

IFRS industry insights: Banking and securities sector

Banks required to adopt new expected loss model and changes to financial asset classification

Headlines

- IFRS 9 has a new classification category, fair value through other comprehensive income (FVTOCI), for debt instruments.
- An expected loss impairment model is added to IFRS 9 which will demand the use of different information and data to measure loan loss allowances compared to IAS 39.
- Impairment losses will be recognised sooner than under IAS 39.
- In many cases provisions will be recognised on initial recognition of loan assets leading to a “day-one” provision.

What’s happened?

The International Accounting Standards Board (IASB) has issued the final version of IFRS 9 *Financial Instruments* incorporating amendments to the classification and measurement model for financial assets and a new expected loss impairment model. IFRS 9 is the replacement to IAS 39 *Financial Instruments: Recognition and Measurement* and is effective for reporting periods beginning on or after 1 January 2018, with earlier application permitted (subject to local endorsement requirements).

The project to replace IAS 39 has been undertaken in stages. The IASB first issued IFRS 9 in 2009 with a new classification and measurement model for financial assets followed by requirements for financial liabilities and derecognition added in 2010. Subsequently, IFRS 9 was amended in 2013 to add the new general hedge accounting requirements. The final version of IFRS 9 issued in July 2014 supersedes all those previous versions although they remain available for early adoption for a limited time¹.

Implications for the banking and securities sector

The changes to financial instrument accounting are likely to have the greatest impact on banks and other financial institutions. Below is a high-level discussion of some of the key impact areas arising from the amendments to the classification and measurement model and the new expected loss impairment model. More detailed guidance on the accounting requirements and further resources are also noted.

Amendment to classification and measurement of financial assets

The new FVTOCI classification is a mandatory classification that is applied to assets that pass the contractual cash flow characteristics test but are held within a business model whose objective is achieved by both holding to collect contractual cash flows *and* selling the assets. A fair value option is available on initial recognition as an alternative to FVTOCI if measuring the asset at fair value through profit or loss (FVTPL) would eliminate or reduce an accounting mismatch.

¹ The previous versions of IFRS 9 may be early adopted if the entity’s relevant date of initial application is before 1 February 2015

The contractual cash flow characteristics test is passed if the financial asset solely consists of a return of principal and interest on the principal outstanding. If the financial asset passes this test it will be measured at amortised cost if it is held in a business model that collects contractual cash flows or FVTOCI if the business objective is to both collect the contractual cash flows and sell the asset. If neither business model applies, or the fair value option is invoked, the asset is measured at FVTPL.

Less profit or loss volatility for banks

Compared to the original requirements in IFRS 9, the introduction of the FVTOCI category can result in some of those assets that would have been measured at FVTPL (due to failing the business model test for amortised cost measurement) to be at FVTOCI. This could result in less profit or loss volatility for banks than would have otherwise arisen. For example, liquidity portfolios where frequent and significant sales arise in order to demonstrate the liquidity of the investments would not have met the requirements for amortised cost measurement but could be eligible for the FVTOCI classification.

Analysing business models

Banks will need to distinguish their business models to determine which are those with an objective to “hold to collect contractual cash flows” and which are to “both hold to collect and to sell”. In some cases this may require significant judgment and will need to be tackled early on in the implementation. In particular, if a bank wishes to designate assets that would meet the classification requirements for FVTOCI at FVTPL, it must do so by the date of initial application (i.e. if these assets are identified as meeting the FVTOCI criteria after the date of initial application, the fair value option will no longer be available).

FVTOCI vs AFS

The FVTOCI classification differs from the available-for-sale (AFS) classification under IAS 39 as FVTOCI is not the residual category (instead FVTPL is) and most importantly, expected losses are applied in measuring impairment.

As the AFS classification is used extensively by banks, for example for liquidity portfolios, the impact of this different treatment will need to be considered.

New expected loss impairment model

Wider scope

IFRS 9 introduces a new expected loss impairment model which replaces IAS 39's incurred loss model. It is applied to:

- debt instruments held measured at amortised cost or FVTOCI;
- written loan commitments and written financial guarantee contracts where IFRS 9 is applied (unless they are measured at FVTPL);
- lease receivables within the scope of IAS 17 *Leases*; and
- contract assets within the scope of IFRS 15 *Revenue from Contracts with Customers* (i.e. rights to consideration following transfer of goods or services that the entity has transferred to a customer when that right is conditioned on something other than the passage of time, for example, the entity's future performance).

The main difference in scope to IAS 39 is that certain loan commitments and financial guarantee contracts are assessed for impairment under IFRS 9, rather than IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. This makes sense given loan commitments and financial guarantee contracts are similar and that a forecast credit loss on a potential drawdown on a loan will now be measured the same way as if it is drawn down.

A single model

Furthermore, the single model approach will mean that both debt instruments measured at amortised cost and those measured at FVTOCI will have the same loan loss allowance despite the different measurement basis on the balance sheet. This will result in more comparable loan loss results amongst banks that have similar assets but classified differently between amortised cost and FVTOCI.

Day-one provision

The loan loss allowance is measured one of two ways²:

- 12-month expected loss allowance.
- Lifetime expected loss allowance.

Generally, when a financial asset is first recognised a 12-month expected loss allowance is recognised. Hence, when a bank originates or purchases a loan or debt security measured at amortised cost or FVTOCI a day-one provision with a debit to profit or loss will be recognised. This day-one loss could have a more significant effect on the performance of a bank that is growing its loan book since with more loans being recognised than derecognised, the overall loan loss allowance will increase (everything else being equal). This effect on profit or loss, as well as the impact of reduced net assets, will need to be evaluated for some banks (e.g. the knock-on consequences for regulatory capital, the pricing of loan products and messaging to stakeholders).

² With the exception of purchased credit-impaired assets where expected losses are incorporated into the expected cash flows from which the (credit-adjusted) effective interest rate is derived which is the same treatment as under IAS 39

Monitoring credit risk migration

When there is a significant increase in credit risk the loss allowance moves from a 12-month expected loss allowance to an allowance for lifetime expected losses. This new, earlier, trigger for recognising impairment losses will mean banks will have to establish appropriate systems and processes for identifying when there has been a significant increase in credit risk. This will involve assessing the availability of data and information about the credit risk of the items in scope of the model and also consider how that data and information can be tracked to identify when credit risk has increased significantly from inception of the exposure.

Measuring expected losses

Loss allowances will be measured on a probability-weighted basis, discounted by the effective interest rate (or an approximation thereof), based on information regarding past events, current conditions and a reasonable and supportable forecast of future economic conditions that is reasonably available without undue cost and effort. This measure of the loan loss allowance will again demand the use of data and information not previously used under IAS 39.

As with the data used for monitoring credit risk, much of the necessary information would exist within a bank, however, the challenges will be around the accurateness and reliability of such data given that some will not have been used for accounting purposes (rather they would be used for credit risk management or regulatory reporting).

Transparency

Given the number of judgments and assumptions required to apply the model, IFRS 7 *Financial Instruments: Disclosures* requires extensive disclosures to accompany the accounting. These disclosures will provide transparency on the application of the model and is likely to be used to compare banks' provisioning amongst peers and track changes in provisions from year to year. Therefore the messaging of these enhanced disclosures is likely to require some advance consideration.

Transition

When IFRS 9 is first applied, both the classification and measurement, and impairment requirements are to be applied retrospectively, with an option not to restate prior periods.

In addition to the exception from restating comparatives, if at the date of initial application, determining whether there has been a significant increase in credit risk since initial recognition would require undue cost or effort, a lifetime expected loss allowance is recognised until the financial instrument is derecognised (unless the credit risk is low at the reporting date). The effect of this is that an absolute measure of credit risk at the reporting rate dictates the recognition of lifetime expected losses rather than a relative measure comparing to initial recognition. The practical benefit of this approach for a bank would have to be weighed against the consequence of recognising a higher provision on transition and the burden of having two impairment approaches running parallel for future periods.

Further information

More detailed information on the requirements of IFRS 9 can be found in Deloitte's IFRS in Focus publication, along with video interviews discussing the impact on banks, at www.iasplus.com

Deloitte's Fourth Global IFRS Banking Survey – Ready to Land, capturing the current views of 54 major banking groups on these accounting changes is also available at

<http://www.iasplus.com/en/publications/global/surveys/fourth-global-ifs-banking-survey>

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee (“DTTL”), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as “Deloitte Global”) does not provide services to clients. Please see www.deloitte.com/about for a more detailed description of DTTL and its member firms.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries and territories, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. Deloitte’s more than 200,000 professionals are committed to becoming the standard of excellence.

This communication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively, the “Deloitte Network”) is, by means of this communication, rendering professional advice or services. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this communication.

© 2014. For information, contact Deloitte Touche Tohmatsu Limited.

Deloitte LLP is a limited liability partnership registered in England and Wales with registered number OC303675 and its registered office at 2 New Street Square, London EC4A 3BZ, United Kingdom. Tel: +44 (0) 20 7936 3000 Fax: +44 (0) 20 7583 1198.

Designed and produced by The Creative Studio at Deloitte, London. 37236A