KPMG
cutting through complexity

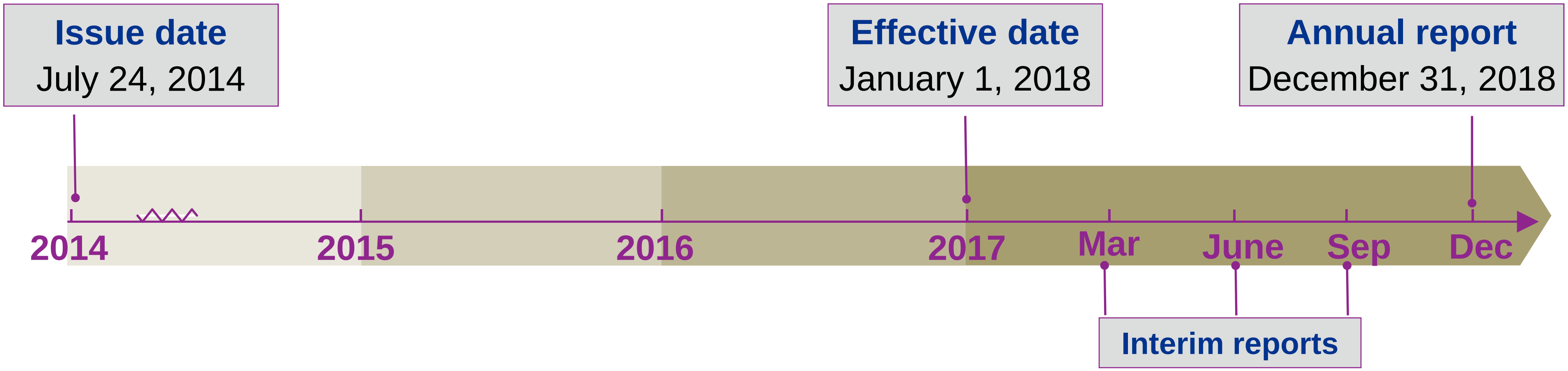
IFRS 9 *Financial Instruments*

Caribbean Actuarial Association

December 4, 2015

IFRS 9: Effective date

IFRS 9 Effective Date



- Optional transitional relief – see next slide
- Transition options:
  - IFRS 9 is effective from 1 January 2018 and contains certain exemptions from full retrospective application (including from restatement of comparatives and limited reopening of fair value option)
  - Retrospective restatement of comparative information is likely to be required by the forthcoming insurance contracts standard.

Insurance contracts project & IFRS 9

- **The project to complete a new insurance contracts accounting standard continues but release of the final standard will not be until later in 2016, and will likely not be effective before 2020 – well after the effective date of IFRS 9 in 2018**
- **The IASB has tentatively decided to provide optional transitional relief for the mismatches and volatility that can arise as a result of implementing IFRS 9 in the period prior to the implementation of the forthcoming insurance contracts standard:**
  - permit a reporting entity whose activities are predominantly insurance* a temporary exemption from applying IFRS 9 until 1 January 2021 (the 'deferral approach'); and
  - give entities issuing insurance contracts that implement IFRS 9 the option to remove from profit or loss some of the accounting mismatches and temporary volatility that could occur before the forthcoming insurance contracts standard is implemented (the 'overlay approach').

* "*predominantly insurance*" *would be evaluated based on the proportion of total liabilities made up by insurance contract liabilities; no specific quantitative threshold intended but staff example used 80%*

Insurance - IASB timeline for amendment of existing IFRS 4

The proposed optional relief measures will result in a fast track exposure draft process to amend the existing IFRS 4 Insurance Contracts standard, and these measures will also need to be in the new insurance contracts standard

December 2015

- **Publish ED to amend IFRS 4**

February 2016

- **Recommended 60 day comment period ends**

2Q 2016

- **Redeliberations on the proposals in the ED to amend IFRS 4**

3Q 2016

- **Issuance of amendments to IFRS 4**

Reaction from preparers so far:

- Many EU life insurers believe that they will be unable to meet the “predominantly insurance” condition due to the amount of investment contracts and other liabilities issued

IFRS 9: Classification and Measurement

Measurement categories

- The measurement categories are similar:

IFRS 9	IAS 39
FVTPL*	FVTPL
Amortised cost	Loans and receivables/ HTM*
FVOCI*	AFS*

- Significant changes in criteria for classifying assets.

Derivatives embedded in a financial asset are not separated – the whole asset is assessed for classification.

Reclassification of financial assets is subject to strict conditions and expected to be very infrequent.

* FVTPL – fair value through profit or loss, FVOCI – fair value through other comprehensive income,
HTM – held to maturity, AFS – available for sale

Reclassifications

Financial assets

Reclassification is required if the business model has changed.

Expected to be very infrequent as changes must be significant to the entity's operations and demonstrable to external parties.

Financial liabilities

Reclassifications are not permitted.

✓ Reclassify Financial Assets

✗ Reclassify Financial Liabilities

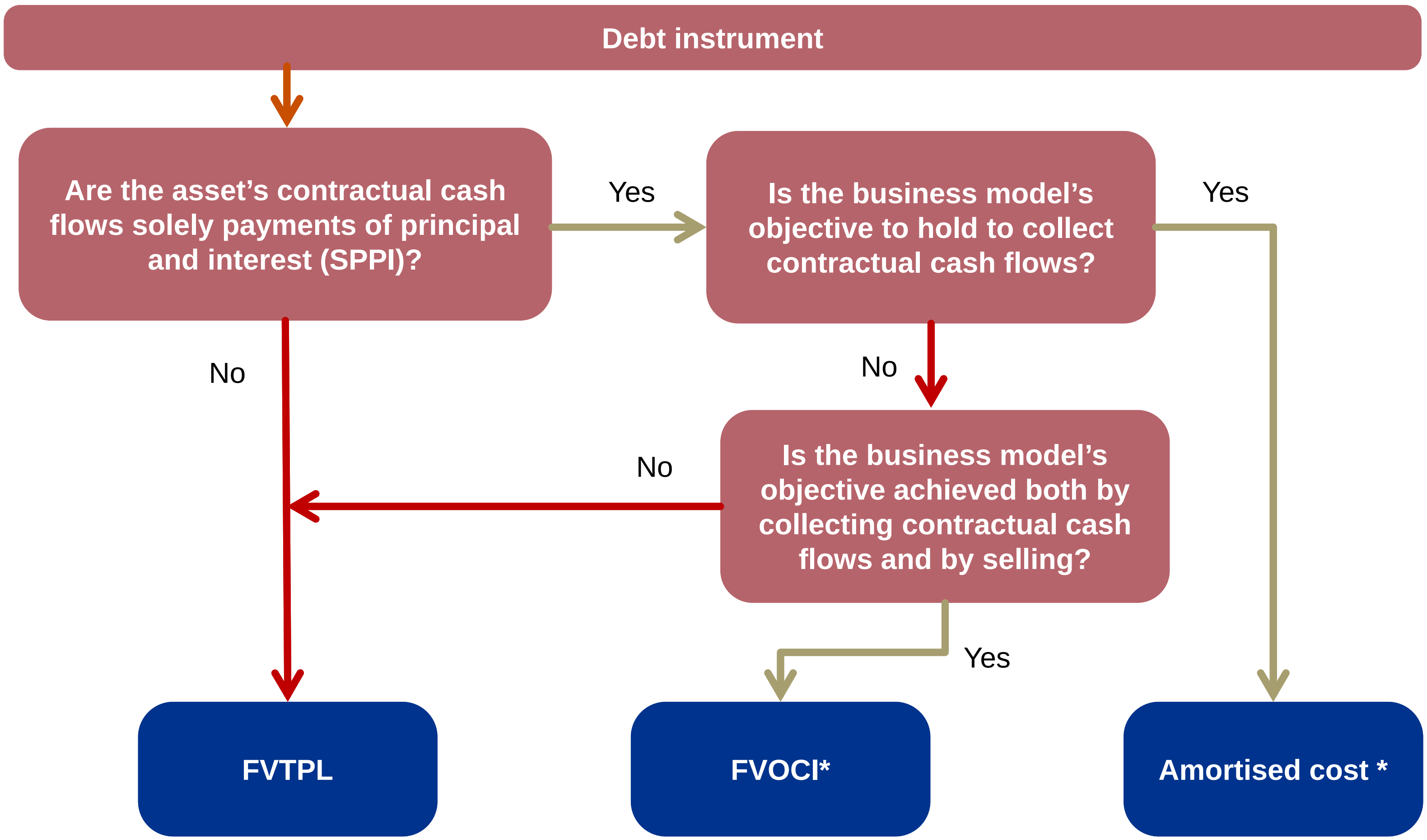
Classification and Measurement
Financial Liability

Measurement categories

- Requirements from IAS 39 largely retained.
  - Classified as measured at amortised cost or FVTPL.
- Presentation in OCI* of gain or loss on a financial liability designated at FVTPL attributable to changes in own credit risk.

* OCI – other comprehensive income

Classification of Financial Assets – Debt Instruments



* Subject to FVTPL designation option - if it reduces accounting mismatch

Business Model Assessment

Business model refers to how an entity manages its financial assets in order to generate cash flows.

Business model is a matter of fact – typically observable through the activities undertaken.

Does not depend on management's intention for an individual instrument.

However, judgement is often needed.

Types of Business Models

Held-to-collect contractual cash flows

- Financial assets held to collect contractual cash flows over the life of the instrument.
- Need not hold all instruments until maturity.
- Selling assets is incidental to business model objective.

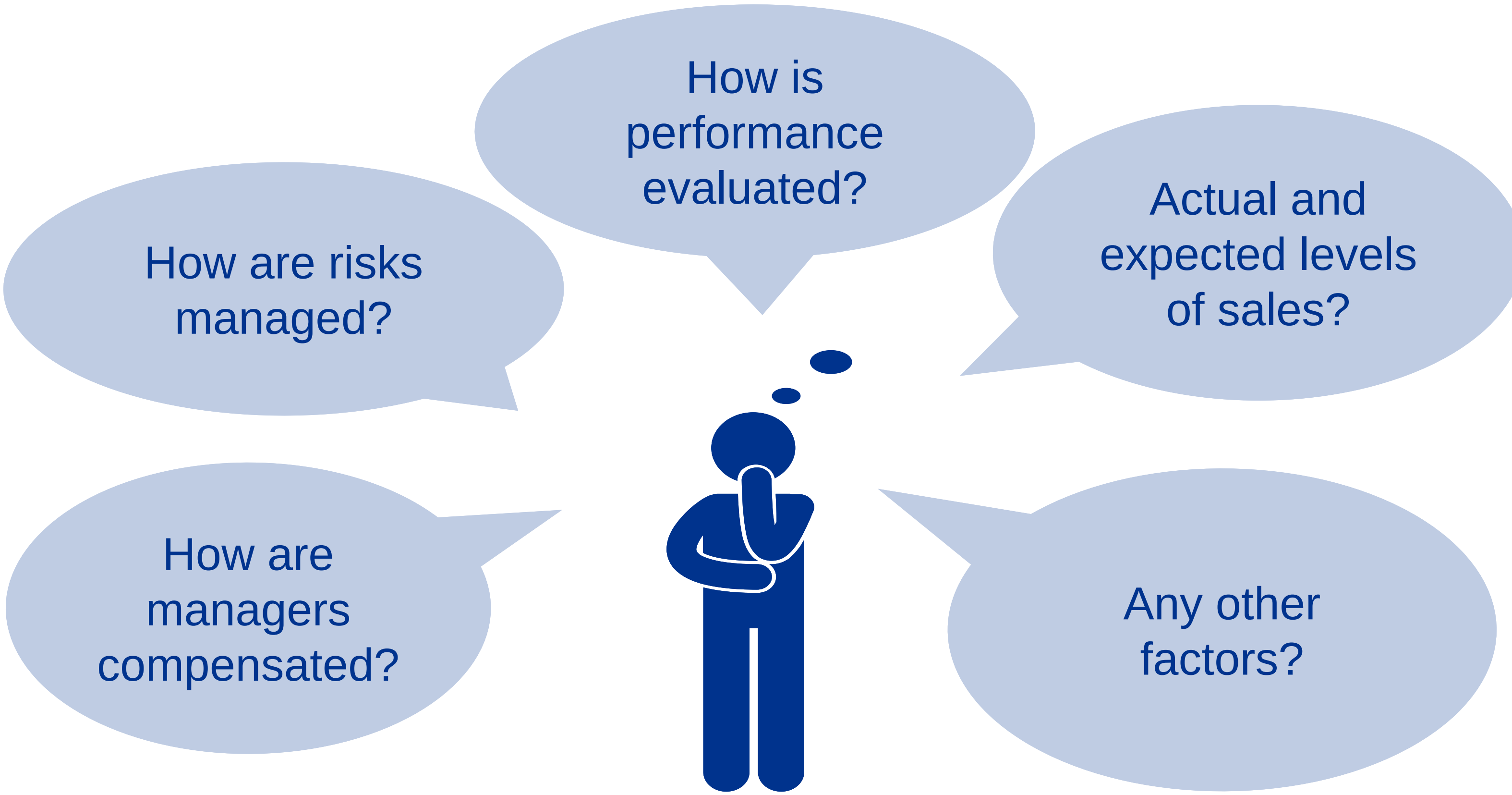
Held both to collect contractual cash flows and to sell

- Both collecting contractual cash flows and selling financial assets are integral to achieving objective of business model.
- Typically involves greater frequency and value of sales compared to held to collect model.

Other business models

- Models that do not meet the above criteria.

Business model: Assessment considerations



Assessed at a level at which groups of assets are managed, e.g. a portfolio.

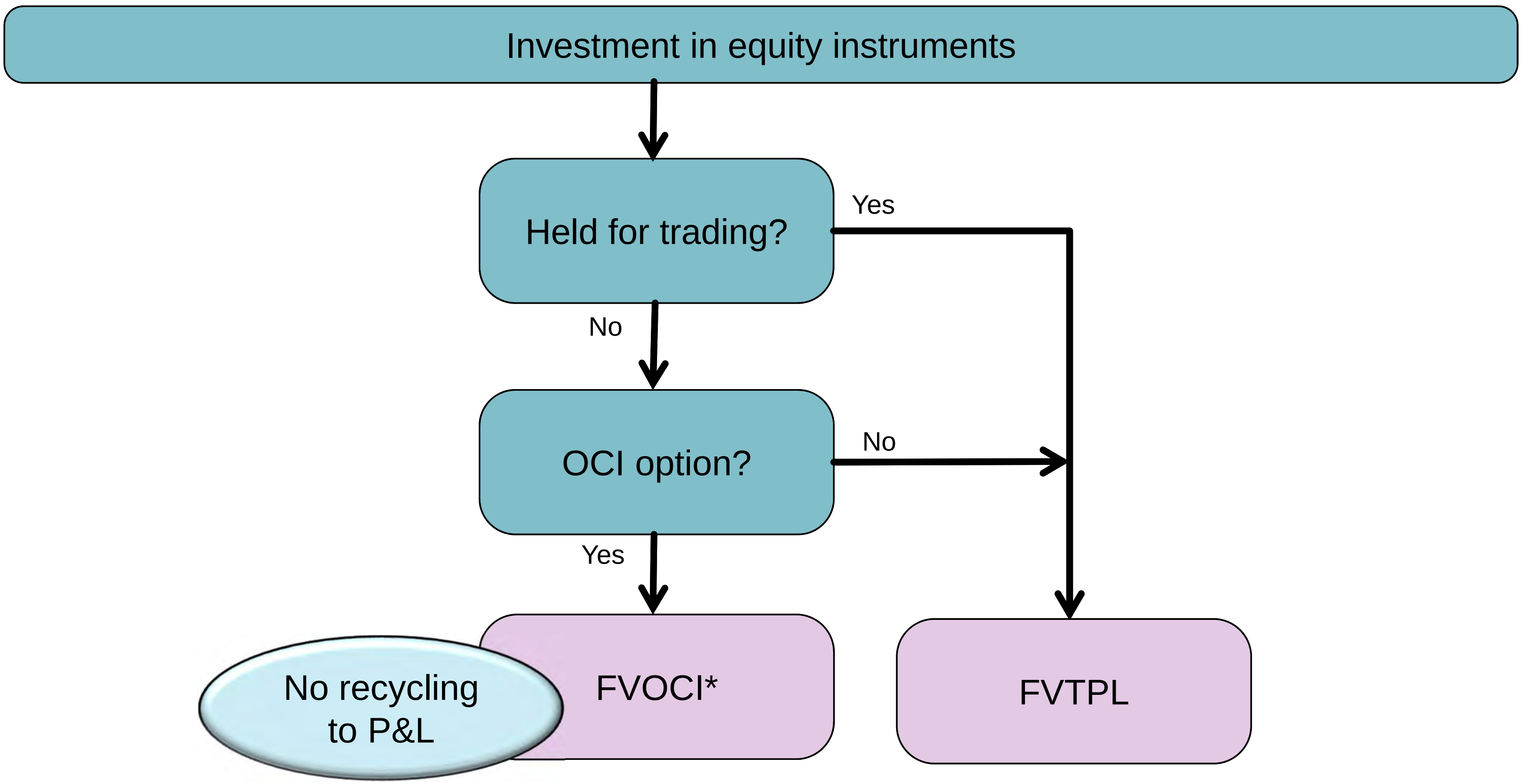
The SPPI Criterion

Do the cash flows consist only of principal and interest?

Consistent with a basic lending arrangement.

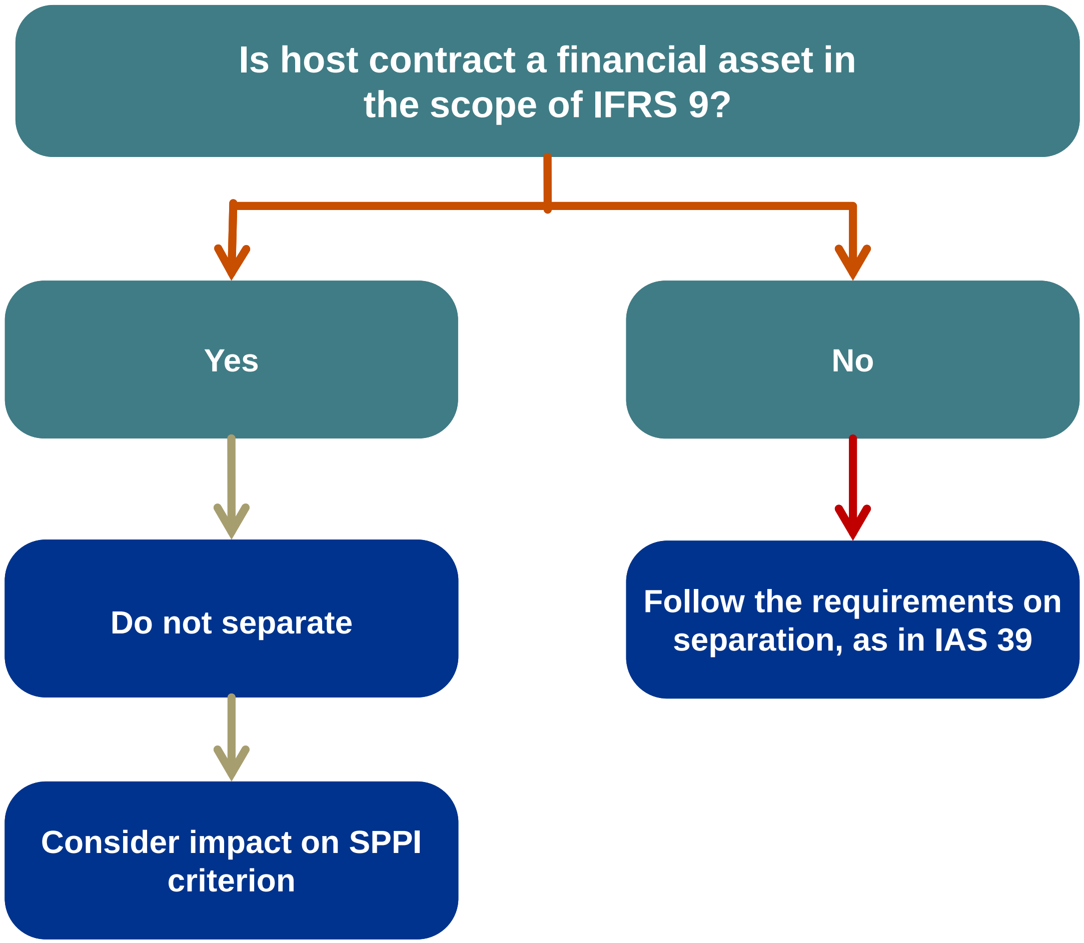
	Definition
Principal	Fair value of asset on initial recognition.
Interest	Consideration for: time value of money; credit risk; other basic lending risks (such as liquidity risk); other associated costs (such as administrative costs); and a profit margin.

Classification of investments in equity instruments



*This election is irrevocable and can be made on an instrument-by-instrument (e.g., Individual share) basis.

Classification and measurement
Embedded Derivatives



Option to Designate at FVTPL

Financial assets

May designate only if doing so eliminates or significantly reduces measurement or recognition inconsistency (accounting mismatch).

Financial liabilities – no change from IAS 39

Additionally, a financial liability can be designated as at FVTPL if:

- Managed on fair value basis or
- Contains separable embedded derivative

In addition, the following can be designated as at FVTPL if specific conditions are met:

Certain contracts to buy or sell a non-financial item.

Certain credit exposures.

Measurement of Financial Assets

Measurement category	P&L	OCI	Presentation of gains/losses same as under IAS 39?
Amortised cost	All gains and losses	-	✓
Debt investments at FVOCI	Interest, impairment losses, foreign exchange gains and losses, gain or loss on disposal	Other gains and losses	✓
Equity investments at FVOCI	Dividends (unless clearly represents recovery of part of cost of investment)	Fair value gains and losses	✗
FVTPL	All gains and losses	-	✓

Measurement of Financial Assets: Equity Investments

Equity investments at FVOCI:

- On derecognition, amounts recognised in OCI are not reclassified to profit or loss (different to debt investments at FVOCI).
- No impairment loss recognised in profit or loss.

No cost exemption for equity investments and derivatives linked to such investments.

IFRS 9: Impairment

Principal changes from IAS 39

	IAS 39	IFRS 9
Type of model	Incurred loss	Expected loss
Number of models	Several	One
Scope	Extended	
Equity investments	Impairment recognized for AFS* equity investments	No impairment recognized for equity investments
Judgement	Increased	

* AFS – Available for sale

Impairment – The new model

Expected loss model

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Past events

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Current conditions

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Forecast of future economic conditions

- Generally, all financial assets carry a loss allowance
  - No trigger is required for recognizing impairment
- More judgement
- One model for financial instruments in the scope of IFRS 9

Scope of impairment model

In scope

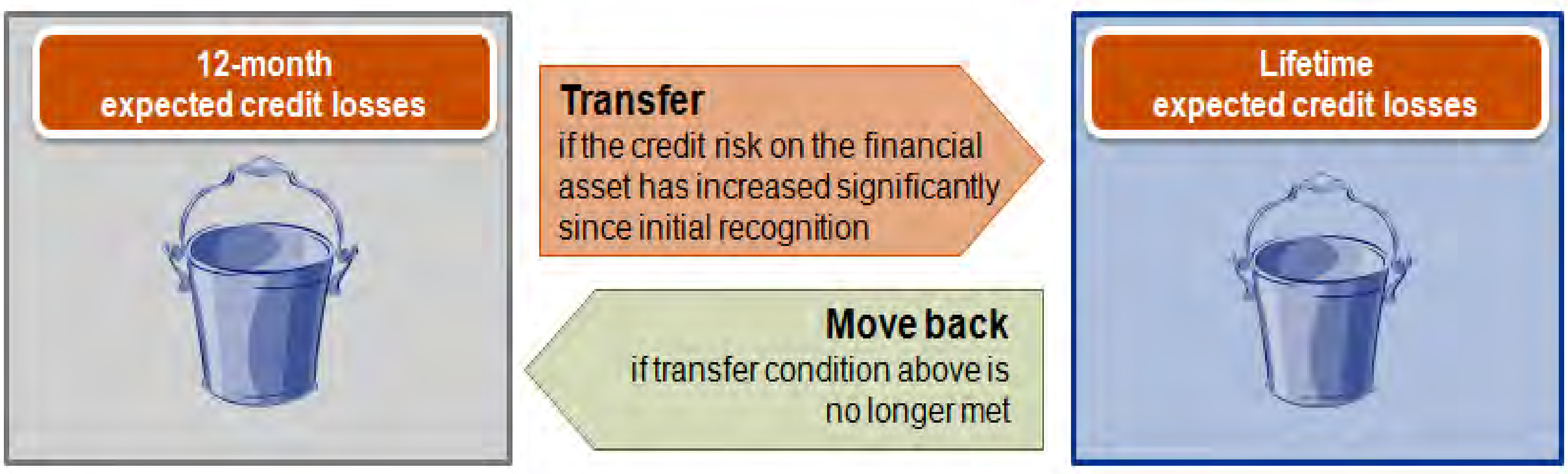
- Debt instruments measured at amortized cost or at FVOCI*
- Loan commitments issued not measured at FVTPL*
- Financial guarantee contracts issued in the scope of IFRS 9 not measured at FVTPL
- Lease receivables in the scope of IAS 17
- Contract assets in the scope of IFRS 15

Out of scope

- Equity investments
- Financial instruments measured at FVTPL

* FVTPL – Fair-value through profit or loss
  FVOCI – Fair-value through other comprehensive income

General (dual measurement) approach



- Under the general principle, one of two measurement bases will apply:
  - 12-month expected credit losses: losses associated with possible default in the next 12 months, or
  - Lifetime expected credit losses: losses associated with possible default during life of the financial asset
- The measurement basis depends on whether there has been a significant increase in credit risk since initial recognition

Dual Measurement Approach – Key Concepts

12-month expected credit losses	▪ Losses resulting from default events possible within 12 months after reporting date.
Lifetime expected credit losses	▪ Losses resulting from all possible default events over expected life of financial instrument.
Significant increase in credit risk	▪ Not defined.
Default	▪ Not defined.

Assessment of significant increases in credit risk – A relative concept

- **Assessment based on change in risk of default since initial recognition**
- **Not based on change in amount of ECL**
- **Based on all reasonable and supportable information, including forward-looking info, available without undue cost or effort such as:**
  - Actual/expected internal/external credit rating changes
  - Actual/forecast macroeconomic data
  - Changes in price and market indicators of credit risk
  - Actual/expected changes in operating results/environment of borrower

Trade and lease receivables

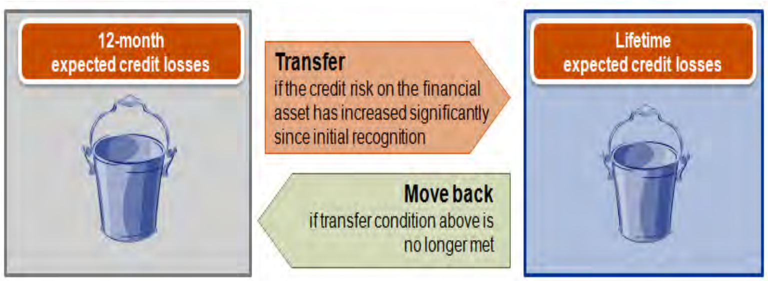
Lease receivables

Trade receivables and contract assets with a significant financing component

Trade receivables and contract assets without a significant financing component

Policy election to apply

General approach



Simplified approach

Loss allowance always equal to lifetime expected credit losses

Practical expedient to calculate expected credit losses – provision matrix

Practical Expedient: Provision Matrix

- Entity M operates only in one geographical location, and has a portfolio of trade receivables of CU30million on 31 December 20X1.
- The customer base consists of a large number of small clients.
- The trade receivables have common risk characteristics.
- The trade receivables do not have a significant financing component.
- M uses a provision matrix to calculate impairment.

Provision matrix estimate*:

	Current	1–30 days past due	31–60 days past due	61–90 days past due	More than 90 days past due
Default rate	0.3%	1.6%	3.6%	6.6%	10.6%

*The provision matrix is based on:
- historical default rates over the expected life of the trade receivables; and
- adjustment for forward-looking estimates.

Practical Expedient: Provision Matrix – Impairment Calculation

Calculation of impairment using the provision matrix:

	Gross carrying amount (A)	Lifetime expected credit loss rate (B)	Lifetime expected credit loss allowance (A x B)
Current	CU15,000,000	0.3%	CU45,000
1–30 days past due	CU7,500,000	1.6%	CU120,000
31–60 days past due	CU4,000,000	3.6%	CU144,000
61–90 days past due	CU2,500,000	6.6%	CU165,000
>90 days past due	CU1,000,000	10.6%	CU106,000
	CU30,000,000		**CU580,000**

IFRS 9: Hedging

Hedge Accounting overview

Overview

- Aligns hedge accounting with risk management
- Additional qualifying exposures
- Cash instruments may be hedging instruments in additional circumstances
- New requirements to achieve, continue and discontinue hedge accounting

Differences from Current Practice

- Alternative fair-value option model for certain own-use contracts
- New fair-value option model for managing credit risk
- Additional disclosure requirements regarding an entity’s risk management and hedging activities

A better link between accounting and risk management

IFRS 9 incorporates new hedge accounting requirements that represent a major overhaul of hedge accounting and introduce significant improvements, principally by aligning the accounting more closely with risk management.

Objective of hedge accounting

Represent in the financial statements the effect of an entity's risk management activities when they use financial instruments to manage exposures arising from particular risks

Why use hedge accounting?

An entity uses hedging to manage its exposure to risks, for example

- ✓ foreign exchange risk
- ✓ Interest rate risk
- ✓ the price of a commodity

Many Existing Concepts Retained

- Three hedge accounting models:
  - ✓ Fair value hedge.
  - ✓ Cash flow Hedge.
  - ✓ Hedge of a net investment.
- Hedge documentation requirements.
- Measurement of hedged items and hedging instruments.
- Measurement of ineffectiveness.

Hedge effectiveness assessment

Out	In
80% – 125% test	Qualitative, forward-looking

- Economic relationship exists.
- Credit risk does not dominate value changes.
- Hedge ratio matches actual ratio used for risk management.

Establish link between hedging relationships and risk management objectives

KPMG OBSERVATION

Hedge effectiveness assessment

Frequency of Assessment

- Inception; and
- On going basis:
  - Each reporting date; or
  - A significant change in the circumstances

Qualitative or quantitative?

- Depends on facts and circumstances
- Qualitative assessment appropriate in some circumstances
- Risk management policy – main source of information
- May require change in methodologies assessment

- More judgment required
- Changes to systems and procedures

For insurers, changes will be more complex than the initial adoption of IFRS

High-level implementation plan

This plan assumes 2020 implementation of IFRS 4 Phase II and a deferral approach for IFRS 9

2015 — 2016 — 2017 — 2018 — 2019 — 2020 Go LIVE!

IFRS 4 Phase II

- Make key decisions and revisit
- Design and test systems & processes
- Implement and dry run BAU processes
- Determine transitional adjustment and IAS 1 disclosures

What could you start now?

- Cash flows
- Determination of discount rates
- Locked-in discount rates/FVTPL
- Risk margin approach

IFRS 9

- Assess impact of requirements
- Prepare limited transitional disclosures
- Design and test systems & processes
- Implement and dry run systems and processes
- Determine transitional adjustment and IAS 1 disclosures

What could you start now?

- Consider IFRS 9 options
- Asset classification
- Impairment

Wider business impacts

- Set up project team
- Assess wider business implications
- Design and implement solutions
- Provide indicative reporting to the market/key stakeholders

Sustain

Project management, communications, training and development

Questions and Discussion

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