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International Financial Reporting Standard 9: A Digest

This digest is aimed specifically at non-complex financial institutions and does not purport to be a comprehensive examination of IFRS 9; it does not address, by way of example only, the IFRS9 provisions for derivatives embedded or otherwise, securitisation, hedge accounting or purchased credit-impaired assets.

Governance, Risk, Compliance & Assurance Solutions

A KnowCo digest

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The objective of the impairment requirements is to recognise lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition - whether assessed on an individual or collective basis - considering all reasonable and supportable information, including that which is forward-looking.

Firms [which account under IFRS rules] shall apply this Standard for annual periods beginning on or after January 1st 2018

Contents

Application & Scope; Recognition and Derecognition

- This Standard shall be applied by all firms to all types of financial instruments other than
  - leases to which *IFRS 16* applies, except that finance lease and operating lease receivables are subject to the derecognition and impairment requirements; and
  - equity issued by the firm
- Recognition occurs when a contract creating a financial instrument is made, irrespective of the movement of cash
  - Where a firm uses settlement date accounting the trade date, not the settlement date, is the date of recognition
- Recognition triggers initial classification
- Derecognition occurs only when contractual rights to pay or receive cash flows expire, or are written-off, or are transferred without recourse

Classification – financial assets

- A firm shall classify financial assets as measured at
  - amortised cost ('AmCost'); or
  - fair value through other comprehensive income ('FVOCI'); or
  - fair value through profit or loss ('FVTPL')
- A financial asset shall be classified as AmCost if both of the following conditions are met:
  1. the business model* objective is to hold assets in order to collect contractual cash flows
  2. the contractual terms give rise on specified dates to cash flows that are solely payments of principal and interest
- A financial asset shall be classified as FVOCI if condition 2 above applies and
  - the business model objective is to both collect contractual cash flows and to sell financial assets
- A financial asset [credit risk exposure] shall be classified as FVTPL unless it is classified as AmCost or FVOCI

*It may be appropriate to separate portfolios into sub-portfolios for this purpose

Classification – financial assets (II)

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- Most if not all of many institutions' lending portfolios fit the AmCost business model definition

- Many AfS portfolios fit the FVOCI business model

- Many off-balance sheet exposures such as Letters of Credit fit neither of the above and should therefore be classified as FVTPL

    - But business models are a matter of fact: for example if you routinely sell liquidity buffer assets to demonstrate that they are liquid, and the value of the assets sold is significant, the business model is not purely to hold financial assets to collect contractual cash flows – the fact that sales are at the insistence of the regulator is not relevant

Reclassification; Classification of financial liabilities*

- Financial assets may be reclassified only upon change to the business model objective
  - …and previously-recognised gains, losses and interest may not be restated (so adjustments are taken to P&L)
- All financial liabilities, except for financial guarantee contracts, are classified as measured at AmCost through the life of the contract
- The fair value of a financial guarantee contract not regarded as an insurance contract, issued to an unrelated party in a stand-alone arm's length transaction, is likely to equal the premium received
- Subsequently, unless the financial guarantee contract was designated at inception as at fair value through profit or loss, the issuer measures it at the higher of
  - the allowance for expected credit losses and
  - the amount initially recognised less the cumulative amount of income recognised
- A firm shall present in profit or loss all gains and losses on loan commitments and financial guarantee contracts that are classified as FVTPL

*Financial guarantee contracts are described as financial labilities in IFRS9

- At initial recognition, a firm shall measure a financial asset or liability at its fair value plus or minus, in the case of an asset or liability not at FVTPL, incremental transaction costs* that are directly attributable to the acquisition or issue of the asset or liability
    - A firm shall measure trade receivables at their transaction price (as defined in IFRS 15)
- After initial recognition, a firm shall measure a financial asset in accordance with its classification as AmCost, FVOCI or FVTPL

*Includes fees and commission paid, transfer taxes and duties. Does not include debt premiums or discounts, financing costs or internal administrative or holding costs

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- Interest revenue shall be calculated by applying the effective interest rate to the gross carrying amount of a financial asset except for

  - …financial assets that have become credit-impaired since recognition. For those financial assets, the firm shall apply the effective interest rate to the amortised cost of the financial asset (i.e. net of loss allowances) in subsequent reporting periods

  - If the credit risk on the financial instrument can subsequently be judged objectively to have improved so that the financial asset is no longer credit-impaired, then the effective interest rate should be applied to the gross carrying amount

'Low Credit Risk'

- Financial instruments cannot be considered to have low credit risk simply because of the value of collateral
- Financial instruments are also not considered to have low credit risk simply because they have a lower risk of default than the firm's other financial instruments, or relative to the credit risk of the jurisdiction within which a firm operates
- To determine whether a financial instrument has low credit risk, a firm may use its internal credit risk ratings or other methodologies that are consistent with a globally understood definition of low credit risk and that consider the risks and the type of financial instruments that are being assessed
  - An investment grade rating is an example of a financial instrument that may be considered as having low credit risk. However, financial instruments are not required to be externally rated to be considered to have low credit risk
- Lifetime ECL cannot be recognised simply because it was considered to have low credit risk in the previous reporting period and is not considered to have low credit risk at the reporting date - a firm must determine that there has been a significant increase in credit risk

Determining Significant Increases in Credit Risk

- Firms must consider *relevant, reasonable and supportable information, that is available without undue cost or effort*, that is indicative of significant increases in credit risk since recognition, but
  - a firm need not undertake an exhaustive search for information
- You may assume that the credit risk on a financial instrument has not increased significantly if the financial instrument is determined to have low credit risk at the reporting date
- If reasonable and supportable forward-looking information is available without undue cost or effort, a firm must take it into account
  - *…however, when forward-looking information (either on an individual or a collective basis) is not available without undue cost or effort, a firm may use past due information to determine whether there have been significant increases in credit risk since initial recognition*
- There is a rebuttable presumption that credit risk has increased significantly when contractual payments are more than 30 days past due
- Some factors or indicators may not be identifiable on an individual financial instrument level. In such a case, they should be assessed for appropriate portfolios, or portions of a portfolio, to determine whether the requirement for the recognition of lifetime expected credit losses has been met

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- A financial asset is credit-impaired *when there is observable data* that has a detrimental impact on estimated future cash flows, such as:
  - significant financial difficulty of the issuer or obligor
  - a breach of contract, such as a default or past due event
  - lender(s) to the obligor, for reasons relating to the obligor's financial difficulty, have granted concessions
  - it is becoming probable that the obligor will enter bankruptcy or other financial reorganisation
  - the disappearance of an active market for that financial asset because of financial difficulties; or
  - the purchase or origination of a [similar] financial asset at a deep discount that reflects the incurred credit losses
- It may not be possible to identify a single discrete event: instead, the combined effect of several events may have caused financial assets to become credit-impaired

Loss Allowances for Expected Credit Losses

- If, at any reporting date, the credit risk on a financial instrument has not increased significantly since recognition, a firm shall measure the loss allowance for that financial instrument at an amount equal to 12-month ECL
- If the credit risk on a financial instrument has increased significantly since recognition, a firm shall measure the loss allowance for a financial instrument at an amount equal to the lifetime ECL
  - If a firm has measured the loss allowance for a financial instrument at an amount equal to lifetime ECL in the previous reporting period, but determines at the current reporting date that credit risk is no longer significantly increased since recognition, the firm shall measure the loss allowance at an amount equal to 12-month ECL at the current reporting date
- a firm shall recognise in P&L, as an impairment gain or loss, the amount of ECL (or reversal) that is required to adjust the loss allowance at the reporting date to the amount required

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	Stage 1: no significant increase in credit risk	Stage 2: significant increase in credit risk	Stage 3: impaired credit risk
Interest revenue calculated on:	Gross carrying cost i.e. incl. loss allowances	Gross carrying cost	Amortised cost i.e. excluding loss allowances
Loss allowances calculated as:	12-month ECL	Lifetime ECL	Lifetime ECL

- ‘Stage 4’ is write-off: a derecognition event

- ECL is
  - An unbiased and probability-weighted amount (neither a worst-case nor best-case scenario) determined by evaluating a range of possible outcomes…
  - …reflecting the time value of money and…
  - …using reasonable and supportable information that is available without undue cost or effort about past events, current conditions and forecasts of future economic conditions
- You must consider the risk or probability that a credit loss occurs by reflecting the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low
- The maximum period to consider when measuring ECL is the maximum contractual lifetime (including extension options)
  - …however, a firm's contractual ability to demand repayment and cancel an undrawn commitment does not limit the firm's exposure to ECL to the contractual notice period. *In such cases only, a firm shall measure ECL over the period for which it judges it will be exposed to credit risk, even if that period extends beyond the contractual period*

Accounting for gains & losses

- A gain or loss on an FVTPL asset or liability* shall be recognised in profit or loss
- A gain or loss on an FVOCI asset shall be recognised in other comprehensive income until the financial asset is derecognised
  - …except for impairment gains or losses and FX gains and losses
- When an FVOCI asset is derecognised the cumulative gain or loss previously recognised in OCI is reclassified from equity to P&L as a reclassification adjustment
- The [non-credit, non-FX, FVOCI] loss allowance shall be recognised in other comprehensive income and shall not reduce the carrying amount of the financial asset in the statement of financial position
- For an FVOCI asset, the amounts that are recognised in P&L are the same as the amounts that would have been recognised in P&L for an AmCost asset
  - If a firm recognises assets using settlement date accounting, any change in fair value during the period between trade date and settlement date is not recognised for AmCost assets
  - For assets measured at fair value, however, the change in fair value shall be recognised in profit or loss or in other comprehensive income

*Financial guarantee contracts are described as financial labilities in IFRS9

Definitions

- *Credit loss*
  - The difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls), discounted at the original effective interest rate
- *Principal*
  - the fair value of a financial asset at initial recognition
- *Effective Interest Rate*
  - the rate that exactly discounts estimated future cash payments or receipts through the expected life of the asset or liability to the gross carrying amount of a financial asset (or to the amortised cost of a financial liability) excluding expected credit losses ECL. The **credit-adjusted interest rate** is calculated based on the carrying amount *net* of ECL
  - Fees that are an integral part of the effective interest rate include origination fees received and/or paid, and commitment fees
- *Amortised Cost*
  - the amount at which the financial asset or liability is measured at initial recognition minus the principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for assets, adjusted for any loss allowance
- *Gross Carrying Amount*
  - the amortised cost of a financial asset, before adjusting for any loss allowance

Transition: Classification and Measurement

- At the date of initial application, a firm shall assess whether a financial asset should be classified as AmCost or FVOCI *on the basis of the facts and circumstances that exist at that date*. The resulting classification shall be applied retrospectively, irrespective of the firm's business model in prior reporting periods
- Despite the requirement for retrospective application, a firm that adopts the classification and measurement requirements of this Standard shall provide the disclosures set out in paragraphs 42L–42O of IFRS 7 but need not restate prior periods.
- A firm shall apply the impairment requirements in Section 5.5 retrospectively in accordance with IAS 8*
- At the date of initial application, a firm shall *use reasonable and supportable information that is available without undue cost or effort to determine the credit risk at the date that a financial instrument was initially recognised* (or for loan commitments and financial guarantee contracts at the date that the firm became a party to the irrevocable commitment) and compare that to the credit risk at the date of initial application of this Standard
- If, at the date of initial application of this Standard, determining whether there has been a significant increase in credit risk since initial recognition would require undue cost or effort, a firm shall recognise a loss allowance at an amount equal to lifetime expected credit losses at each reporting date until that financial instrument is derecognised (unless that financial instrument is low credit risk at a reporting date)

*Accounting Policies, Changes in Accounting Estimates and Errors

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KnowCo is a specialist resource for financial institutions

We offer support for governance, risk and compliance issues both at the strategic and policy level and the 'heavy lifting'

Our IFRS9 technical solution is founded on the platform of our tried-and-tested ALM system for non-complex institutions

If you would like to discuss further any aspect of this digest, please contact us for an informal discussion:

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- As discussed elsewhere in this digest, IFRS 9 changes the way we *account* for expected losses, not necessarily how we calculate them
- The Standard does not impose IRB-type modelling requirements on all institutions across the board – each firm must decide on that which is realistically achievable ‘without undue cost or effort’
- You may already have a fit-for-purpose ECL models, but this is an opportunity to review your ECL modelling (and its governance) and plan improvements
- Many smaller institutions’ ECL modelling is a combination of historical loss rates and expert judgement, but it helps to put some structure into the process, for example the Basel IRB concepts:
  - Expected credit loss in percentage terms is *Probability of default*Loss given default*
  - Expected credit loss in money terms is *Probability of default*Loss given default*Exposure at default*
- LGD and EAD modelling are relatively straightforward, PD less so…

Modelling ECL (II)

- For retail and SME lending there are publicly available statistical and credit reference data which, together with historical loss rates, can guide general PD forecasting (i.e. at portfolio level)
- For wholesale portfolios where the credit risk is to unrated corporates the PD methodology often includes a combination of financial analysis of accounting information, external credit reference data and PD inputs from 'deemed' equivalent rated entities
  - …but note the difference between ratings based on PD and those based on ECL
  - Often a credit score is generated by populating a scorecard with quantitative data and then a series of judgment-based modifiers applied to reach a final score, which can be converted into a PD range
- If you're a UK institution, the PRA's annual cyclical scenario may help to inform your view of relevant external factors such as property price movements *but*…
  - …that scenario is not a forecast, it's a stress test…
  - …and there may be no identifiable, direct relationship between UK macroeconomic events and PD levels in your own business lines
  - The PRA scenario is, for most non-complex firms, simply a severity benchmark for their capital stress-testing and not an ECL input

- You will need to be able to override portfolio-level ECL in cases where there has been a significant increase in credit risk or an impairment
  - …however an increase in credit risk, or even a credit impairment, does not automatically result in an increased ECL for strongly-collateralised loans (although the exposure must be recategorised accordingly as ‘Stage 2’ or ‘Stage 3’)

- Approved ECL models-per-business-line, how portfolio-level ECLs are determined, who can override them and in what circumstances are all part of the governance layer which must be put around IFRS 9 implementation

- These and other policy decisions need to be made and signed-off, if they haven’t been already, before implementation starts - they will affect the project design and resources, data-capture requirements, etc.