IFRS 9, viewed by an accountant

Thomas Heneryd, PwC
4 November 2015
**PwC has strong IFRS 9 competence locally and throughout the network**

PwC is a global audit and consulting practice, with a key focus on Banking & Capital markets and a large network of experts available to clients. PwC has an unmatched experience in supporting many financial institutions with IFRS 9 programmes across Europe.

With over **18,700 professionals** the PwC global Banking & Capital Markets network has the resources and experience to provide the industry expertise and quality expected by our clients. We understand that our client’s businesses are evolving and we have specialists around the world that are ready to deliver.

What does our banking and capital markets leadership mean to clients?

- Extensive, specialist qualified resources in place in all key locations. This includes IFRS specialists within all areas who are extensively involved in driving thought leadership.

- IFRS 9 experienced professionals who have conducted projects in a wide range of countries, including the U.S., Germany and the UK.

- Up to date knowledge of business and regulatory environment in all locations. Strong experience from supporting global clients in responding to regulatory challenges and change.

- Understanding of business priorities, and the knowledge and experience to help clients deal with them.

**The PwC-network**

- **157 countries**
- **758 locations**
- **18,700 Banking & Capital Markets professionals**

*Source: Global People Statistics, June 2014, Global Data Warehouse*

Some of our clients we worked with on IFRS 9 projects

- IFRS 9 all phases, pre-study and implementation concept
- IFRS 9 Classification & Measurement
- IFRS 9 portfolio screening and implementation of the SPPI test
- IFRS 9 implementation project on Classification and Measurement and Hedge Accounting
- IFRS 9 implementation project on Classification and Measurement
- IFRS 9 transformation project – LLP test calculation

Further IFRS 9 projects have been performed at:

- DekaBank
- HSH Nordbank
- NORD/LB
- DEG
- WGL Bank
- WL Bank
- Postbank
- Finanzgruppe Deutscher Sparkassen- und Giroverband

IFRS 9, viewed by an accountant

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The effective date will be for annual periods starting on or after 1 January 2018.
EU endorsement expected H1 2016
- IASB is considering specific transition solutions for insurance companies
Retrospective application is required except:
- If on transition application requires undue cost or effort, operational simplifications are provided.
- No requirement to restate comparatives.
IFRS 9

1. Classification & Measurement

2. Impairment – Expected credit losses (ECL)

3. Hedge accounting

Transition rules:
- Entities permitted to early apply IFRS 9 (subject to EU-approval)
- "Own credit" requirements available for early application, in isolation, until the mandatory effective date
- Policy choice between applying IFRS 9 or continue to apply IAS 39 regarding hedge accounting until the Macro hedging project has been finalized
Audit of impairment estimates

IAS 39 → IFRS 9 Transition → IFRS 9 Business as usual

Audit
Audit?

“My responsibility is to express an opinion on these annual accounts based on my audit. “

“An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the annual accounts and consolidated accounts. “

“An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Board of Directors and the Managing Director”

“In my opinion, the annual accounts have been prepared in accordance with the Annual Accounts Act and present fairly, in all material respects, the financial position of the company as of 31 December 201X and of its financial performance for the year then ended.”
## Amounts and disclosures

### Performance

<table>
<thead>
<tr>
<th>EURm</th>
<th>Note</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before loan losses</td>
<td></td>
<td>4,858</td>
<td>4,851</td>
</tr>
<tr>
<td>Net loan losses</td>
<td>G10</td>
<td>-534</td>
<td>-735</td>
</tr>
<tr>
<td>Operating profit</td>
<td></td>
<td>4,324</td>
<td>4,116</td>
</tr>
</tbody>
</table>

### Financial position

#### Cash and balances with central banks

<table>
<thead>
<tr>
<th>EURm</th>
<th>Note</th>
<th>31 Dec 2014</th>
<th>31 Dec 2013</th>
<th>1 Jan 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans to central banks</td>
<td>G13</td>
<td>31,067</td>
<td>33,529</td>
<td>36,060</td>
</tr>
<tr>
<td>Loans to credit institutions</td>
<td>G13</td>
<td>6,958</td>
<td>11,769</td>
<td>8,005</td>
</tr>
<tr>
<td>Loans to the public</td>
<td>G13</td>
<td>12,217</td>
<td>10,743</td>
<td>10,569</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td>348,085</td>
<td>342,451</td>
<td>346,251</td>
</tr>
</tbody>
</table>

### Disclosures

#### Central banks and credit institutions

<table>
<thead>
<tr>
<th>EURm</th>
<th>31 Dec 2014</th>
<th>31 Dec 2013</th>
<th>The public&lt;sup&gt;1&lt;/sup&gt;</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loans, not impaired</td>
<td>19,177</td>
<td>22,515</td>
<td>344,407</td>
<td>338,703</td>
</tr>
<tr>
<td>Impaired loans</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Performing</td>
<td></td>
<td></td>
<td>6,425</td>
<td>6,540</td>
</tr>
<tr>
<td>- Non-performing</td>
<td></td>
<td></td>
<td>4,115</td>
<td>3,909</td>
</tr>
<tr>
<td>Loans before allowances</td>
<td>19,177</td>
<td>22,515</td>
<td>350,832</td>
<td>345,243</td>
</tr>
<tr>
<td>Allowances for individually assessed impaired loans</td>
<td></td>
<td></td>
<td>-2,329</td>
<td>-2,373</td>
</tr>
<tr>
<td>- Performing</td>
<td></td>
<td></td>
<td>-1,432</td>
<td>-1,372</td>
</tr>
<tr>
<td>- Non-performing</td>
<td></td>
<td></td>
<td>-897</td>
<td>-1,001</td>
</tr>
<tr>
<td>Allowances for collectively assessed impaired loans</td>
<td>-2</td>
<td>-3</td>
<td>-418</td>
<td>-419</td>
</tr>
</tbody>
</table>

#### Loans, carrying amount

<table>
<thead>
<tr>
<th>EURm</th>
<th>31 Dec 2014</th>
<th>31 Dec 2013</th>
<th>31 Dec 2014</th>
<th>31 Dec 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>19,175</td>
<td>22,512</td>
<td>348,085</td>
<td>342,451</td>
</tr>
</tbody>
</table>

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Source: Nordea Bank AB Annual Report 2014

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4 November 2015
Accounting estimates

Data
- Internal
- External

Model
- Accounting framework applied
- Method appropriate?

Assumptions
- PD
- LGD

IFRS 9, viewed by an accountant
PwC

4 November 2015
**Expected credit losses**

**General model**

**Change in credit quality since initial recognition**

**Recognition of expected credit losses**

12 month expected credit losses

Lifetime expected credit losses

Lifetime expected credit losses

**Interest revenue**

Effective interest on gross carrying amount

Effective interest on gross carrying amount

Effective interest on amortised cost carrying amount (i.e. net of credit allowance)

**Stage 1**

*Performing*
(Initial recognition*)

**Stage 2**

*Underperforming*
(Assets with significant increase in credit risk since initial recognition*)

**Stage 3**

*Non-performing*
(Credit impaired assets)

*Except for purchased or originated credit impaired assets*

IFRS 9, viewed by an accountant

PwC
## Impairment model: current IAS 39 vs IFRS 9

<table>
<thead>
<tr>
<th>Current Recognised on an incurred basis (IAS 39)</th>
<th>Future Recognised on an expected loss basis IFRS 9</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Stage 1</strong> Performing loans</td>
<td><strong>Stage 1</strong> Performing loans</td>
</tr>
<tr>
<td>Impairments: None</td>
<td>Impairments: Lifetime expected loss</td>
</tr>
<tr>
<td><strong>Stage 2</strong>: Under-performing loans</td>
<td><strong>Stage 2</strong>: Under-performing loans</td>
</tr>
<tr>
<td>Impairments: Minimal*</td>
<td>Impairments: Lifetime expected loss</td>
</tr>
<tr>
<td><strong>Stage 3</strong>: Non-performing loans</td>
<td><strong>Stage 3</strong>: Non-performing loans</td>
</tr>
<tr>
<td>Impairments: As incurred</td>
<td>Impairments: Lifetime expected loss</td>
</tr>
</tbody>
</table>

* Under the current approach it is possible to overprovide or make collective provisions
**Expected credit losses**

General model

Information to take into account for assessment of increased credit risk

- Changes in external market indicators
- Changes in internal price indicators
- Changes in credit ratings
- Changes in operating results
- Changes in business
- Other qualitative inputs

However....
# Expected Credit Losses

**PD-parameters compared to IAS39 and Basel III**

<table>
<thead>
<tr>
<th>Probability of Default</th>
<th>Basel III Framework</th>
<th>IAS 39</th>
<th>IFRS 9</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Point in time calculation</strong></td>
<td>Through the cycle approach</td>
<td>Based on Point-in-Time (PIT) approach.</td>
<td>Point-in-time approach taking into account forward-looking information</td>
</tr>
<tr>
<td><strong>Loss identification period</strong></td>
<td>Not applicable</td>
<td>Introduction of LIP for (GLLP)EL calculation</td>
<td>Not applicable</td>
</tr>
<tr>
<td><strong>Lifetime estimation</strong></td>
<td>12-months estimation</td>
<td>12-months estimation for GLLP</td>
<td>12–month for Stage 1 loans; Lifetime for Stage 2 and Stage 3 loans</td>
</tr>
<tr>
<td><strong>Conservatism</strong></td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
Expected Credit Losses
Stage transfers in credit deterioration model

Consequences of the three-stage credit deterioration model
- Relative change in credit risk needs to be tracked (initial recognition vs. current date)
- No derivation of amount of loss provisions from the absolute credit risk at the reporting date
- Further communication requirements (e.g. to the management and analysts)

<table>
<thead>
<tr>
<th>Investment Grade</th>
<th>Non Investment Grade</th>
<th>Watchlist</th>
<th>Impaired</th>
</tr>
</thead>
<tbody>
<tr>
<td>( t_0 )</td>
<td>( S_1 )</td>
<td></td>
<td>POCI</td>
</tr>
<tr>
<td>( t_1 )</td>
<td></td>
<td></td>
<td>POCI</td>
</tr>
<tr>
<td>( t_2 )</td>
<td>( S_1 ), POCI</td>
<td></td>
<td>POCI</td>
</tr>
</tbody>
</table>

Caption:
- Stage 1 (\( S_1 \)) \( \rightarrow \) 12 months EL
- Stage 2 (\( S_2 \)) \( \rightarrow \) Lifetime EL
- Stage 3 (\( S_3 \)) \( \rightarrow \) Lifetime EL
**Expected credit losses**

**General model**

**Expected credit losses**

- An entity’s estimate of expected credit losses shall reflect:
  - the best available information.
  - an unbiased and probability-weighted estimate of cash flows associated with a range of possible outcomes (including at least the possibility that a credit loss occurs and the possibility that no credit loss occurs).
  - the time value of money.

- Various approaches can be used.
- An entity should apply a default definition that is consistent with internal credit risk management purposes and take into account qualitative indicators of default when appropriate.

However...
**Expected credit losses**

General model

**Expected credit losses**

**Financial assets**

ECL represent a probability-weighted estimate of the difference over the remaining life of the financial instrument, between:

- Present value of cash flows according to contract
- Present value of cash flows the entity expects to receive

**Undrawn loan commitments**

ECL represent a probability-weighted estimate of the difference over the remaining life of the financial instrument, between:

- Present value of cash flows if holder draws down
- Present value of cash flows the entity expects to receive if drawn down
# Expected Credit Losses

*LGD-parameters compared to IAS39 and Basel III*

<table>
<thead>
<tr>
<th>Loss Given Default</th>
<th>Basel III Framework</th>
<th>IAS 39</th>
<th>IFRS 9</th>
</tr>
</thead>
<tbody>
<tr>
<td>LGD costs</td>
<td>Direct &amp; Indirect costs included</td>
<td>Direct costs included only</td>
<td>Direct costs included only</td>
</tr>
<tr>
<td>Discount rates</td>
<td>Contractual Rate (CIR)</td>
<td>Effective Interest Rate (EIR)</td>
<td>Effective Interest Rate (EIR) to reporting date</td>
</tr>
<tr>
<td>Downturn correction</td>
<td>Yes</td>
<td>No</td>
<td>No, but forward looking.</td>
</tr>
<tr>
<td>Conservatism</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
</tbody>
</table>
# Expected Credit Losses

**EAD-parameters compared to IAS39 and Basel III**

<table>
<thead>
<tr>
<th>Exposure at Default</th>
<th>Basel III Framework</th>
<th>IAS 39</th>
<th>IFRS 9</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Lifetime estimation</strong></td>
<td>EL calculated on undrawn exposures</td>
<td>On-balance sheet lending only</td>
<td>Will require inclusion of expected future drawdowns on undrawn exposures</td>
</tr>
</tbody>
</table>

**EAD development over lifetime**

- **Today**: Book value
- **Time**: Annuities and prepayments

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IFRS 9, viewed by an accountant

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4 November 2015
**Expected credit losses**

**Disclosures**

**Quantitative**

- Reconciliation of opening to closing amounts of loss allowance showing key drivers of change
- Write off, recovers and modifications
- Reconciliation of opening to closing amounts of gross carrying amounts showing key drivers of change
- Gross carrying amounts per credit risk grade

**Qualitative**

- Inputs, assumptions and estimation techniques for estimating ECL
- Write off policies, modification policies and collateral
- Inputs, assumptions and estimation techniques to determine significant increases in credit risk and default
- Inputs, assumptions and techniques to determine credit impaired

IFRS 9, viewed by an accountant
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4 november 2015
How will IFRS 9 impairment model impact banks?

**Book value**

- ECL on 12 month PD for performing loans
- Lifetime ECL for underperforming loans

**CET 1 Capital**

- Lifetime ECL for underperforming loans vs 12 month ECL for IRB models

**Increased volatility due to change in estimates**

- ‘Cliff effect’ when financial instruments move between 12-month ECL and lifetime ECL and vice versa
**Key implementation considerations/issues**

- How do I determine significant deterioration in credit risk?
- What data do I need for the model estimates and disclosures?
- How will this impact my provision and capital?
- How can I use my models to develop lifetime EL estimates?
- How can I link this new model to Basel III?

IFRS 9 impairment
# Summary and final remarks

**Impairments**

## Challenges

<table>
<thead>
<tr>
<th>ECL</th>
<th>Expected loss calculations</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Multi year expected losses required</td>
</tr>
<tr>
<td></td>
<td>• Forward looking expectations required</td>
</tr>
<tr>
<td></td>
<td>• Regulatory and risk management data not sufficient</td>
</tr>
<tr>
<td></td>
<td>• Maturity: contractual term vs. behavioral; considerations of prepayments &amp; others</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stage transfers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Historic data required &amp; multi year PD’s required</td>
</tr>
<tr>
<td>• Recalibration of rating methods</td>
</tr>
<tr>
<td>• Definition of trigger events &amp; significant deterioration</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Broadened disclosure requirements (e.g. reconciliations, modification gains/losses)</td>
</tr>
</tbody>
</table>

## Approach

<table>
<thead>
<tr>
<th>ECL</th>
<th>Assessment of available data and closing of data gaps</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>• Use of simulation (tool) to identify gaps</td>
</tr>
<tr>
<td></td>
<td>• Portfolio based approach</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stage transfers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Development of comprehensive solution to reflect all requirements based on existing and new data</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Disclosures</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Defining comprehensive data requirements for EL, stage transfers &amp; disclosures</td>
</tr>
</tbody>
</table>
Thanks!

Thomas Heneryd
Authorized Public Accountant
thomas.heneryd@se.pwc.com
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