Agenda Paper X

asian-oceanian standard-setters group

THE ELEVENTH ANNUAL AOSSG MEETING

Joining hands in regional cooperation and the development of IFRS

12-13 November, 2019, India

AOSSG FI WG meeting – 11 November 2019
IFRS 9 Financial Instruments Implementation Feedback

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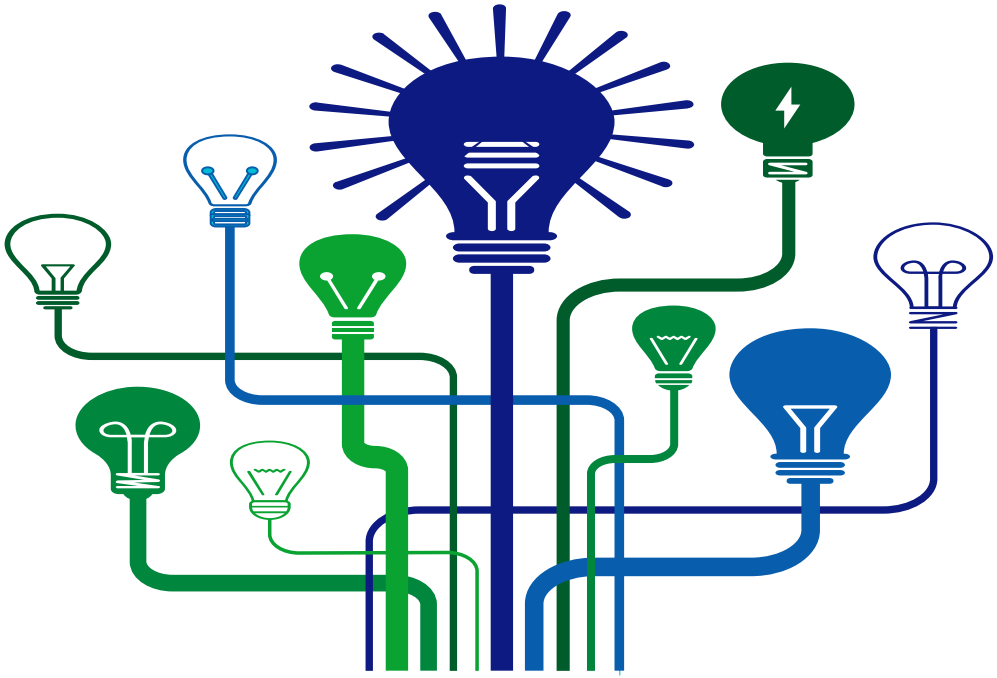
Agenda

- Introduction
- Objective of session
- Overview of changes introduced by IFRS 9
- IFRS IC agenda decisions related to IFRS 9
- Literature review highlights
- Summary of AASB outreach
- Summary of feedback from other jurisdictions:
  - Sri Lanka
  - South Korea
  - Hong Kong
- Q&A

Objective of the session

Share IFRS 9 implementation experience to date

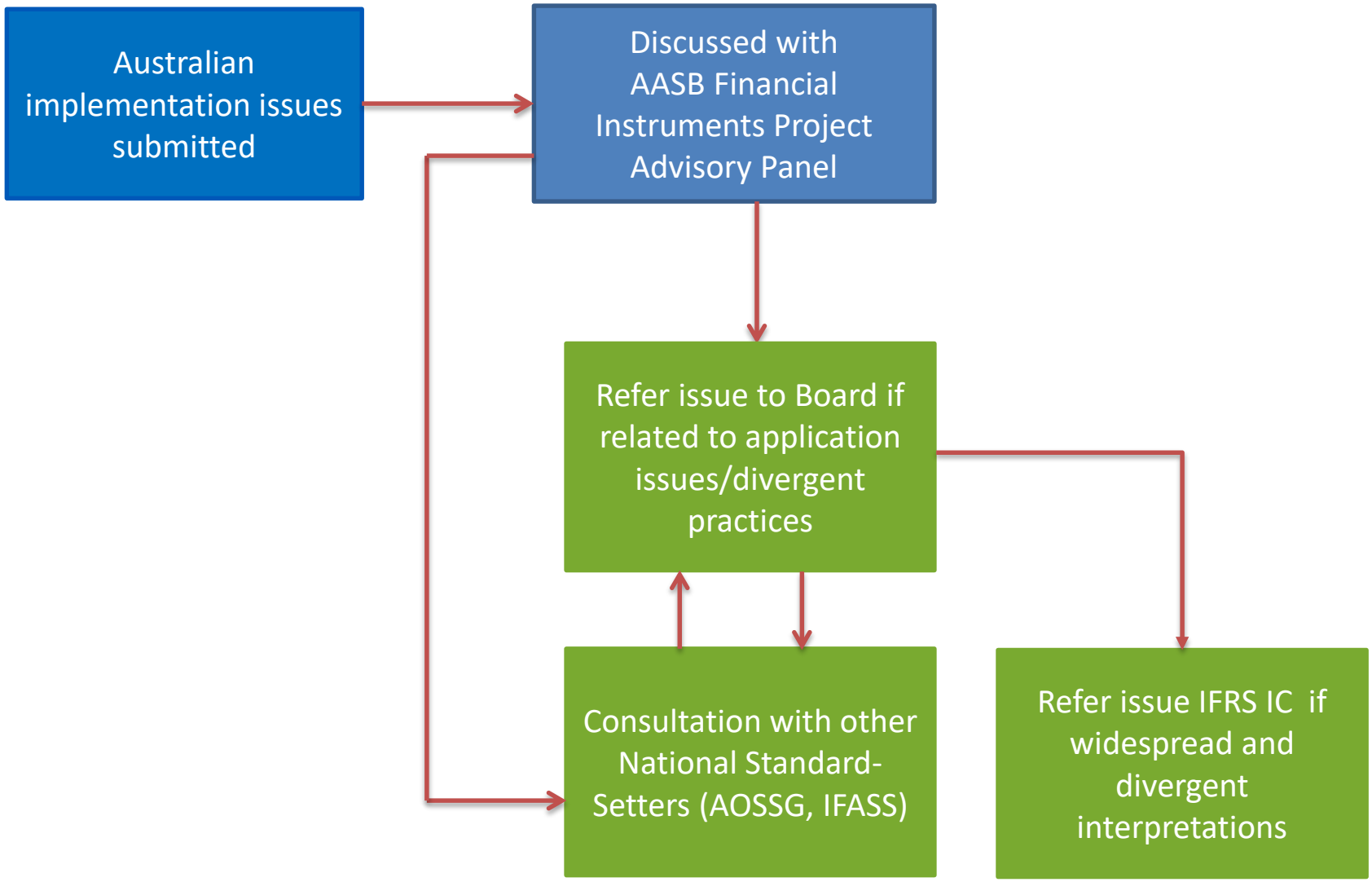


Discussion

Overview IFRS 9 Financial Instruments

- IFRS 9 brought together the classification and measurement, impairment and hedge accounting to replace IAS 39.
- Single classification and measurement approach for financial assets reflecting the business model in which they are managed and their cash flow characteristics
- Forward-looking expected credit loss model that results in more timely recognition of loan losses
- ‘Own credit’ issue addressed
- Improved hedge accounting model to better link the economics of risk management with its accounting treatment

AASB Consultation Process



IFRS IC Agenda Decisions

Financial assets eligible for the election to present changes in fair value in other comprehensive income	Classification of a particular type of dual currency bond	Commodity Loans	Separation of an embedded floor from a floating rate host contract
Derecognition of modified financial assets	Physical Settlement of Contracts to Buy or Sell a Non-financial Item	Credit Enhancement in the Measurement of Expected Credit Losses	Curing of a Credit-impaired Financial Asset
Application of the highly probable Requirement when a Specific Derivative is Designated as a Hedging Instrument	Fair Value Hedge of Foreign Currency Risk on Non-Financial Assets	Determining hedge effectiveness for net investment hedges	Centrally cleared client derivatives

The Committee decided not to add these matters to its standard-setting agenda

Literature Review Highlights

- Majority of research focusing on impairment to date
- More timely & adequate provisions under IFRS 9 compared to IAS 39
- Increased judgement needed
- Mixed signals on pro- and counter-cyclicality

- Increase in provisions but not as severe as some expected
- More assets reported at FVTPL
- Larger impact of ECL on banks using standardized approach compared to internal ratings-based approach
- Majority of banks did not adopt IFRS 9 Hedge Accounting

Highlights from AASB Outreach

- Opportunity to shape governance and culture
- Closer cooperation between risk and finance
- Data and system intensive
- Majority of expectations met, but not all
- Operationalization challenges
- Practical approach to disclosures

AASB outreach – Classification and Measurement

Although the intention of IFRS 9 was to simplify the Classification and Measurement with alignment to the business model, space for interpretation (e.g. which level within the organisation to assess resulting in “dual classification”) and required initial period of education and opinion alignment (e.g. residual business model)

Identification of modifications (and whether substantial) often depending on manual processes

While conceptually an easy concept, in many instances difficult to apply and may be more complex than embedded derivative. Some banks with more assets at FV on Balance Sheet.

Isolation of own credit in OCI for some instruments (e.g. with optionality) complex

Some found scope of contractually-linked instruments guidance challenging to apply

Significant data gathering on transition as not available readily (for SPPI assessment) – e.g. break-cost

Hold to collect & sell can feel very foreign concept to F/O and as a accounting construct (e.g. if managed to amortised cost), thresholds assessed on case-by-case for deciding whether “collect & sell”- includes judgement and difficult to operationalise

AASB outreach – Impairment

Practical approaches to operationalisation of process e.g. overlays over core model

Process of determining ECL data intensive, time consuming and costly. Some leverage of existing capital models, but alignment to financial reporting significant exercise

Operationalizing various interest income calculations (across 3 stages, especially for Stage 3) complex including unwinding of time value of money while using PD/LGD/EAD

Better governance and cultural aspect of getting closer risk management and financial reporting

Important to ensure there is no double up on assumptions (e.g. forward-looking) across core calculations and overlays

While applying new concept of POCI with some distress debt, an impairment gain without previously recognised impairment loss unintuitive outcome

Agreement that impairment model needed revision and the need for more forward looking approach.

Varied impact on banks depending whether IRB or SA as well depending how IBNR concept was implemented under IAS 39

Some non-FS constituents found model too complex and would welcome further "simplications" for non-trade receivables

AASB outreach – Hedge Accounting

IFRS 9 expected benefits largely materialised (aggregated exposures, component hedging, options)

Certain limitations still present (e.g. load-following swaps)

While corporates have adopted IFRS 9, number of banks continue to apply IAS 39

Hedging equity earnings – in associates and JVs still not possible

Disclosures required makes sense from single perspective may not deliver same value from a portfolio perspective.

Sometimes expectation IFRS 9 raised expectations of alignment with risk management – some limitations.

AASB outreach – Disclosures

Limited feedback to date:

- Practical approach to disclosures taken in many cases
- Some requirements underestimated – provisioning matrix, reconciliation from IAS 39 to IFRS 9
- Potentially missed opportunity in some cases to tell the story “why” provisions moved that may become important when the cycle turns

Summary of Feedback from Sri Lanka

Credit Risk Assessment

Product focus vs Borrower focus

- Lack of information for borrower focused risk assessment
- Most other risk assessments are product focused
- Insufficient segmentation of portfolios

Significant Increase in Credit Risk (SICR)

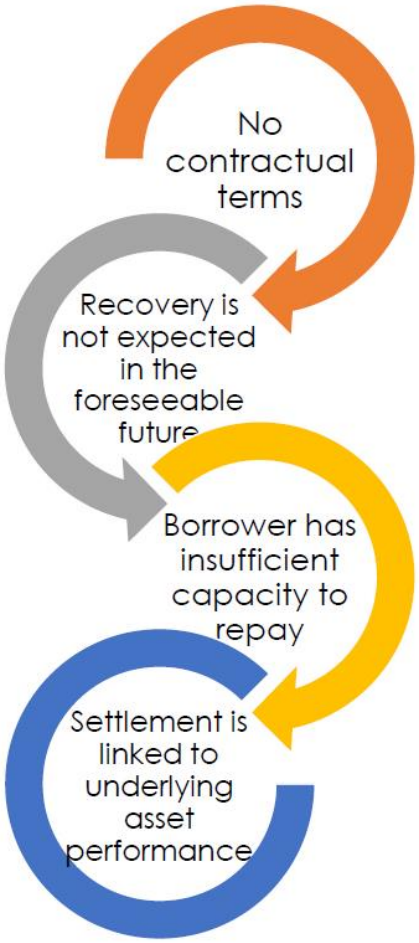
- SICR is based predominantly on past due presumption (30/90 days)
- Micro loans where collections are made daily/weekly basis
- Medium term loans structured with bullet repayment

Consequences

- Borrower focused analysis: only for stage 3 loans
- Pricing does not vary with the risk of the borrowers
- Lack of reasonable and supportable information to rebut presumption

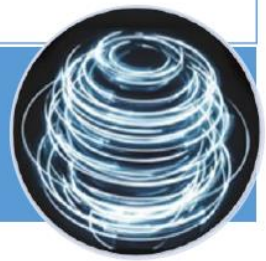
Summary of Feedback from Sri Lanka

Related Party Loans



- Capital contribution (IFRS 10 / IAS 28) vs Financial Asset (IFRS 9)
  - Once classified as equity, it is not expected to be repaid
- Financial Asset….?
  - Impairment - discounting and unwinding
- Repayable on demand….?
  - Capacity to repay on demand
  - Staging

Issues

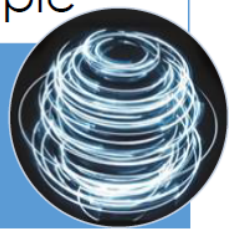


Summary of Feedback from Sri Lanka (Cont.)

Special Cases – Moratorium to Tourism Sector

- With the explosions took place on 21/4, bookings made by tourists got cancelled
- Businesses connected to tourism were negatively impacted
- Servicing of loans were considered difficult
- Government requested all banks to offer moratorium on interest and principle

Issue



- If there is a significant modification to the original cash flows
  - Derecognised and new financial asset – 12M ECL
- If not derecognised: no SICR
- Interest revenue recognized on EIR method during the moratorium period

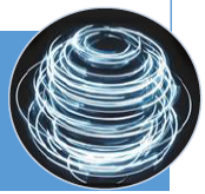
Solution Provided

Summary of Feedback from Sri Lanka (Cont.)

Special Cases – Loans to SME Sector

- Credit management cycle was 150 -180 days
- PDs and LGDs of the sector were comparatively higher
- Reduction of NPL trigger from 150/180 to 30/90 increase ECL
- Financial Institutions were reluctant to extend facilities to SME sector
- Became a political issue

Issue



- Impairment rules were relaxed for loans < LKR 25Mn till mid 2020.
- 30 day rule was extended to 60 days
- Presumption may be rebutted in the first year based on management judgement
- Other relevant risk factors to be considered for SICR

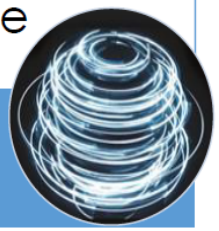
Solution Provided

Summary of Feedback from Sri Lanka (Cont.)

Special Cases – ST Liquidity Support Facilities

- Credit facilities are given to meet short term liquidity requirements
- Often these facilities are rolled over at the end of the period
- Technically past due because of non settlement hence moved to stage 3
- Banks were reluctant to provide these facilities
- Became a political issue

Issue



- Advised to devise the covenants based on the substance
- SICR not considered simply based on the number of days in the rebuttable presumption
- In deciding past due status advised to consider other risk factors without limiting to days overdue

Solution Provided

Summary of Feedback from Hong Kong

Corporates - Key implementation challenges

- **Fair value of unquoted equity instruments**

- IFRS 9 removes the cost measurement basis for unquoted equity investments whose fair value cannot be reliably measured.
- Paragraph B5.2.3 of IFRS 9 requires entities to measure all investments in equity instruments at fair value. Cost may be an appropriate estimate of fair value only in limited circumstances. Paragraph B5.2.4 of IFRS 9 provides examples of indicators that cost might not be representative of fair value.
- Corporates particularly SMEs find it challenging to measure unquoted equity investments at fair value on a recurring basis because:
  - In the absence of active markets and observable inputs for unquoted equity investments, measurements of fair values of unquoted equity investments usually involve level 3 inputs which require entities to exercise significant judgement and incur additional cost and effort; and
  - SMEs usually only hold a minority interest and have limited information to do a valuation on the investee.

Summary of Feedback from Hong Kong (Cont.)

Corporates - Key implementation challenges

- **Expected Credit Loss (ECL)**
  - Finding and using the relevant external and/or forward-looking information that is reasonable and supportable.
  - Determining the appropriate time band and historical loss rates when using a provision matrix for determining the ECL for trade receivables.
  - Disaggregating the investment portfolio appropriately for ECL assessment (some entities only used one loss rate for financial assets with different credit risk characteristics).

Banks – key observations

- Different banks take different views on how assumptions such as 'Brexit' and 'Trade war' would impact the ECL calculation.
- Significant judgement involved in determining what 'significant increase' in credit risk is.
- Important to have enough disclosures about the assumptions used and the judgement involved in determining ECL.
- A high-level review of 2018 financial statements of some larger banks in Hong Kong revealed that disclosures about the assumptions and inputs for ECL are quite comprehensive.

Summary of Feedback from South Korea

SPPI test of specific beneficiary interests in a trust

Beneficiary interests in a trust whose assets are composed entirely of debt securities

- Entity Y purchased a beneficiary interest in a trust whose assets are composed entirely of debt securities (government bonds, etc.)

Previous accounting treatment: Under the previous Standard (IAS 39), such beneficiary interests in a bond type trust were classified as available-for-sale financial assets and changes in fair value were recognized in other comprehensive income (OCI)

Key features of the beneficiary interest in the trust

- Assets of the trust are composed entirely of debt securities such as government bonds
- The trust distributes to the beneficiary its profit, less trust fees
- The profit is distributed in proportion to the share of the beneficiary interest

❶ Is the beneficiary interest in a trust a debt instrument or an equity instrument?
❷ If the beneficiary interest in a trust is a debt instrument, does it meet the SPPI criteria?

Summary of Feedback from South Korea (Cont.)

SPPI test of callable bond

- Entity X acquires a callable bond at face value in which the prepayment option is granted only to the issuer of the bond
- There are two types of premiums for the prepayment feature:
  - ✓ Paying higher interest rates to investors than the non-callable bonds (prepayment amount does not include additional compensation), or
  - ✓ The price of the prepayment option is included in the prepayment amount at termination (the price of the prepayment option agreed by the issuers and the holder is added to the principals and interests due to the holder)
- In general, the price of the prepayment option increases as the maturity of the callable bond increases
- There are conflicting views on what to do with the fair value of the prepayment feature when testing for the SPPI criteria
  - **View 1 The fair value of the prepayment feature is not considered in the SPPI test**
  - **View 2 In order to meet the SPPI criteria, the fair value of the prepayment feature should be considered, an the fair value should be insignificant.**

Should companies always consider whether the fair value of the prepayment feature is insignificant in the SPPI test of callable bond acquired at face value?

Summary of Feedback from South Korea (Cont.)

Accounting mismatch: Own credit risk of financial liability

- Entity X issued a Financial liability A and designated it as measured at FV-PL using the fair value option
  - The change in fair value of Financial liability A caused by the change in own credit risk of Entity X is recognised in other comprehensive income
- Entity X purchases a derivative asset for the purpose of hedging Financial liability A
  - The change in fair value of that derivative asset is recognized in profit or loss

Accounting mismatch

A measurement or inconsistency…that would…arise from measuring assets or liabilities or recognizing the gains and losses on them on different bases (para 4.1.5 of IFRS 9)

Is the above case an accounting mismatch as set out in IFRS 9?

Summary of Feedback from South Korea (Cont.)

Point of initial recognition for rollover loans

- Bank X holds 1-year bullet loan products and they are rolled over every year
- According to the internal criteria of the bank (e.g., whether the customer has a high credit rating), the products are divided into automatic rollovers and counter rollovers*

*****Counter rollover:*** *A certain amount may be required to be repaid for rollover at maturity, and the repayment amount differs for each credit rating. Unlike automatic rollover, counter rollover applies to cases where a change needs to be made in the terms, such as debt-to-income ratio, as a result of the change in the credit rating compared to that at the inception.*

- As for household loans, the bank automatically rolls over the product if certain conditions are met based on the rollover provision in the agreement

(Loan agreement) Rollover provision
➢ **When the terms and conditions for automatic rollover are satisfied** in accordance with the bank's standard, the bank shall **roll over the product and change the interest rate according to the standard set by the bank** without executing a separate agreement on "rollover and change of interest rate". ➢ The bank shall **notify the customer** of the interest rate and maturity date of **the rolled over loan by telephone or in writing within 10 days from the rollover**

Summary of Feedback from South Korea (Cont.)

- Bank X holds 1-year bullet loan products and they are rolled over every year
- At each reporting date, an entity shall assess whether the credit risk on a financial instrument has increased significantly since initial recognition which might have impact on the stage category of the loan. Therefore, determining the point of initial recognition is important when judging significant increase of credit risk.

Is a rollover an issuance of a new financial product or an extension of an existing contract?

Question and Answers

Appendix

IFRS 9 overview

	Overview
Classification & Measurement	• One classification approach • Financial assets are classified in their entirety rather than being subject to complex bifurcation requirements. Criteria used to determine how financial assets should be classified and measured: (a) the entity's business model for managing the financial assets; and (b) the contractual cash flow characteristics of the financial asset
Impairment	• More useful information about an entity's expected credit losses (ECL). • Requires an entity to recognise ECL at all times and to update the amount of ECL recognised at each reporting date to reflect changes in the credit risk of financial instruments. • A forward-looking model and it eliminates the threshold for the recognition of ECL • ECL measurement based on reasonable and supportable information that is available without undue cost or effort, and that includes historical, current and forecast information
Hedge Accounting	• IFRS 9 allows more exposures to be hedged. • Establishes new criteria for hedge accounting that are somewhat less complex
Disclosures	• Significant consequential amendments to IFRS 7 especially in respect of credit risk and expected credit losses.
Transition	• No grandfathering for financial assets and liabilities existing at the date of initial recognition; i.e. the general requirement is that an entity must apply IFRS 9 retrospectively at the date of initial application (other than hedging).

IFRS IC Agenda Decisions

Classification and Measurement

Financial assets eligible for the election to present changes in fair value in other comprehensive income

- The Committee discussed whether particular financial instruments are eligible for the presentation election in paragraph 4.1.4 of IFRS 9. That election permits the holder of particular investments in equity instruments to present subsequent changes in fair value in other comprehensive income, rather than in profit or loss.

Classification of a particular type of dual currency bond

- Committee discussed how a holder would classify a particular financial asset applying IFRS 9.
- A 'dual currency bond' with a par amount denominated in one currency and fixed interest coupon payments denominated in another currency.
- The fixed interest payments are paid annually and the par amount is repaid at a stated maturity date. The submitter asked whether such a financial instrument has contractual cash flows that are solely payments of principal and interest on the principal amount outstanding applying paragraphs 4.1.2(b) and 4.1.2A(b) of IFRS 9.

Commodity Loans

- The Committee discussed how to account for a commodity loan transaction. Specifically, the transaction is one in which a bank borrows gold from a third party (Contract 1) and then lends that gold to a different third party for the same term and for a higher fee (Contract 2).

The Committee decided not to add these matters to its standard-setting agenda.

IFRS IC Agenda Decisions (Cont.)

Classification and Measurement (cont.)

Separation of an embedded floor from a floating rate host contract

- The Committee discussed whether to clarify the application of the embedded derivative requirements of IAS 39 *Financial Instruments: Recognition and Measurement* in a negative interest rate environment.

Physical Settlement of Contracts to Buy or Sell a Non-financial Item

- The Committee discussed how an entity applies IFRS 9 to particular contracts to buy or sell a non-financial item in the future at a fixed price.

Derecognition of modified financial assets

- The Committee discussed whether to undertake a potential narrow-scope project to clarify the requirements in IFRS 9 and IAS 39 about when a modification or exchange of financial assets results in derecognition of the original asset.

The Committee decided not to add these matters to its standard-setting agenda.

IFRS IC Agenda Decisions (Cont.)

Impairment

Credit Enhancement in the Measurement of Expected Credit Losses

- The effect of a credit enhancement on the measurement of expected credit losses when applying the impairment requirements in IFRS 9.
- The Committee discussed whether the cash flows expected from a financial guarantee contract or any other credit enhancement can be included in the measurement of expected credit losses if the credit enhancement is required to be recognised separately applying IFRS Standards.

Curing of a Credit-impaired Financial Asset

- The Committee discussed how does an entity present amounts recognised in the statement of profit or loss when a credit-impaired financial asset is subsequently cured (ie paid in full or no longer credit-impaired).

The Committee decided not to add these matters to its standard-setting agenda.

IFRS IC Agenda Decisions (Cont.)

Hedging

Application of the highly probable Requirement when a Specific Derivative is Designated as a Hedging Instrument

- There is a requirement in IFRS 9 and IAS 39 that a forecast transaction must be 'highly probable' to qualify as a hedged item in a cash flow hedge relationship.
- The Committee discussed how an entity applies that requirement when the notional amount of the derivative designated as a hedging instrument (load following swap) varies depending on the outcome of the hedged item (forecast energy sales).

Fair Value Hedge of Foreign Currency Risk on Non-Financial Assets

- The Committee discussed whether foreign currency risk can be a separately identifiable and reliably measurable risk component of a non-financial asset held for consumption that an entity can designate as the hedged item in a fair value hedge accounting relationship

Determining hedge effectiveness for net investment hedges

- The Committee discussed whether to clarify how an entity should determine hedge effectiveness when accounting for net investment hedges in accordance with IFRS 9. Specifically, when accounting for net investment hedges, an entity should apply the 'lower of' test required for cash flow hedges in determining the effective portion of the gains or losses arising from the hedging instrument.

•Centrally cleared client derivatives

- The Committee discussed whether to clarify the accounting for centrally cleared client derivative contracts from the perspective of the clearing member.

The Committee decided not to add these matters to its standard-setting agenda.

Related Projects

Applying IFRS 9 with IFRS 4 *Insurance Contracts*

- The amendments address concerns arising from implementing IFRS 9, before implementing IFRS 17 Insurance Contracts and supplement existing options in IFRS 4 to address those concerns.

Dynamic Risk Management

- IASB is exploring whether to develop an accounting model that will enable investors to understand a company's dynamic risk management activities and evaluate the effectiveness of those activities.

Fees in the '`0 per cent' Test for Derecognition of Financial Liabilities

- IASB proposes to amend IFRS 9 to clarify the fees that an entity includes when assessing whether the terms of a new or modified financial liability are substantially different from the terms of the original financial liability.

Long-term Interests in Associates and Joint Ventures

- The amendments clarify that a company applies IFRS 9 to long-term interests in an associate or joint venture that form part of the net investment in the associate or joint venture.

Modifications or exchanges of financial liabilities that do not result in derecognition

- At its meeting in July 2017, the IASB affirmed a previous conclusion that further standard-setting is not required.

Prepayment Features with Negative Compensation

- These amendments enable entities to measure at amortised cost some prepayable financial assets with so-called negative compensation

Interest Rate Benchmark Reform

- The amendments are designed to support the provision of useful financial information by companies during the period of uncertainty arising from the phasing out of interest-rate benchmarks such as IBORs

Literature review summary

- banks' loan loss provisions (LLP) are marginally more credit-risk relevant under IFRS 9 and affect to a greater extent the pricing of credit risk for longer CDS maturities compared to the IAS 39, consistent with more forward-looking measure of credit risk.

  (The credit-risk relevance of bank loan loss provisions under IFRS 9: Early evidence, Romain Oberson,2019)

- indications that ECL would have pro-cyclical effects, due to 1) transition from stage 1 to stage 2 and 2) the cyclical evolution of the expected losses parameters (i.e. PDs and LGDs) given a point-in-time approach rather than through-the-cycle one.

  (IFRS 9 Pro-Cyclicality of Provisions. Spanish Banks as an Illustration, Maria Rocamora et al,2018)

- more timely and adequate estimation of credit losses under ECL, however, allows for greater subjectivity and expert judgment (incl. forward-looking information) in its application (which may help to prevent pro-cyclicality).

  (Unveiling The Expected Loss Model In IFRS 9 And Circular 4/2017 , Sanchidrián, J.P and García, C.J.R, 2017)

- relatively large provisioning pro-cyclicality in the euro area and considerable heterogeneity in provisioning suggesting that banks have used material discretion in applying the incurred loss model of loan loss provisioning that is unlikely to be remediated under IFRS 9.

  *(**The Procyclicality of Banking: Evidence From The Euro Area, Huizinga. H and Laeven.L, 2019**)*

- combined effects of eliminating the minimum 'probable' threshold condition together with allowing to incorporate forward-looking information increase both the amount and adequacy of periodic reserve decisions, with the resulting increased earnings management varies across compensation schemes less than predicted.

  (The Efficacy of Replacing the Incurred Credit Loss Model with the Expected Credit Loss Model, Gomaa. M et al, 2017)

- earlier and larger impairment allowances under IFRS 9 more closely aligned with regulatory expected loss, reducing the build-up of loss-overhangs and the overstatement of regulatory capital, however, provides significant room for managerial discretion. Extended disclosure requirements are likely to contribute to more effective market discipline and may enhance financial stability. However, due to the reliance on point-in-time estimates of the main input parameters (probability of default and loss given default) IFRS 9 ECLs will increase the volatility of regulatory capital for some banks.

  (The Interaction of the IFRS 9 Expected Loss Approach with Supervisory Rules and Implications for Financial Stability, Farkas Z.N ,2016)

Literature review summary (cont.)

- IFRS 9 has a considerable impact on the loan loss provision for banks in sample and consequently their capital adequacy.

  (Non-Performing Loans management in the European Banking sector, Georgios. C,2019)

- analysis of Australian banks indicated that banks were already closely aligned with the ECL model before the adoption of IFRS 9. However, significant changes were found in collective provisions upon IFRS 9's adoption, while specific provisions exhibited less change.

  (The Adoption of IFRS 9 by Banks: An Australian Perspective, Niass. J,2019, working paper)

- an increase of the amount of their assets designed at fair value through profit and loss, due to failures in Solely Payment of Principal and Interest test, and a decrease on earnings generated by the implementation of the expected losses-based provisioning.

  (How Do Banks Account For Short-term Effects of IFRS 9? Lejard.C,2016)

- the initial impact of IFRS 9 not as severe as some had expected, increases in provisions of between 16.1% – 58.4% on transition, differing judgements e.g. SICR thresholds implemented, Brexit uncertainties and other overlays and sensitivity analysis disclosures.

  (After the first year of IFRS 9: Analysis of the initial impact on the large UK Banks, Deloitte,2019)

- banks using mainly an Internal ratings-based (IRB) approach experienced a smaller negative impact in terms of the CET1 fully loaded ratio than banks mainly using an SA approach for credit risk, on the transition date. The classification and measurement impact on transition to IFRS 9 seems to be considered relevant only for a minority of banks in the sample. SPPI a limited impact in terms of mandatorily classifying financial instruments in the residual category - fair value through profit or loss (FVPL).

  (First Observations On The Impact And Implementation of IFRS 9 By EU Institutions, EBA,2018)

- 75 entities in the study have opted for exemption from restating the prior year comparative financial information. While this fact provides substantial operational relief to preparers, there would be loss of information about IFRS 9 initial impact on the Income Statement. Further, majority of the entities have chosen to continue to apply the hedge accounting requirements of previous standard IAS 39. Moreover, 72 out of the total sample 75 entities have reportedly based their ECL computations on sophisticated credit risk measurement parameters viz. Probability of Default (PD), Loss Given Default (LGD) and Exposure at Default (EAD).

  (IFRS 9: Financial Instruments A Study: Transition Impact on Banks Across the Globe, ICAI,2019)