IFRS 9

Application to banks

May 2017

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Agenda

Introduce IFRS 9 Financial Instruments as applied to banks

Focus on impairment

Discuss key challenges and milestones

Why is there a new standard?

IFRS 9 was developed largely in response to ***2 concerns raised during the financial crisis***, that:

01 Current accounting (under IAS 39) was extremely complicated, and

02 Losses were recorded by some financial institutions ‘too little, too late’

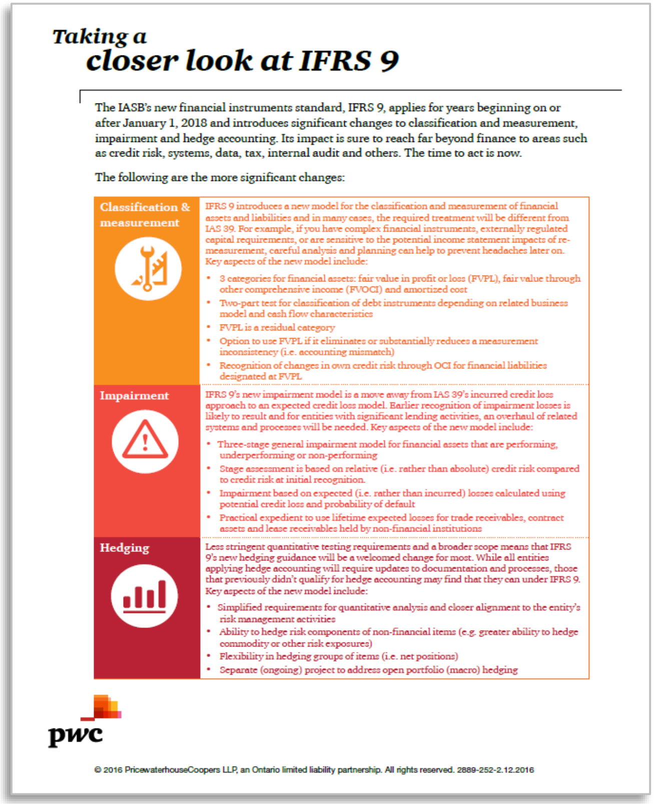
IFRS 9 is ***effective*** for annual reporting periods commencing on or after ***January 1, 2018***.

What’s changing?

IFRS 9 includes changes in 3 key areas:

- Classification & measurement
- Impairment model
- Hedge accounting

Focus today will be primarily on impairment.



Taking a closer look at IFRS 9

The IASB’s new financial instruments standard, IFRS 9, applies for years beginning on or after January 1, 2018 and introduces significant changes to classification and measurement, impairment and hedge accounting. Its impact is sure to reach far beyond finance to areas such as credit risk, systems, data, tax, internal audit and others. The time to act is now.

The following are the more significant changes:

Classification & measurement	IFRS 9 introduces a new model for the classification and measurement of financial assets and liabilities and in many cases, the required treatment will be different from IAS 39. For example, if you have complex financial instruments, externally regulated capital requirements, or are sensitive to the potential income statement impacts of re-measurement, careful analysis and planning can help to prevent headaches later on. Key aspects of the new model include: • 3 categories for financial assets: fair value in profit or loss (FVPL), fair value through other comprehensive income (FVOCI) and amortized cost • Two-part test for classification of debt instruments depending on related business model and cash flow characteristics • FVPL is a residual category • Option to use FVPL if it eliminates or substantially reduces a measurement inconsistency (i.e. accounting mismatch) • Recognition of changes in own credit risk through OCI for financial liabilities designated at FVPL
Impairment	IFRS 9’s new impairment model is a move away from IAS 39’s incurred credit loss approach to an expected credit loss model. Earlier recognition of impairment losses is likely to result and for entities with significant lending activities, an overhaul of related systems and processes will be needed. Key aspects of the new model include: • Three-stage general impairment model for financial assets that are performing, underperforming or non-performing • Stage assessment is based on relative (i.e. rather than absolute) credit risk compared to credit risk at initial recognition. • Impairment based on expected (i.e. rather than incurred) losses calculated using potential credit loss and probability of default • Practical expedient to use lifetime expected losses for trade receivables, contract assets and lease receivables held by non-financial institutions
Hedging	Less stringent quantitative testing requirements and a broader scope means that IFRS 9’s new hedging guidance will be a welcomed change for most. While all entities applying hedge accounting will require updates to documentation and processes, those that previously didn’t qualify for hedge accounting may find that they can under IFRS 9. Key aspects of the new model include: • Simplified requirements for quantitative analysis and closer alignment to the entity’s risk management activities • Ability to hedge risk components of non-financial items (e.g. greater ability to hedge commodity or other risk exposures) • Flexibility in hedging groups of items (i.e. net positions) • Separate (ongoing) project to address open portfolio (macro) hedging

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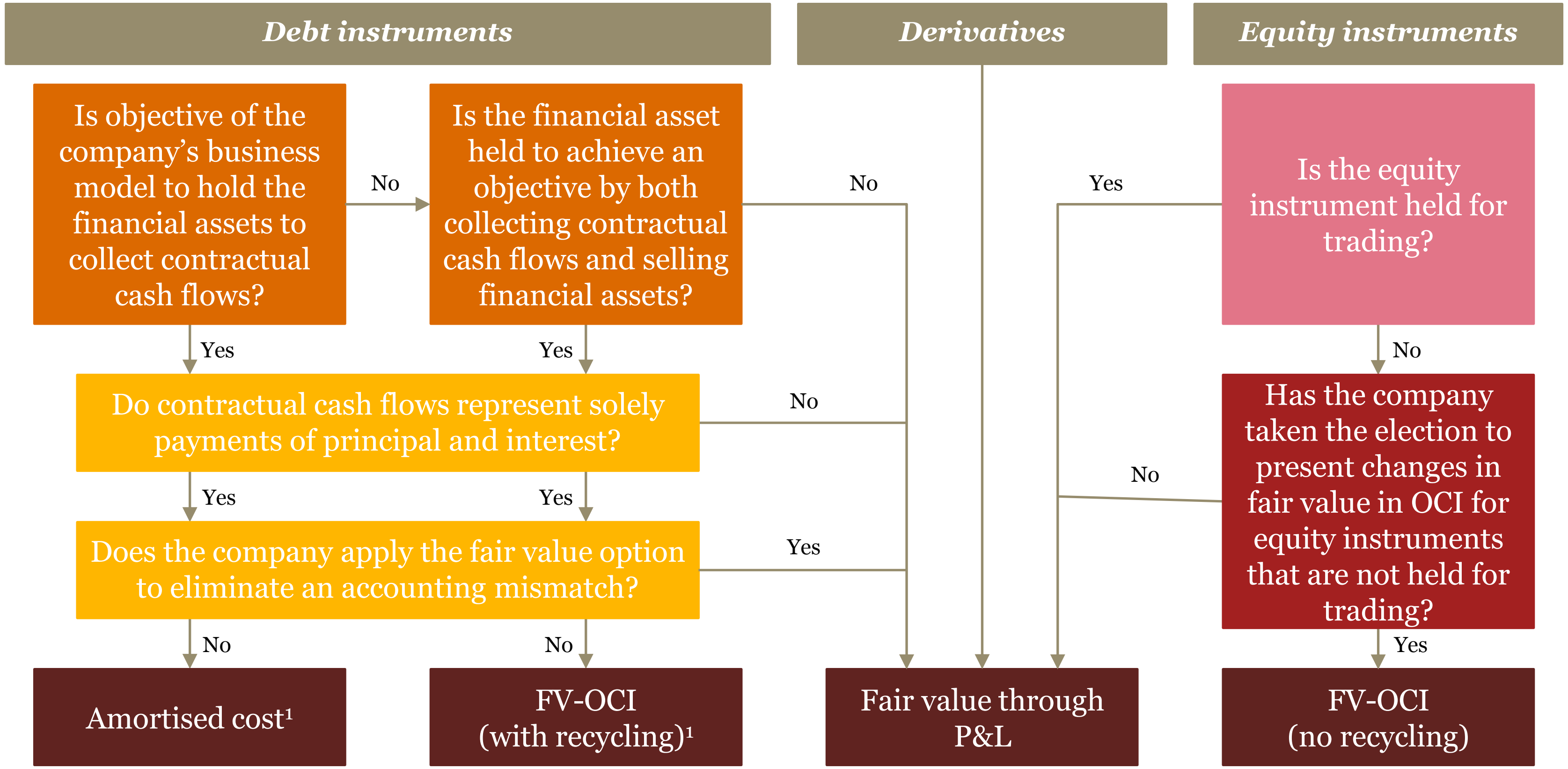
What's changing – classification & measurement

The following diagram illustrates the decision making process for classification of debt and equity instruments.



[1] Impairment considerations apply.

What's changing – impairment (1/5)

Incurred loss
(IAS 39)

Probability of Default (PD)	Exposure at Default (EAD)	Loss given default (LGD)
Portfolio Allowances	Balance sheet exposure	DCF* / Collateral
What is the probability that a counterparty ***has*** defaulted?	What is our exposure ***today***?	How much of this are we ***likely to lose***?
What is the probability that a counterparty ***will*** default?	What will be our exposure ***at this point in time***?	How much of this are we ***likely to lose***?
Future loss	Future performance	DCF* / Collateral

Expected loss
(IFRS 9)

* Discounted Cash Flows

What's changing – impairment (2/5)

The three stages – Decision tree

Absolute credit quality
Is the financial asset subject to low credit risk at the reporting date?

no

Relative credit quality

Has the credit risk increased significantly since initial recognition?

Assessment based on payment status:

If more than 30 days overdue → yes (rebuttable presumption)

no

yes

yes

Credit-impaired

Does the financial asset meet the credit-impaired definition?

no

yes

1	2	3
Performing	Significant increase in credit risk ("SICR")	Credit-impaired ("Defaulted")

- ***Stage 2 is not to be treated as a stepping ground for defaults****. I.e., there will be loans in stage 2 that do not eventually default.*
- ***There is no set definition of "Default"***

What's changing – impairment (3/5)

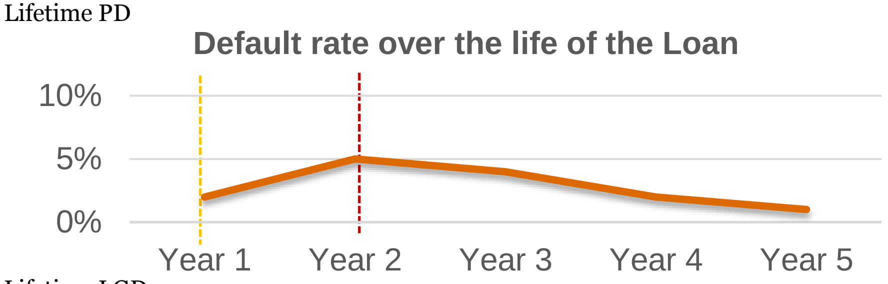
The three stages – What do they represent in practice and what are the implications

	Stage 1	Stage 2	Stage 3
What do they include	Non – SICR exposures and Low Credit Risk exposures Examples: • Up to date • No forbearance flag • Passed PD test	SICR exposures Examples: • 30-89 dpd • Forbearance flag (some cases) • Significant increase in PD (fails PD trigger test)	Credit impaired exposures Examples: • Defaulted loans • Greater than or equal to 90 dpd • Forbearance flag (some cases)
ECL	12 months ECL $\sum_{t=1}^{12} PD(t) \times EAD(t) \times LGD(t) \times DF(t)$	Lifetime ECL $\sum_{t=1}^{lifetime} PD(t) \times EAD(t) \times LGD(t) \times DF(t)$	Lifetime ECL Specific provision; or $EAD_{\text{stage 3}} \times LGD_{\text{stage 3}}$
Interest	Interest revenue on gross basis (i.e., on amount before ECL provision)	Interest revenue on gross basis (i.e., on amount before ECL provision)	Interest revenue on net basis (i.e., on amount after ECL provision)

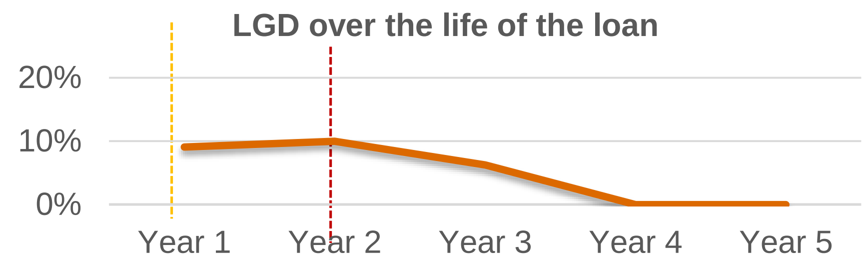
What's changing – impairment (4/5)

12 month ECL– Cash-flow approach

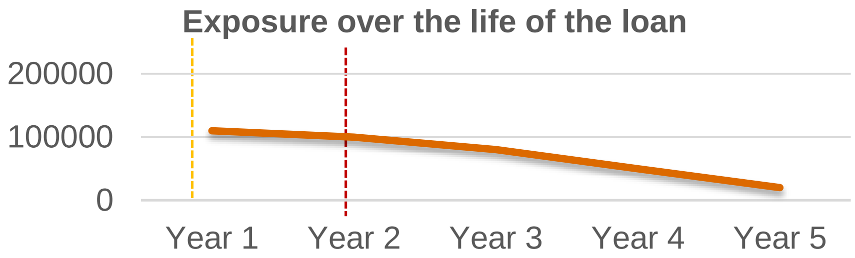
Lifetime PD



Lifetime LGD



Lifetime EAD



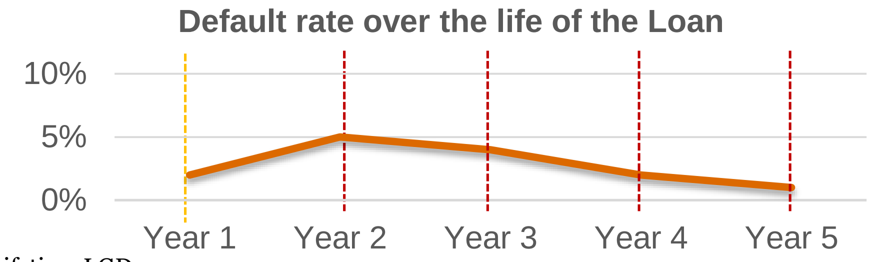
	Year 2
Probability of default (PD)	5%
Exposure at default (EAD)	100,000
Loss given default (LGD)	10%
Expected loss [PD *EAD *LGD]	**500**

12m ECL = €500

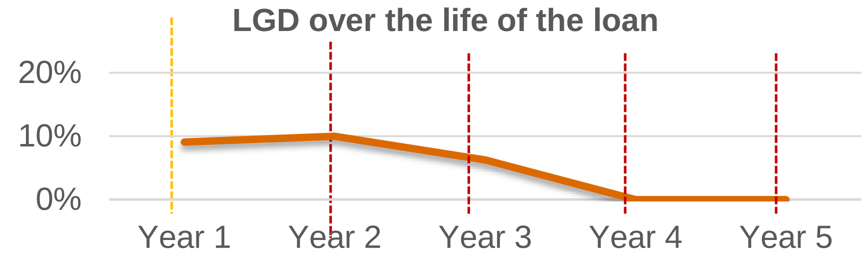
What's changing – impairment (5/5)

Lifetime ECL– Cash-flow approach

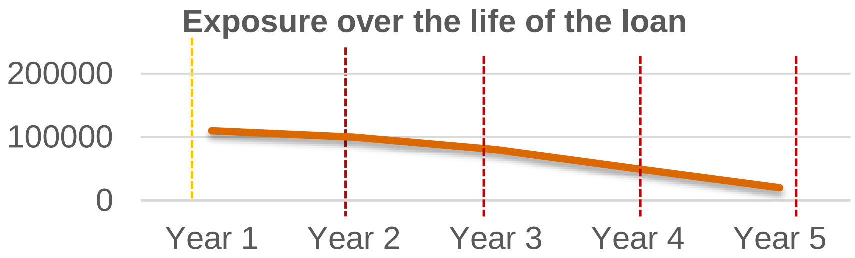
Lifetime PD



Lifetime LGD



Lifetime EAD



	Year 2	Year 3	Year 4	Year 5
Probability of default (PD)	5%	4%	2%	1%
Exposure at default (EAD)	100,000	80,000	50,000	20,000
Loss given default (LGD)	10%	6%	0%	0%
Expected loss [PD *EAD *LGD]	**500**	**192**	**0**	**0**

Lifetime ECL = €500 + €192 + €0 + €0 = €692

What are the key risks and challenges? (1/2)

From the bank's perspective

(Very) significant additional judgments	▪ Forward-looking information ▪ Multiple scenarios ▪ Interpretation of "significant increase in credit risk" and other key terms
Data	▪ Low default portfolios ▪ Historical (pre-transition) information ▪ Quality
Forward looking macro economic information	▪ What data is relevant? ▪ Where will it come from and what is the governance?
Project management	▪ Timing ▪ Sequencing
Resources	▪ Internal and market competition

What are the key risks and challenges? (2/2)

10 key questions from the Global Public Policy Committee

1	What plans are in place to **conclude on key decisions**, build and test necessary models and infrastructure, execute dry/parallel runs and deliver high quality implementation by 2018?
2	Has the bank identified all **changes to existing systems and processes**, including data requirements and internal controls, to ensure they are IFRS 9 appropriate?
3	How will **reporting processes and controls** be documented and tested, particularly for systems and data sources not previously subject to audit?
4	What are the **planned levels of sophistication** for different portfolios and why are these appropriate?
5	What are the **key accounting interpretations and judgements** and why are they appropriate?
6	How will a **'significant increase in credit risk'** be identified and why are the chosen criteria appropriate?
7	How will a **representative range of forward-looking scenarios** be used to capture non-linear and asymmetric impacts?
8	What KPIs and management information will be used to **monitor drivers of expected credit loss** and support governance over key judgements?
9	How will **IFRS disclosure requirements** be met and facilitate comparability?
10	How will **implementation decisions be monitored** to ensure they remain appropriate?

The impact of IFRS 9 is broad

What's the timing?

2016 | 2017 | 2018 | 2019

Impact assessment
- Programme governance
- Financial impact assessment
- Gap analysis and impact on downstream systems
- Implementation roadmap

Design and build
- Target operating model
- Roles and responsibilities
- Methodology build
- Data, systems, and controls build or integration
- Consider other impacts on the business

Implementation
- Implement target operating model
- Model testing
- Data, systems, and controls testing
- Systems integration
- Reporting and disclosure

Deployment (Parallel run)
- Parallel run
- Impact analysis
- Reporting
- Deployment into full production starting 2018

Go live
First IFRS 9 compliant financial statements

Audit

Training

Stakeholder Management/Develop Communication Plan to the Market

Programme management

Useful links

The implementation of IFRS 9 impairment requirements by banks

Global Public Policy Committee (GPPC) paper on implementation of IFRS 9 by banks

[LINK]

Taking a closer look at IFRS 9

PwC publication *IFRS 9 - Taking a closer look*

[LINK]

In brief
A look at current financial reporting issues

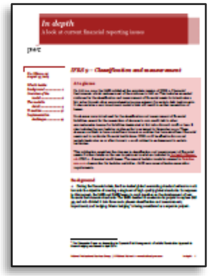
PwC *In Brief* publication summarizing the Global Public Policy Committee (GPPC) paper on implementation of IFRS 9 by banks (above)

[LINK]

In depth
A look at current financial reporting issues

IFRS 9: Expected credit loss disclosures for banking

[LINK]



In depth
A look at current financial reporting issues

IFRS 9: Classification and Measurement

[LINK]

Thank you.

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