IASB, IFRS 9 is effective for accounting periods beginning on or after 1 January 2018.

► SECP has notified IFRS as part of approved financial reporting standards applicable in Pakistan for accounting periods beginning on or after 1 July 2018.

► SBP is expected to issue instructions specifying the applicability date for Banks, DFIs and MFIs.
IFRS 9
Classification and Measurement of Financial Assets
Overview
The standard draws distinction between:

- Those instruments that have highly variable cashflows (Equity investments and derivatives); and

- Those instruments that have cashflows which are either fixed or vary only with market interest rates (loan, bonds, simple debt instruments)

For the first category, IASB believe that Fair value is the most appropriate measurement basis.

For the second category, the IASB accepts that a cost-based approach would be feasible especially when they are held to collect contractual cashflows rather than for selling.
Under **SBP directives** debt and equity instruments may be classified in the following **categories**:

- **Held For Trading**
- **Held to Maturity (only for debt)**
- **Available for Sale**

**IAS 39 also allows designation of investments at Fair value through P&L – this category is not used for Banks as per SBP directives**
Under IFRS 9, the classification and measurement of financial assets depends on whether the asset is an equity instrument, debt instrument or derivative.
Classification of Equity Portfolio

In case of non-trading investments classified under FVTOCI category, all fair value changes in there investments will be recognized to Other Comprehensive Income without any transfer of gains and losses to P&L account on:

- Disposal; or
- Impairment

Realized gain / losses on AFS equity investments may no longer be recognized through the P&L account

No exemption for unquoted equity instruments → all equities at fair value
Classification of Debt Portfolio

Debt Instruments

**BUSINESS MODEL ASSESSMENT**

Cash flows are solely payment of principal and interest
(time value of money plus credit risk plus admin cost)

**FAIR VALUE**

Arrangement that are not basic lending arrangements
(such as exposures linked to commodity, equity prices)
Classification of Debt Portfolio (Continued)

Debt instruments
Cash flows are solely payment of Principal and Interest

Business model at portfolio level

- Held to collect contractual cash flows
  - Amortized Cost
- BM to collect cash flows and selling financial assets
  - Fair Value through OCI (with recycling)
- BM is trading of financial assets
  - Fair value through P&L

Fair value through P&L option available on initial recognition
In some cases, an entity may have more than one business model, in which case, the assessment would be made at a portfolio level rather than an entity level.

- Is a matter of fact and not management intention.


- Reclassifications of portfolio is not allowed unless there is a change in business model.
Impact of IFRS 9 on Debt Instruments accounted for under SBP Regulations

- Considering the stringent (SPPI test) of IFRS-9, non-basic instruments such as certain equity-convertible debt instruments will not qualify for ‘Amortized cost’

- Held-for-trading portfolios are expected to be accounted for the same way as currently being treated under SBP Regulations.

- Available-for-sale and Held-to-maturity debt securities - Banks have to assess the business model such as held to meet the liquidity requirements or a target yield OR held to collect the contractual cashflows accordingly measure the instruments at Fair value or Amortized cost
IFRS 9 Impairment
Overview
In response to the reporting issues highlighted by the Global Financial Crisis, a Financial Crisis Advisory Group (FCAG) was set up in October 2008.

The objective of FCAG was to advice IASB and US FASB to bring improvements in the financial reporting standards that could enhance investor confidence in the financial markets.

The FCAG, in its report published in July 2009, identified *delayed recognition of loan losses* as one of the primary weaknesses in the accounting standards and recommended to explore alternatives model which is more forward looking.

**Why the new IFRS 9 Impairment model?**
IFRS 9 Impairment Overview

**IAS 39 IMPAIRMENT**

- **Backward Looking**
  - Based on **Incurred Loss** in reporting period (~ Specific Provisions)
  - Default 1
  - Default 2

- **Provision only on evidence of impairment or incurred loss (practically also for incurred but not recognized)**
- **No day 1 provision for new loans**

**IFRS 9 IMPAIRMENT**

- **Forward Looking**
  - Based on **12 Month Expected Loss** (Stage 1) and **Lifetime Expected Loss** (Stage 2)
  - 12 Month EL
  - EL yr2
  - EL yr3
  - EL yr-n

- **Based on expectation of losses**
- **3-Stage mechanism**
- **Provision required on day 1 for all loans**
Interest income is recognized over the period of the loan on the basis of contractual cashflows (Effective interest method)

Impairment is recognized only when there is a objective evidence of impairment i.e. when a loss event has occurred

It may argued that interest income is overstated in periods before a loss event occurs because it is inherent in the nature of assets that certain credit losses will occur
The impairment requirements applies to debt instruments such as loans, debt securities, bank deposits, lease receivables, loan commitments and financial guarantee contracts.

Under the expected loss model impairment is recognized over the life of assets on the basis of future expected loss events.

In other words, impairment allowance is made even before there any objective evidence of impairment or occurrence of default event.

The scope of impairment requirements, therefore is much broader and are designed to result in earlier recognition of credit losses.

This model will potentially address the concerns about IAS 39 incurred loss model i.e. too little and too late.
Staging of Portfolios for Determination of Credit Loss Provision

The credit risk has increased significantly since initial recognition

1. **Stage 1**
   - **Allowance:** 12-month expected credit losses
   - **Criterion:** Gross carrying amount

2. **Stage 2**
   - **Lifetime expected credit losses**
   - **Criterion:** Gross carrying amount

3. **Stage 3**
   - **Objective evidence of impairment**
   - **Net carrying amount**

If no reasonable expectation of recovery – Write off
Staging Approach

► Information to take into account for assessment of increased credit risk

- Changes in external market indicators – price of borrower debt or equity
- Changes in external credit ratings
- Changes in internal price indicators and credit ratings downgrade
- Changes in operating results
- Adverse changes in business or economic conditions
- Changes in the value of collaterals and repayment behaviour
- Internal watch-list accounts
- 30 days past due rebuttable presumption
ECL Methodology

► An entity’s estimate of expected credit losses must reflect:
  ► the best available information – historical and forward looking
  ► an unbiased and probability-weighted estimate of cash flows associated with a range of possible outcomes (including at least the possibility that a credit loss occurs and the possibility that no credit loss occurs).
  ► the time value of money

► Various approaches can be used.

► For the purposes of estimating ECL, credit exposure may be grouped based on shared credit risk characteristics such as industry, collateral type, nature of facility, credit risk ratings etc. This collective assessment is particularly relevant for retail portfolios.
Elements of Credit Loss Determination

\[ \text{ECL} = \text{PD} \times \text{LGD} \times \text{EAD} \]

Risk Parameters

1. **PD**
   - The probability of defaulting if you haven’t already

2. **LGD**
   - The forecasted economic loss if the default happens

3. **EAD**
   - The forecasted exposure at each point in time

- Discount factor (EIR)
Key Challenges

Exposure at Default (EAD):
- Revocable and Irrevocable commitments
- Credit Conversion Factors Estimation
- Behavioral analysis of revolving facilities

Probability of Defaults (PDs):
- Lack of availability of historical data of 5 to 7 years
- Determination of statistically significant relationship between Macro-economic factors and defaults ratio

Loss Given Default (LGD):
- Economic LDG rather than collateral based LGD
- Lack of availability of historical recovery data for credit portfolio to compute workout LGD
- Allocation of collateral amongst facilities
- Discounting of future cash flows
Business Impact

► Aim to reduce volatility in profits, however, may
  ► Reduce profitability for expanding loan booked in earlier year.
  ► Result in larger losses in periods with significant changes in future credit loss expectations (may be more pro-cyclical)

► Significant system changes required due to:
  ► Complexity in computing effective credit losses on a continuous basis
  ► Extensive disclosures require data and analysis and hence a need to gather such data through the accounting system
Potential benefits

► Recognition of loan losses **promptly** as the credit risk increases – bad credit decisions to be visible soon

► Would enhance the focus on the effectiveness of **credit risk management systems** implemented by the banks – to result in improvements in internal credit rating systems and processes

► **Credit pricing** / lending rates expected to reflect credit risk premiums that are measured in a systematic way

► Banks with **better credit risk management** would be able to reflect the same in the financial performance

► The loan loss model would be in line **with the international standards** and Basel requirements
Basel III - Regulatory Treatment of Accounting Provisions
The IRB regulatory EL estimates use a 12 month ECL. IFRS 9 uses a 12 month ECL in Stage 1 and a lifetime ECL in Stages 2 and 3.

The Basel loss estimates are based on loss severity experienced during economic downturn conditions while accounting models represent a neutral estimate based on expected economic conditions.

Given the above differences, it is possible that accounting ECL could be higher or lower than regulatory EL.
The Basel Committee is supportive of the ECL provisioning approach and has considered implications on regulatory capital.

The Basel Committee intends to harmonize regulatory treatment of accounting provisions for capital adequacy purposes, which may result in Standardized EL component under the Standard Credit Risk Approach.

The Basel Committee has recently released a consultative document on the policy considerations related to the regulatory treatment of accounting provisions under the Basel III capital framework.
Key Considerations for IFRS 9 implementation

- Governance – policies, systems and oversight
- Operational requirements of the Expected Credit Loss model – historic data and systems
- Impact on current NPL provisions
- Impact on the Capital Adequacy ratios
- Treatment of IFRS 9 loan loss provisions for tax purposes
- Cost of compliance with IFRS 9
IFRS 9 is **not a rule-based standard way of computing loan loss provisions** and therefore, banks depending upon their sophistication, may use **different approaches** to be compliant with the principles set out by the standard.

The policies adopted, methodologies applied and the processes followed should be adequately documented and approved at the appropriate levels of management.

Requires engagement of risk management, finance and IT departments with the oversight of CEO, CFO and the audit committee of the Board.

**Extensive disclosures** to be made in the financial statements.
Thank You