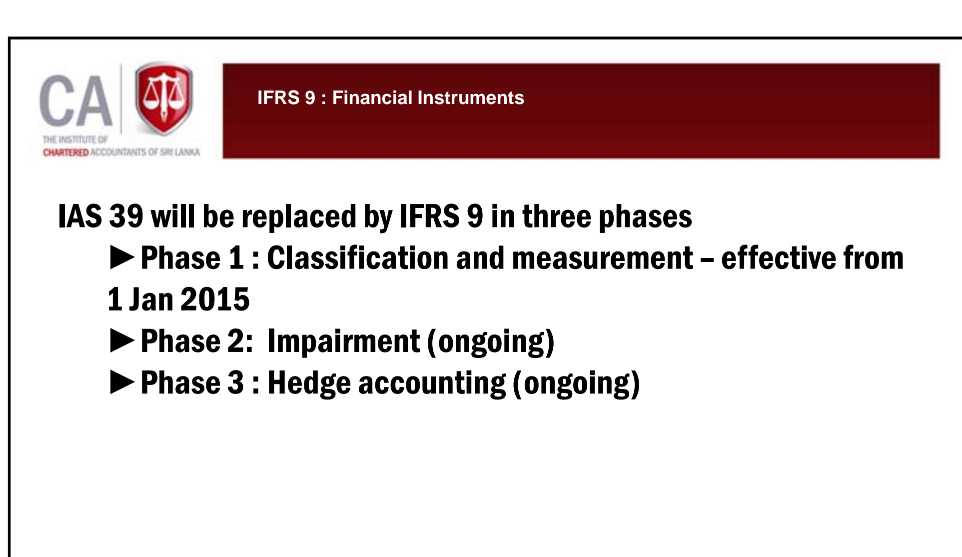
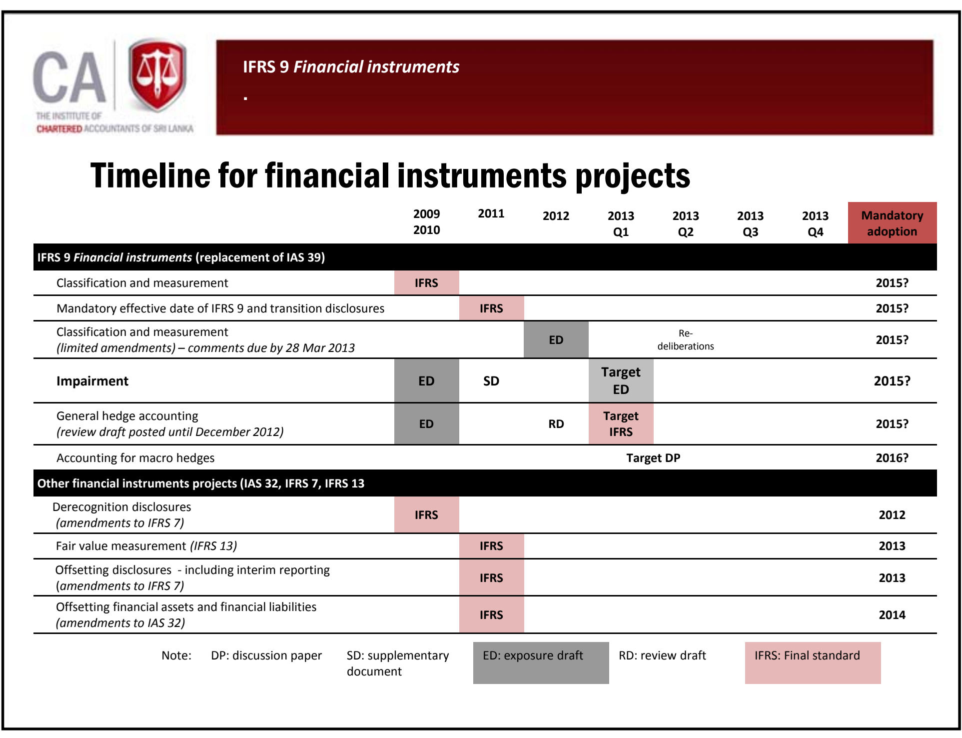
A Presentation to-
IFRS 9 *Financial instruments*
20th June 2013
Manil Jayasinghe
Senior Partner , Ernst & Young

IFRS 9 *Financial instruments*
Introduction





	2009 2010	2011	2012	2013 Q1	2013 Q2	2013 Q3	2013 Q4	Mandatory adoption
IFRS 9 *Financial instruments* (replacement of IAS 39)								
Classification and measurement	IFRS							2015?
Mandatory effective date of IFRS 9 and transition disclosures		IFRS						2015?
Classification and measurement *(limited amendments) – comments due by 28 Mar 2013*			ED		Re-deliberations			2015?
Impairment	ED	SD		Target ED				2015?
General hedge accounting *(review draft posted until December 2012)*	ED		RD	Target IFRS				2015?
Accounting for macro hedges				Target DP				2016?
Other financial instruments projects (IAS 32, IFRS 7, IFRS 13								
Derecognition disclosures *(amendments to IFRS 7)*	IFRS							2012
Fair value measurement *(IFRS 13)*		IFRS						2013
Offsetting disclosures - including interim reporting *(amendments to IFRS 7)*		IFRS						2013
Offsetting financial assets and financial liabilities *(amendments to IAS 32)*		IFRS						2014

Note: DP: discussion paper SD: supplementary document ED: exposure draft RD: review draft IFRS: Final standard

IFRS 9 : Financial Instruments

Scope

within the scope of IAS 39 Financial Instruments: Recognition and Measurement

Page 5

IFRS 9 : Financial Instruments

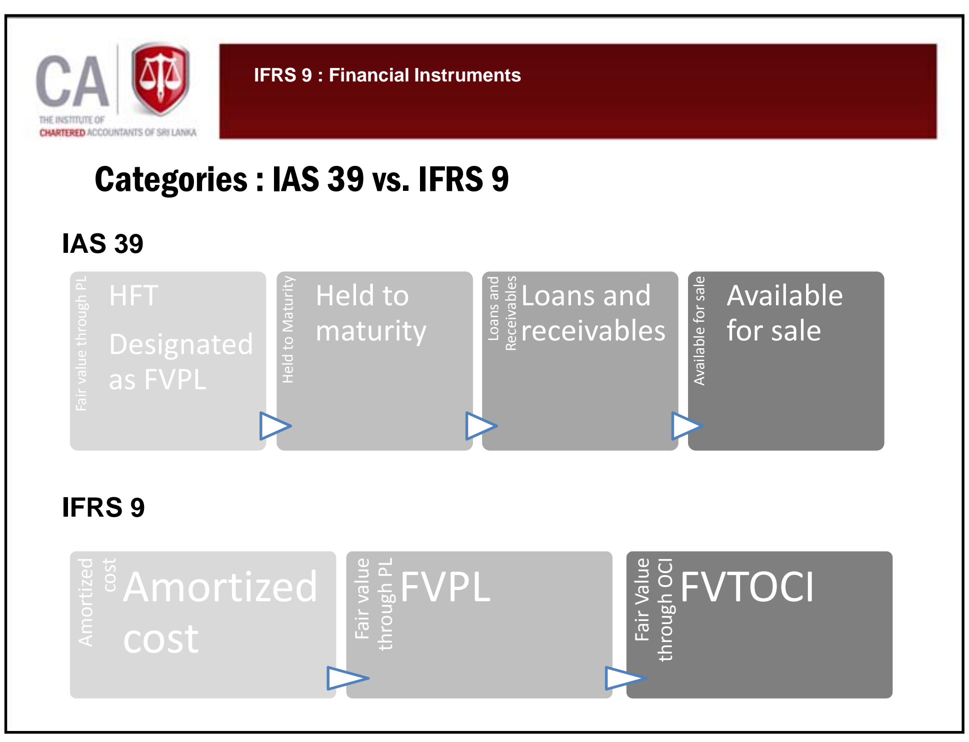
Classification IAS 39 vs. IFRS 9

IAS 39

- Intention (hold / short term gains)?
- Ability to hold (financial resources) ?
- Quoted in active market ?
- Fixed and determinable payment ?
- FA / FL bifurcation for embedded derivatives
- FVO is available

IFRS 9

- Characteristics of the assets test
- Business model test
- No bifurcation for Financial assets
- FVO is available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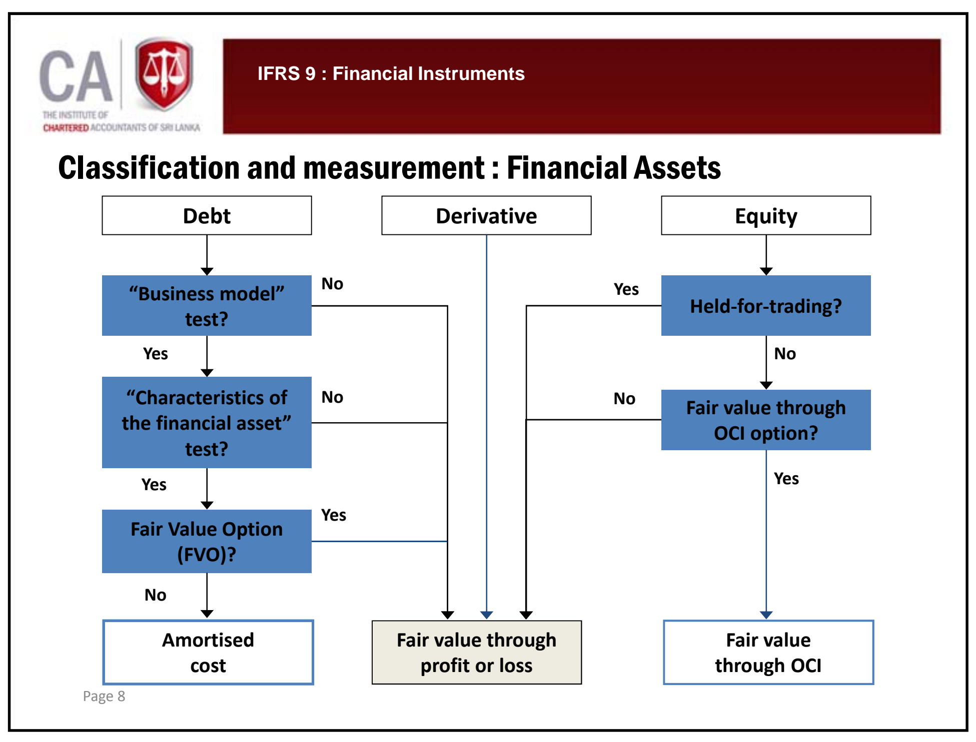
IFRS 9 : Financial Instruments
Categories : IAS 39 vs. IFRS 9
IAS 39
Fair value through PL
HFT
Designated as FVPL
Held to Maturity
Held to maturity
Loans and Receivables
Loans and receivables
Available for sale
Available for sale
IFRS 9
Amortized cost
Amortized cost
Fair value through PL
FVPL
Fair Value through OCI
FVTOCI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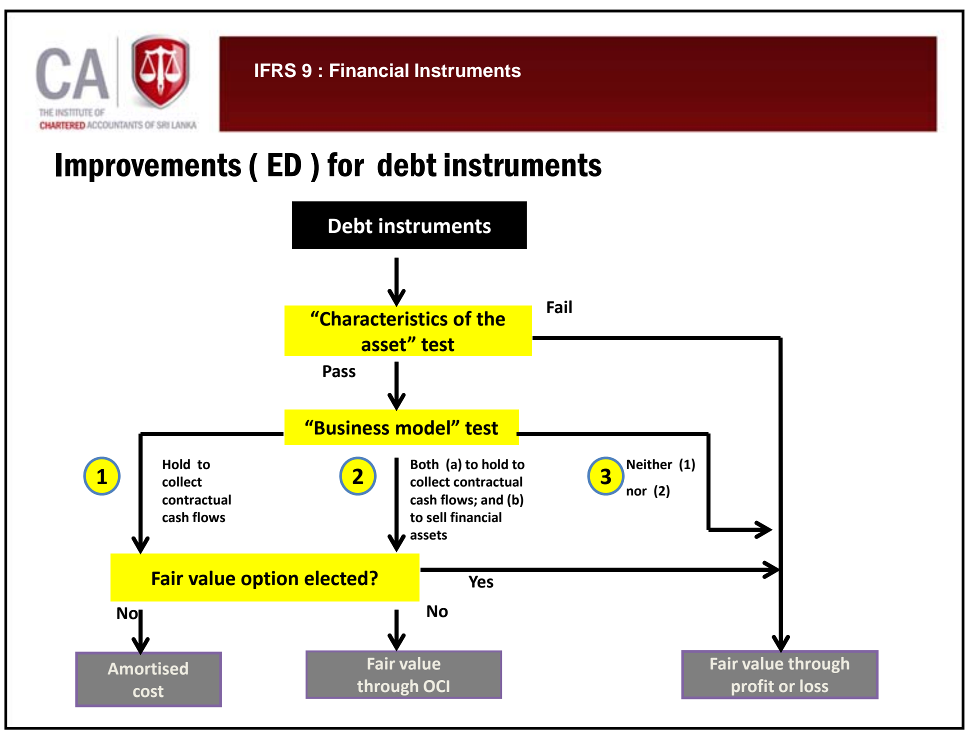
IFRS 9 : Financial Instruments
Classification and measurement : Financial Assets
Debt
Derivative
Equity
"Business model" test?
No
Yes
"Characteristics of the financial asset" test?
No
Yes
Fair Value Option (FVO)?
Yes
No
Amortised cost
Fair value through profit or loss
Held-for-trading?
Yes
No
Fair value through OCI option?
No
Yes
Fair value through OCI
Page 8



IFRS 9 : Financial Instruments

The business model test

- The objective of the entity's business model must be to hold instruments to collect contractual cash flows (ie principal and interest)
- Some sales *may* be permitted, for example:
  - If the asset no longer meets investment policy (e.g., decline in credit rating)
  - The entity is an insurer and it adjusts its investment portfolio to match the duration of its liabilities
  - If the asset is sold to fund unexpected cash outflows or losses
- Amortised cost may not be appropriate if "more than infrequent" sales occur
- Disclosures required
  - On derecognition of amortised cost assets, gains or losses are to be disclosed on the face of the income statement
  - Additional qualitative disclosures of the reasons for the sale

IFRS 9 : Financial Instruments

The business model test : Example 1

- Group A operates in 10 geographic locations, nine retail subsidiaries meet amortised cost
- The tenth subsidiary
  - » accounts for 5% of Group's retail banking business
  - » holds assets to maximise return, but not 'held-for-trading'
  - » more than infrequent sales are expected
- How many business models does Group A have?
  - » Two – investment banking and retail banking
  - » Three – investment banking, 9 retail subsidiaries and the tenth retail subsidiary
  - » Assessment based on the (more granular) level at which strategy is set
  - » Any of the above

IFRS 9 : Financial Instruments

The business model test : Example 2

- An entity holds investments to collect their contractual cash flows but would sell an investment in particular circumstances.
- Analysis
  - Although an entity may consider, among other information, the financial assets' fair values from a liquidity perspective (ie the cash amount that would be realised if the entity needs to sell assets), the entity's objective is to hold the financial assets and collect the contractual cash flows. Some sales would not contradict that objective.

IFRS 9 : Financial Instruments

The business model test : Example 3

- An entity's business model is to purchase portfolios of financial assets, such as loans. Those portfolios may or may not include financial assets with incurred credit losses. If payment on the loans is not made on a timely basis, the entity attempts to extract the contractual cash flows through various means—for example, by making contact with the debtor by mail, telephone or other methods.
- In some cases, the entity enters into interest rate swaps to change the interest rate on particular financial assets in a portfolio from a floating interest rate to a fixed interest rate.

IFRS 9 : Financial Instruments

The business model test : Example 3 : Analysis

- The objective of the entity's business model is to hold the financial assets and collect the contractual cash flows. The entity does not purchase the portfolio to make a profit by selling them.
- The same analysis would apply even if the entity does not expect to receive all of the contractual cash flows (eg some of the financial assets have incurred credit losses).
- Moreover, the fact that the entity has entered into derivatives to modify the cash flows of the portfolio does not in itself change the entity's business model. If the portfolio is not managed on a fair value basis, the objective of the business model could be to hold the assets to collect the contractual cash flows.

IFRS 9 : Financial Instruments

The business model test : Example 4

- An entity has a business model with the objective of originating loans to customers and subsequently to sell those loans to a securitisation vehicle. The securitisation vehicle issues instruments to investors.
- The originating entity controls the securitisation vehicle and thus consolidates it.
- The securitisation vehicle collects the contractual cash flows from the loans and passes them on to its investors.
- It is assumed for the purposes of this example that the loans continue to be recognised in the consolidated statement of financial position because they are not derecognised by the securitisation vehicle.

IFRS 9 : Financial Instruments

The business model test : Example 4 : Analysis

- The consolidated group originated the loans with the objective of holding them to collect the contractual cash flows.
- However, the originating entity has an objective of realising cash flows on the loan portfolio by selling the loans to the securitisation vehicle, so for the purposes of its separate financial statements it would not be considered to be managing this portfolio in order to collect the contractual cash flows.

IFRS 9 : Financial Instruments

Characteristics of the financial asset

- Contractual terms of the financial asset give rise, on specified dates, to cash flows that solely represent principal and interest payments
- Features that will still qualify for amortised cost:
  - Prepayment options, extension options
  - Fixed/variable interest rates
  - Caps, floors, collars
  - Unleveraged inflation index linked
- Features/assets that will not qualify:
  - Leverage (options, forwards and swaps)
  - Inverse floaters
  - Convertible bonds, constant maturity rate bonds
  - Catastrophe bonds

IFRS 9 : Financial Instruments

Characteristics of the financial asset test

Features that require further analysis

- Inflation indexed Euro bonds e.g. indexed to the Italian inflation rate
- Constant maturity type bonds - 15 year floating rate JGB, coupons are reset every 6 months by referencing to the 10 year rate
- Products with a time lag in setting interest rates
  - e.g. mortgage is indexed to the average 2 year Libor rate over the last 2 years plus a fixed spread
- Restructured bank loans, for e.g. with an equity kicker
- Step up features: spread above benchmark rate increases if borrower’s EBITDA or debt to equity ratio deteriorates
- Dual currency bonds
- Investments in units issued by money market or debt funds

IFRS 9 : Financial Instruments

Instrument A

- Instrument A is a bond with a stated maturity date.
- Payments of principal and interest on the principal amount outstanding are linked to an inflation index of the currency in which the instrument is issued.
- The inflation link is not leveraged and the principal is protected.

IFRS 9 : Financial Instruments

Instrument A : Analysis

- The contractual cash flows are solely payments of principal and interest on the principal amount outstanding.
- Linking payments of principal and interest on the principal amount outstanding to an unleveraged inflation index resets the time value of money to a current level.
- Thus, the interest amounts are consideration for the time value of money on the principal amount outstanding.
- However, if the interest payments were indexed to another variable such as the debtor's performance (eg the debtor's net income) or an equity index, the contractual cash flows are not payments of principal and interest on the principal amount outstanding.
- That is because the interest payments are not consideration for the time value of money and for credit risk associated with the principal amount outstanding.

IFRS 9 : Financial Instruments

Instrument B

- Instrument B is a variable interest rate instrument with a stated maturity date that permits the borrower to choose the market interest rate on an ongoing basis.
- For example, at each interest rate reset date, the borrower can choose to pay three-month LIBOR for a three-month term or one-month LIBOR for a one-month term.

IFRS 9 : Financial Instruments

Instrument B : Analysis

- The contractual cash flows are solely payments of principal and interest on the principal amount outstanding as long as the interest paid over the life of the instrument reflects consideration for the time value of money and for the credit risk associated with the instrument.
- The fact that the LIBOR interest rate is reset during the life of the instrument does not in itself disqualify the instrument

IFRS 9 : Financial Instruments

Instrument B. 1

- Instrument B is a variable interest rate instrument with a stated maturity.
- At each interest rate reset date, the borrower pay one-month LIBOR for a three-month term
- Analysis :
  - As the borrower pay one-month LIBOR for three months and that one-month LIBOR is not reset each month, the contractual cash flows are not payments of principal and interest.

IFRS 9 : Financial Instruments

Instrument C

- Instrument C is a bond with a stated maturity date and pays a variable market interest rate.
- That variable interest rate is capped.

IFRS 9 : Financial Instruments

Instrument C : Analysis

- The contractual cash flows of both:
  - (a) an instrument that has a fixed interest rate and
  - (b) an instrument that has a variable interest rate
- are payments of principal and interest on the principal amount outstanding as long as the interest reflects the time value of money and the credit risk associated.
- Therefore, an instrument that is a combination of (a) and (b) (eg a bond with an interest rate cap) can have cash flows that are solely payments of principal and interest .

IFRS 9 : Financial Instruments

Instrument D

- Instrument D is a full recourse loan and is secured by collateral.
- Analysis
  - The fact that a full recourse loan is collateralised does not in itself affect the analysis of whether the contractual cash flows are solely payments of principal and interest on the principal amount outstanding.

IFRS 9 : Financial Instruments

Instrument E

- Instrument E is a bond that is convertible into equity instruments of the issuer.
- Analysis
  - The holder would analyze the convertible bond in its entirety.
  - The contractual cash flows are not payments of principal and interest on the principal amount outstanding because the interest rate does not reflect only consideration for the time value of money and the credit risk.
  - The return is also linked to the value of the equity of the issuer.

IFRS 9 : Financial Instruments

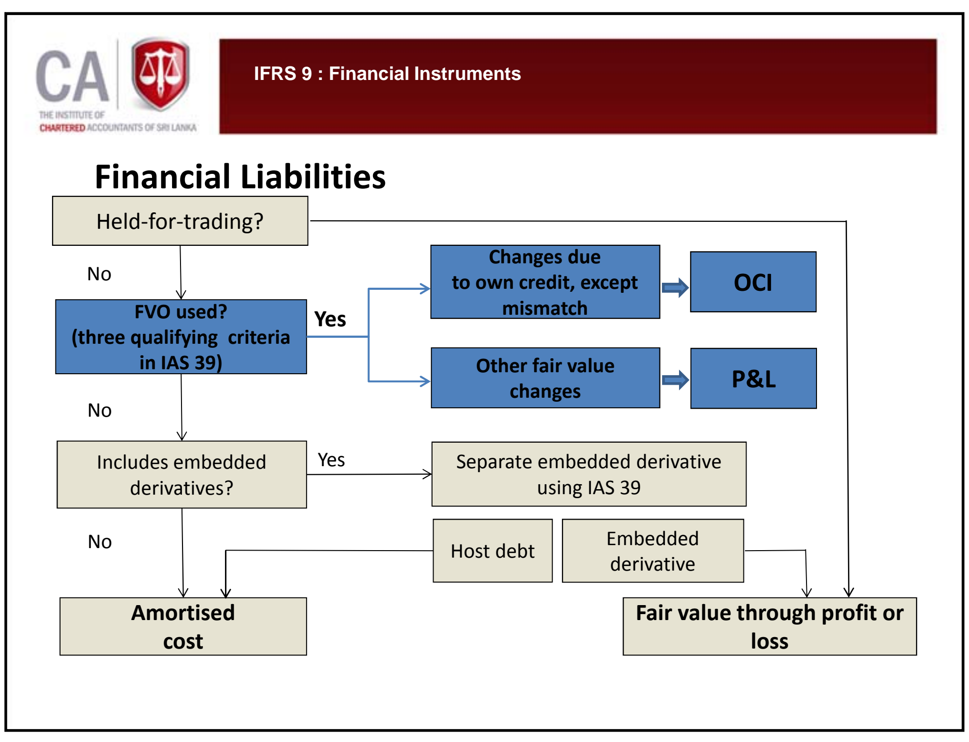
Instrument F

- Instrument F is a loan that pays an inverse floating interest rate (ie the interest rate has an inverse relationship to market interest rates).
- Analysis
  - The contractual cash flows are not solely payments of principal and interest on the principal amount outstanding.
  - The interest amounts are not consideration for the time value of money on the principal amount outstanding.

IFRS 9 : Financial Instruments

Equities

- Option to record fair value changes through OCI, with no recycling of gain/loss on disposal
  - Irrevocable choice on an instrument by instrument basis, unless held for trading
  - Only if meet the *definition* of equity – therefore equity derivatives and puttables do not qualify
  - Dividends recorded in profit or loss if not a recovery of part of the cost
  - Extensive disclosures including reasons for using the option, fair value of each instrument



IFRS 9 : Financial Instruments

High level comparison
Financial assets –vs– financial liabilities

- Business impact – no change for many financial liabilities
- Asymmetrical treatment of FVO financial assets and liabilities

	Financial assets (Phase 1 of IFRS 9)	Financial liabilities (IFRS 9)
Business model test?	Yes	No
Characteristics of financial asset test?	Yes	No
Separate embedded derivatives?	No	Yes
Fair value option?	Only when there is an 'accounting mismatch'	The three criteria in IAS 39 will remain
Changes in own credit risk where FVO is used	Not applicable	Recognize in OCI

IFRS 9 : Financial Instruments

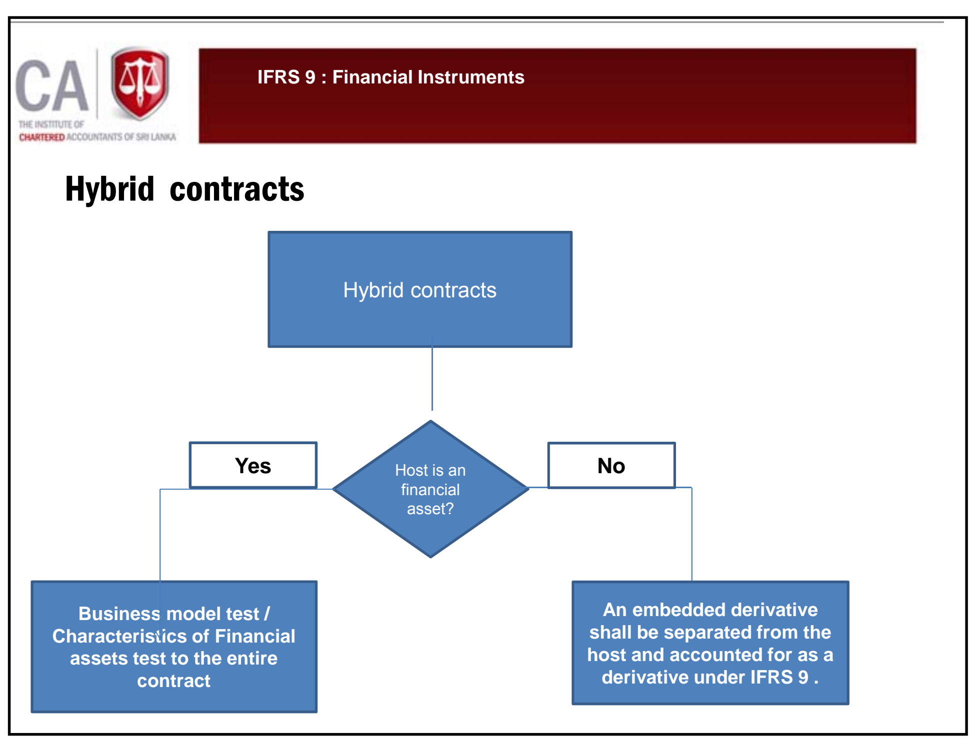
Reclassifications

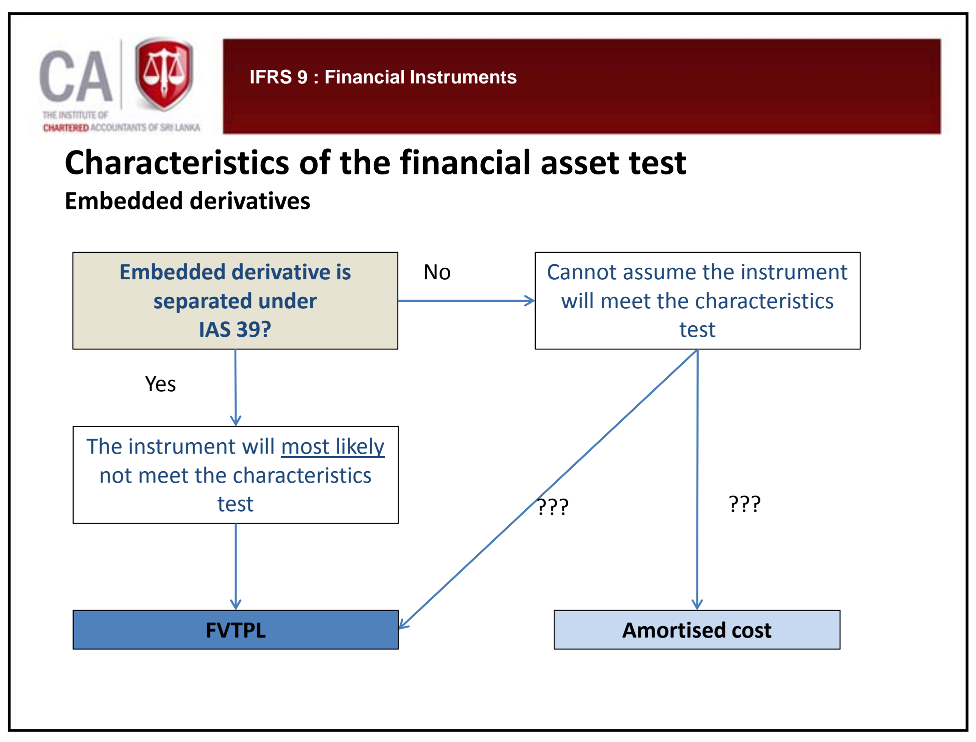
IAS 39

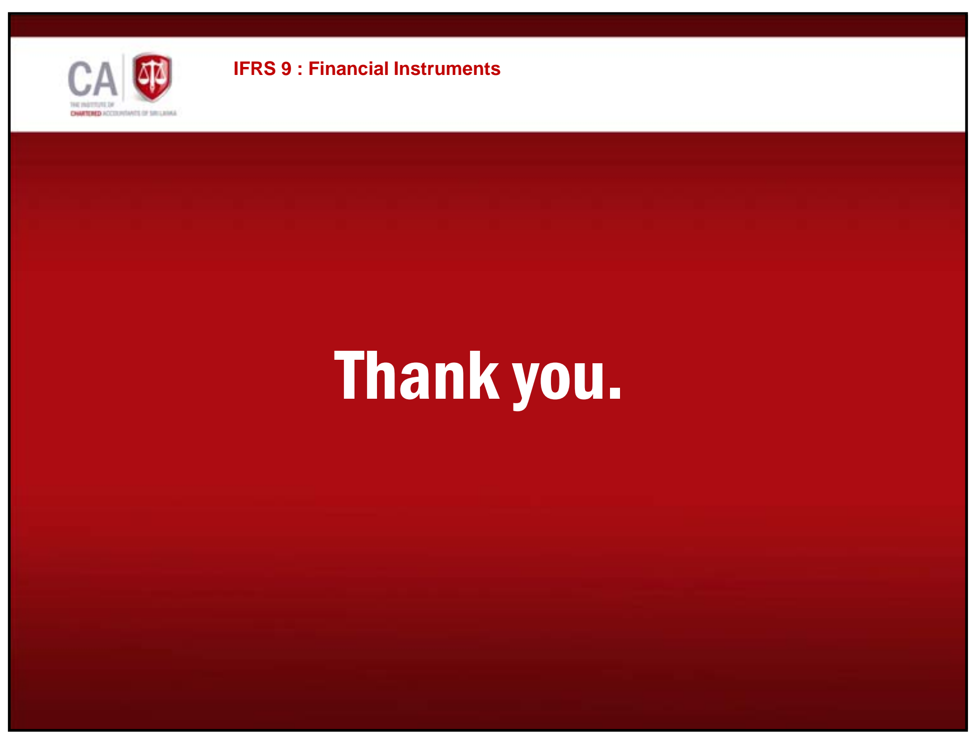
- Limited reclassification options for IN / OUT
- Tainting rule for HTM

IFRS 9

- when, and only when, an entity **changes its business model** for managing financial assets


IFRS 9 : Financial Instruments
Hybrid contracts
Hybrid contracts
Yes
Host is an financial asset?
No
Business model test / Characteristics of Financial assets test to the entire contract
An embedded derivative shall be separated from the host and accounted for as a derivative under IFRS 9 .


IFRS 9 : Financial Instruments
Characteristics of the financial asset test
Embedded derivatives
Embedded derivative is separated under IAS 39?
No
Cannot assume the instrument will meet the characteristics test
Yes
The instrument will most likely not meet the characteristics test
???
???
FVTPL
Amortised cost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Thank you.