IFRS 9 (PSAK 71)

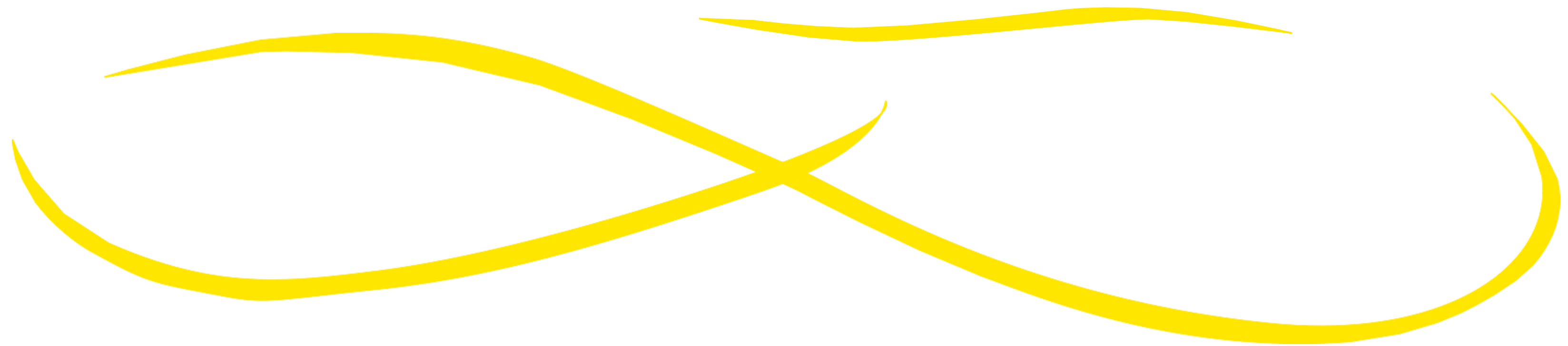
Danil Setiadi Handaja

12 Agustus 2019

Graha Akuntan Jl. Sindanglaya No. 1 Menteng

Disclaimer

"This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting or other professional advice. Please refer to your advisors for specific advice. This is not a substitute for reading the standards and interpretations themselves. Therefore, the participants should refer to these standards and interpretations and evaluate their applicability and the impact of current and future adoption".



Why the replacement of IAS 39?

Benefits & criticism on IAS 39 include …

Benefits

Attention on pricing

- Otherwise may result in day-1 gain or loss

Governance

- Upfront or early analysis of financial impact before any major transactions
- Both for internal management, & for customers in some cases

Transparency

- More items measured at fair value, e.g. all equity instruments & derivatives
- Timing of recovery will affect provisions for bad debts

Criticism

Complex & difficult to understand

- Substance over form?
- *Bright lines* or rule-based in many instances
- Many exceptions to underlying principles

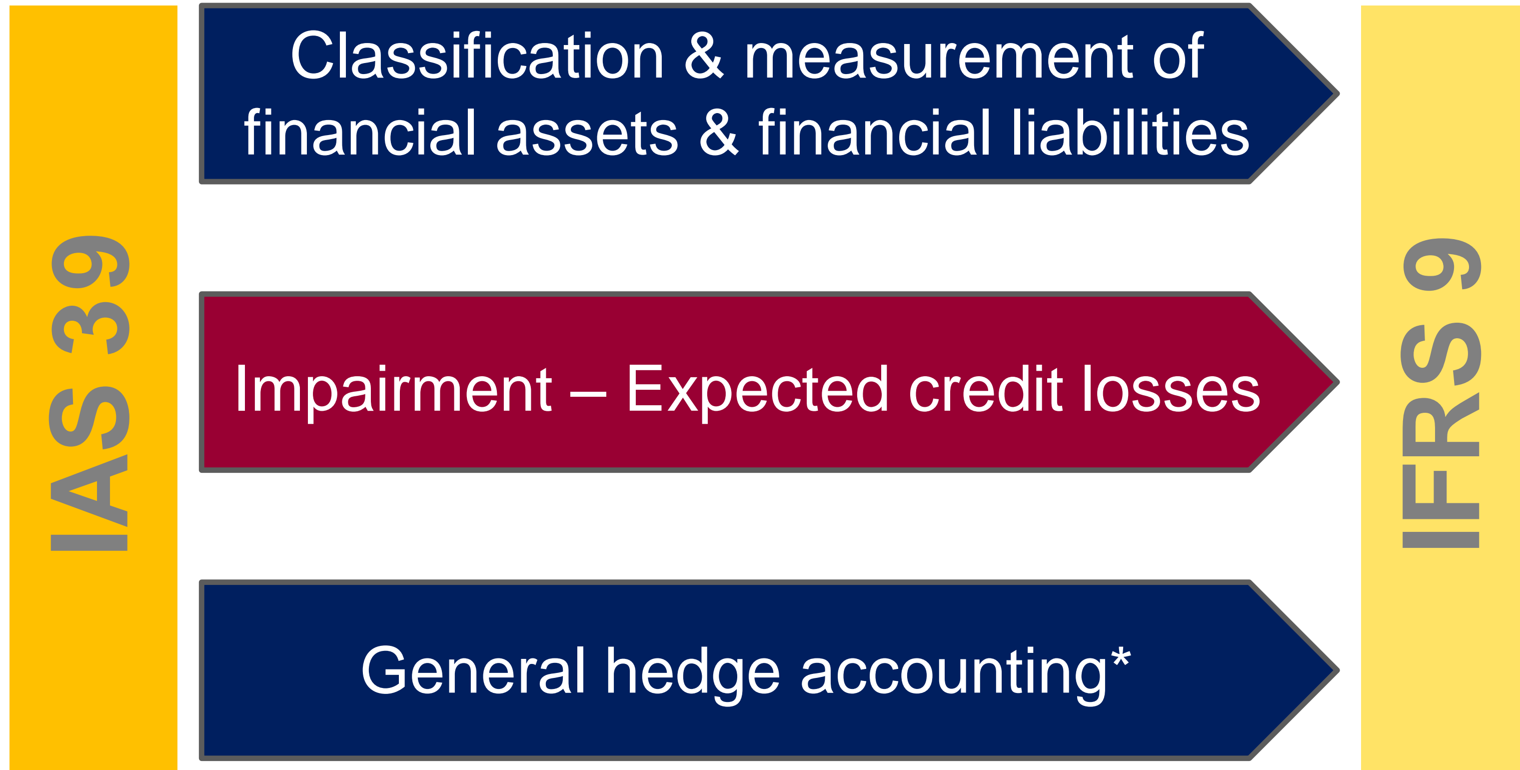
Fair value determination rules

- Market-based approach
- Pro-cyclical
- Judgmental at times

Impairment assessment

- Different measurement models for different items
- "Too little too late"

IAS 39 replacement – IFRS 9



Mandatory effective date: January 1, 2018

**Macro hedge accounting will be covered in a separate standard*

IFRS 9 – Table of Contents

Section	Topics
Classification & measurement	❑ New classification of financial assets ❑ Solely Payment of Principal and Interest (SPPI) test ❑ New business model ❑ Requirement change
Impairment	❑ 12-month expected credit loss ❑ Life time expected credit loss ❑ Significant increase in credit risk ❑ Expected credit loss on letter of credit and credit card
Derivatives and Hedging	❑ Derivatives overview ❑ Increased flexibility ❑ Better connection with risk management ❑ Some positive changes
Transition	❑ Effective date and relief

Phase 1 - Classification and Measurement
Key aspects and overview

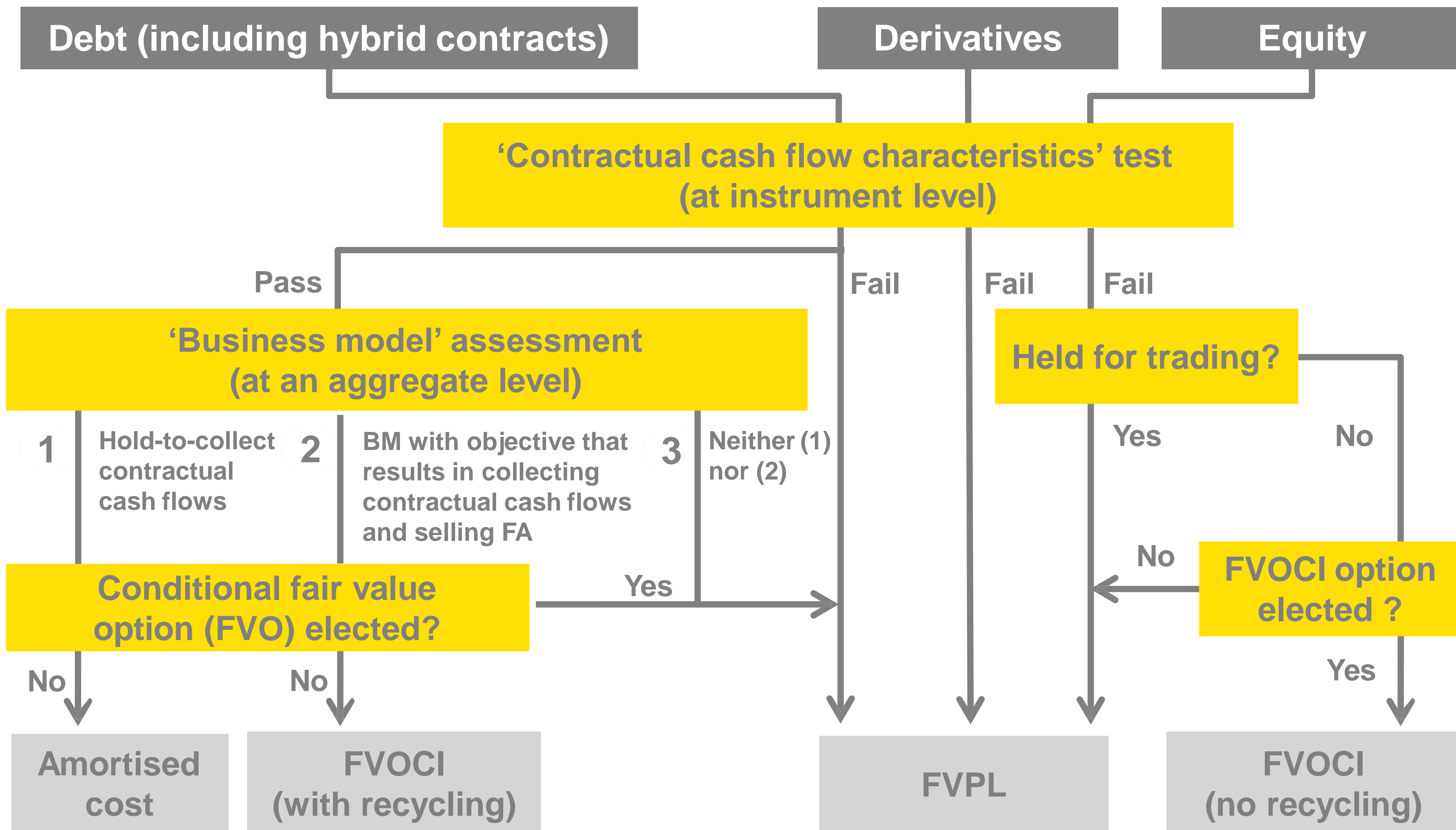
Classification of financial assets – a new model

- Two assessments:
  - Contractual cash flows give rise to solely payments of principal and interest (also colloquially referred to as the 'SPPI test')
  - Business model for managing the financial assets
- The outcome determines whether the investment is accounted for:
  - At fair value through profit or loss
  - At fair value through other comprehensive income (OCI) (with or without recycling)
  - At amortised cost
- Classification requirements are applied to a financial asset in its entirety without separating embedded derivatives

Classification of financial liabilities

- Gains and losses on liabilities designated at FVPL arising from changes in own credit risk are recorded in OCI and never recycled
  - Unless recognising such fair value changes in OCI would create or enlarge an accounting mismatch in P&L
- No other changes from IAS 39, this means that embeded derivatives separation rules are retained for financial liabilities

Synopsis of key aspects of the new model for financial assets

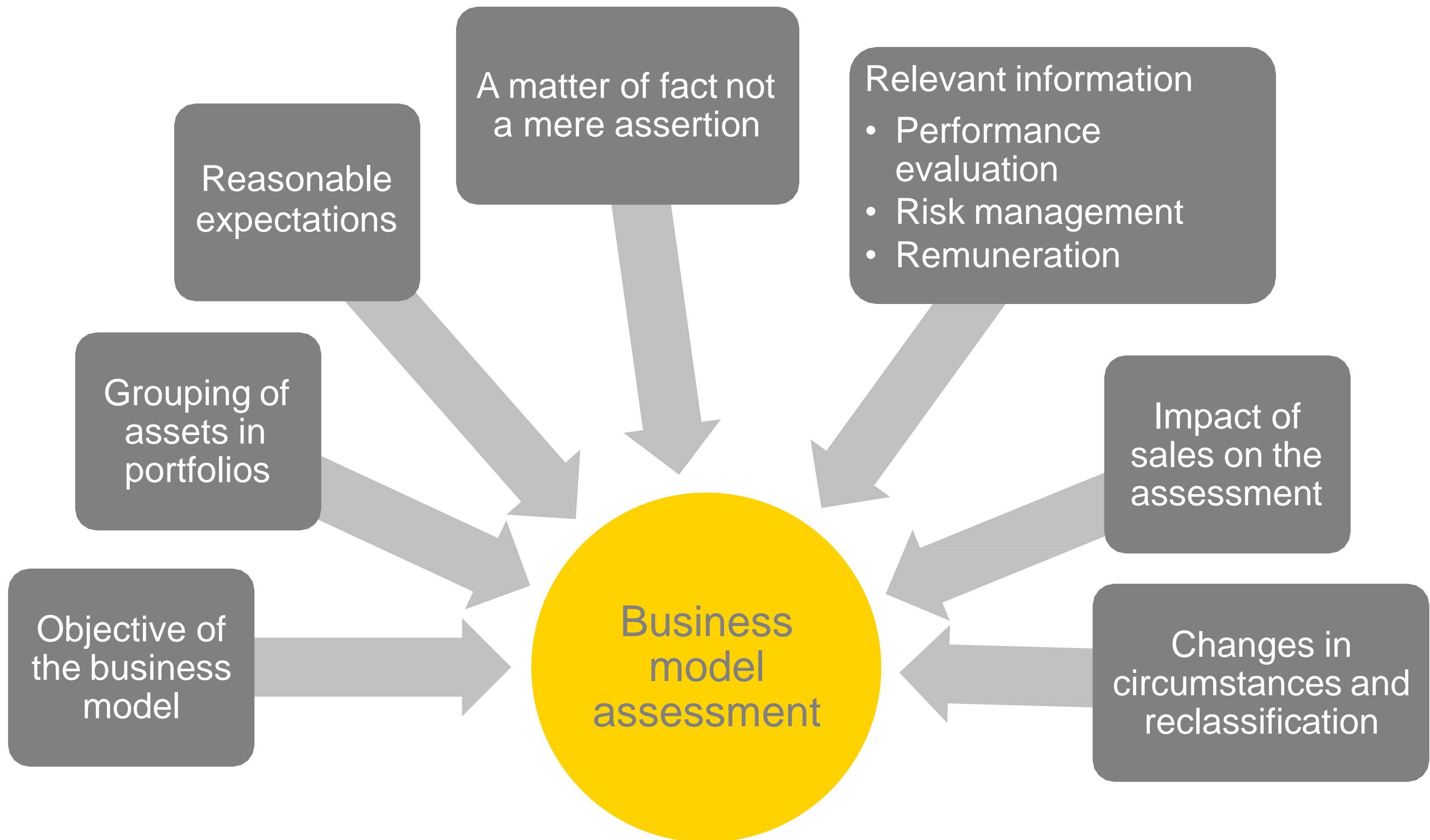


Solely payments of principal and interest cash flows – the SPPI test

Contractual cash flows that are solely payments of principal and interest (SPPI)	
Consistent with a **basic lending arrangement** which includes consideration for:	Do not introduce exposure to risks or volatility unrelated to a basic lending arrangement

► **Time value of money**
► **Credit risk**
► Other basic lending risks and costs:
  ► Liquidity risk
  ► Admin costs
  ► Profit margin
	► Elements inconsistent with a basic lending arrangement include:
	  ► Exposure to changes in equity or commodity prices
	  ► Leverage

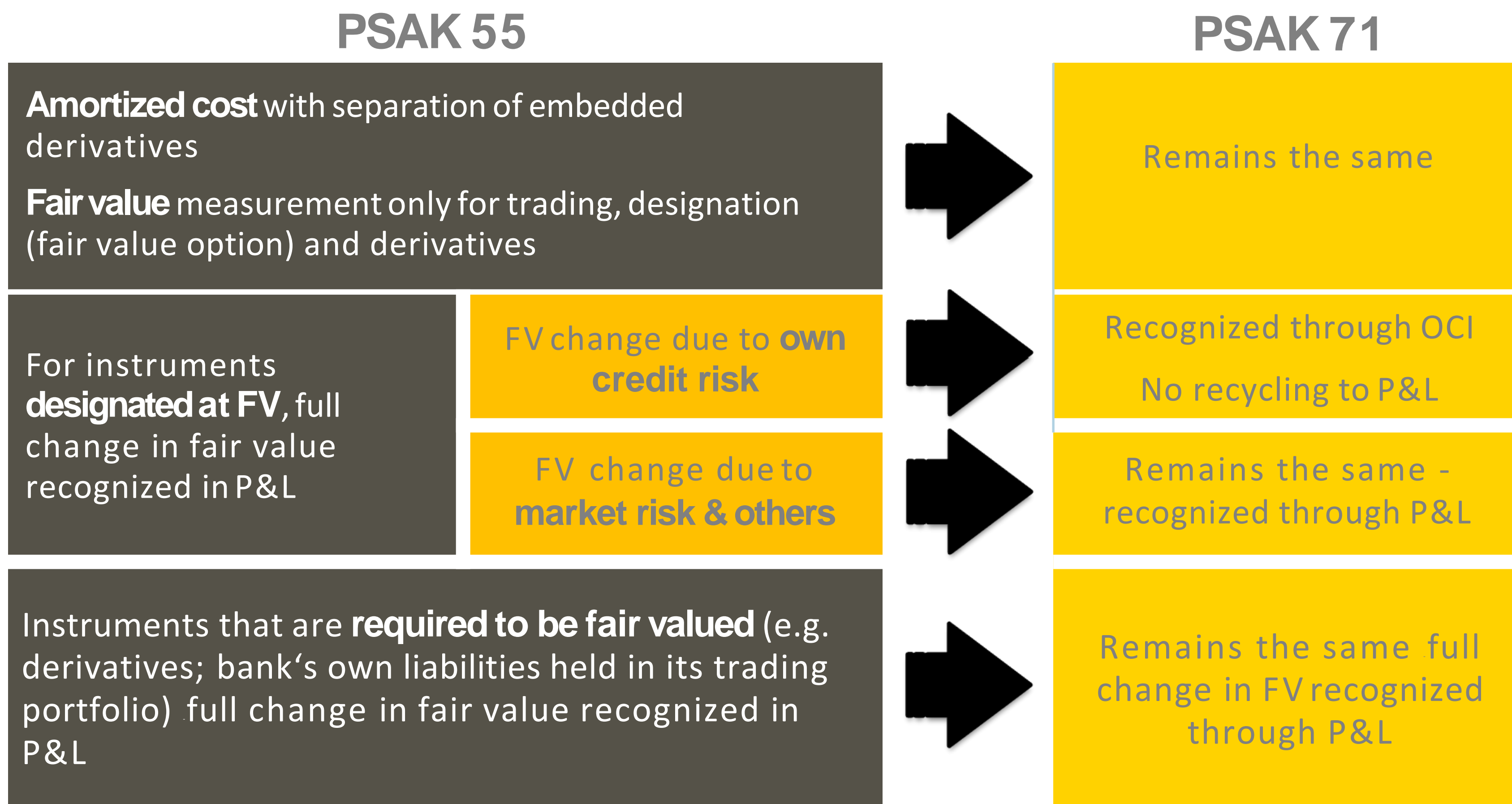
Business model assessment – factors to consider



Overall business model assessment – defining factors

- Business model assessment refers to how an entity manages its financial assets in order to generate cash flows
- Business model is a matter of fact and not merely an assertion
- Assessment based on reasonable expectations and not on worst or stress case scenarios
- Typically observable through particular activities that are undertaken to achieve the objectives of that business model
  - Performance measurement
  - Risks and risk management
  - Compensation
- The expected frequency and value of sales are important elements of the assessment. However, information about past sales should not be considered in isolation

Financial Liabilities
Limited changes to the classification and measurement



Reclassifications of financial assets (1)

- When, and only when, an entity changes its business model for managing financial assets
- A high hurdle
  - Expected to be very infrequent
  - Changes causing reclassifications are determined by senior management
  - Occur only when an entity either begins or ceases to perform an activity that is significant to its operations (e.g., via acquisition or disposal)
- Examples that are not a change in business model:
  - Change in intention for particular financial assets
  - Temporary disappearance of an active market
  - Transfer of an asset between parts of an entity

Reclassifications of financial assets (2)

Original category	New category	Accounting impact
Amortised Cost	FVTPL	FV is measured at reclassification date. Difference with carrying amount should be recognised in P&L.
FVTPL	Amortised Cost	FV at the reclassification date becomes its new gross carrying amount*
Amortised Cost	FVOCI	FV is measured at reclassification date. Difference with amortised cost should be recognised in OCI. Effective interest rate is not adjusted as a result of the reclassification.
FVOCI	Amortised Cost	FV at the reclassification date becomes its new amortised cost carrying amount. Cumulative gain or loss on OCI is adjusted against the FV of the financial asset at reclassification date.
FVTPL	FVOCI	FV at reclassification date becomes its new carrying amount.*
FVOCI	FVTPL	FV at reclassification date becomes carrying amount. Cumulative gain or loss on OCI is reclassified to P&L at reclassification date.

Impairment Assessment under IFRS 9

IFRS 9 Expected Credit Loss (ECL) requirement

- There are many approaches that could be adopted for an IFRS 9 expected loss impairment model, regardless of the approach adopted the requirements of IFRS 9 must be satisfied.

> An entity shall measure expected credit losses of a financial instrument in a way that reflects:
>
> (a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
>
> (b) the time value of money; and
>
> (c) reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

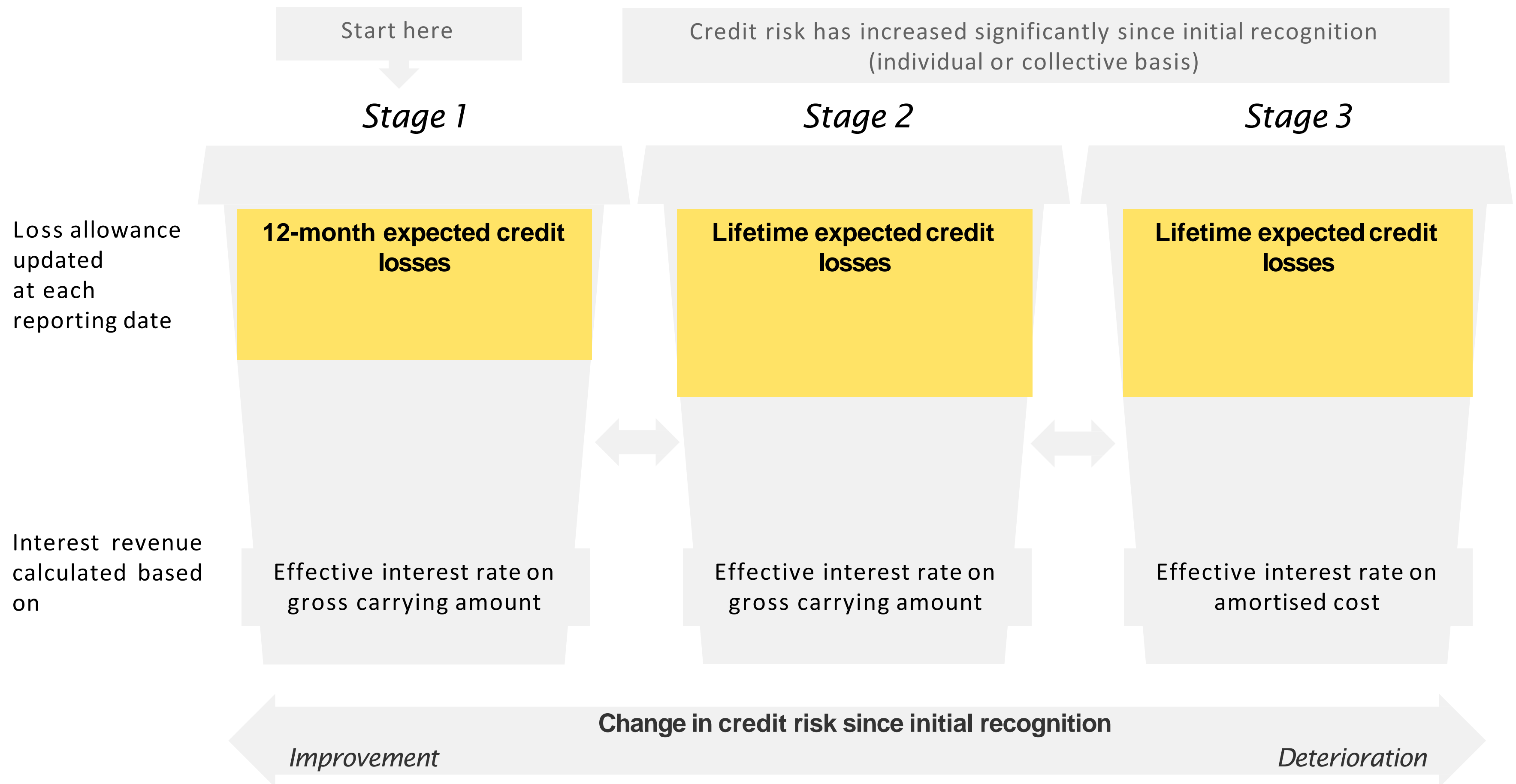
IFRS 9 5.5.17

IFRS 9 Expected Credit Loss (ECL) Model Requirements		
12 month and lifetime expected loss models required	Forward looking loss estimate	Sensitive to economic cycle
Discounting incorporated	Forecasting elements	Assess credit deterioration from origination
Determine 'significant deterioration'	Default must be defined	Define product lifetimes

Key decisions for IFRS 9 impairment

- **Design of IFRS 9 methodologies and models**
  - Granularity/calibration
  - What and how existing IRB models (or other models) could be leveraged and what should be done for portfolios that are on Standardised approaches
  - Definition and interpretation of "significant deterioration"
  - Application of forward-looking judgement: use of macro-economic factors and alignment of IFRS9 with forecasting / stress testing
- **Design of operating model (e.g., data, systems, calculations, governance, process and controls)**
  - Governance and control standards
  - Degree of centralisation
  - Alignment with planning processes
  - Data and system architecture

The 3-buckets approach for impairment



ECL measurement

Expected credit losses

Present value of all cash shortfalls over the remaining life, discounted at the original effective interest rate (EIR)

Numerator: *cash shortfalls*

- **The period over which to estimate ECL:** maximum contractual period (for revolving credit facilities, this extends beyond contractual period)
- **Probability-weighted outcomes:** possibility that a credit loss occurs, no matter how low the possibility
- **Reasonable and supportable information:** information available without undue cost or effort about the past, current and future forecasts

Denominator: *discount rate*

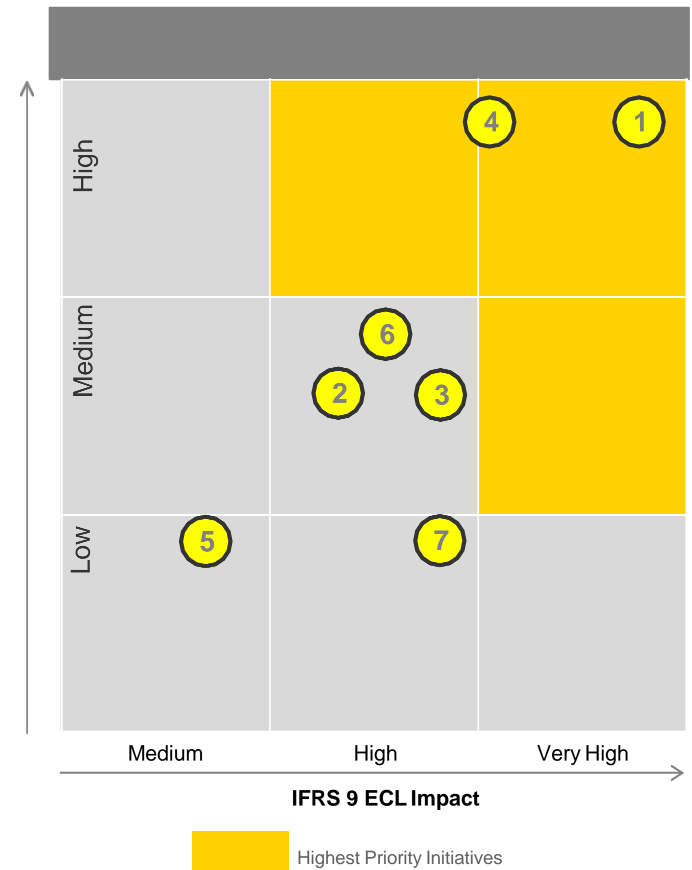
- **Discounting period:** from cash flows date to reporting date
- **Assets:** EIR or approximate (if credit-impaired on initial recognition, then use credit-adjusted EIR)
- **Commitments and guarantees:** current rate representing risk of the cash flows (for commitments, use EIR of resulting asset if this is determinable)

IFRS 9 Expected Credit Loss
Expected Work Effort and Key Judgments

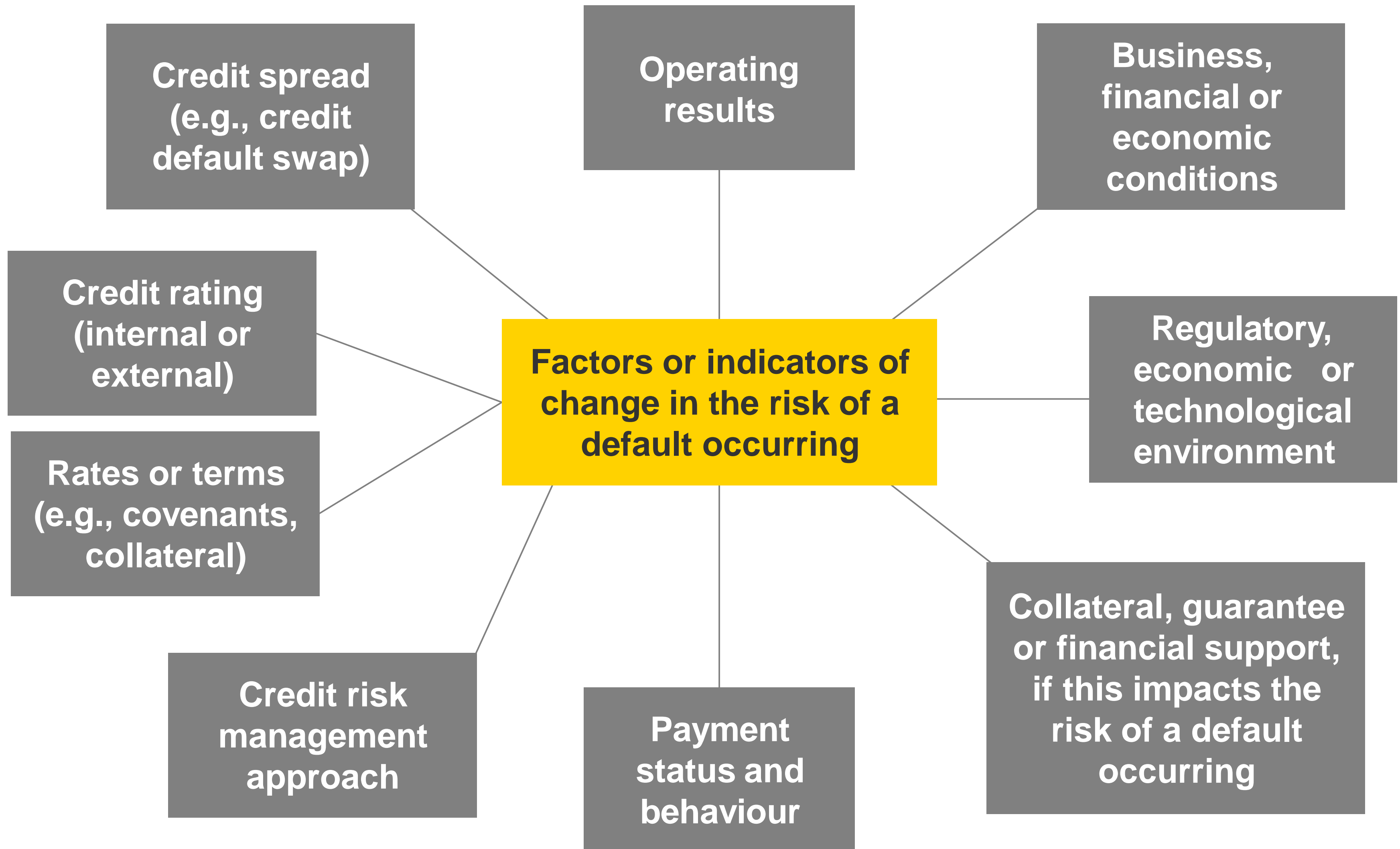
Based on our work with client, the following graph depicts the example of 7 key judgement areas of IFRS 9, and where we have seen the most impact and work effort involved in defining and implementing the methodology.

The Key Judgement Areas

1. Definition of significant deterioration (the transfer criteria)
2. Definition of lifetime
3. Discounting
4. Forward looking forecasting - Linkages to internal forecasts and plans likely, requiring the development of new forecasting processes and governance
5. Definition of default
6. Treatment of revolving products – (what is the contractual life and is there a difference between the 12 month and lifetime PDs)
7. Use of practical expedients and rebuttable presumptions



Factors or indicators of change in the risk of a default occurring



Loss rate approach

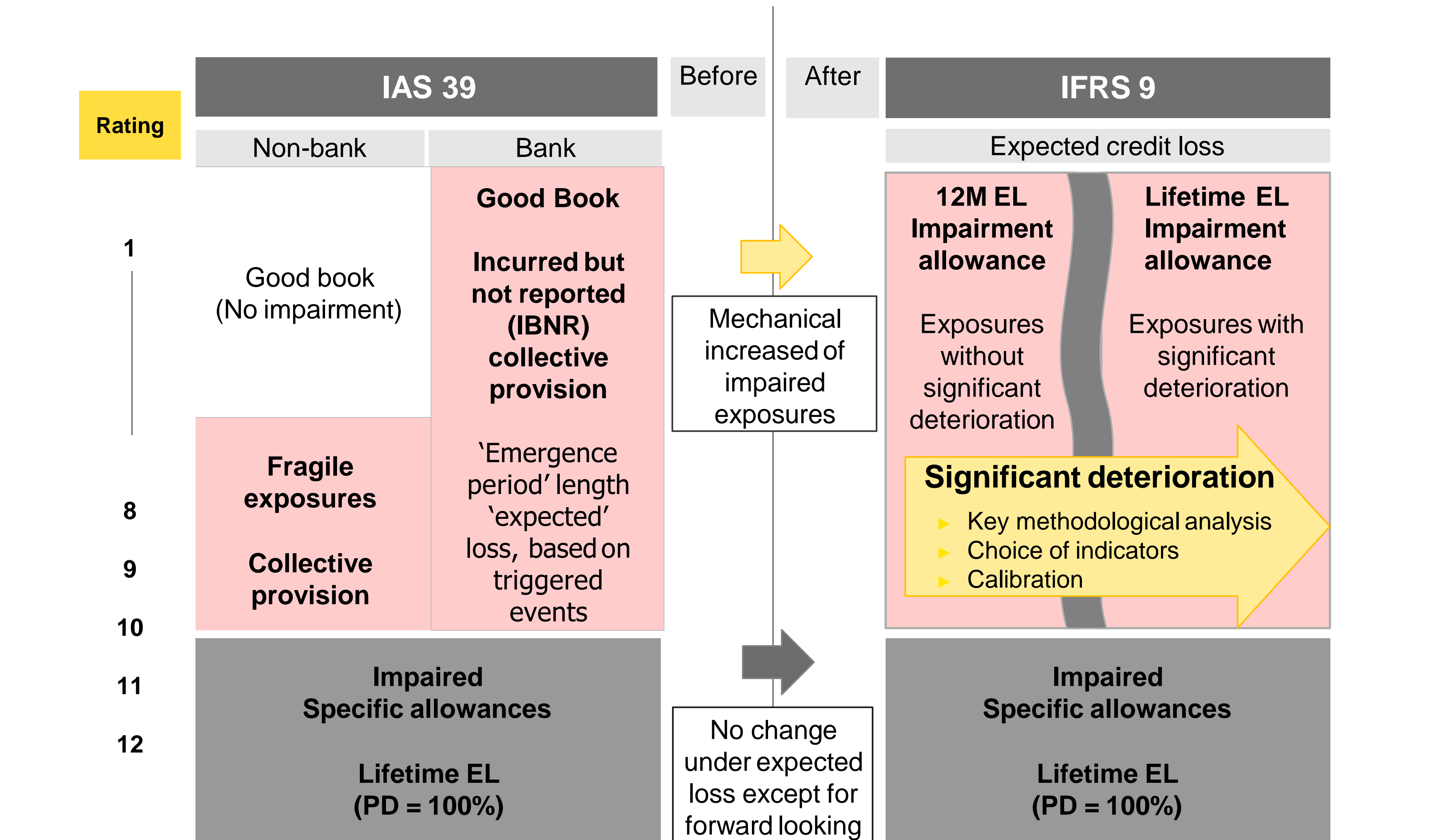
Loss rate approach: An entity develops **loss rate statistics** on the basis of the amount written off over the life of the financial assets **rather than** developing a **separate probability of default and loss given default statistics** and then adjusts these historical credit loss trends for current conditions and expectations about the future.

In practice

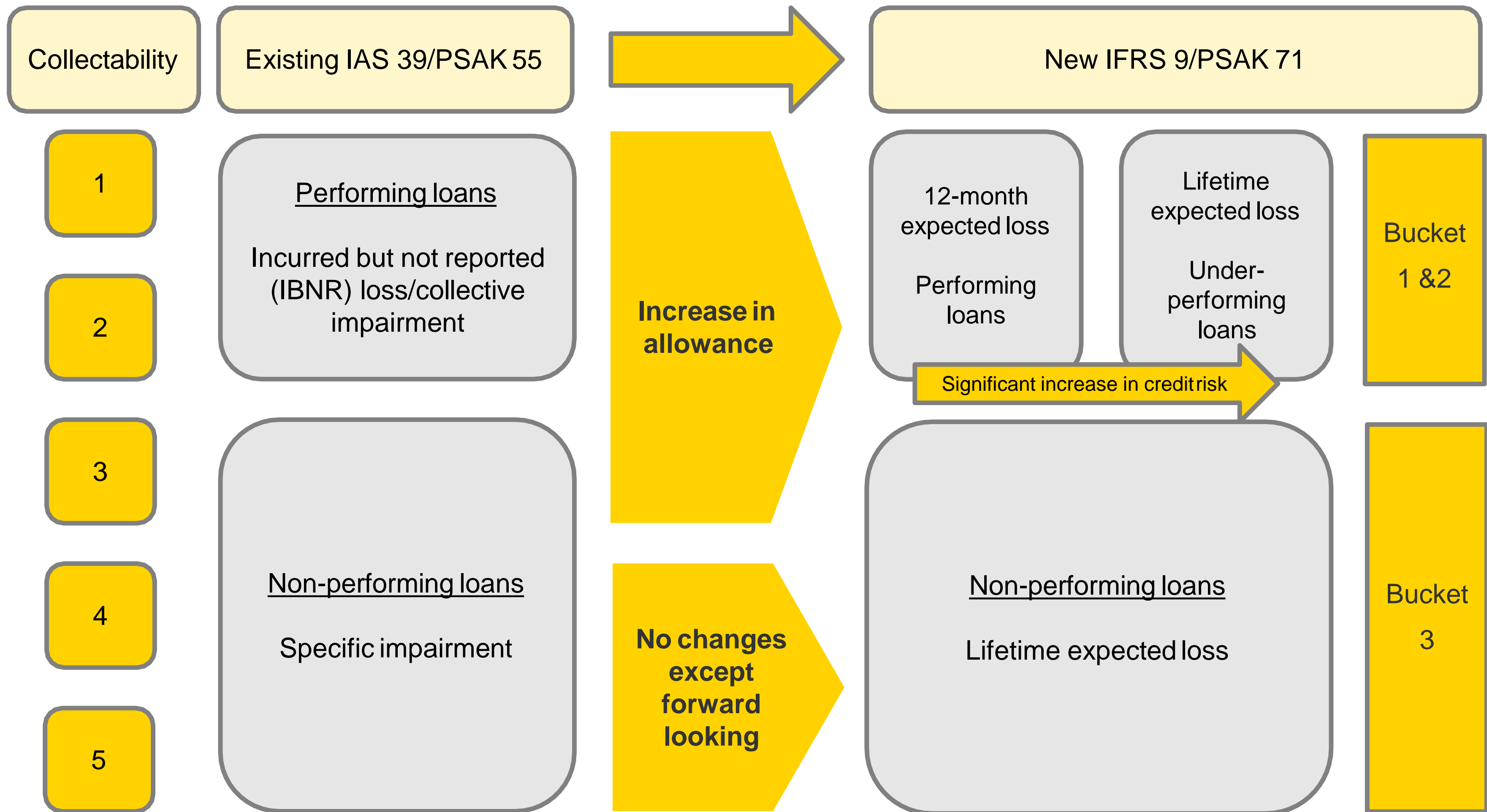
- Difficulty in assessing significant increases in credit risk based on the change in the risk of a default occurring
- Requires an overlay of measuring and forecasting the level of default

From IAS 39 to IFRS 9

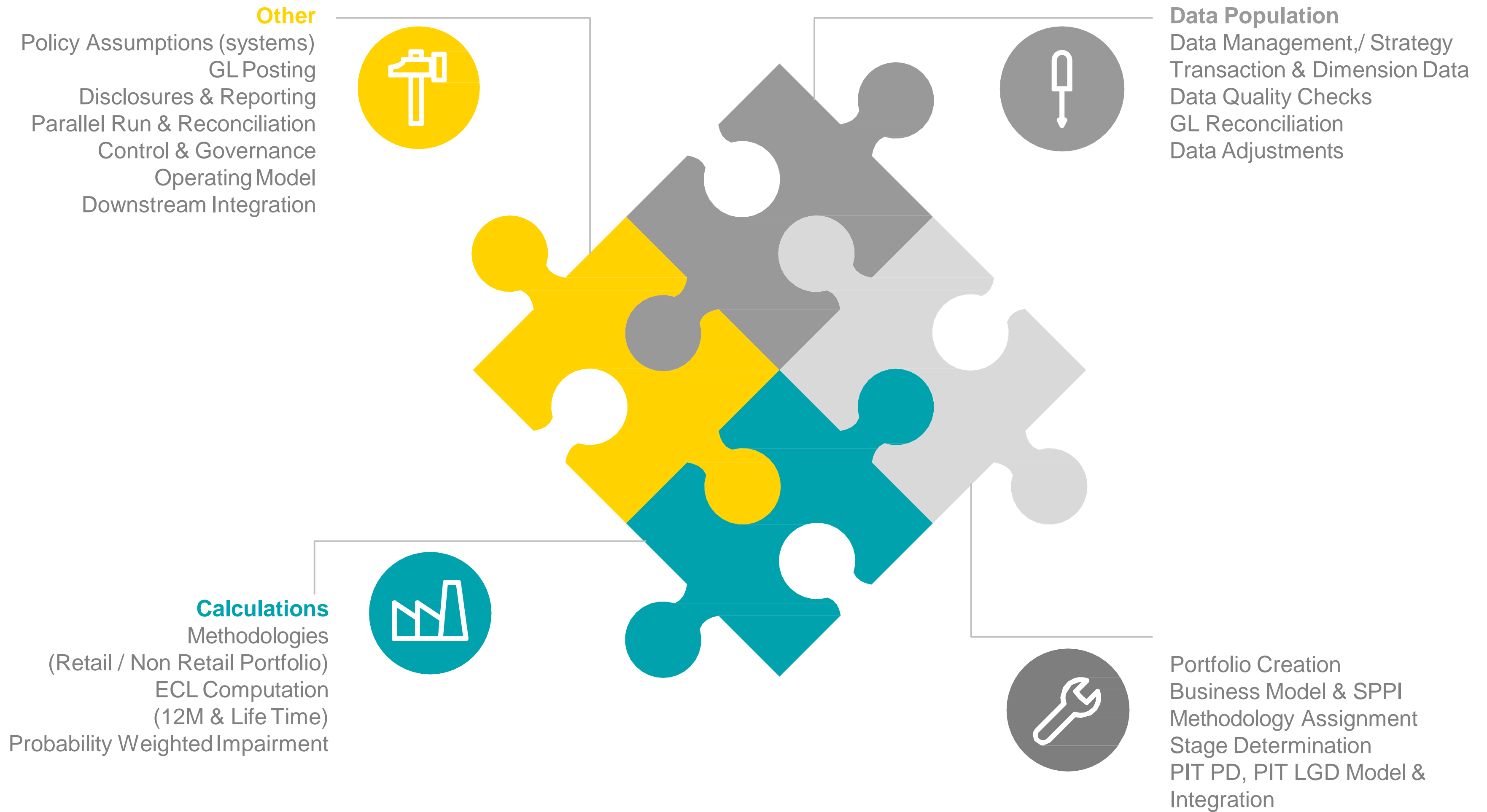
- **Example:**



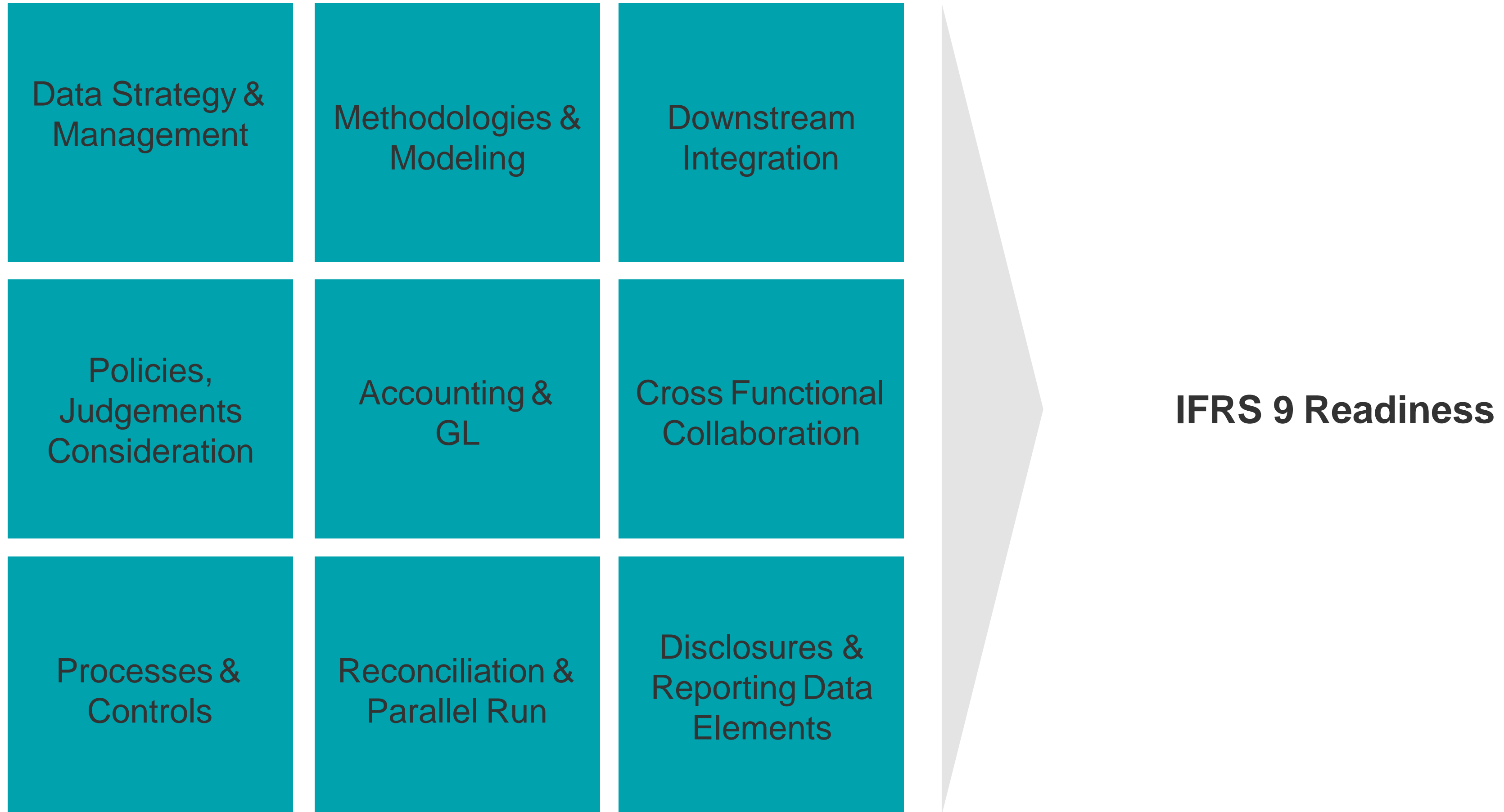
IFRS 9 – Incurred to expected credit loss (In Indonesia)



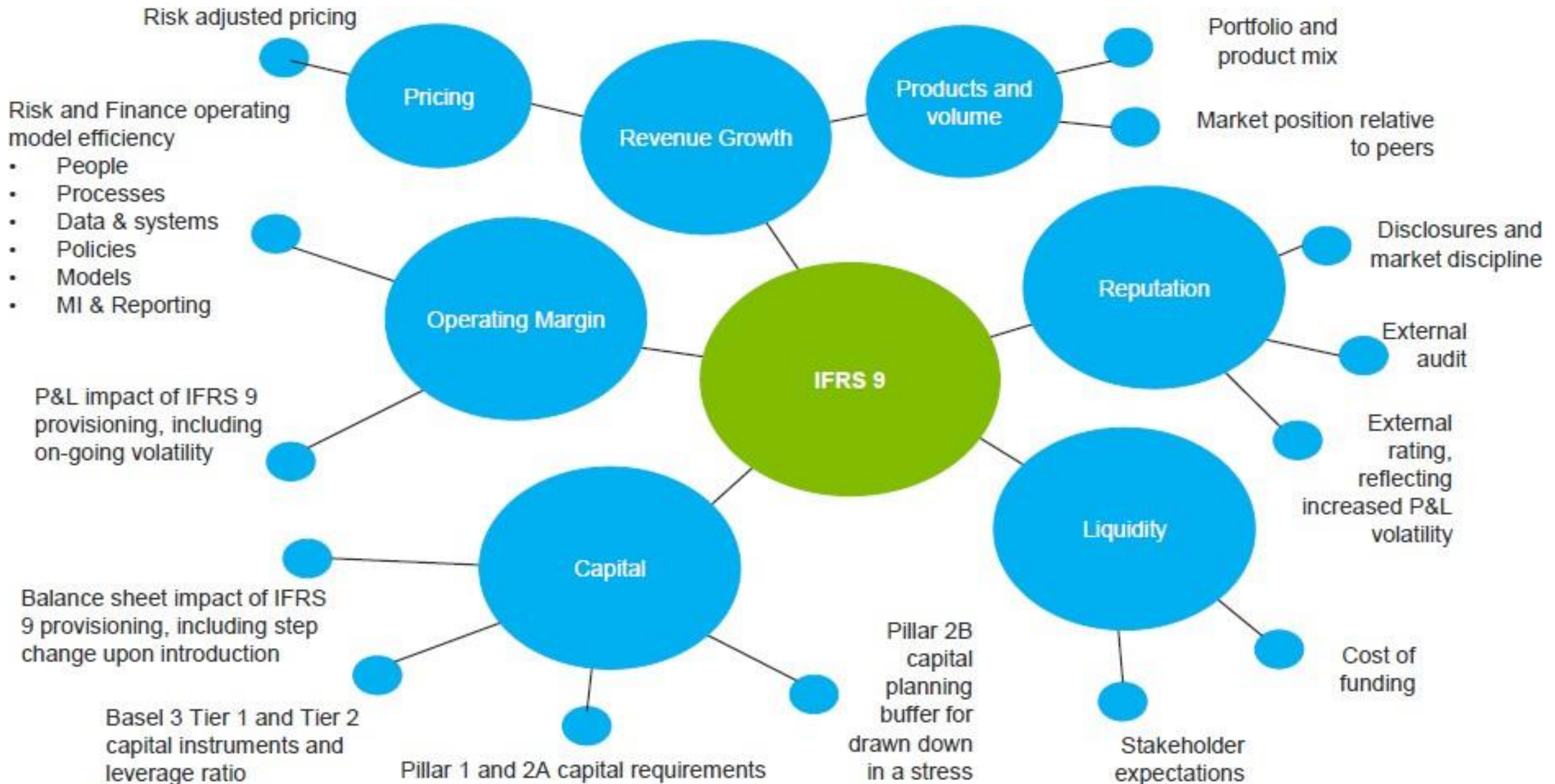
IFRS 9 System Implementation – Building Blocks



IFRS 9 Readiness and Implementation Challenges



IFRS 9 Implementation Complexities: Firm-wide Impact



Significant
deterioration

Overview

Significant deterioration = Transfer Point

Defining 'significant deterioration' is highly judgmental area of the standard.

No specific guidance as to what is deemed significant

Considerations:

- What information is currently available and used in the credit risk management processes ?
- The appropriate approach will vary depending on the level of sophistication of entities, the financial instruments and the availability of data
- Use of simplifications and presumptions

Transfer Criteria

Stage 1

Low credit risk

Stage 2

Significant increase in credit risk from initial recognition

AND

Not in low credit risk

Stage 3

Credit impaired

Disclosures

Roll-Forward Reconciliation Disclosure

Mortgage loans-loss allowance	12-month expected credit losses	Lifetime expected credit losses (collectively assessed)	Lifetime expected credit losses (individually assessed)	Credit impaired financial assets (lifetime expected credit losses)
CU'000				
Loss allowance as at 1 January	x	x	x	x
Changes due to financial instruments recognised as at 1 January:	x	-	(x)	-
• Transfer to lifetime expected credit losses	(x)	x	x	-
• Transfer to credit-impaired financial assets	(x)	-	(x)	x
• Transfer to 12-month expected credit losses	x	(x)	(x)	-
• Financial assets that have been derecognised during the period	(x)	(x)	(x)	(x)
New financial assets originated or purchased	x	-	-	-
Write-offs	-	-	(x)	(x)
Changes in models/risk parameters	x	x	x	x
Changes in time value	(x)	(x)	(x)	(x)
Foreign exchange and other Movements	x	x	x	x
Loss allowance as at 31 December	x	x	x	x

- IFRS 7 para 35H requires entities to present a reconciliation from the opening balance to the closing balance of the loss allowance (referred to as a 'roll forward' reconciliation).
- This reconciliation is required by class of financial instrument and, for each class, by each of stages 1, 2 and 3 and purchased/ originated credit-impaired assets. An illustrative example in PSAK 71 of how such a disclosure might look for mortgages, is reproduced adjacently.
- This reconciliation does not include a number of items which might be needed for mortgages or other types of loans, either as a separate row in the reconciliation or as supporting narrative disclosure.

Phase 3 – The New Hedge Accounting

Financial derivatives

- According to the standard, a financial derivative must meet the following **three (3) characteristics**:

Fair value or cash flow changes depending on the **underlying variable(s)**	Requires **no initial net investment** or **smaller initial net investment**	Settled at a **future date**

- The standard does not provide a definite list of what it considers as financial derivatives, because the list will become obsolete over time, given the evolution of the derivative markets.

Purpose of entering into derivatives

- Possible purpose of entering into a derivative contracts:

Hedging

- Strategy used to offset investment risk
- It is often used as a tool to manage risk
- A perfect hedge completely eliminates possible future gain or loss

Speculation

- "Betting" on the movement of the underlying asset in the hope of making profits
- Sometimes it might be difficult to differentiate between hedging and speculation

Key differences: snapshot

Requirement	IAS 39	IFRS 9
Risk component as eligible hedged item	Financial Items	All Items
80%-125% test	✓	X
Prospective effectiveness testing	✓	✓
Retrospective effectiveness testing	✓	X
Quantitative effectiveness test	✓	Depends
Qualitative effectiveness test	X	Depends
All ineffectiveness must be recognised	✓	✓
Accounting for ‘costs of hedging’	X	✓
Rebalancing of hedge ratio	X	✓
Dedesignation (risk management objective unchanged)	✓	X
Discontinuation (risk management objective changed or other qualifying criteria not met)	✓	✓

Risk management strategy and risk management objective

Risk management *strategy*

- Established at a high level (e.g., entity)
- Identifies risks (in general) and how entity responds to them
- Typically in place for longer period
- May include flexibility
- Often a formal policy document
- Part of hedge documentation

Risk management *objective*

- Applies at level of particular hedging relationship
- Describes how a particular hedging instrument is used to hedge a particular exposure designated as the hedged item
- Part of hedge documentation

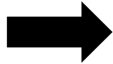
Risk management strategy and objective: a closer look

Why do risk management strategy and objective matter?

- Link between risk management activity and accounting
- Affects discontinuation of hedge accounting

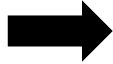
The new hedge effectiveness assessment: overview

Hedge effectiveness test



1) Economic relationship

- Between hedged item and hedging instrument
- Systematic change (opposite direction) in response to same or economically related underlyings



2) Credit risk does not dominate

- Credit risk does not frustrate economic relationship
- Credit risk can arise from hedging instrument and hedged item

3) Hedge ratio

- Consistent with actual ratio used by entity
- Different ratio only if accounting outcome would be inconsistent with purpose of hedge accounting

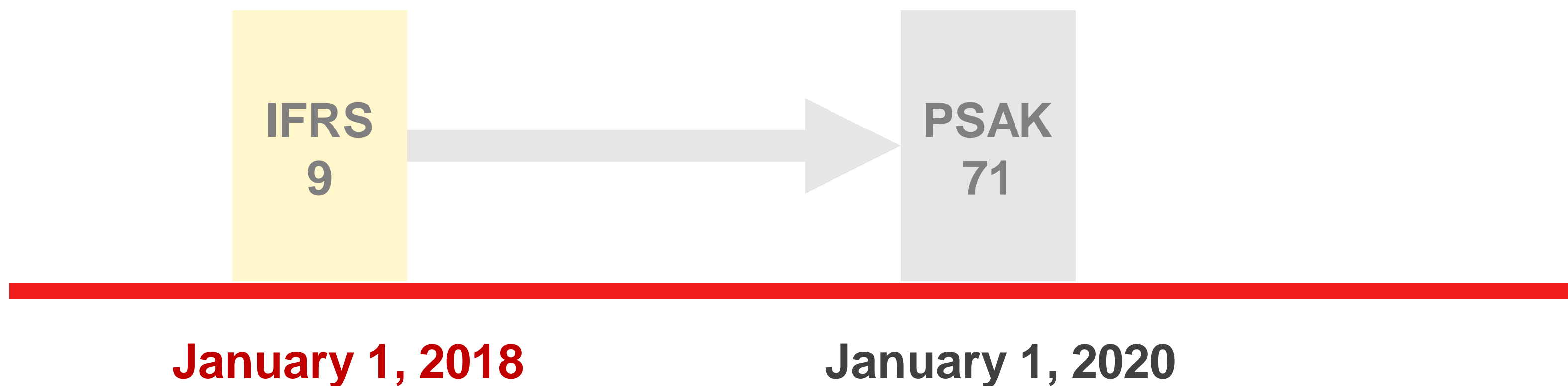
Discontinuation

- Examples in which a hedging relationship has to be (partly) discontinued prospectively:
  - There is no longer an economic relationship between the hedged item and the hedging instrument
  - The effect of credit risk dominates the value changes of the hedging relationship
  - The hedging instrument expires or is sold, terminated or exercised
  - The risk management objective has changed
  - As part of rebalancing, the volume of the hedged item or the hedging instrument is reduced

Transition

Transition Period and Effective Date of IFRS 9/PSAK 71

- Retrospective
- Early adoption



Transition Requirements (Paragraph 7.2)

Classification

On the date of Early Adoption:

- The entity assess all its financial assets and classified it according to the business model and cashflow management based on the facts and condition existing on the date.
- The classification is adopted retrospectively without considering the entity's business model on the previous reporting period

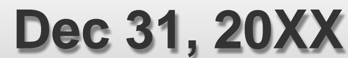
Transition Requirements (Paragraph 7.2)

On the date of early adoption:

- Determine whether there is a significant increase in the credit risk: credit risk on the date of initial recognition of the financial instrument and compare it to the credit risk on the date of early adoption of the standard. (using the applicable information which supported and available without significant effort and cost.)

- If such determination required significant effort and cost, then the entity recognized allowance for loss amounting to the expected credit loss over the instrument period on each reporting date until the financial instrument is derecognize

Transition Requirements (Paragraph 7.2)



Disclosure

The Entity which adopted the requirement for classification and recognition under this standard would provide disclosure in accordance to PSAK 60 paragraph 42L-42O however it is not required to revised the previous period disclosure

- The entity do not need to revise the previous year disclosure, the entity recognized the difference between the previous year carrying value with the carrying value at the beginning period of the annual reporting
- If the entity revised the previous period, the financial report which is revised should disclose all of the requirement under this standard.

Thank You