IFRS 9 – From Incurred to Expected loss model

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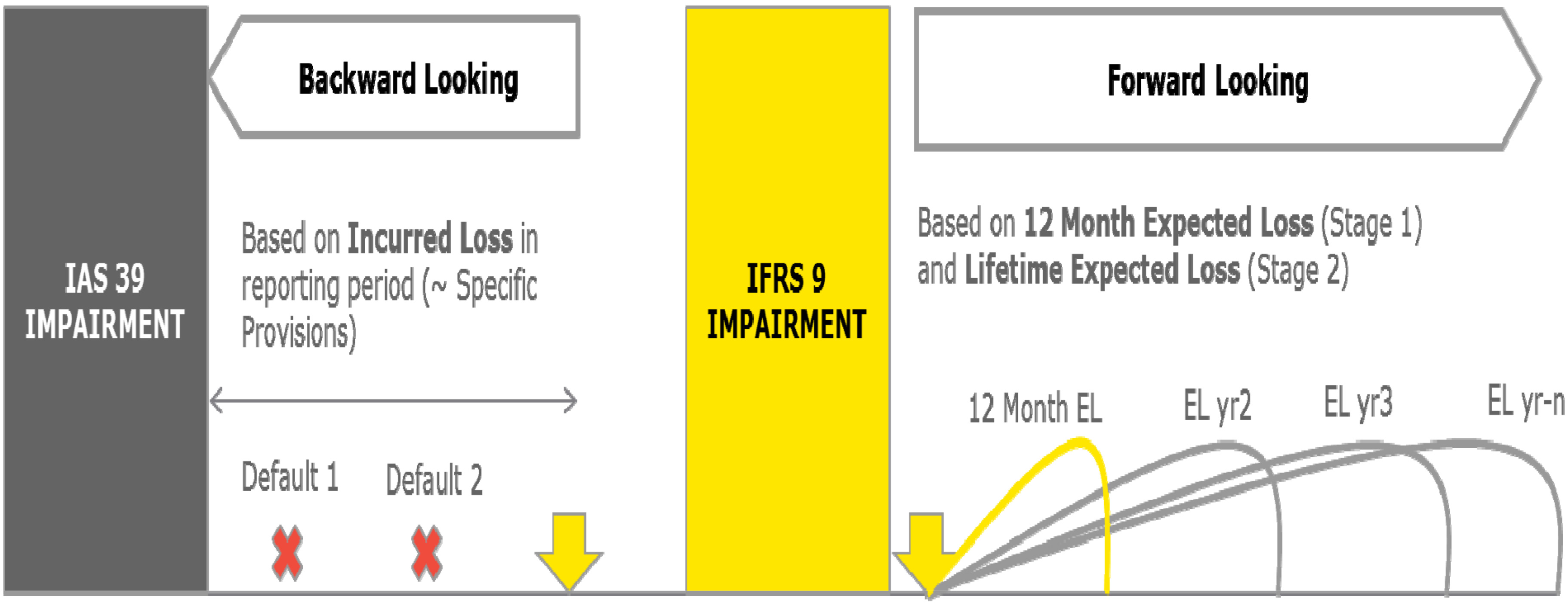
Agenda

- Conceptual background
- ECL approach for banks and financial institutions
- ECL approach for non-financial sector entities
- Implications for “Dues from Government”

Why the New IFRS 9 Impairment Model?

- In response to the reporting issues highlighted by the Global Financial Crisis, a Financial Crisis Advisory Group (FCAG) was setup in October 2008
- The objective of FCAG was to advice IASB and US FASB to bring improvements in the financial reporting standards that could enhance investor confidence in the financial markets
- The FCAG, in its report published in July 2009, identified **delayed recognition of loan losses** as one of the primary weaknesses in the accounting standards and recommended to explore alternatives model which is more forward looking

IFRS 9 Impairment Overview



- Provision only on evidence of impairment or incurred loss (practically also for incurred but not recognized)
- **No day 1 provision for new loans**

- Based on expectation of losses
- 3-Stage mechanism
- **Provision required on day 1 for all loans**

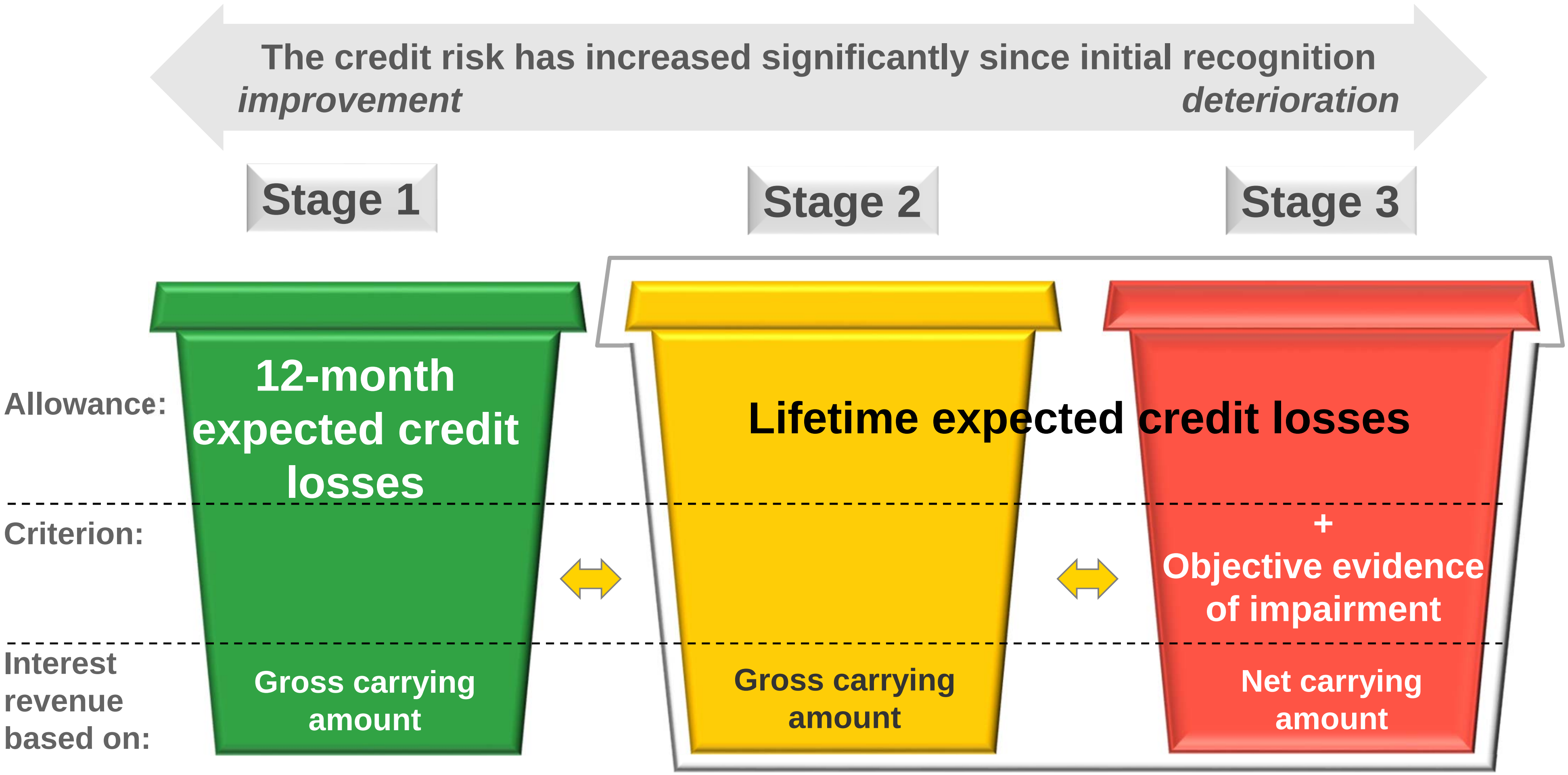
Incurred Loan Model under IAS - 39

- Interest income is recognized over the period of the loan on the basis of contractual cashflows (Effective interest method)
- **Impairment is recognized only when there is a objective evidence of impairment i.e. when a loss event has occurred**
- It may argued that interest income is overstated in periods before a loss event occurs because it is inherent in the nature of assets that certain credit losses will occur

Expected Loss Model of IFRS 9

- The impairment requirements applies to debt instruments such as loans, debt securities, bank deposits, lease receivables, loan commitments and financial guarantee contracts.
- Under the expected loss model impairment is recognized over the life of assets on the basis of future expected loss events
- In other words, impairment allowance is made even before there any objective evidence of impairment or occurrence of default event
- The scope of impairment requirements, therefore is much broader and are designed to result in earlier recognition of credit losses
- This model will potentially address the concerns about IAS 39 incurred loss model i.e. too little and too late

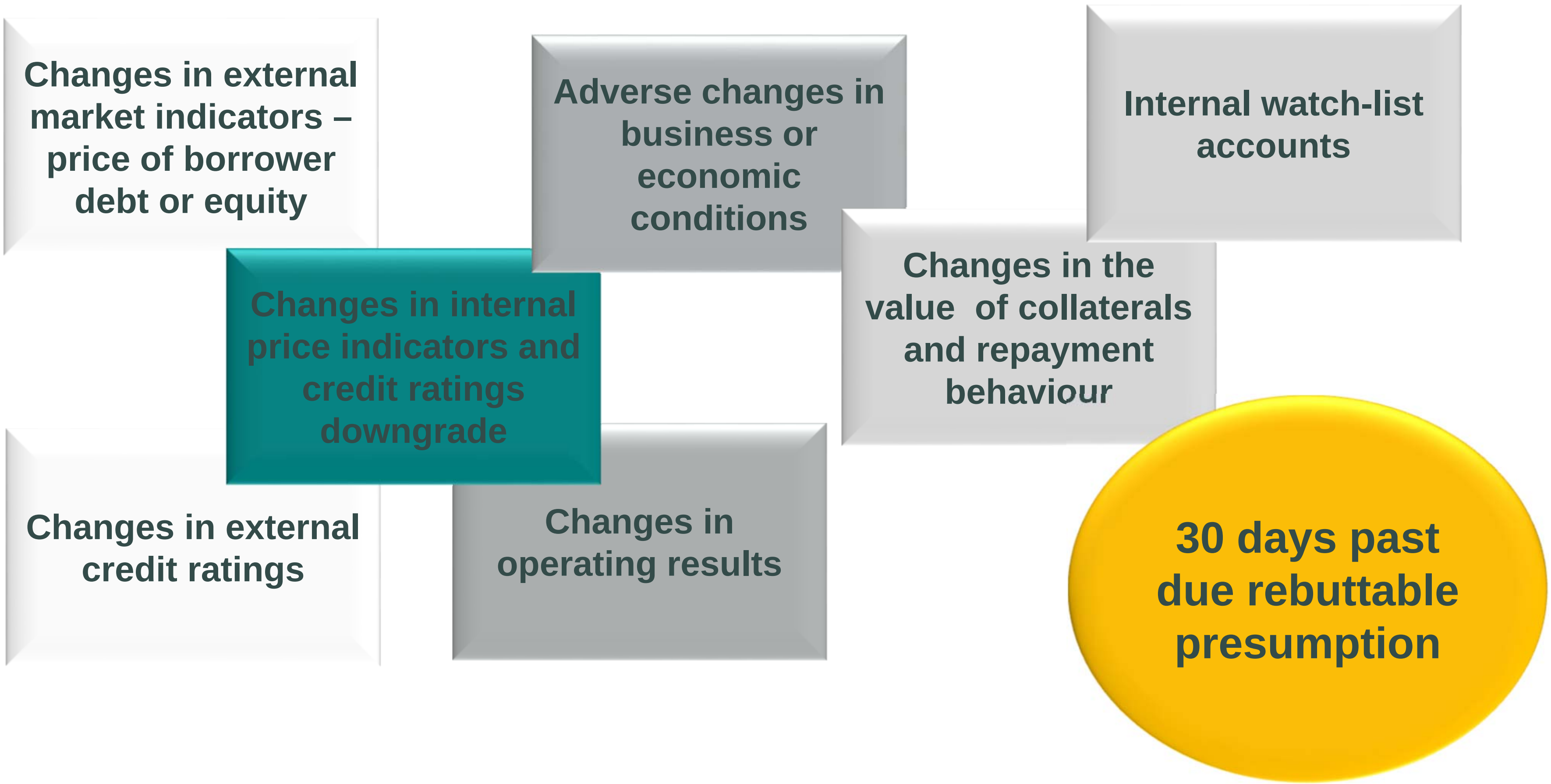
Staging of Portfolios for Determination of Credit Loss Provision- General approach



If no reasonable expectation of recovery – Write off

Staging Approach

- Information to take into account for assessment of increased credit risk



ECL Methodology

- An entity's estimate of expected credit losses must reflect:
  - the best available information – historical and forward looking
  - 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.
- For the purposes of estimating ECL, credit exposure may be grouped based on shared credit risk characteristics such as industry, collateral type, nature of facility, credit risk ratings etc. This collective assessment is particularly relevant for retail portfolios.

Elements of Credit Loss Determination

1 2 3

ECL = PD x LGD x EAD

Risk Parameters

1

PD

- The probability of defaulting if you haven't already

2

LGD

- The forecasted economic loss if the default happens

3

EAD

- The forecasted exposure at each point in time

- Discount factor (EIR)

Approach for Non-Financial Sector Entities

- Although the effect of IFRS 9 is not as significant on non-financial entities, the impact of adopting IFRS 9 should not be under estimated;
- The **general approach** of ECL will be applied to most debt securities, long term contract receivables;
- The **simplified approach** may be applied to short term trade receivables – entities have a policy choice to apply simplified approach or a general approach of ECL;
- **Simplified Approach**
- Simplified approach **does not require tracking of changes in credit risk** from initial recognition; instead it requires the recognition of **life-time ECL at all times**;

Approach for Non-Financial Sector Entities

- IFRS 9 allows using a provision matrix as a practical expedient for determining ECL on trade receivables;
- The provision matrix is typically based on historical loss rates for various customer segments such as by geography, product type, customer ratings or age buckets;
- The loss rates should also be adjusted on the basis of forward looking macro-economic factors before they are applied to determine the current level of ECL provisions;
- The time value of money is usually not considered due to short term nature of receivables;

ECL for long outstanding receivables from Government

- Many public sector entities have long outstanding receivables and payables due from and to Government or entities owned by the Government mainly due to the “circular debt issue”;
- **Some of these receivables are guaranteed by the Federal Government** such as receivable of power generation projects;
- The overdue receivables are in some cases are subject to interest / mark-up but such **late payment mark-up is not usually enforced** and therefore, only principal amount is expected to be realized;
- Whilst these amounts are contractually due at reporting date but **the timing of realization is highly uncertain** and may extend to number of years considering the historical experiences;

ECL for long outstanding receivables from Government

- For receivable which are guaranteed by the Government, no ECL is considered as the Government debts are sovereign in nature;
- For non-guaranteed receivables, ECL is a probability-weighted estimate of credit losses.
- **A credit loss** is the difference between the cash flows that are due to an entity in accordance with the contract and the present value of cash flows that the entity expects to receive.
- **ECL consider the amount and timing of payments**, thus a credit loss arises even if the entity expects to be paid in full but later than when contractually due;

ECL for long outstanding receivables from Government

- As the timing of the cashflows is uncertain in case of long outstanding government receivables, an entity may have to take the following approach for estimating ECL:

  a) build scenarios reflecting the different possibilities of cashflows on present value basis;

  b) Assign probability to each scenario based on best judgment;

  c) compute expected cashflows (PV of cashflows under each scenario x its probability);

  d) Compare expected cashflows with the contractually due amount (book value) to determine ECL.

End Note

- IFRS 9 is **not a rule -based standard way of computing loan loss provisions and therefore, entities depending upon their sophistication, may use different approaches** to be compliant with the principles set out by the standard;
- The policies adopted, methodologies applied and the processes followed should be adequately documented and approved at the appropriate levels of management;
- **Requires engagement of risk management , finance and IT departments with the oversight of CEO, CFO and the audit committee of the Board;**
- **Extensive disclosures** to be made in the financial statements.

Thank You