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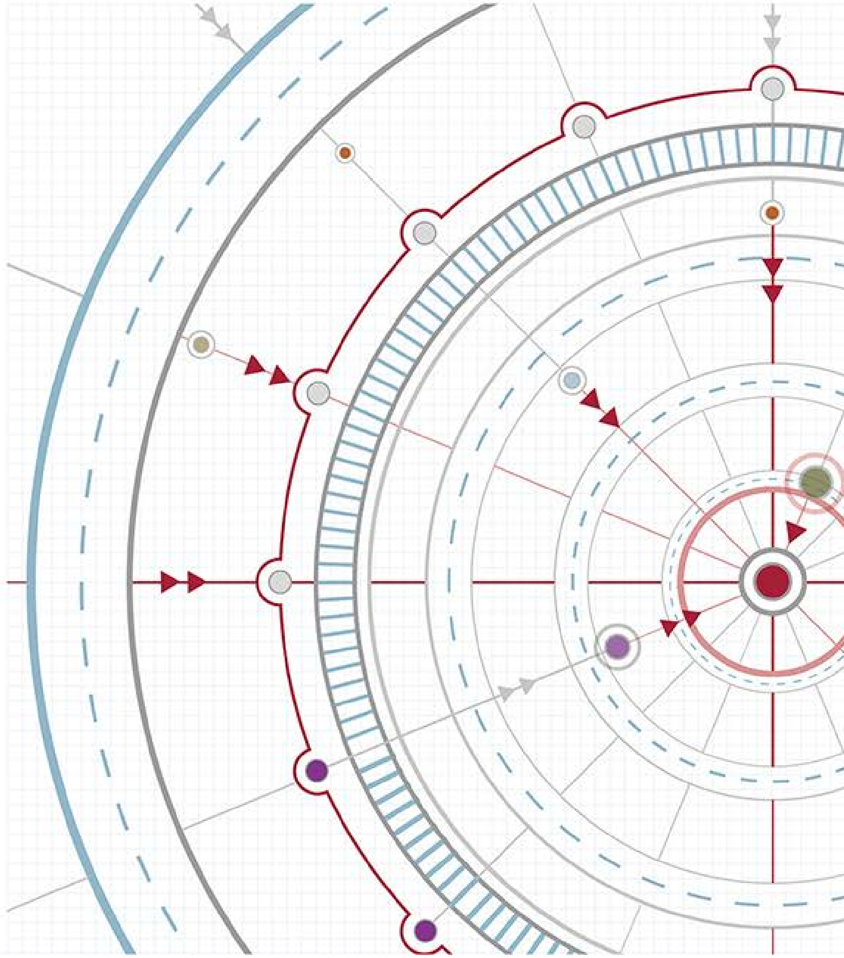

Financial crisis and accounting

Santiago de Chile, Chile

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Amaro Gomes, Board Member, IASB
agomes@ifrs.org

G20 Summit – 25 September 2009

- Redouble efforts to:
  - achieve a single set of high quality, global accounting standards within the context of their independent standard setting process
  - complete convergence project by June 2011.
- IASB’s institutional framework should further enhance the involvement of various stakeholders.
- G20 acknowledge that there could be differences between capital requirements and accounting rules:
  - to ensure comparability, the details of the leverage ratio will be harmonized internationally, fully adjusting for differences in accounting.

IFRS and the Financial crisis: The major Projects

Project	Standard issued	Completion
Derecognition and off-setting	**Amended IFRS 7 (disclosure)**	▪ December 2011 Improved disclosure requirements similar to US GAAP
Consolidation	**IFRS 10-11-12**	▪ May 2011 Replacement of IAS 27 Disclosures about unconsolidated SPEs/structured entities Investment companies

IFRS and the Financial crisis: The major Projects

Project	Standard issued	Completion
Fair Value Measurement	IFRS 13	May 2011 Converged definition of fair value and common implementation guidance (including for illiquid markets)

IFRS and the Financial crisis: The major Projects

Project	Objective	Completion
Financial instruments	Comprehensive improvements to foster international comparability of financial instruments Responding to stakeholder concerns (BCBS and FSB and others) to address differences between IFRSs and US GAAP	**Phase 1**: Classification and Measurement - IFRS 9 issued in November 2009 (assets) and October 2010 (liabilities) **Phase 2**: Impairment (2014) **Phase 3**: Hedge (2013)

International Financial Reporting Standards

IFRS 9: Classification and measurement

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IFRS 9 classification of financial assets

Business model[‡]

Contractual cash flow characteristics

Amortised cost*

FVOCI*

FVO for accounting mismatch

All other instruments:

- Equities
- Derivatives
- Some hybrid contracts
- …

Fair value (No impairment)

Equities: OCI presentation available (alternative)

‡ Reclassification required if business model changes

* Same impairment model for amortised cost and FVOCI

The IFRS 9 classification model for assets

	Business model is hold to collect	Business model is hold to collect and sell	Other business models
Cash flows are solely payments of principal and interest (P&I)	Amortised cost	FVOCI NEW	FVPL
Other types of cash flows	FVPL	FVPL	FVPL

*Excludes equity investments. Can elect to present in OCI.

Disclosure requirements

- Gains/losses out of ‘held to collect’
- Reclassification disclosures
  - Details of business model change
  - Amounts in/out of categories
  - If moved to amortised cost, fair value amounts
  - Presentation of any cumulative gain or loss previously recognised in OCI reclassified to profit or loss when a financial asset is reclassified from the FVOCI to FVPL
- Judgement involved in assessment of contractual cash flow characteristics added to IAS 1 as an example that could have a significant effect on amounts recognised

Financial liabilities – 'own credit'
designated under fair value option (FVO)

Financial statements – IFRS 9			
Balance sheet		*P&L*	
Financial liabilities – FVO	Full FV	Gain or loss	all FV Δ except own credit
		OCI	
		Gain or loss	FV Δ due to 'own credit'*

* Not recycled

- Otherwise, **P&L gain when 'own credit' deteriorates**, loss when it improves
- ***Required* by IFRS 9** for liabilities under the FVO
- **IFRS 9** allows the 'own credit' requirements to be applied before the rest of IFRS 9

Improved approach to classification and measurement

- Principle-based, unified model with a logical structure and rationale for classification and measurement of financial assets
  - measurement categories and use of business model reflect nature of cash flows and how they are managed
- Improved reclassification rules consistent with changes in management
- Addresses ‘own credit’ concerns
  - P&L volatility will no longer result from changes in own credit, while information on own credit will still be available for users
- Single approach eliminates complex bifurcation requirements and multiple impairment approaches
- Elimination of IAS 39 tainting rules

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IFRS 9: Impairment

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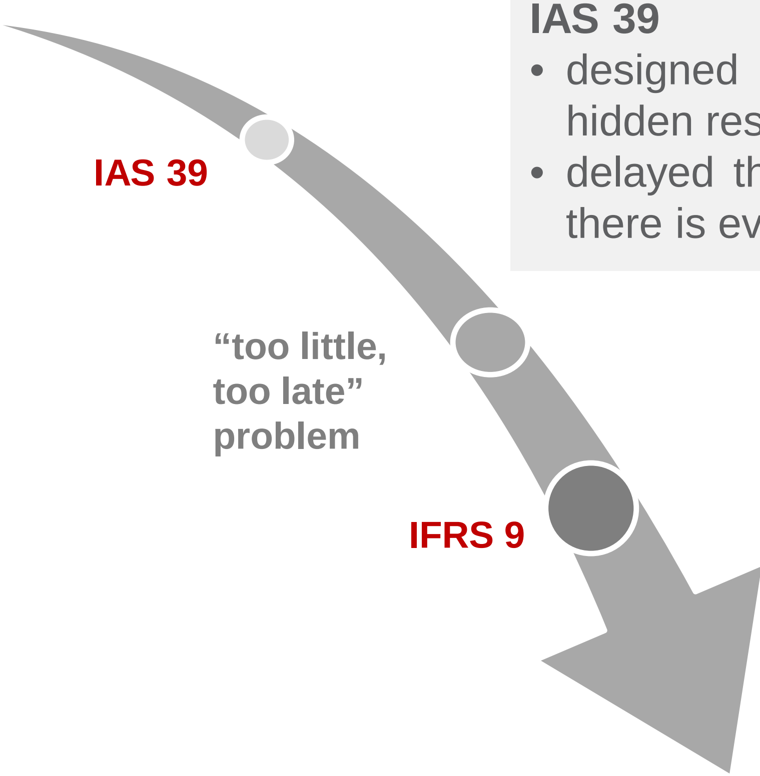
IAS 39 vs. IFRS 9



IAS 39

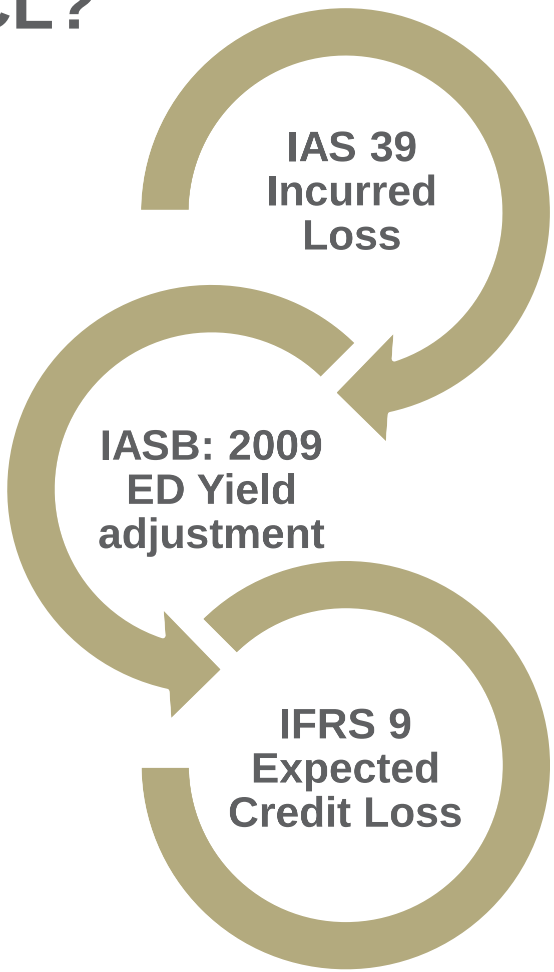
- designed to limit entity’s ability to create hidden reserves
- delayed the recognition of credit losses until there is evidence of a trigger event

IFRS 9

- forward-looking impairment model
- Update the amount of expected losses recognised at each reporting date to reflect changes in the credit risk

IFRS 9: Expected Credit Losses

How did the IASB land on ECL?



What does an ECL look like?

Example of Day-1 provision:

- Portfolio of 10m loans repayable over 5 years
- 2% probability of a default occurring in the next 12-months
- Entire loss that would arise on default is 10%
- **ECL** = 20,000 (2%x10%x**10m**)

Until significant increase in credit risk

IFRS 9 *ECL*: Overview

Change in credit risk since initial recognition

	Stage 1	Stage 2	Stage 3
Expected credit losses	12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Interest revenue	Gross basis	Gross basis	Net basis

ECL model: Determining significant increase in credit risk

- Key aspect
- Change in credit risk *over the life* of the instrument (ie risk of a default occurring)
  - Compared to credit risk *at initial recognition*
  - *Relative* rather than absolute assessment
  - Need to determine what is meant by "*default*"
- Maturity matters
- *Not* changes in expected credit *losses*
- Done on an individual or collective basis
- Need to use *reasonable and supportable* information…

ECL model: Measurement

Need to reflect:

- Probability weighted outcome
  - must consider possibility that default will/will not occur
- Time value of money
  - discount at the original effective interest rate or an approximation thereof
- Reasonable and supportable information…

Particular measurement methods are not prescribed

IFRS 9: What information is used to develop ECL?

- Borrower-specific factors:
  - changes in operating results of the borrower, technological advances that affect future operations, changes in collateral supporting the obligation.
- Macroeconomic factors:
  - house price indexes, GDP, household debt ratios.
- The data sources could be:
  - internal data – credit loss experience and ratings; and
  - external data – ratings, statistics or reports.

Leverage credit risk management

Disclosures - objectives

To enable users
to understand the ***effect of credit risk***
on the ***amount***, ***timing*** and ***uncertainty***
of ***future cash flows***

Entities' ***credit risk management practices*** and how they relate to recognition and measurement of ECL

Quantitative and qualitative information to evaluate amounts in the financials arising from ECL

Entities' ***credit risk exposure*** including significant credit risk concentrations

IFRS 9 *ECL*: Benefits

Forward-looking model that is responsive to changes in credit risk and responds to the calls of the G20 and others

- Broader range of information required to be considered
    - Ensures more timely recognition of expected credit losses
    - Elimination of IAS 39 threshold
- Builds on existing systems to balance costs and benefits
    - Approximates 2009 ED in more operational manner
- Single model reduces complexity of multiple approaches
- Enhanced disclosures:
    - Illustrate how an entity has applied the requirements
    - Show instruments which have significantly increased in credit risk

International Financial Reporting Standards

IFRS 9: Hedge accounting

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A better link between accounting and risk management

Feedback on IAS 39: *Recognition and Measurement*

- Lack of an overarching principle; complex and rule-based
- Inability for **preparers** to reflect hedges in financial statements
- Hard for **users** to understand risk management practices

Solutions in IFRS 9: *Financial Instruments*

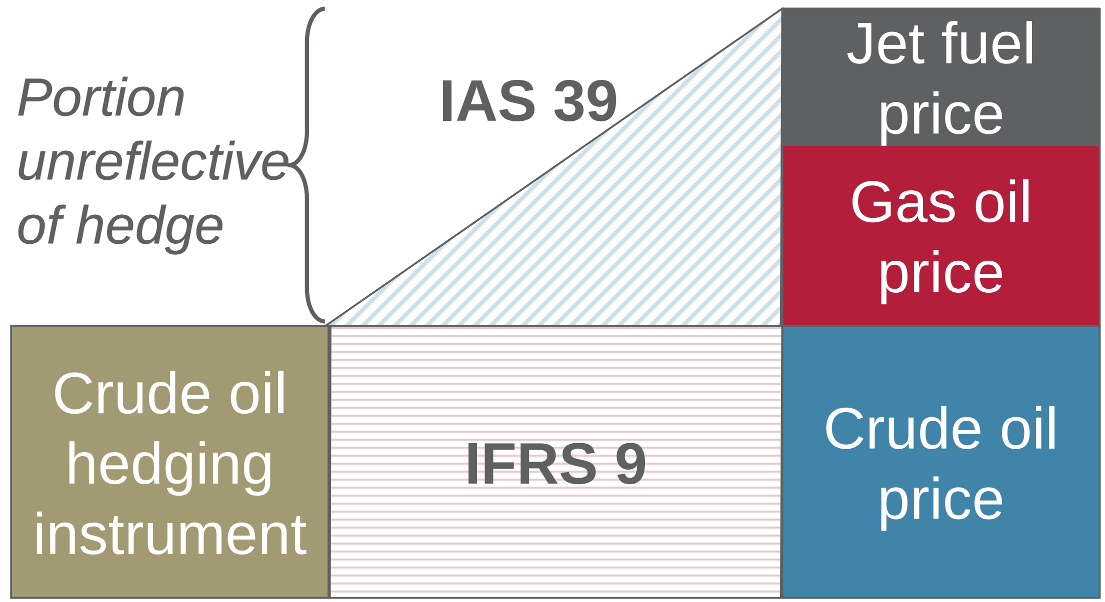
- Align accounting treatment with risk management activity
- Enable **preparers** to better reflect hedging in financial statements
- Provide disclosures to help **users** understand risk management and its impact on the financial statements

Key changes from current accounting

This has been a comprehensive review of hedge accounting

- Links economics of risk management with accounting treatment
- Significantly reduces accounting considerations that affect risk management decisions
- Ability to account for more hedges of non-financial items

Example: Measuring the success of hedging jet fuel contracts with crude oil futures



Other core improvements

Hedge effectiveness testing

1. Economic relationship
2. Effect of credit risk
3. Hedge ratio

Costs of hedging

Improves the transparency around some hedging instruments:

- time value of options
- forward element of foreign currency
- basis risk for hedges of foreign exchange risk

Disclosures

To understand risks being hedged; how those risks are managed; and the effect of hedging those risks on the financial statements.

Project <u>doesn't</u> address macro hedging

Even if apply IFRS 9 can still use specific portfolio hedge accounting requirements in IAS 39

For now entities can choose to keep using IAS 39

IAS 39 hedge accounting

Accounting policy choice

IFRS 9 hedge accounting

Some banks may not make any changes to their hedge accounting at this time

- The IASB is working on a specific project to consider accounting for macro hedges

IFRS and the financial crisis: the end of a chapter

- IASB work on financial instruments: improved transparency and timeliness of impairment allowances (expected model)
- IFRS applied properly = fewer surprises
  - clearer risks an entity is exposed to;
  - changes in credit expectations reflected in loan loss provisions.
- More efficient allocation of capital.
- Help avoid the next crisis? Remains to be seen

IFRS and the financial crisis: Improved and additional outreach activities

- ✓ Enhanced investor engagement (among others dedicated Investor Relations Manager)
- ✓ Enhanced outreach practices (project specific email alerts, pod casts of Board meetings, Feedback statements...)
- ✓ Enhanced technical dialogue with prudential supervisors and market regulators
  - in line with G20 recommendations: proposals take account of guiding principles of Basel Committee and Financial Crisis Advisory Group report
  - regular meetings with the Basel Committee
  - member of the Financial Stability Board
  - regular meetings with EFRAG
  - national standard-setters as partners in the work (ASAF, EEG)
  - participation in regional meetings of national standard-setters (GLENIF)

Get involved

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Appendix

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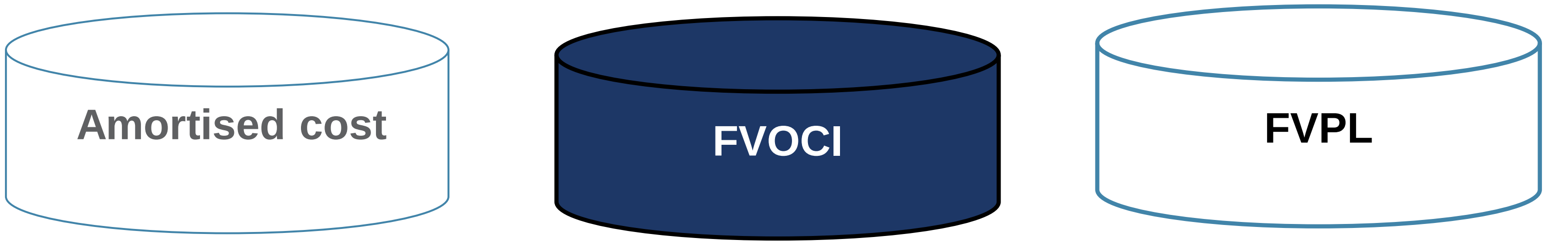
IFRS 9: Classification - Limited amendments



- Introduces new business model
- Assets managed with the objective of both:
  - Collecting contractual cash flows; and
  - Selling financial assets
- Addresses a business model some felt was missing
- Furthermore addresses potential accounting mismatches due to interaction with accounting for insurance contract liabilities

IFRS 9: Classification - Business model test

- Factual assessment based on how assets are managed
  - Not based on intent for individual asset
  - Typically observable through activities entity undertakes
  - Anchor is how cash flows are realised
- Hold to collect (amortised cost)
  - Generate value by collecting contractual cash flows
  - Consider past sales information and future expectations
  - Some sales may be consistent if infrequent or insignificant
- Hold to collect and sell (FVOCI)
  - Achieve objective by collecting contractual cash flows and selling
  - Involves greater frequency and volume of sales
  - eg. liquidity needs, interest yield management, asset/liability management
- Reclassify if business model changes

IFRS 9: Classification - Contractual cash flow characteristics for amortised cost and FVOCI

Contractual cash flow characteristics

Contractual terms that give rise to solely payments of

Principal

Amount transferred for financial asset at initial recognition

Interest

Interest =
Consideration for
- time value of money
- credit risk
- other basic lending risks, costs and profit margin

Limited Amendments:

'Modified' P&I satisfies test IF
- **Compared with a perfect instrument, not significantly different cash flows**

IFRS 9: Classification - Additional considerations for SPPI

Time value of money

- Consideration just for ‘passage of time’
- Exception for instruments with regulated rates to be eligible for amortised cost measurement
- Must consider factors that could affect future cash flows

Contractual provisions that change timing or amount of cash flows

- Must determine whether cash flows resulting from provision are SPPI
  - Assess cash flows that could arise before and after change
  - May need to assess nature of contingent event
  - Should not have variability inconsistent with a basic lending arrangement

IFRS 9: ECL model - Reasonable and supportable information

- Available *without undue cost or effort* at the reporting date: past events, current conditions and forecasts of future economic conditions. For example:
  - Borrower specific factors:
    - ➢ changes in operating results of borrower, technological advances that affect future operations, changes in collateral supporting obligation
  - Macro-economic factors:
    - ➢ house price indexes, GDP, household debt ratios
  - The data sources could be:
    - Internal data - credit loss experience and ratings

Historical information can be used as a base but must be updated to reflect current conditions and future forecasts