IFRS 9 Financial Instruments

Expected Credit Losses

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Overview – IFRS 9 Financial Instruments

2009	2010	2013	2014
▪ Classification & Measurement of Financial Assets	▪ Classification & Measurement of Financial Liabilities ▪ De-recognition	▪ Hedge Accounting	▪ Completed standard ▪ Classification & Measurement of Financial Assets (November 2009 amended) ▪ Expected Credit Loss Impairment Model

Quantitative and Qualitative Disclosures

IFRS 9 (2009), IFRS 9 (2010) and IFRS 9 (2013) are available for early application if date of initial application is before 1 February 2015

Effective 1 January 2018 - early application permitted

Overview – IFRS 9 Financial Instruments

- **Criticism of IAS 39**
  - classification of financial assets – complex and rules based
  - incurred loss model – ‘too little, too late’
  - hedge accounting – rules based and not linked to risk management practices

- **IFRS 9 includes**
  - business model test for classification of financial assets
  - earlier recognition and ongoing assessment of expected credit losses
  - simplification of hedge accounting linked to risk management practices

- More impact on banks, less for non-financial sectors

Summary – Classification of Financial Assets

Business model test

and

Contractual cash flows characteristics

- Hold to collect → Amortised cost
- Hold to collect & sell → Fair value through OCI

Fair value through profit or loss option (for accounting mismatches)

- Held-for-trading
- Assets managed on fair value basis
- Derivatives
- Hybrid debt (host is IFRS 9 financial asset)

→ Fair value through profit or loss

Fair value through OCI option for equity instruments not held-for-trading (irrevocable and no recycling of gains/losses)

Reclassification required when there is a change in the business model

Classification – Financial Assets

Contractual cash flows

- Contractual cash flows are **solely payments of principal and interest on outstanding principal** (SPPI)
- Interest is consideration for:
  - time value of money
  - credit risk
  - basic lending risks
  - costs
  - profit margins

Business model

- **Factors to consider are:**
  - way assets are managed
  - KPIs used for reporting
  - nature of risks and how they are managed
  - management compensation
  - frequency, volume and reasons for sales in prior periods
  - expected future sales activity
- Applied at higher level of aggregation (e.g. business unit or portfolio level)

Financial Assets - Classification and Impairment

Amortised cost	Fair value through OCI	Fair value through profit or loss
Debt instruments (impairment in profit or loss)	Debt instruments (impairment in profit or loss)	Debt instruments
	Equity instruments (no recycling)	Equity instruments
		Others – Derivatives, Hybrid contracts with financial host

- **Banks**: Early recognition of loss allowance on significant assets - loans and other debt instruments at amortised cost / fair value through OCI
- **Non-financial sectors:** Less of these instruments with simplified approach and practical expedients e.g. trade receivables

Expected credit loss (ECL) model

Stage 1	Stage 2	Stage 3
Investment grade asset / Low credit risk	Significant increase in credit risk / Not low credit risk asset anymore	Credit loss is incurred / Asset is credit-impaired
12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Performing	Under-performing	Non-performing

Expected credit loss measurement

- ECLs are probability-weighted estimate of credit losses over the expected life of the financial instrument

  - models to incorporate forward looking information

As the estimation period becomes longer:

- Difficult to forecast future conditions over entire expected life
- May need to develop projections by extrapolation

Expected credit loss measurement

Information that may be used to assess changes in credit risk:

- **Borrower specific**
  - changes in actual or expected operating results of the borrower including due to regulatory or technological changes
  - decrease in value of collateral supporting the obligation
  - increase in credit risk of other financial instruments of the borrower
- **Internal/external factors**
  - changes in internal price indicators of credit risk since inception
  - more active management of the financial instruments by credit risk team
  - changes in rates or terms if asset is newly originated at reporting date (e.g. more stringent covenants due to increase in credit risk)
  - length of time fair value has been lower than amortised cost
  - actual or expected significant change in external credit rating

Expected credit loss measurement

Information that may be used to assess changes in credit risk:

- **Macro-economic data**

- interest rates
- GDP
- unemployment
- real estate price indexes

Need to use reasonable and supportable information that is available without undue cost or effort

Expected credit loss measurement

Default

- Definition consistent with that used for internal risk management
- May use regulatory definition of default
- Rebuttable presumption: Does not occur later than 90 days past due

Consider changes in risk of default

- Relative assessment (e.g. 1% change in risk of a default is more significant if initial risk of a default is 3% as compared to say 15%)
- Default can arise before missed contractual payments (e.g. breach of contractual covenants)
- Rebuttable presumption: Significant increase in credit risk if payments are more than 30 days past due

Simplified approach

Trade receivables / Contract assets (no significant financing component)

- Lifetime ECL

Trade receivables / Contract assets (with a significant financing component)

Policy choice

- Lifetime ECL or
- General approach

Lease receivables

Policy choice

- Lifetime ECL or
- General approach

Lifetime ECL approach allows preparers to avoid calculating 12-month ECL and assessment of significant changes in credit risk

Practical expedients

Trade receivables:

- Use of provision matrix as a practical expedient

Financial assets with low credit risk (Stage 1)

- Measure impairment using 12-month ECL
- No requirement to assess significant increase in credit risk

Simplified approach and practical expedients provide operational simplification in application of impairment model in non-financial sector

Impact of ECL model – Banks v/s Non-financial sectors

Banks	▪ Significant volumes and amounts of mortgages, loans and debt instruments subject to impairment: - varying levels of credit risk - need robust estimates of 12-month and lifetime ECLs - ECLs also measured for some loan commitments and financial guarantee contracts ▪ Incorporation of the ECL approach in comprehensive credit risk management system to include: - data sourcing and controls around the system, and - effective governance of the system
Non-financial sectors	▪ Financial assets subject to impairment: - generally short-term (receivables, debt instruments) - low volumes and amounts compared to banks - may use simplified approach and practical expedients

ECL model – some implementation issues

Planning and execution	Co-ordination between finance, credit risk, IT	Incorporation of ECL approach in credit risk management system
Data availability and quality	Adjust historical data for current and forward looking information	Reconciliation of financial reporting and credit data
Estimates, assumptions and use of judgements	Information (including macro economic data) to use as inputs	Significant increase in credit risk
	More than one credible set of inputs/ assumptions	Quantitative and qualitative disclosures

Auditors will need to assess assumptions and management judgements used to estimate ECLs. This will broaden the scope of audit of estimates to ensure that all reasonable and supportable information is considered.

Questions