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IFRS 9, viewed by an accountant

Thomas Heneryd, PwC
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pwc

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 — KfW Entwicklungsbank

IFRS 9 Classification & Measurement — Raiffeisen Bank International

IFRS 9 phase I and II project — KBC Bank

IFRS 9 implementation project on Classification and Measurement and Hedge Accounting — Commerzbank

IFRS 9 portfolio screening and implementation of the SPPI test — BayernLB

IFRS 9 implementation project on Classification and Measurement — HSBC

IFRS 9 transformation project – LLP test calculation — Rabobank

Further IFRS 9 projects have been performed at:

DekaBank, HSH Nordbank, Finanzgruppe Deutscher Sparkassen- und Giroverband, WGZ Bank Die Initiativbank, WL Bank, DEG KfW Bankengruppe, NORD/LB Die norddeutsche Art., Aareal Bank Group, Postbank

Timeline of IFRS 9

July 2014
Final Standard

H1 2016?
EU Endorsement

- 2018
Transition

2018
Effective date

- **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.**

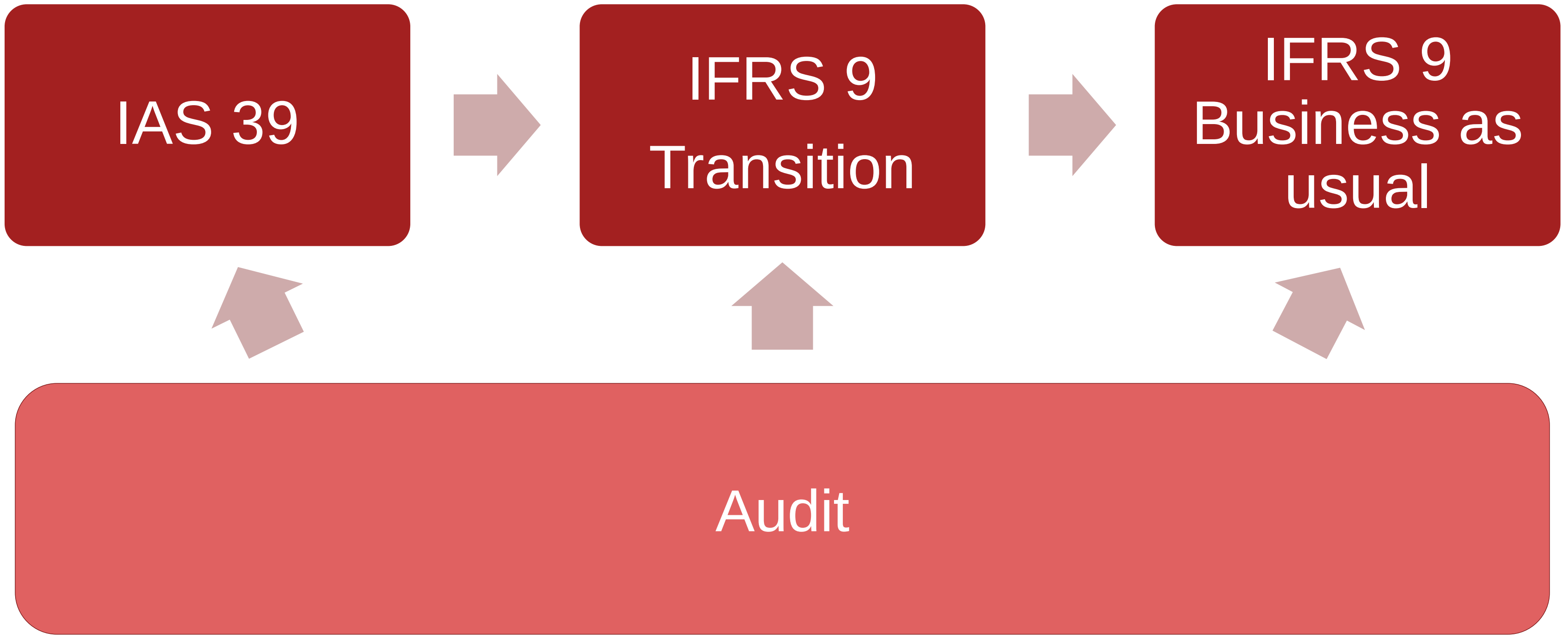
IFRS 9

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 impariment estimates



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

EURm	Note	2014	2013
Profit before loan losses		**4,858**	**4,851**
Net loan losses	G10	–534	–735
Operating profit		**4,324**	**4,116**

Financial position

EURm	Note	31 Dec 2014	31 Dec 2013	1 Jan 2013
Assets				
Cash and balances with central banks		31,067	33,529	36,060
Loans to central banks	G13	6,958	11,769	8,005
Loans to credit institutions	G13	12,217	10,743	10,569
Loans to the public	G13	348,085	342,451	346,251

Disclosures

G13 Loans and impairment

	Central banks and credit institutions		The public[1]		Total	
EURm	31 Dec 2014	31 Dec 2013	31 Dec 2014	31 Dec 2013	31 Dec 2014	31 Dec 2013
Loans, not impaired	19,177	22,515	344,407	338,703	363,584	361,218
Impaired loans	—	24	6,425	6,540	6,425	6,564
– Performing	—	—	4,115	3,909	4,115	3,909
– Non-performing	—	24	2,310	2,631	2,310	2,655
Loans before allowances	**19,177**	**22,539**	**350,832**	**345,243**	**370,009**	**367,782**
Allowances for individually assessed impaired loans	—	–24	–2,329	–2,373	–2,329	–2,397
– Performing	—	—	–1,432	–1,372	–1,432	–1,372
– Non-performing	—	–24	–897	–1,001	–897	–1,025
Allowances for collectively assessed impaired loans	–2	–3	–418	–419	–420	–422
Allowances	**–2**	**–27**	**–2,747**	**–2,792**	**–2,749**	**–2,819**
Loans, carrying amount	**19,175**	**22,512**	**348,085**	**342,451**	**367,260**	**364,963**

Source: Nordea Bank AB Annual Report 2014

Accounting estimates

Data
- Internal
- External

Model
- Accounting framework applied
- Method appropriate?

Assumptions
- PD
- LGD

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	Stage 2	Stage 3
Performing (Initial recognition*)	*Underperforming* (Assets with significant increase in credit risk since initial recognition*)	*Non-performing* (Credit impaired assets)

**Except for purchased or originated credit impaired assets*

Impairment model: current IAS 39 vs IFRS 9

Current **Recognised on an incurred basis (IAS 39)**	***Stage 1*** ***Performing loans*** ***Impairments:*** ***None***	***Stage 2:*** ***Under-performing loans*** ***Impairments:*** ***Minimal****	***Stage 3:*** ***Non-performing loans*** ***Impairments:*** ***As incured***
Future **Recognised on an expected loss basis IFRS 9**	***Stage 1*** ***Performing loans*** ***Impairments:*** ***12m expected loss***	***Stage 2:*** ***Under-performing loans*** ***Impairments:*** ***Lifetime expected loss***	***Stage 3:*** ***Non-performing loans*** ***Impairments:*** ***Lifetime expected loss***

* 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 business

Changes in internal price indicators

Other qualitative inputs

Changes in credit ratings

Changes in operating results

30 days past due rebuttable presumption

However….

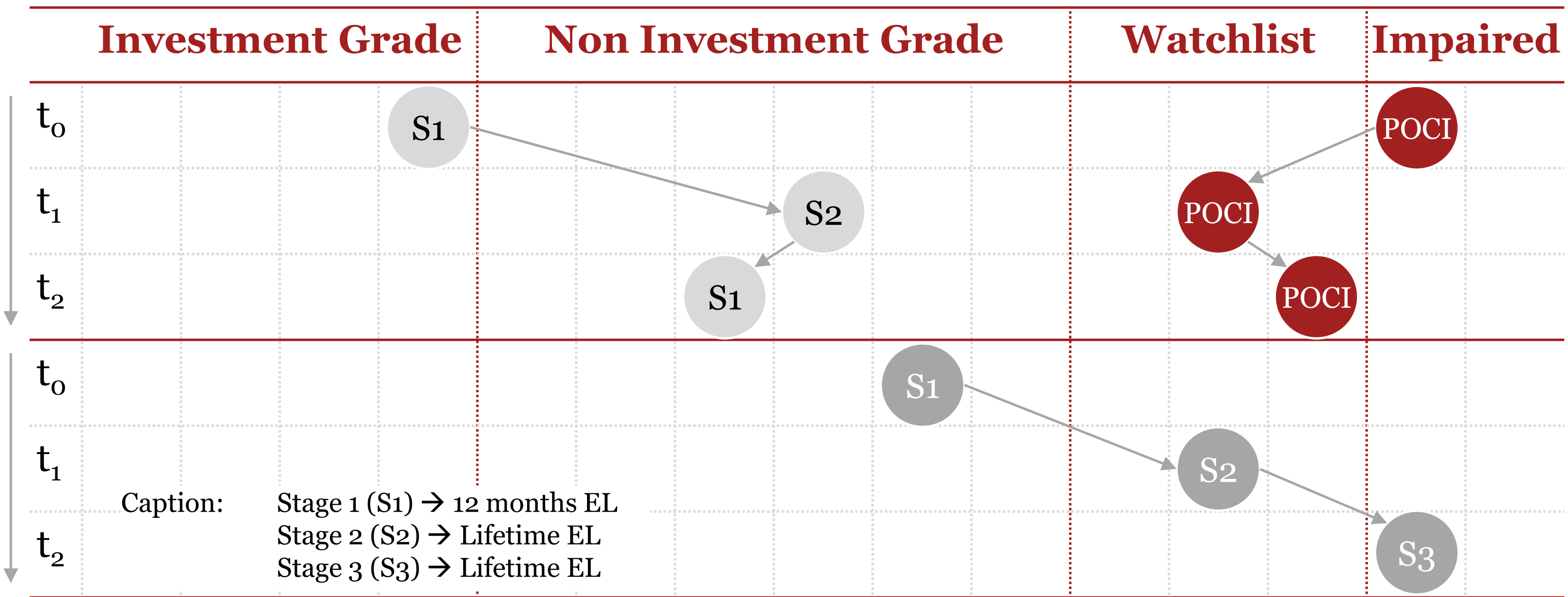
Expected Credit Losses
PD-parameters compared to IAS39 and Basel III

Probability of Default		Basel III Framework	IAS 39	IFRS 9
	Point in time calculation	Through the cycle approach	Based on Point-in-Time (PIT) approach.	Point-in-time approach taking into account forward-looking. information
	Loss identification period	Not applicable	Introduction of LIP for (GLLP)EL calculation	Not applicable
	Lifetime estimation	12-months estimation	12-months estimation for GLLP	12–month for Stage 1 loans; Lifetime for Stage 2 and Stage 3 loans
	Conservatism	Yes	No	No

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)



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.

90 days past due rebuttable presumption

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

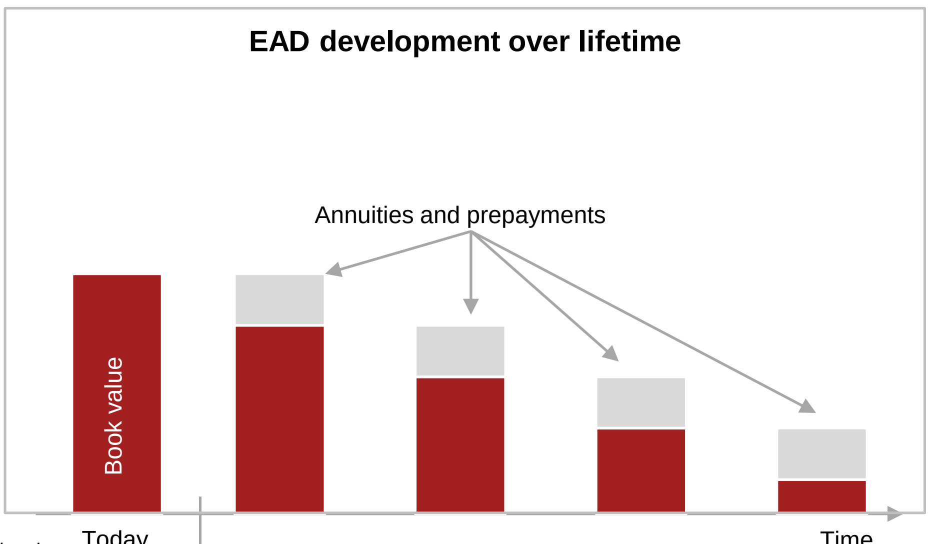
Loss Given Default

	Basel III Framework	IAS 39	IFRS 9
LGD costs	Direct & Indirect costs included	Direct costs included only	Direct costs included only
Discount rates	Contractual Rate (CIR)	Effective Interest Rate (EIR)	Effective Interest Rate (EIR) to reporting date
Downturn correction	Yes.	No	No, but forward looking.
Conservatism	Yes	No	No

Expected Credit Losses

EAD-parameters compared to IAS39 and Basel III

		Basel III Framework	IAS 39	IFRS 9
Exposure at Default	**Lifetime estimation**	EL calculated on undrawn exposures	On-balance sheet lending only	Will require inclusion of expected future drawdowns on undrawn exposures



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

How will IFRS 9 impairment model impact banks?

Book value

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

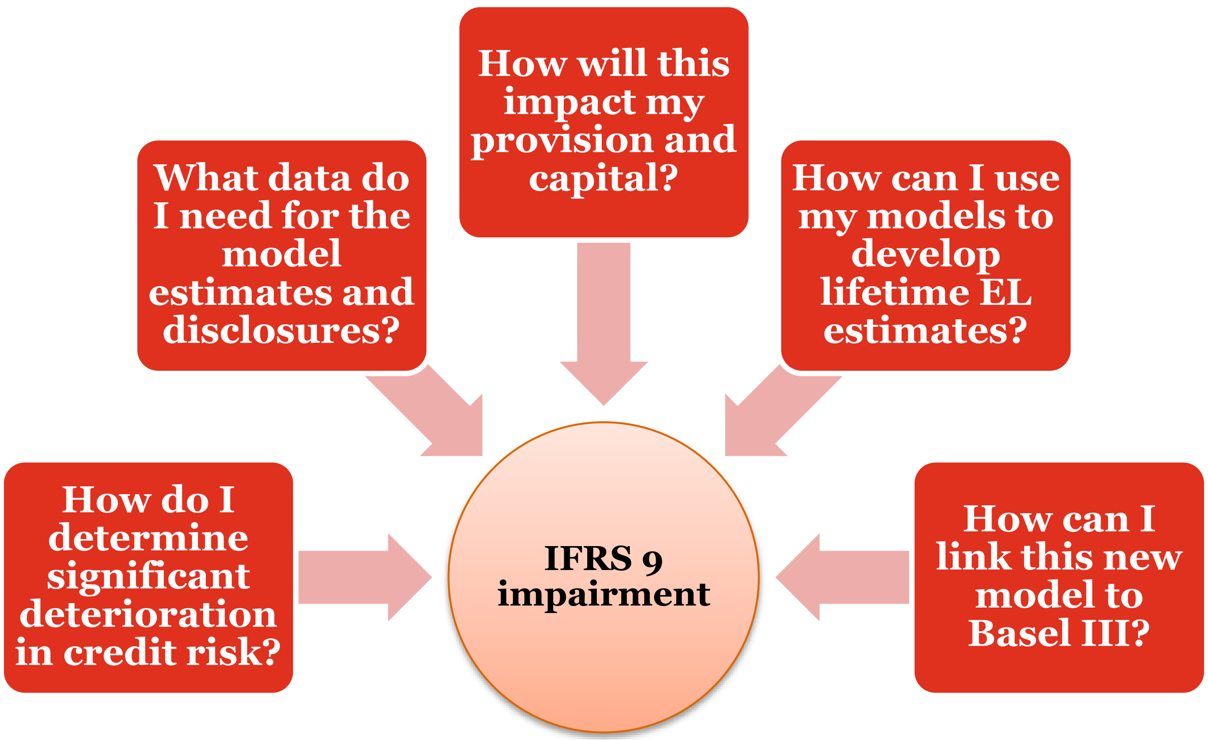
CET 1 Capital

- 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



Summary and final remarks

Impairments

		Challenges	Approach
ECL	Expected loss calculations	• Multi year expected losses required • Forward looking expectations required • Regulatory and risk management data not sufficient • Maturity: contractual term vs. behavioral; considerations of prepayments & others	• Assessment of available data and closing of data gaps • Use of simulation (tool) to identify gaps • Portfolio based approach
	Stage transfers	• Historic data required & multi year PD's required • Recalibration of rating methods • Definition of trigger events & significant deterioration	• Development of comprehensive solution to reflect all requirements based on existing and new data
	Disclosures	• Broadened disclosure requirements (e.g. reconciliations, modification gains/losses)	• Defining comprehensive data requirements for EL, stage transfers & disclosures

Thanks!

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