

The Bank Statement

IFRS – Global Banking Newsletter

“One of the most prominent areas of judgement relates to stage transfer criteria, which determine whether the loss allowance is measured as 12-month or lifetime expected credit losses.”

– **Dr Jürgen Ringschmidt,**
Richard Nußbaum and
Christian Maaß,
KPMG in Germany

Stage transfer criteria for impairment

Welcome to the Q1 2017 issue of our quarterly banking newsletter in which we provide updates on IFRS developments that directly impact banks and consider the potential accounting implications of regulatory requirements.

Spotlight on IFRS 9

The IASB has proposed a narrow-scope amendment to IFRS 9 *Financial Instruments* relating to symmetric ‘make-whole’ prepayment options included in financial assets – see [page 2](#).

Stage allocation challenges

We explore the challenges of and one possible approach to determining the stage transfer criteria under the IFRS 9 impairment model – see [page 8](#).

How do you compare? IFRSs issued but not yet effective

We look at disclosures that banks have made in their financial statements for certain accounting standards that have been issued but are not yet effective – see [page 15](#).

Regulation in action – IFRS 9 and FINREP reporting

We discuss the European Banking Authority’s recently published changes to FINREP reporting requirements – see [page 19](#).

Spotlight on IFRS 9

The Board decided to propose a narrow-scope amendment to IFRS 9 relating to financial assets with symmetric prepayment options.

Effect of symmetric 'make-whole' and fair value prepayment options on the assessment of the SPPI condition

In January and February 2017, the IASB discussed symmetric 'make-whole' prepayment options included in the contractual terms of financial assets. The issue considered was the impact of such options on the 'solely payments of principal and interest' (SPPI) criterion and classification of a financial asset under IFRS 9.

The Board decided to propose a narrow-scope amendment to IFRS 9 so that a financial asset with a symmetric prepayment option would be eligible for amortised cost or fair value through other comprehensive income (FVOCI) measurement if:

- the financial asset would otherwise meet the requirements of paragraph B4.1.11(b) of IFRS 9 but does not do so only as a result of the symmetric nature of the prepayment feature; and
- the fair value of the symmetric prepayment feature is insignificant when the financial asset is initially recognised.

The Board aims to issue a final amendment in Q4 2017 – i.e. before IFRS 9 becomes effective – and require retrospective application of the proposed amendment. The Board also discussed the due process steps taken in developing the proposed amendments to IFRS 9 and tentatively decided to allow 30 days for comments on the exposure draft (ED).

Modification or exchange of financial liabilities

This topic was discussed by the Board in February 2017 and at the IFRS Interpretations Committee's November 2016 and March 2017 meetings. It relates to the modification of a liability measured at amortised cost that does not result in its derecognition. More specifically, whether, when applying IFRS 9, an entity recognises an adjustment to the amortised cost of the financial liability arising from such a modification in profit or loss at the date of the modification.

In March 2017, the Committee noted that the requirements of paragraph B5.4.6 of IFRS 9 apply to all revisions of estimated payments and receipts, including changes in cash flows resulting from a modification or exchange of a financial liability that does not result in derecognition of that liability. This is consistent with the requirements of IFRS 9 on the modification of financial assets. Accordingly, an entity recalculates the amortised cost of a financial liability by discounting the modified contractual cash flows using the original effective interest rate. The entity recognises any resulting adjustment to the amortised cost of a financial liability in profit or loss as income or expense at the date of the modification or exchange.

The Committee noted that IFRS 9 had introduced additional wording in paragraph 5.4.3 on the accounting for the modification of financial assets, and if an entity changes its accounting policy on adoption of IFRS 9 then it applies the transitional provisions of the standard, which require retrospective application subject to specific reliefs included in Chapter 7.2 of IFRS 9. The Committee concluded that the principles and requirements in IFRS 9 provide an adequate basis for an entity to account for modifications and exchanges of financial liabilities that do not result in derecognition and tentatively decided not to add this matter to its standard-setting agenda.

Meanwhile, the Board decided in February 2017 that it will consider other ways to highlight this matter, such as a webcast, given its importance.

Impairment – Period of exposure for credit card facilities

At its February 2017 meeting, the Board discussed how entities incorporate credit risk management actions into determining the period of exposure when measuring expected credit losses (ECLs) for instruments in the scope of paragraph 5.5.20 of IFRS 9 – i.e. revolving credit facilities such as credit cards.

The IASB staff provided a summary of the relevant requirements of IFRS 9 and the related observations made by members of the IFRS Transition Resource Group for Impairment of Financial Instruments (ITG) in their meetings. The main observations were about how to apply paragraph B5.5.40 of IFRS 9 and included reiteration of the following.

- In determining the period of credit exposure, an entity is required to consider all three factors listed in paragraphs B5.5.40(a)–(c). Questions have arisen about how these requirements, especially (c), should be applied in practice.
- If an entity chooses not to take credit risk-mitigating actions on some instruments, then this decision affects the expected life of the related financial instrument.
- An entity is required to consider the effects of its credit risk management actions to the extent that they mitigate credit risk.

The staff also provided a simplified illustration of how the principles in paragraph B5.5.40 might be applied. The Board did not have questions or comments on the summary given by the staff. The staff informed the Board of their intention to develop educational material on this and other challenging areas – should the need arise – to support IFRS 9 implementation.

For more information, see our *IFRS Newsletter: IFRS 9 Impairment*, [February 2017](#).

Application of IFRS 9 to long-term interests

In January 2017, the Board published the exposure draft *Annual Improvements to IFRS Standards 2015–2017 Cycle*. It included proposed amendments to IAS 28 *Investments in Associates and Joint Ventures* to clarify that an entity should apply IFRS 9, including its impairment requirements, to its long-term investments in an associate or joint venture that in substance form part of the net investments in an associate or joint venture but to which it does not apply the equity method.

Dynamic risk management – Findings from EFRAG’s 2016 outreach

In January 2017, the European Financial Reporting Advisory Group (EFRAG) published the [findings](#) from its outreach conducted to support the IASB’s development of a new dynamic risk management (DRM) accounting solution. The DRM project was initially part of the IFRS 9 hedge accounting project, but was separated into a stand-alone one so that IFRS 9 could be completed in a timely manner.

The outreach undertaken by EFRAG was a fact-finding exercise focused on gaining a better understanding of banks’ practices in managing interest rate risk.

IASB activities affecting your bank

The Committee concluded that the principles and requirements in IFRS provide an adequate basis for a clearing member to account for centrally cleared client derivative contracts.

IAS 32 *Financial Instruments: Presentation* – Centrally cleared client derivatives

In March 2017, the IFRS Interpretations Committee discussed how a clearing member¹ accounts for centrally cleared client derivative contracts. The Committee concluded that the clearing member first applies the requirements for financial instruments in IFRS 9 or IAS 39 *Financial Instruments: Recognition and Measurement*. The Committee observed that:

- IFRS 9 and IAS 39 require an entity to recognise a financial instrument in its statement of financial position when the entity becomes a party to the contractual provisions of the instrument. The clearing member presents recognised financial assets and financial liabilities separately, unless net presentation in the statement of financial position is required under the offsetting requirements in IAS 32; and
- if the transaction(s) is not in the scope of IFRS 9 or IAS 39 and another standard does not specifically apply, only then would the clearing member apply the hierarchy in IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* to determine an appropriate accounting policy for the transaction(s).

The Committee concluded that the principles and requirements in IFRS provide an adequate basis for a clearing member to account for centrally cleared client derivative contracts and tentatively decided not to add this matter to its standard-setting agenda.

Commodity loans

In March 2017, the IFRS Interpretations Committee confirmed its tentative decision made in November 2016 on how an entity accounts for a commodity loan transaction in which it borrows gold from a third party (Contract 1) and then lends that gold to a different third party for the same term and for a higher fee (Contract 2).

The Committee observed that the particular transaction might not be clearly captured in the scope of any standard, and in this case an entity applies paragraphs 10–11 of IAS 8.

The Committee concluded that it would be unable to resolve the question efficiently within the confines of existing IFRSs and noted that the wide range of transactions involving commodities means that any narrow-scope standard-setting activity would be of limited benefit to entities and would have a high risk of unintended consequences.

IAS 28 – Fund manager’s assessment of significant influence

In March 2017, the IFRS Interpretations Committee continued its discussions from November 2016 about whether and, if so, how a fund manager assesses significant influence over a fund that it manages and in which it has an investment.

The Committee observed that, unlike IFRS 10 *Consolidated Financial Statements*, IAS 28 does not address decision making authority held in the capacity of an agent in the assessment of significant influence. The Committee concluded that

1. Some jurisdictions require the clearing of certain derivatives through a central clearing counterparty (CCP). An entity has to be a clearing member to clear transactions through a CCP.

requirements in this area could not be developed separately from a comprehensive review of the definition of significant influence in IAS 28.

The Committee finalised its tentative agenda decision reached in November that it would be unable to resolve the question efficiently within the confines of existing IFRS and, accordingly, decided not to add this matter to its standard-setting agenda.

IFRS 10 – Investment entities and subsidiaries

In March 2017, the IFRS Interpretations Committee continued its discussion from November 2016 of the investment entity requirements in IFRS 10, including how an investment entity assesses whether it consolidates a subsidiary under paragraph 32 of IFRS 10 in certain circumstances. The Committee discussed:

- whether an entity qualifies as an investment entity if it possesses all three elements described in paragraph 27 of IFRS 10, but does not have one or more of the typical characteristics of an investment entity included in paragraph 28;
- whether an entity provides investment management services to investors (under paragraph 27(a) of IFRS 10) if it outsources the performance of these services to a third party;
- to what extent an investment entity can provide investment-related services, itself or through a subsidiary, to third parties; and
- whether a subsidiary provides services that relate to its parent investment entity's investment (under paragraph 32 of IFRS 10) by holding an investment portfolio as the beneficial owner.

The Committee provided feedback on each of the above questions and confirmed its previous tentative conclusion that, for all four questions discussed, the principles and requirements under IFRS provide a sufficient basis to enable an entity to determine the appropriate accounting. Accordingly, the Committee decided not to add this issue to its agenda.

Post-implementation review of IFRS 13

The Board is currently undertaking a post-implementation review (PIR) of IFRS 13 *Fair Value Measurement*. In January 2017, the Board discussed Phases 1 and 2 of the PIR. Phase 1 involves identifying the relevant IFRS 13 issues to examine in greater detail and Phase 2 involves assessing whether a request for information (RFI) is required and, if so, which matters will be examined.

For Phase 1, the Board discussed the PIR process, background information on IFRS 13 and work streams related to fair value measurement, as well as whether convergence with Topic 820 *Fair Value Measurement* in US GAAP has been compromised as a result of subsequent standard-setting work carried out by the FASB. No decisions were taken.

For Phase 2, the Board decided to focus on:

- the effectiveness of disclosures about fair value measurements;
- the unit of account and fair value measurement of quoted investments;
- the application of judgement in specific areas;

- the application of highest and best use when measuring the fair value of non-financial assets; and
- the need for education on measuring the fair value of unquoted equity instruments.

The Board also decided to issue an RFI, review academic and non-academic literature and conduct outreach on the questions included in the RFI. In February, the Board decided that the RFI response period would be at least 120 days.

Dynamic risk management

At the March 2017 meeting, the staff presented an education session to the Board following on from the 2014 discussion paper [Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging](#).

The staff explained that the objective of the session was to provide the Board with an overview of the project history and background, and set out the planned project approach, project stages, timeline and next steps. No decisions were made at the meeting.

For more information, see our *IFRS Newsletter: Financial Instruments*, [March 2017](#).

Financial instruments with characteristics of equity

The Board discussed this project at its February and March 2017 meetings, focusing on the following topics.

February 2017

- Whether the effects of law should be considered for the purposes of classifying financial instruments under the Gamma approach.
- Proposed application guidance and illustrative examples that clarify how the Gamma approach would apply to the accounting within equity for different subclasses of equity instrument.

March 2017

- How the Gamma approach would apply to the classification of derivatives on non-controlling interests (NCI) with an exercise price denominated in a foreign currency.
- The interaction of the project with other standards.

The next steps for the project will be to publish a discussion paper towards the end of 2017. The comment period will be 180 days.

For more information, see our *IFRS Newsletter: Financial Instruments*, [February](#) and [March 2017](#).

Stage allocation challenges

“Staging is one of the most material and complex elements of the new IFRS 9 impairment model for financial instruments.”

– Dr Jürgen Ringschmidt,
Richard Nußbaum and
Christian Maaß,
KPMG in Germany

The principles-based approach of IFRS 9 to the measurement of impairment leaves significant room for interpretation and judgement. One of the most prominent areas of judgement relates to the stage transfer criteria, which determine whether the loss allowance is measured as 12-month ECLs (Stage 1) or lifetime ECLs (Stage 2).

A financial instrument is transferred from Stage 1 to Stage 2 if there has been a significant increase in its credit risk since initial recognition. Determining this is challenging. This article explores some of the challenges and describes one possible approach to operationalising the requirements.

The transfer logic

Under the IFRS 9 general approach², all financial instruments are allocated to Stage 1 on initial recognition. However, if a significant increase in credit risk is identified at the reporting date compared with initial recognition, then an instrument is transferred to Stage 2. If there is objective evidence of impairment, then the asset is credit-impaired and goes into Stage 3.

For financial assets in Stage 1, the impairment has to be calculated based on defaults that are possible in the next 12 months, whereas for financial instruments in Stages 2 and 3 the ECL calculation considers default events over the whole life of an instrument.

The differentiation between Stages 1 and 2 is based on a relative approach, because it reflects the significance of the increase in credit risk since initial recognition of an instrument. In contrast, the assignment to Stage 3 is based on an absolute threshold – i.e. the status of being credit-impaired.

More detail on transfer requirements

To determine whether there has been a significant increase in credit risk, paragraph 5.5.9 of IFRS 9 requires comparison of the risk of default estimated on initial recognition with the risk of default estimated at the reporting date, using the change in the risk of default occurring over the expected life of a financial instrument as an assessment tool. The comparison takes into account the impact of a decrease in maturity (paragraphs B5.5.10–B5.5.11 of IFRS 9). Furthermore, collateral is not considered in the comparison unless it impacts the probability that the borrower will default.

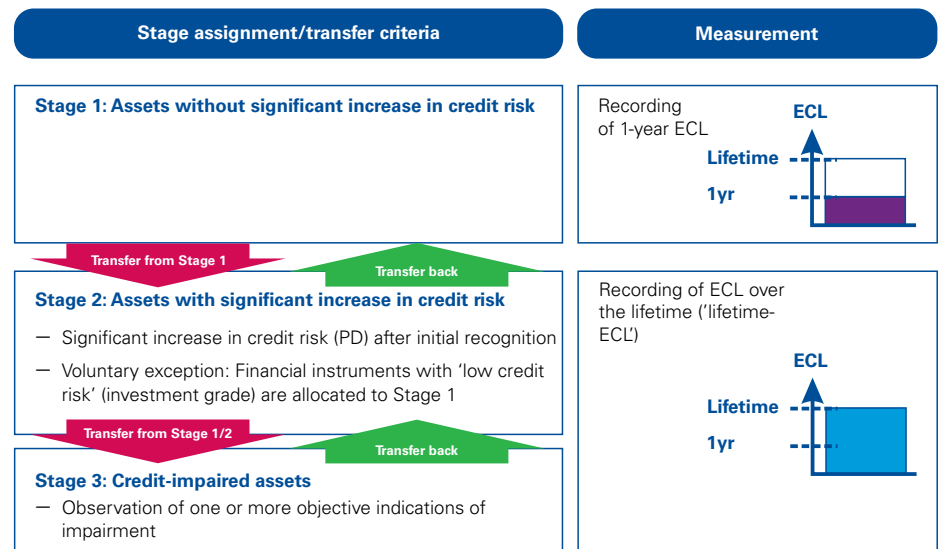
Paragraph B5.5.13 of IFRS 9 states that, in some cases, the change in the 12-month risk of default may be a reasonable approximation of the change in the lifetime risk of default. To justify the use of the 12-month risk of default as an assessment basis, periodic review of its appropriateness should be performed. The use of the 12-month risk of default is not further explored in this article.

In addition to the relative comparison, paragraph 5.5.11 of IFRS 9 contains a rebuttable presumption that a significant increase in credit risk occurs when contractual payments are more than 30 days past due (30dpd). The 30dpd status therefore serves as a backstop for the allocation of financial instruments to Stage 2.

Also, financial instruments with low credit risk at the reporting date may continue to be allocated to Stage 1. This exception from the general model is not considered further in this article.

2. It should be noted that the transfer logic described in this article is only relevant under the general approach. The simplified approach and the approach applied for ‘purchased or originated credit-impaired assets’ are not considered here.

The following diagram summarises the requirements on the stage allocation between Stages 1, 2 and 3.



Possible approach to operationalising the requirements

The approach to determining transfer criteria between Stages 1 and 2 discussed in this article is considered in three steps:

1. choice of the reference parameter to measure the risk of default;
2. choice of the measure to be used to determine significance; and
3. choice of the significance level (amount of increase in credit risk that is deemed significant).

The proposed approach is a tool designed to help with determining whether transfer criteria have been met for a financial instrument, but it cannot be assumed that it will automatically provide an appropriate transfer threshold in all cases. This is further discussed below.

Choice of reference parameter – Lifetime PD

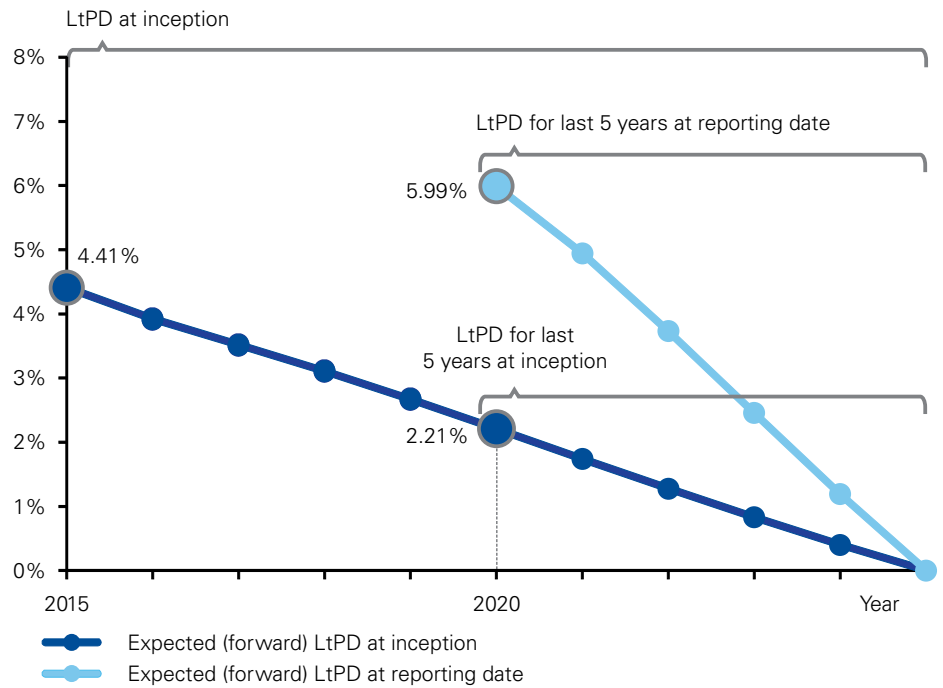
The proposed approach uses the lifetime probability of default (PD) as a reference parameter for assessing whether credit risk on a financial instrument has increased significantly. It compares lifetime PDs over the same time horizon, so that the assessment is made by comparing:

- A. the lifetime PD at the reporting date; with
- B. that *portion* of lifetime PD on initial recognition that corresponds with the remaining maturity at the reporting date, and therefore reflects the reduced maturity.

The reference parameter B is denoted as 'forward lifetime PD (t_R, t_N)', where t_R is the reporting date and t_N is the contract end date. The forward lifetime PD is defined as a conditional value – i.e. under the assumption of survival until the reporting date.

The following graph illustrates this comparison. It shows that the lifetime PD at a *reporting date* at the end of 2019 (5.99 percent in this example) is compared with the *forward* lifetime PD (2.21 percent) estimated *at inception* for the end of 2019, rather than with the full lifetime PD *at inception* (4.41 percent).

Forward LtPD at inception and reporting date



The table below provides more detail on how the reference parameter is calculated. The financial instrument's initial recognition t_0 corresponds to 31 December 2014. The current reporting date t_r is 31 December 2019. The financial instrument is assumed to have the following characteristics:

- the rating class on initial recognition t_0 equals Ba3, corresponding to a one-year PD of 0.51 percent;
- the remaining lifetime at initial recognition t_0 equals 10 years;
- the rating deteriorates at the reporting date by three notches to B3, corresponding to a one-year PD of 1.10 percent; and
- the remaining lifetime at the reporting date t_r equals five years.

The lifetime PDs at initial recognition and the reporting date, as well as the forward lifetime PD, are shown in the table. For demonstration purposes, lifetime PDs are calculated in this example by means of a migration matrix multiplication approach, as follows.

Initial recognition

Year	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Expected 1-year PD	0.51%	0.42%	0.42%	0.45%	0.47%	0.48%	0.47%	0.45%	0.43%	0.40%
Expected lifetime-PD	0.51%	0.92%	1.34%	1.79%	2.26%	2.73%	3.18%	3.62%	4.03%	4.41%

Reporting date

Year	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
Default risk expected at initial recognition										
Expected 1-year PD at initial recognition						0.48%	0.47%	0.45%	0.43%	0.40%
Expected forward lifetime PD						0.48%	0.95%	1.39%	1.81%	2.21%
Default risk expected at reporting date										
Expected 1-year PD						1.10%	1.26%	1.31%	1.28%	1.19%
Expected lifetime-PD						1.10%	2.35%	3.63%	4.86%	5.99%

As can be seen, the lifetime PD at t_0 is 4.41 percent (cumulative amount over the total lifetime of the instrument). The forward lifetime PD at t_R is 2.21 percent. The forward lifetime PD is determined successively from the conditional one-year PDs. For this purpose, the following formula is used: $LPD_n = LPD_{n-1} + (1 - LPD_{n-1}) \times PD_n$ where PD_n is the conditional one-year PD in the annual period $[n - 1, n]$ and LPD_n is the lifetime PD referring to year n . It is based on the non-default assumption until t_R , which implies that the forward lifetime PD is determined under the assumption that the contract under consideration has not defaulted between inception and the reporting date.

Due to the deterioration of the rating class by three notches to B3 and the associated increase of the one-year PD from 0.48 to 1.10 percent, the actual lifetime PD amounts to 5.99 percent at the reporting date t_R .

This example shows that a simple comparison between the lifetime PDs on initial recognition and at the reporting date would result in an increase by a factor of 1.4 (4.41 percent vs 5.99 percent). However, when comparing the lifetime PD at the reporting date with that estimated at the time of initial recognition for the reporting date (in order to compare 'apples with apples'), the factor of increase is 2.7 (2.21 percent vs 5.99 percent). The correct choice of a reference parameter is key for the assessment of how the credit risk of a financial instrument has changed.

Choice of significance measure – The quantile approach

As mentioned above, the criteria for transferring a financial instrument to Stage 2 have to be relative and time-to-maturity-sensitive. Given these requirements and given that the assessment of whether there is a significantly increased credit risk is based on a comparison of the actual credit risk estimated at the reporting date with the initially anticipated development of credit risk, a reasonable and economically meaningful significance measure can be derived with the aid of a statistical technique.

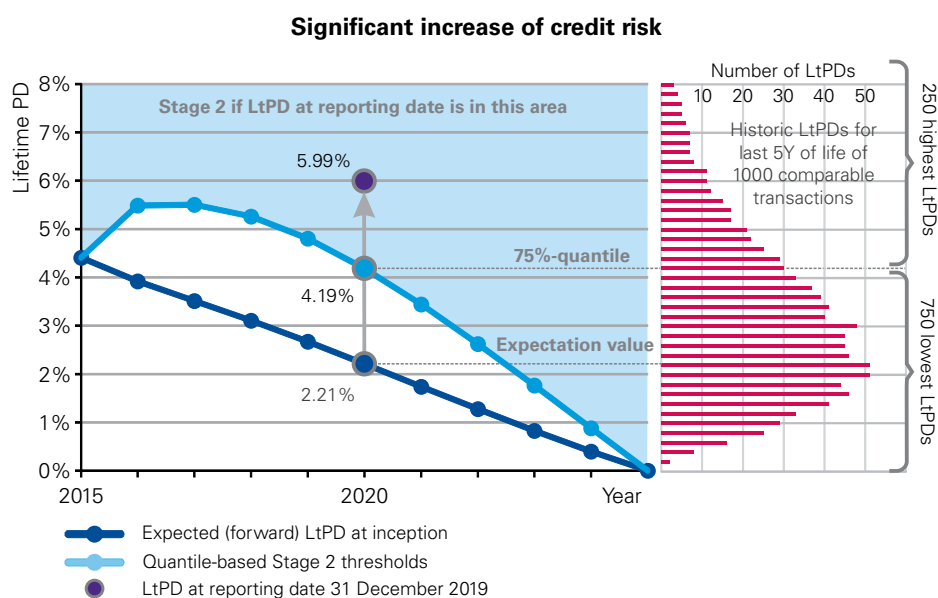
To illustrate this approach, we will continue the example above, in which a lifetime PD of 2.21 percent was expected at initial recognition (t_0) for the last remaining five years. At the reporting date, when the remaining life is actually five years (t_R), the lifetime PD is estimated at 5.99 percent.

To evaluate the significance of this increase in statistical terms, we look at the long-term data history for all financial instruments of different obligors with similar characteristics (e.g. same rating system, same rating at inception, same lifetime) and establish what their lifetime PD was when each of them had a remaining life of five years. Assuming for simplicity reasons a total number of 1,000 of those financial instruments in the data history, we arrange their lifetime PDs in a ranked order from smallest to largest, compiling the *distribution of empirically observed lifetime PDs*. In this approach, a significantly increased credit risk will be measured

as a major deviation from the initially anticipated forward lifetime PD development. Similar to value-at-risk-concepts, the deviation from the expected value of the distribution can be measured with reference to the value of the distribution, which will not be exceeded with probability p ('significance level'). Then, those transactions with a lifetime PD that is greater than this threshold will be assigned to Stage 2; the rest, with lower lifetime PDs, will be in Stage 1.

To apply this concept, we have to decide what significance level to use. The fundamentals of this decision, which is an area of judgement, are discussed briefly below. Let us assume that we decide that the last 250 of our transactions in the ordered sequence (those with the highest lifetime PDs) should be migrated into Stage 2 and the other 750 left in Stage 1. This means that transactions with lifetime PDs greater than a threshold that equals the 750th lifetime PD in the ordered sequence will be transferred to Stage 2. Therefore, this reflects a significance level of $p = 75$ percent³. In our example, this threshold translates to PD of 4.19 percent. This means that the financial instrument will be moved to Stage 2, because its lifetime PD of 5.99 percent at the reporting date is greater than the threshold of 4.19 percent (the purple bullet in the graph below). In statistical terms, this threshold is called the 75 percent-quantile of the distribution of lifetime PDs.

The following graph illustrates this approach.



In this graph, the ordered lifetime PD sequence that is used to derive the threshold for the example transaction with five years' remaining life (reporting date 31 December 2019) is shown as a histogram on the right-hand side. Each number of those 1,000 lifetime PDs that lie within a range of 0.2 percent around a given bar ('bin') is represented by the length of this bar. Adding the bars (number per bin) for all lifetime PDs lower than or equal to 4.19 percent will result in 750. The graph also shows each forward lifetime PD (blue curve) expected at inception and each transfer threshold (light blue curve) for all reporting dates possible with this example transaction in its whole life.

3. The choice of 250 of 1,000 transactions in Stage 2 is just an example and is used for illustration purposes only (discussion about the determination of this threshold is included under the heading 'Determining the significance levels'). Consequently, the corresponding significance level of 75 percent is arbitrary and merely illustrative, too.

Many lifetime PD models calculate the lifetime PD as a function of the current rating class. A transfer threshold should therefore incorporate at least this factor, together with the remaining life and the age of a financial instrument (time after inception) at the reporting date. As a practical approach, these thresholds could be used to compile a look-up table. The source of historical data for the derivation of thresholds could be internal or external, in line with what is used for lifetime PD modelling purposes. Alternatively, migration matrices could be leveraged to derive the thresholds, if those matrices produce reliable lifetime PD curves. Finally, it may be possible to use this approach with one-year PDs instead of lifetime PDs – e.g. by applying appropriate regression techniques or by using one-year Markovian migration matrices. Then the aforementioned look-up table will typically be based on discrete rating classes, which banking professionals are familiar with.

Typically, the approach calculates the quantiles annually. Accordingly, if the reporting date was two weeks after the initial recognition of the portfolio in our example, then the actual lifetime PD at that time would be compared with the PD of the 75 percent quantile estimated for the end of the first year of the portfolio's life.

Using such approaches, on each reporting date a financial instrument exceeding the predefined threshold in the threshold table would be assigned to Stage 2. If the financial instrument was above the threshold at the previous reporting date but is below it at the current reporting date, then it would be assigned back to Stage 1. However, it has to be considered whether the proposed approach has to be supplemented by additional measures. This is further discussed below under the heading 'Additional measures and calibration'.

As the age of a financial instrument increases (i.e. the respective reporting date moves further into the future), but assuming the same remaining time to maturity, the distribution range of lifetime PDs becomes wider due to the increased uncertainty and reduced predictive power of the credit rating system. Consequently, the distance between the expected lifetime PD values and the quantiles (thresholds) will also increase. This is plausible because a given number of rating downgrades after one year may be much more relevant than the same number of downgrades taking place after 20 years. Therefore, the proposed approach is relative (always related to expected values) and time-sensitive (distribution becomes wider with time).

Determining the significance levels

The last step in the proposed stage allocation approach is the determination of the significance level – i.e. the level at which a financial instrument would move to Stage 2. This is an area of significant judgement because IFRS 9 does not provide any specific guidance on it. In addition, different significance levels may be appropriate for different portfolios – e.g. depending on the shape of the PD distribution.

There is currently no generally accepted market practice for the level at which a financial instrument has to be transferred to Stage 2. We expect that the calibration of the stage distribution – which corresponds to the choice of significance level in the case of the quantile approach – will result from an iterative process between market participants, auditors and banking supervisors.

Additional measures and calibration

The results of the quantile approach described above may need to be supplemented by additional measures.

In addition, it may be appropriate to set a minimum level of PD increase necessary for an instrument to move to Stage 2, to cater for circumstances where the actual PDs do not show significant movement.

In the case of insufficient and improper data history, quantiles may correspond to economically unreasonable PD changes. Therefore, in this case the choice of thresholds should be accompanied by additional expert judgement. As a potential consequence, the quantile approach can be amended with additional minimum or maximum thresholds or other qualitative or quantitative criteria if needed. Also, banks will have to consider the impact of measures such as expectation of forbearance in respect of a financial instrument or inclusion of it on a watchlist. These measures are not explored further in this article.

Finally, banks should periodically look at the result of their models and calibrate the parameters where appropriate. For example, a model that results in frequent transfers of a large number of instruments from Stage 1 to Stage 2 and then back from Stage 2 to Stage 1 may use parameters that are too sensitive and so may not capture only significant increases in credit risk.

Conclusion

The approach proposed in this article, if it is applied appropriately, assists in a sound and timely identification of significant increases in credit risk and would help banks comply with the requirements of IFRS 9 and the guidance issued by the Basel Committee on Banking Supervision, the European Banking Authority (EBA) and the Global Public Policy Committee (GPPC). In particular, this approach helps to avoid the creation of any bias, especially between different transaction terms and ages, and is relative and time-sensitive. It can be based on historical internal or external data or on migration matrices.

However, this article does not show techniques to calibrate the stage distribution, which is generally needed independently of the chosen approach; it has instead focused specifically on how the reference parameter may be selected in a quantile approach.

Generally, stage transfers required by the IFRS 9 impairment model are expected to increase the volatility in profit or loss resulting from impairment losses and bear cyclical effects. As a result, it is expected that this will be an area of increased management focus. Given the high degree of judgement required, comparability of loss provisioning across different institutions and jurisdictions will be a further challenge.

How do you compare? IFRSs issued but not yet effective

ESMA noted in its public statement that it expects banks to provide increasingly more qualitative and quantitative information as the implementation of IFRS 9 progresses.

In this article, we look at the disclosures that banks have made in their financial statements about certain accounting standards that have been issued but are not yet effective.

What are the requirements?

For new accounting standards or interpretations that have been issued but are not yet effective, IAS 8 requires banks to provide certain disclosures. These include known or reasonably estimable information that is relevant to assessing the possible impact that the application of the new standard will have on the bank's financial statements when it is first applied.

Building on the requirements of IAS 8, the European Securities and Markets Authority (ESMA) noted in its public statement [Issues for consideration in implementing IFRS 9](#) that it expects banks to be able to provide increasingly more qualitative and quantitative information as the implementation of IFRS 9 progresses. The public statement also illustrated good practices for disclosures in the 2016 and 2017 annual financial statements and the 2017 interim financial statements.

The Enhanced Disclosure Task Force (EDTF) also considered this topic in its report [Impact of Expected Credit Loss Approaches on Bank Risk Disclosures](#) and provided a tentative timeline for disclosures that it recommends banks consider.

Our sample

Our sample consisted of seven large banks' December 2016 annual financial statements that were issued in Q1 2017. The sample is not representative across regions/countries, because many banks publish their financial statements at a later date.

We focused specifically on disclosures relating to IFRS 9, IFRS 15 *Revenue from Contracts with Customers* and IFRS 16 *Leases*.

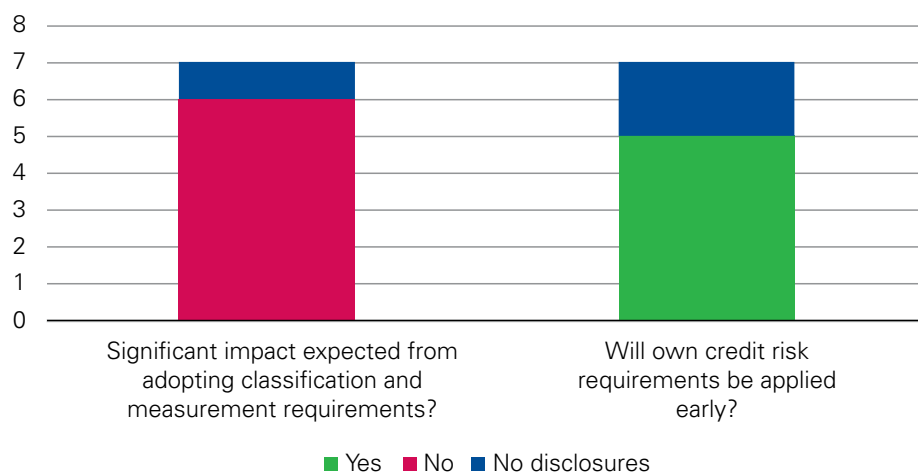
What did banks disclose?

IFRS 9

All of the banks sampled provided general disclosures describing the new requirements of IFRS 9 and disclosures outlining their IFRS 9 implementation plan.

Classification and measurement

The graph below provides a summary of some common disclosure themes.

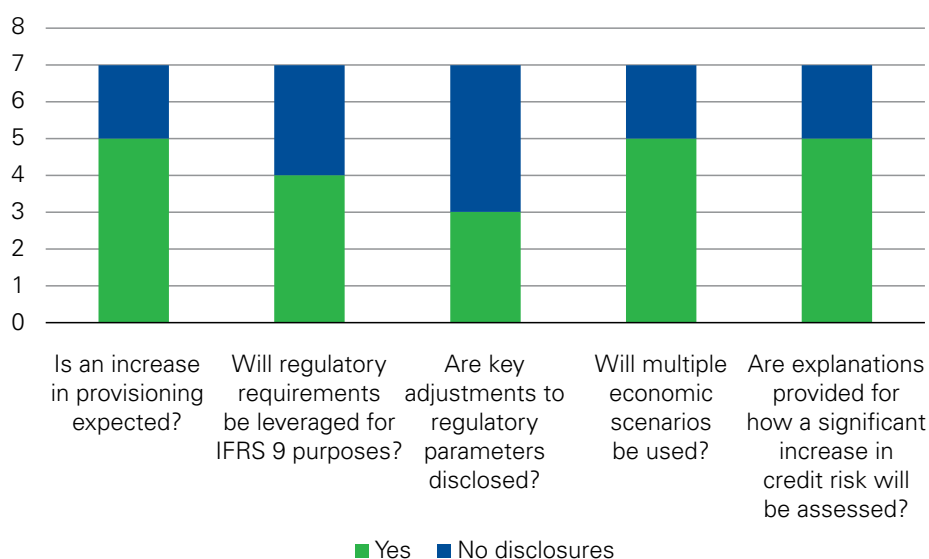


Two banks stated that there could be a potential impact in respect of loans with symmetric prepayment options if these loans were to be measured at fair value through profit or loss (FVTPL). Symmetric prepayment options have been discussed by the IASB and are expected to be the subject of a narrow-scope amendment to IFRS 9.

One bank disclosed that it did not expect to designate any equity securities at FVOCI.

Impairment

The graph below provides a summary of some common disclosure themes.



One bank disclosed that it expected most of the increase in provisioning to relate to Stage 1 financial instruments, with only a moderate increase for Stage 2.

One bank noted that existing advanced internal rating-based (AIRB) models will be leveraged for IFRS 9 purposes, whereas for sufficiently material portfolios on the standardised regulatory approach, new models will be developed.

One bank stated that it expects to consider a minimum of five forward-looking economic scenarios when there is a non-linear relationship between these forward-looking economic scenarios and associated credit losses, and another stated that it will use a Monte-Carlo-based approach.

Banks have disclosed that they will assess whether credit risk has increased significantly from initial recognition using the following data:

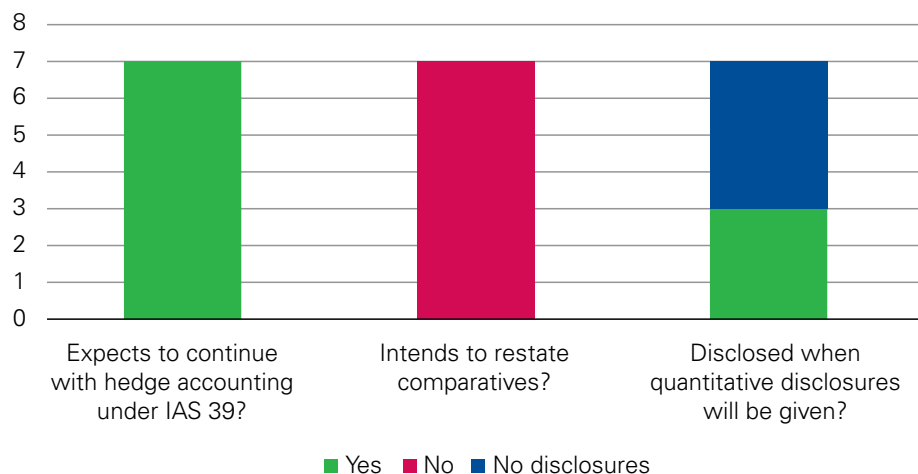
- changes in PD, watch lists and credit default swap spreads (one bank);
- changes in or absolute thresholds for weighted-average cumulative lifetime PDs determined for each portfolio and qualitative factors such as higher risk (one bank);
- changes in lifetime PD plus qualitative factors (one bank);
- changes in PD, whether an asset is forborne and whether contractual payments are 30dpd (one bank); and
- changes in lifetime PD, which will involve setting quantitative tests and supplementary indicators such as credit risk identification (one bank).

Banks also provided specific disclosures about the following.

- Three banks stated that their write-off policies are not expected to change under IFRS 9.
- Four banks stated that the calculation of ECL will be determined primarily by multiplying the PD, loss given default and exposure at default.
- One bank disclosed that the instruments most affected by the new model will be unsecured exposures with longer expected lives, such as credit cards.
- Three banks stated that the definition of default used for determining ECLs is expected to be aligned with the regulatory definition of default, and one bank stated that this will include a 180-day 'backstop' for mortgages.
- One bank stated that for revolving credit facilities, the starting point for measuring a significant increase in credit risk will be when the facility was first entered into.
- One bank stated that credit exposures are expected to migrate back from Stage 2 to Stage 1 when they no longer meet the criteria for a significant increase in credit risk, when any cure criteria for credit risk management are met and subject to a minimum of 12 months' full performance for exposures that have been restructured or granted forbearance.
- One bank disclosed that it is considering whether to apply the low credit risk exception principally for the liquid asset portfolio and for exposure to banks. Another bank stated that it did not plan to rely on this exception as a primary indicator.

Hedge accounting and transition

The graph below provides a summary of some common disclosure themes.



For transition, three banks stated that they will provide quantitative disclosures no later than their 2017 annual financial statements.

IFRS 15

Most banks indicated that IFRS 15 is not expected to have a significant impact on their financial statements. Two noted that they expect the requirements of IFRS 15 mostly to affect contracts that generate fee and commission income. None provided disclosures of the quantitative impact.

IFRS 16

Disclosure focused on a general overview of the requirements of IFRS 16. One bank indicated that it expects an increase in assets and liabilities from the lessee's perspective for transactions that are currently accounted for as operating leases under IAS 17 *Leases* when it transitions to IFRS 16.

Regulation in action – IFRS 9 and FINREP reporting

“IFRS 9 impacts FINREP, and FINREP impacts IFRS 9. It is essential that both are considered concurrently.”

– James Roberts,
KPMG in the UK

In November 2016, the EBA published its final [Implementing Technical Standards \(ITS\)](#) on the changes to the FINREP reporting requirements that institutions will soon need to incorporate in their reporting frameworks.⁴

The first FINREP submissions due following the adoption of IFRS 9 will be made in May 2018, for the quarter ended 31 March (for institutions with a December year end). This effectively means detailed FINREP disclosures will need to be published well before the first annual reports under IFRS 9.

As set out in the [Q4 2016](#) issue of *The Bank Statement*, the EBA has made changes to the FINREP templates to embed the key concepts introduced by IFRS 9 for classification and measurement, impairment and hedge accounting. The incremental reporting requirements set out in the new FINREP templates will need to be considered carefully alongside institutions’ ongoing work to scope and deliver the reporting and disclosure requirements of IFRS 9 to ensure that the twin accounting and regulatory disclosure requirements can be adequately fulfilled and opportunities to align them are fully understood and used.

In particular, the forthcoming FINREP reporting requirements will oblige institutions to make some disclosures on a more granular level than is required for IFRS 9, and some disclosures over and above the requirements of the standard.

The following table summarises some of the key matters and examples where institutions may encounter challenges during the implementation of the new FINREP reporting requirements alongside IFRS 9.

Scope item	FINREP disclosure requirement	Challenges for implementation
1. Financial assets mandatorily measured at FVTPL	<p>Financial assets that fail the SPPI test have to be disclosed separately from financial assets that are either held for trading or designated at FVTPL.</p> <p>For financial assets that failed the SPPI test, making measurement at FVTPL mandatory, institutions also have to disclose information on any negative changes in fair value due to credit risk and the assets’ non-performing/forbearance status.</p>	<p>Institutions will need to develop processes to track assets for which measurement at FVTPL is mandatory separately from other assets measured at FVTPL.</p> <p>This may be straightforward on implementation, but institutions will need to develop processes to ensure that the data continues to be available after assets have been recognised.</p>

4. EBA/ITS/2016/07 *Final Draft Implementing Technical Standards amending Commission Implementing Regulation (EU) 680/2014 on supervisory reporting of institutions with regard to financial reporting (FINREP) following the changes in the International Accounting Standards (IFRS 9).*

Scope item	FINREP disclosure requirement	Challenges for implementation
2. Granular reporting of ECL	<p>For FINREP purposes, ECLs have to be disaggregated and reported by product, instrument, counterparty, country of residence and days past due for each ECL stage.</p>	<p>IFRS 9 credit risk reporting systems and processes will need to be configured to record data down to the level needed for FINREP reporting.</p> <p>FINREP reporting processes will also need to be embedded to maximise operational efficiency in light of the granularity of data required and ensure that there is adequate scope in the reporting cycle to review and challenge the quality of outputs.</p>
3. Off-balance sheet (OBS) exposures	<p>OBS exposures have to be disclosed for FINREP according to their accounting treatment.</p> <p>Firms will need to disaggregate OBS exposures (e.g. commitments and guarantees) according to whether they are accounted for under IFRS 9, IFRS 4 <i>Insurance Contracts</i> or IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i>.</p>	<p>Non-IFRS 9 OBS guarantees and commitments (e.g. bid bonds) will need to be identified and monitored at exposure level for disclosure purposes.</p>
4. Forborne and non-performing exposures	<p>The EBA has issued ITS on FINREP reporting of forbearance and non-performing exposures, setting out definitions for these key terms.</p> <p>When embedding the new FINREP disclosure requirements, institutions will need to revisit their current assumptions and interpretations for key impairment definitions to identify and resolve any inconsistencies between IFRS 9 requirements, policy choices and the FINREP guidance.</p>	<p>Potential challenges and points of inconsistency between definitions may include:</p> <ul style="list-style-type: none"> – monitoring ongoing alignment between EBA defaulted and non-performing exposures and IFRS 9 credit-impaired (i.e. Stage 3) exposures; and – aligning the EBA forbearance definitions with the relevant IFRS 9 accounting treatment.

Scope item	FINREP disclosure requirement	Challenges for implementation
5. Movements in impairment provisions	<p>FINREP sets out more prescriptive guidance on the reconciliation of movements in ECL provisions.</p> <p>In particular, the guidance mandates which types of ECL movements have to be disclosed, split by collectively and individually assessed allowance for each stage (the stages are aligned with those required by IFRS 9). Furthermore, a tabular disclosure of movements of gross carrying amount between stages for on- and off-balance sheet exposures is also required.</p>	<p>Although IFRS 9 sets out similar guidance, the format is not prescribed to the same degree.</p>

Conclusion

The EBA has now finalised the new FINREP reporting rules to accommodate IFRS 9. Institutions that are in the midst of pushing forward IFRS 9 projects through parallel runs and detailed testing before the date of initial adoption of the standard on 1 January 2018 will need to consider how the new FINREP requirements can be scoped and effectively embedded in time for the first reports due in May 2018.

Maximising opportunities to create consistency and operational efficiency by aligning these two sets of reporting requirements as far as possible will be critical to ensuring that FINREP reporting obligations can be embedded at the same time as IFRS 9 projects move towards their latter stages.

Where regulation and reporting meet...

The issuer did not provide qualitative or sensitivity analysis disclosures about the property market risk inherent in the acquired portfolio of loans.

ESMA publishes extracts from its database of enforcement decisions

On 5 January 2017, ESMA issued the 20th extract from its confidential database of enforcement decisions on financial statements⁵. The aim of the publication is to strengthen supervisory convergence and provide issuers and users of financial statements with relevant information on the appropriate application of IFRS.

The decisions included in this extract were taken by national enforcers in the period from February 2014 to April 2016. ESMA expects to publish the next extract later in 2017.

The document describes 14 enforcement decisions, with one on the qualitative disclosures of risks arising from financial instruments being particularly relevant for banks.

Qualitative disclosures of the risks arising from financial instruments

Fact pattern

The issuer purchased a portfolio of loans that amounted to 67 percent of the issuer's total assets. The loans were acquired at a substantial discount to their nominal value, reflecting their distressed state at the time of the acquisition. All of the loans were past due and were in default. They were secured by the borrower's property assets. The issuer's objective in purchasing the portfolio of loans was to generate future returns through a combination of:

- acquisition of collateral assets for inclusion as inventory in its development portfolio;
- disposal of collateral assets over time to achieve a redemption of a loan at a value greater than the acquisition cost; and
- income from the underlying property asset portfolio.

The loan portfolio was categorised as loans and receivables under IAS 39 and measured at amortised cost. The issuer did not provide qualitative or sensitivity analysis disclosures about the property market risk inherent in the acquired portfolio of loans in its financial statements for the year ended 31 December 2015.

Enforcer's decision

The enforcer did not agree with the issuer's view and noted that the issuer should have:

- described its objectives, policies and processes for managing property market risk and the methods used to measure that risk, together with a detailed description of how the exposures to property market risk arose; and
- provided an appropriate sensitivity analysis for property market risk, with supplementary disclosures.

5. Available on [ESMA's website](#).

Rationale for the enforcement decision

Under paragraph 33 of IFRS 7 *Financial Instruments: Disclosures*, an entity makes qualitative disclosures for each type of risk arising from financial instruments. In this specific case, the value and the future cash flows of the distressed loans are based on the value of the underlying property collateral, so the market risk of the property has a significant impact on the value of the loan portfolio. Furthermore, paragraph 40 of IFRS 7 requires an entity to disclose a sensitivity analysis for each type of market risk to which it is exposed.

The loan portfolio amounted to 67 percent of the issuer's total assets. Therefore, the enforcer considered the disclosures about the market risk of the property to be important information for users of the financial statements.

EBA publishes opinion on transitional arrangements due to the introduction of IFRS 9

In March 2017, the EBA published an [opinion](#)⁶ on proposals issued in November 2016 by the European Commission for transitional arrangements to mitigate the effect of IFRS 9 on regulatory capital and on a related topic of credit risk adjustments.

Transitional arrangements

The EBA makes a number of specific observations on the European Commission's proposals, including:

- as currently drafted, the proposal is not sufficiently prudent, because it may allow provisions that would exist under IAS 39 to be subject to the transitional arrangements;
- it should be considered whether the transitional arrangements should apply to IFRS 9 as a whole, not just to the impairment requirements;
- the application of transitional arrangements would require calculation of the IAS 39 figure every year, which, although prudent, would be operationally burdensome and difficult for stakeholders to understand;
- there should not be a full neutralisation of the IFRS 9 impact during the first year or any of the following years;
- a phase-in transitional period of four years would be appropriate; and
- application of the transitional arrangements should be mandatory, except that institutions should have an option to recognise the full impact of IFRS 9 on own funds.

Specific and general provisions

The EBA believes that all IFRS 9 provisions should be considered as specific credit risk adjustments in the context of the current [EBA regulatory technical standards \(RTS\) on credit risk adjustments](#). The EBA's view is that, although a revision to the RTS would be desirable to make it explicit, the current text does not prevent this conclusion.

6. Opinion of the EBA on transitional arrangements and credit risk adjustments due to the introduction of IFRS 9.

Basel Committee – Regulatory treatment of accounting provisions: Interim approach and transitional arrangements

In March 2017, in response to the forthcoming ECL impairment models in IFRS 9 and US GAAP⁷, the Basel Committee issued [standards](#) on the interim regulatory treatment of accounting provisions and transitional arrangements.

The Basel Committee decided to retain the current regulatory treatment of provisions under the Basel framework for an interim period, given the limited time until the effective date of IFRS 9. It notes that this approach will allow it to consider more thoroughly the longer-term regulatory treatment of accounting provisions.

The standards also set out the transitional arrangements to take effect from 1 January 2018 and the corresponding Pillar 3 disclosure requirements, if individual jurisdictions choose to implement such transitional arrangements. The Basel Committee notes that jurisdictions may adopt transitional arrangements to smooth any potential significant negative impact on regulatory capital arising from the introduction of the ECL impairment model.

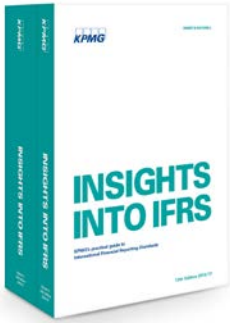
ECB finalises its guidance to banks on non-performing loans

On 20 March 2017, the ECB published its [final guidance](#) to banks on non-performing loans (NPLs). The guidance, which was published as a draft in September 2016 (see the [Q3 2016](#) issue of *The Bank Statement*), was subject to a two-month consultation phase and a public hearing. According to the ECB, the guidance should be applied from its date of publication, meaning that it has effectively already entered into force. Overall, the final guidance includes only a few changes from the previous proposals. Some of it covers common ground with the impairment requirements of IFRS 9.

7. In October 2016, the Basel Committee published both a [consultation paper](#) and a [discussion paper](#) on the regulatory treatment of accounting provisions, which dealt with how the upcoming IFRS 9 regime interacts with the Basel regulatory capital requirements for banks.

You may also be interested to read...

Insights into IFRS: 13th Edition 2016/17



Helping you apply IFRS to real transactions and arrangements. Includes our interpretative guidance based on IFRS 9 (2014).

September 2016

IFRS Newsletter: Financial Instruments – Issues 36, 37 and 38



Follows the IASB's deliberations on amendments to financial instruments accounting.

January, February and March 2017

First Impressions: Amendments to IFRS 4



Contains insight and analysis to help you assess the potential impact of the amendments on your business.

September 2016

IFRS Newsletter: IFRS 9 Impairment – Issue 4



Highlights the discussions of the IFRS Transition Group for Impairment of Financial Instruments on the impairment requirements of IFRS 9.

February 2017

First Impressions: IFRS 16 Leases



Explains the key requirements, highlights areas that may result in a change in practice, and features KPMG insights.

January 2016

IFRS Newsletter: Insurance – Issue 57



Summarises the IASB's recent discussions on the insurance contracts project.

February 2017

Click on the images above to access the publications.

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