IFRS 9 & KEY CHANGES WITH IAS 39

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The introduction of new requirements in IFRS 9 *Financial Instruments* will be a significant change to the financial reporting of banks. It will impact many stakeholders including investors, regulators, analysts and auditors. Given the importance of banks in the global capital markets and the wider economy, the effective implementation of the new standard has the potential to benefit many. Conversely, a low-quality implementation based on approaches that are not fit for purpose has the risk of undermining confidence in the financial results of the banks.

The International Accounting Standards Board (IASB) published the final version of IFRS 9 Financial Instruments in July 2014. IFRS 9 replaces IAS 39 Financial Instruments: Recognition and Measurement, and is effective for annual periods beginning on or after January 1, 2018. Earlier application is permitted. The new standard aims to simplify the accounting for financial instruments and address perceived deficiencies which were highlighted by the recent financial crisis.

Time is running out. Banks that report under IFRSs must apply IFRS 9 *Financial Instruments* in their 2018 financial statements. To be ready, banks must complete a large multi-disciplinary project combining the skills of finance, risk and IT. The project will require strong governance and internal controls to give all stakeholders confidence in resulting financial information. For many banks, the adoption of expected credit loss accounting will be the most momentous accounting change they have experienced, even more significant than their transition to IFRSs.

The **key changes** between IFRS 9 and IAS 39 are summarized below.

Changes in Scope

- Financial instruments that are in the scope of IAS 39 are also in the scope of IFRS 9. However, in accordance with IFRS 9, an entity can designate certain instruments subject to the own-use exception at fair value through profit or loss (FVTPL); hence, IFRS 9 will apply to these instruments.
- The IFRS 9 impairment requirements apply to all loan commitments and contract assets in the scope of IFRS 15 Revenue from Contracts with Customers.

Changes in Classification and Measurement

- The classification categories for financial assets under IAS 39 of held to maturity, loans and receivables, FVTPL, and available-for-sale determine their measurement. These are replaced in IFRS 9 with categories that reflect the measurement, namely amortized cost, fair value through other comprehensive income (FVOCI) and FVTPL.

- IFRS 9 bases the classification of financial assets on the contractual cash flow characteristics and the entity's business model for managing the financial asset, whereas IAS 39 bases the classification on specific definitions for each category. Overall, the IFRS 9 financial asset classification requirements are considered more principle based than under IAS 39.
- Under IFRS 9, embedded derivatives are not separated (or bifurcated) if the host contract is an asset within the scope of the standard. Rather, the entire hybrid contract is assessed for classification and measurement. This removes the complex IAS 39 bifurcation assessment for financial asset host contracts.
- Under IAS 39, derivative financial assets/liabilities that are linked to, and settled by, delivery of unquoted equity instruments, and whose fair value cannot be reliably determined are required to be measured at cost. IFRS 9 removes this cost exception for derivative financial assets/liabilities; therefore, all derivative liabilities will be measured at FVTPL.
- IAS 39 allows certain equity investments in private companies for which the fair value is not reliably determinable to be measured at cost, while under IFRS 9 all equity investments are measured at fair value
- For certain financial liabilities designated at FVTPL under IFRS 9, changes in the fair value that relate to an entity's own credit risk are recognized in other comprehensive income (OCI) while the remaining change in fair value is recognized in profit or loss. Exceptions to this recognition principle include when this treatment creates, or enlarges, an accounting mismatch and also does not apply to loan commitments or financial guarantee contracts designated as FVTPL. In such instances, IFRS 9 requires the recognition of all changes in fair value in profit or loss.
- Reclassification of financial assets under IFRS 9 is required only when an entity changes its business model for managing financial assets and is prohibited for financial liabilities; hence, reclassifications are expected to be vary rare.

Impairment

- IFRS 9 applies a single impairment model to all financial instruments subject to impairment testing while IAS 39 has different models for different financial instruments. Impairment losses are recognized on initial recognition, and at each subsequent reporting period, even if the loss has not yet been incurred.
- In addition to past events and current conditions, reasonable and supportable forecasts affecting collectability are also considered when determining the amount of impairment in accordance with IFRS 9

The impairment requirements under IFRS 9 are significantly different from those under IAS 39. The followings highlights the key differences between the two standards.

IAS 39 Incurred Loss Model

- Delays the recognition of credit losses until there is objective evidence of impairment.
- Only past events and current conditions are considered when determining the amount of impairment (i.e., the effects of future credit loss events cannot be considered, even when they are expected).
- Different impairment models for different financial instruments subject to impairment testing, including equity investments classified as available-for-sale.

IFRS 9 Expected Credit Loss Model

- Expected credit losses (ECLs) are recognized at each reporting period, even if no actual loss events have taken place.
- In addition to past events and current conditions, reasonable and supportable forward-looking information that is available without undue cost or effort is considered in determining impairment.
- The model will be applied to all financial instruments subject to impairment testing.

The general (or three-stage) impairment approach

IFRS 9's general approach to recognizing impairment is based on a three-stage process which is intended to reflect the deterioration in credit quality of a financial instrument.

- Stage 1 covers instruments that have not deteriorated significantly in credit quality since initial recognition or (where the optional low credit risk simplification is applied) that have low credit risk
- Stage 2 covers financial instruments that have deteriorated significantly in credit quality since initial recognition (unless the low credit risk simplification has been applied and is relevant) but that do not have objective evidence of a credit loss event
- Stage 3 covers financial assets that have objective evidence of impairment at the reporting date.

12-month expected credit losses are recognized in stage 1, while lifetime expected credit losses are recognized in stages 2 and 3.

What are 'credit losses'?

Credit losses are defined as the difference between all the contractual cash flows that are due to an entity and the cash flows that it actually expects to receive ('cash shortfalls'). This difference is discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets).

What are '12-month expected credit losses'?

- 12-month expected credit losses are a portion of the lifetime expected credit losses
- they are calculated by multiplying the probability of a default occurring on the instrument in the next 12 months by the total (lifetime) expected credit losses that would result from that default
- they are not the expected cash shortfalls over the next 12 months.

They are also not the credit losses on financial instruments that are forecast to actually default in the next 12 months.

What are 'lifetime expected credit losses'?

Lifetime expected credit losses are the expected shortfalls in contractual cash flows, taking into account the potential for default at any point during the life of the financial instrument.

IFRS 9 draws a distinction between financial instruments that have not deteriorated significantly in credit quality since initial recognition and those that have. '12-month expected credit losses' are recognized for the first of these two categories. 'Lifetime expected credit losses' are recognized for the second category. Measurement of the expected credit losses is determined by a probability-weighted estimate of credit losses over the expected life of the financial instrument. An asset moves from 12-month expected credit losses to lifetime expected credit losses when there has been a significant deterioration in credit quality since initial recognition. Hence the 'boundary' between 12-month and lifetime losses is based on the change in credit risk not the absolute level of risk at the reporting date.

Finally, it is possible for an instrument for which lifetime expected credit losses have been recognized to revert to 12-month expected credit losses should the credit risk of the instrument subsequently improve so that the requirement for recognizing lifetime expected credit losses is no longer met.

What is the definition of "default"

IFRS 9 explains that changes in credit risk are assessed based on changes in the risk of a default occurring over the expected life of the financial instrument (the assessment is not based on the amount of expected losses). 'Default' is not itself actually defined in IFRS 9 however. Banks must instead reach their own definition and IFRS 9 provides guidance on how to do this. The Standard states that when defining default, an entity shall apply a default definition that is consistent with the definition used for internal credit risk management purposes for the relevant financial instrument and consider qualitative indicators (for example, financial covenants) when appropriate. However, there is a 'rebuttable presumption' that default does not occur later than when a financial asset is 90 days past due unless an entity has reasonable and supportable information to demonstrate that a more lagging default criterion is more appropriate.

Individual or collective assessment for impairment

Depending on the nature of the financial instrument and the information available about its credit risk, it may not be possible to identify significant changes in credit risk at individual instrument level before the financial instrument becomes past due. It may therefore be necessary to assess significant increases in credit risk on a collective or portfolio basis. This is particularly relevant to financial institutions with a large number of relatively small exposures such as retail loans. In practice, the lender may not obtain or monitor forward-looking credit information about each customer. In such cases the lender would assess changes in credit risk for appropriate portfolios, groups of portfolios or portions of a portfolio of financial instruments. Any instruments that are assessed collectively must possess shared credit risk characteristics. This is to prevent significant increases in credit risk being obscured by aggregating instruments that have different risks. When instruments are assessed collectively, it is important to remember that the aggregation may need to change over time as new information becomes available.

Collateral

While the existence of collateral plays a limited role in the assessment of whether there has been a significant increase in credit risk, it is very relevant to the measurement of expected credit losses. IFRS 9 states that the estimate of expected cash shortfalls reflects the cash flows expected from collateral and other credit enhancements that are integral to the instrument's contractual terms. The estimate of expected cash shortfalls on a collateralized financial instrument reflects:

- the amount and timing of cash flows that are expected from foreclosure on the collateral
- less the costs of obtaining and selling the collateral.

This is irrespective of whether or not foreclosure is probable. In other words, the estimate of expected cash flows considers both the probability of a foreclosure and the

cash flows that would result from it.
A consequence of this is that any cash flows that are expected from the realization of the collateral beyond the contractual maturity of the contract are included in the analysis. This is not to say that the entity is required to assume that recovery will be through foreclosure only however. Instead the entity should calculate the cash flows arising from the various ways in which the asset might be recovered and assign probability-weightings to those outcomes.

Key Disclosures

The disclosures added to IFRS 7 are intended to enable users of the financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows.

IFRS 7 has been amended to include both extensive qualitative and quantitative disclosure requirements. Some of the more important disclosures include:

Qualitative disclosures

- inputs, assumptions and techniques used to:
  - estimate expected credit losses (and changes in techniques or assumptions)
  - determine 'significant increase in credit risk' and the reporting entity's definition of 'default'
  - determine 'credit-impaired' assets
- write-off policies
- policies regarding the modification of contractual cash flows of financial assets
- a narrative description of collateral held as security and other credit enhancements.

Quantitative disclosures

- reconciliation of loss 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 and modifications
- quantitative information about the collateral held as security and other credit enhancements for credit-impaired assets.

To conclude, the classification and measurement based on IFRS 9 rules will achieve increased comparability internationally in the accounting for financial instruments and paint a fairer picture of the entity's unique risk management policy and strategy.