IFRS 9 Financial Instruments

Breakfast with the CIAA
Presented by KPMG

May 10, 2016

This morning's agenda

- Classification and measurement
- Impairment
- Presentation and disclosure
- Hedge accounting
- Transition

Classification and measurement

In this section

We will walk through some of the classification and measurement requirements, including practical examples, and highlight some of the questions you could be asking today.

Topics we plan to cover include:

- An overview of the classification requirements;
- The business model assessment;
- The contractual cash flow assessment (SPPI);
- Proposed regulatory guidance; and
- Classification of financial liabilities.

An overview of the classification requirements

IAS 39 vs IFRS 9

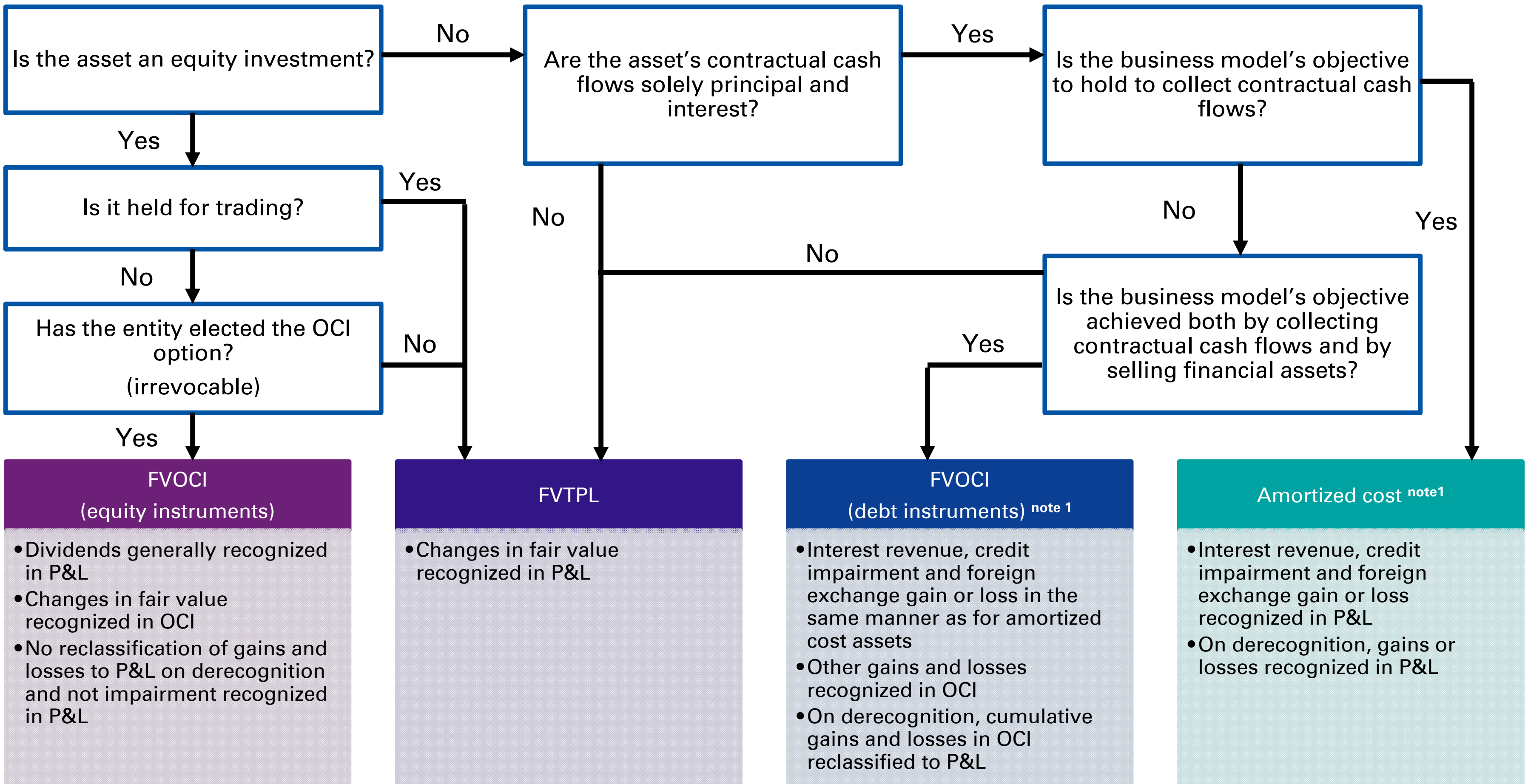
IAS 39	Loans & receivables	Held to maturity	FVTPL[1]	Available for sale
	Amortized cost			FVOCI
IFRS 9	Amortized cost		FVTPL[1]	FVOCI[2]

1 FVTPL = fair value through profit or loss
2 FVOCI = fair value through other comprehensive income

While the measurement categories for financial assets are very similar to IAS 39, the criteria for classification into the appropriate measurement category are significantly different…

An overview of the classification requirements

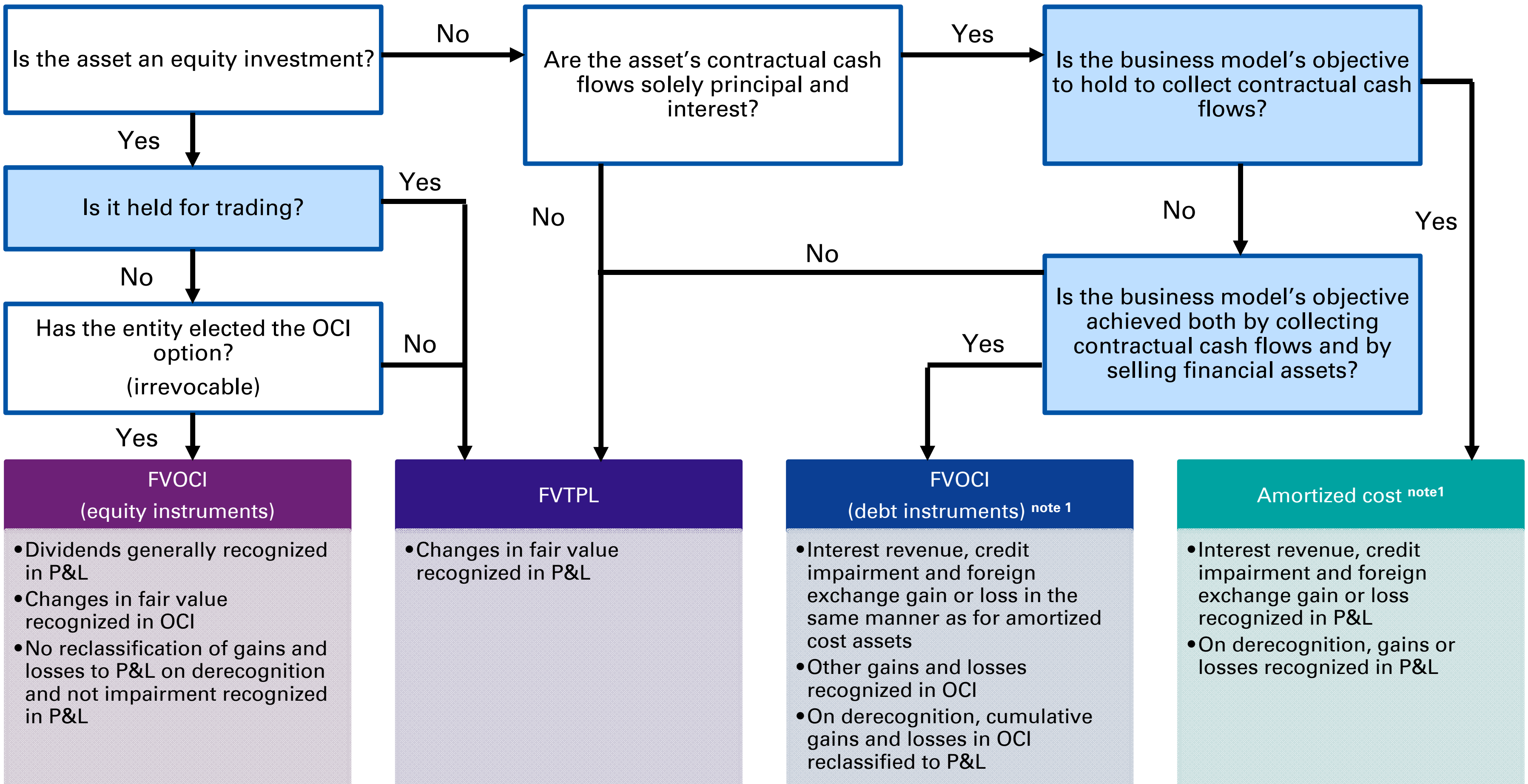
Financial assets in the scope of IFRS 9



Note 1 Per IFRS 9, this is subject to an entity's irrevocable option to designate such a financial asset as FVTPL on initial recognition, if such designation eliminates or significantly reduces a measurement or recognition inconsistency.

The business model assessment

Financial assets in the scope of IFRS 9



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Business models and their key features

The business model is determined at a level that reflects how groups of financial assets are managed together to achieve a particular business objective.

Business model	Key features
Held to collect	• The objective of the business model is to hold assets to collect contractual cash flows • Sales are incidental to the objective of the model • Typically lowest sales (in frequency and volume)
Held to collect AND for sale	• Both collecting contractual cash flows and sales are integral to objective of the business model • Typically more sales (in frequency and volume) than held-to-collect models
Other business models: - Trading; - Managing assets on a FV basis; or - Maximizing cash flows	• Business models are neither held-to-collect nor held-to-collect and for sale • Collection of contractual cash flow is incidental to the objective of the model

The business model assessment

Business model considerations

Factors to be considered	Description
Portfolios	Business model is determined at a level that financial assets are managed to achieve a particular business objective
Investment strategy	If the investment strategy focuses on realizing gains on fair value differences rather than earning contractual interest this may be an indicator of a business model different from held to collect
Frequency, value, and timing of sales	Past sales provide evidence related to how the stated objective for holding the financial assets is achieved and, how cash flows are realised Some sales or transfers of financial instruments before maturity might be consistent with held-to-collect business model if they are infrequent (even if significant in value) or insignificant in value either individually or in aggregate (even if frequent) Sales that are made close to the maturity with proceeds approximate the collection of the remaining contractual cash flows, may be consistent with held-to-collect business model
Increase in credit risk	Sales due to an increase in the assets' credit risk, irrespective of their frequency and value, are not inconsistent with a held to collect business model because credit quality of financial assets is relevant to an entity's ability to collect contractual cash flows e.g. selling a financial asset that no longer meets credit criteria specified in the entity's documented investment policy
Other reasons for sales	An increase in the frequency or value of sales is not necessarily inconsistent with a held-to-collect business model if an entity can explain the reasons for sales and why those sales do not reflect a change in the objective for the business model

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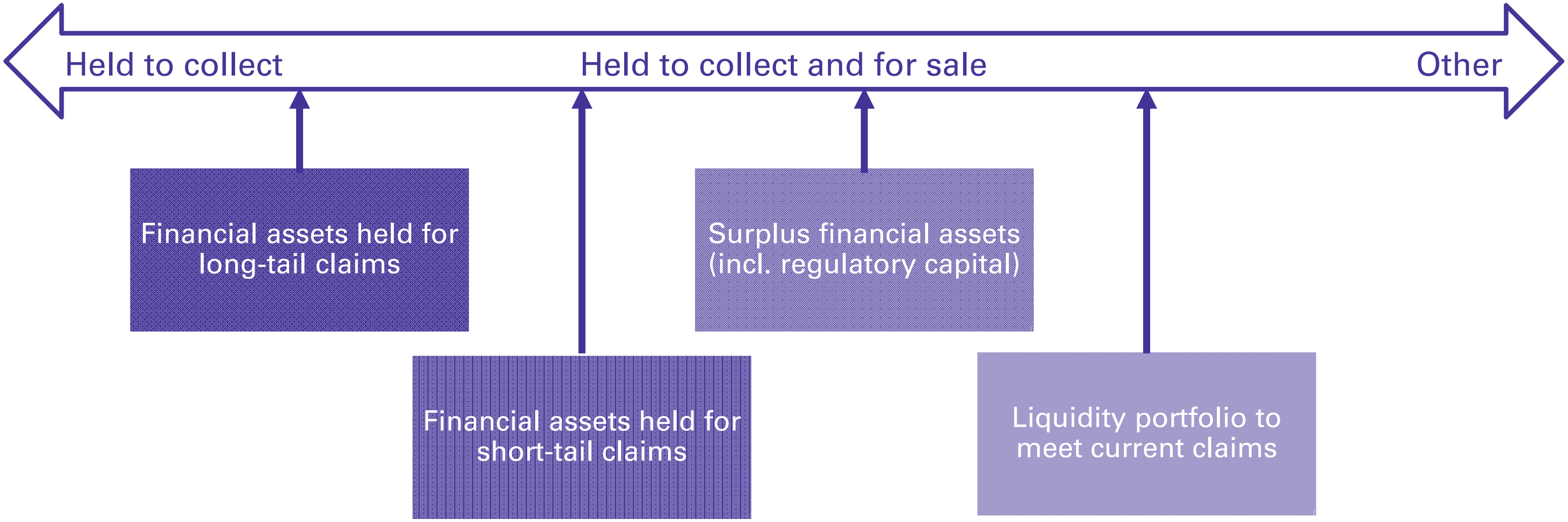
The business model assessment

Business model considerations (cont.)

Factors to be considered	Description
Prospective view	Consider not just historic view, but also future expected strategy
Holding period	Whether debt investments are expected to be held for an extended period of time relative to their contractual maturity
Performance evaluation	If managerial reporting and KPIs on a portfolio's performance is based on fair value, this may be an indicator of a business model different from held to collect
Management compensation	How the management is compensated (e.g. whether the compensation is based on the fair value of the assets managed or on the contractual cash flows collected)
Reclassification	Reclassification is needed if the objective of the entity's business model for managing those financial assets changes
Credit risk management	The use of CDS to actively manage and transfer credit risk is not consistent with a held to collect business model

Example portfolios for P&C insurance companies

The following diagram provides examples of possible portfolios (and sub-portfolios) for insurance companies within Canada.



Although IFRS 9 states that an entity’s business model is a matter of fact, it also acknowledges that judgment is needed to assess the business model for managing particular financial assets…

Case studies

Case #1

Insurance company A has a portfolio of financial assets that it has determined to be part of a held-to-collect business model. A change in the regulatory treatment of the assets has caused A to undertake a significant rebalancing of its portfolio in a particular period.

Case #2

Insurance company B is required by its regulator to routinely sell financial assets from a portfolio to demonstrate that the assets were liquid, and the value of the assets sold was significant.

Case #3

Insurance company C holds financial assets to meet liquidity needs in a ‘stress case’ scenario (e.g. run on deposits). C monitors credit quality of the assets and its objective is to collect the contractual cash flows.

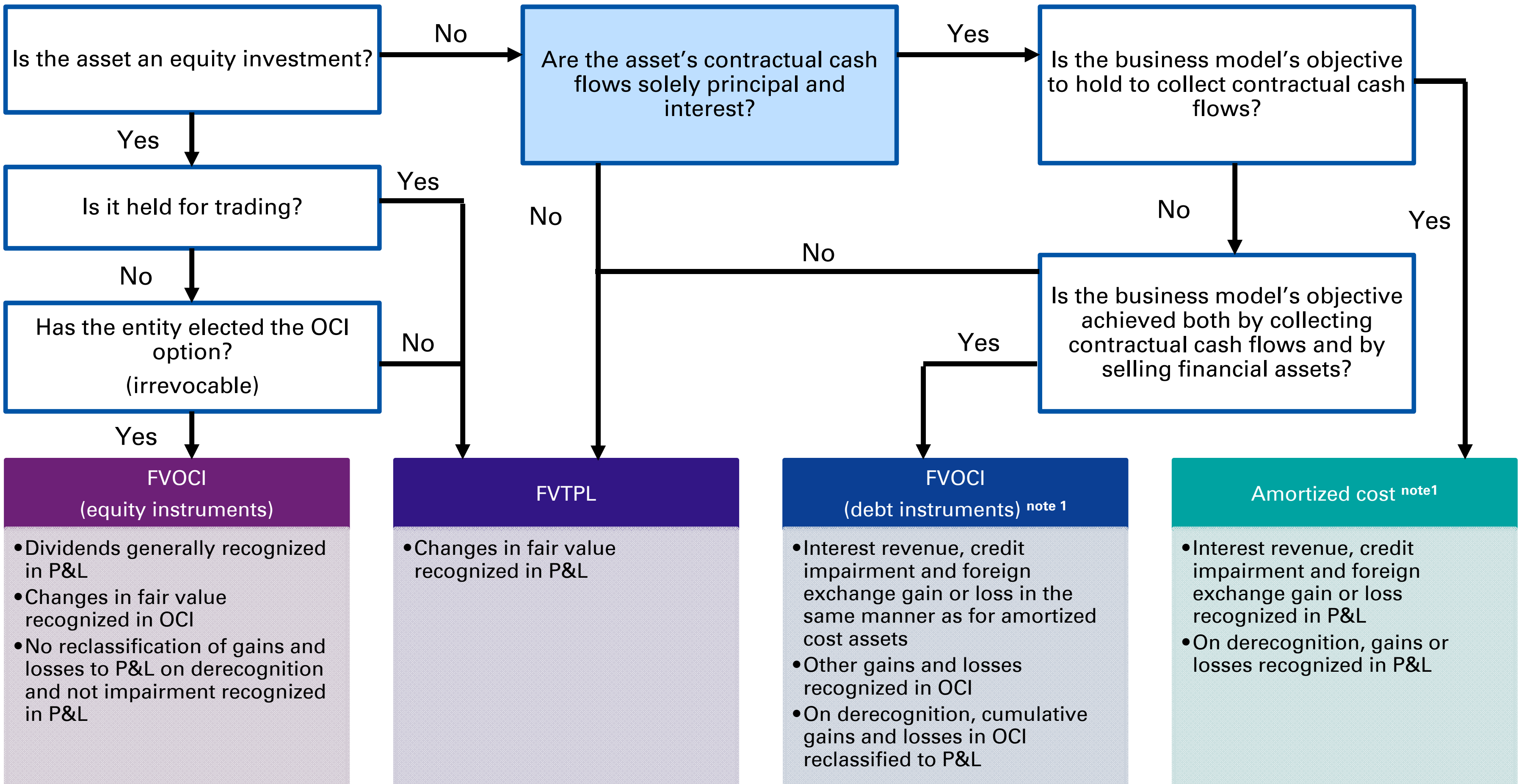
C evaluates performance of assets on basis of interest earned and credit losses incurred. C also monitors fair value of financial assets from liquidity perspective to ensure cash realized in sale in stress case scenario will be sufficient to meet the liquidity needs.

Case #4

Insurance Company D holds financial assets to meet its everyday liquidity needs. D actively manages the return on the portfolio in order to minimise the cost of its liquidity requirements. That return consists of collecting contractual cash flows and realizing gains and losses from sales to reinvest in higher yielding assets or to better match the duration of its liabilities. Sales have been frequent and significant in value.

The contractual cash flow assessment

Financial assets in the scope of IFRS 9



Note 1 Per IFRS 9, this is subject to an entity's irrevocable option to designate such a financial asset as FVTPL on initial recognition, if such designation eliminates or significantly reduces a measurement or recognition inconsistency.

The meaning of 'principal' and 'interest'

Contractual cash flows that meet the SPPI criterion are consistent with a basic lending arrangement.

Principal

The fair value of the financial asset at initial recognition. However, principal may change over time – e.g. if there are repayments of principal

Interest

Consideration for:

- The time value of money;
- Credit risk associated with the principal amount outstanding during a particular period of time
- Consideration for other basic lending risks (e.g. liquidity risk) and costs (e.g. administrative costs);
- Profit margin.

The contractual cash flows assessment (SPPI)

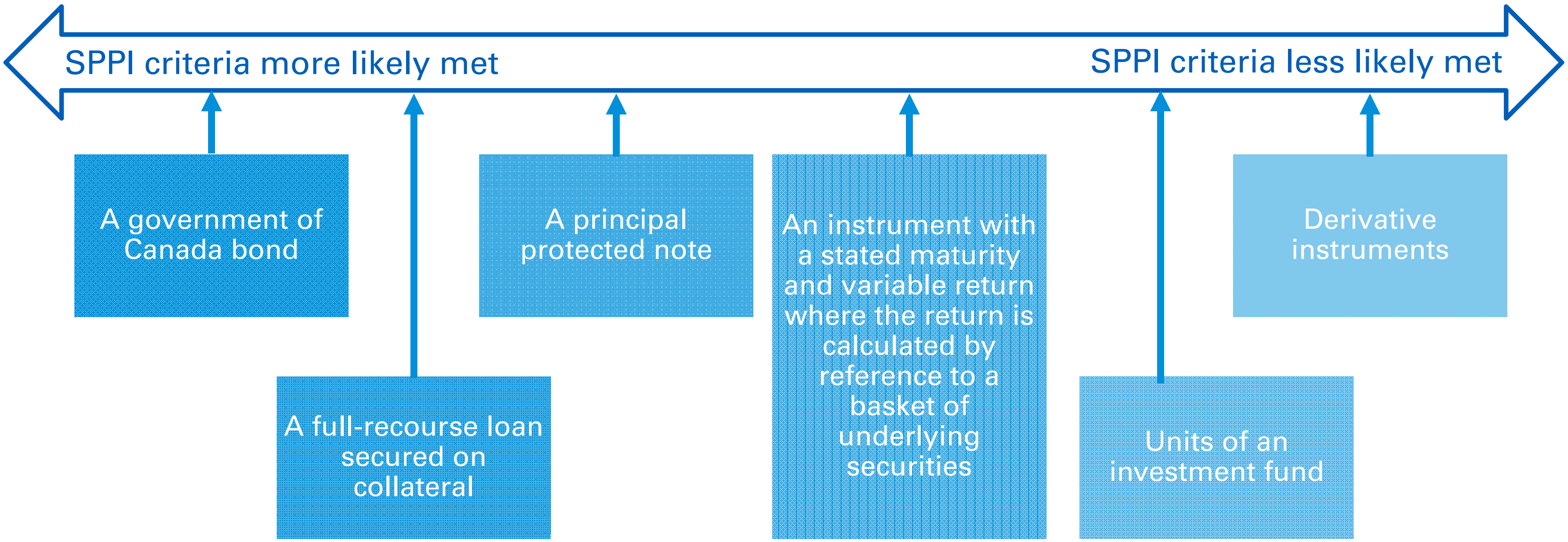
Features for further consideration

Feature	Description
Non-standard interest rate	Contractual terms that change the timing or amount of cash flows
Leverage	Contractual term that increases variability of the contractual cash flows
Prepayment options	Contractual terms that allow the issuer to prepay before maturity. Prepayment options do not preclude Amortized Cost category as long as these features are consistent with the SPPI concept
Term extension options	Contractual terms that allow the issuer or the holder to extend the term of financial asset. Extension options do not preclude Amortized Cost category as long as these features are consistent with the SPPI concept
Non-recourse loan	Contractual term in which a creditor's claims are limited to specified assets, which may be financial or non-financial assets
Contractually linked instruments	The right to payment on more junior tranches (i.e. exposed to more credit risk) depends on the issuer's generation of sufficient cash flows to pay more senior tranches. A look-through approach is required to determine whether the SPPI criterion is met.
Hybrid instrument	Existence in the contract of an embedded derivative feature
Financial assets acquired at a significant premium or discount	If such assets could be prepaid early at contractual par amount (plus accrued interest), the resulting cash flows would differ from the principal amount (plus accrued interest) as defined in IFRS 9. However, subject to the business model test, IFRS 9 provides an exception from FVTPL classification if fair value of the prepayment feature is insignificant when the asset is initially recognized.

The contractual cash flows assessment (SPPI)

Example assets for P&C insurance companies

The following diagram provides examples of assets frequently held by insurance companies within Canada.



Deciding whether the SPPI criterion is met will require an assessment of contractual provisions that do **or may** change the timing or amount of contractual cash flows…

Draft OSFI Guideline: IFRS 9

During March, OSFI released Draft Guideline: *IFRS 9 Financial Instruments and Disclosures*, intended to replace a variety of guidelines under IAS 39.

Comments were due Friday, May 6, 2016.

Section III *IFRS 9 Guidance on Fair Value Option*

"…Institutions may apply the Fair Value Option under this criterion if (a) consistent with documented risk management strategy, it eliminates or significantly reduces the measurement or recognition inconsistency of measuring financial assets or liabilities together on a different basis, and (b) the fair values are reliable at inception and throughout the life of the instrument."

Section IV *Using the Fair Value Option for Loans* states:

"Generally, the Fair Value Option should not be used for loans to companies having annual gross revenues below $62.5m, for loans to individuals, or for portfolios made up of such loans"

Classification of financial liabilities

IFRS 9 retains almost all of the existing requirements from IAS 39 on the classification of financial liabilities – including those relating to embedded derivatives.

Therefore, under IFRS 9 financial liabilities are classified as subsequently measured at amortized cost, except for the following instruments.

Financial liabilities that are not measured at amortized cost	Measurement requirements
Financial liabilities that are held for trading – including derivatives	FVTPL
Financial liabilities that are designated as FVTPL	FVTPL
Financial liabilities that arise when a transfer of a financial asset does not qualify for derecognition or when the continuing involvement approach applies	Specific guidance carried forward from IAS 39
Financial guarantee contracts	**Note 1**
Contingent consideration recognized by an acquirer in a business combination	FVTPL

1 IFRS 9 requires liabilities that result from financial guarantee contracts in its scope to be measured, after initial recognition, at the higher of:

- the amount of the provision for expected credit losses; and
- The amount initially recognised, less the cumulative amount of income recognised under the principles of IFRS 15.

Things to remember

Significant changes in classification criteria

Classification of debt instruments is based on contractual cash flow characteristics and business model assessment

Fair value exemption – equity instruments

Removal of the cost exemption which may have an impact on investments in system-related equity shares that are currently carried at cost

FVOCI classification – equity instruments

Gains or losses will no longer be reclassified into net income upon disposition

Regulation

Application of IFRS 9 may be impacted by the proposed OSFI guideline.

Taxes

The CRA has not yet disclosed what (if any) changes will be necessitated in response to implementation of IFRS 9.

Impairment

In this section

We will walk through the requirements of the new expected credit loss model, including implementation issues, and highlight some of the questions you could be asking today.

Topics we plan to cover include:

- An overview of the new impairment model;
- Staging of financial assets and migration;
- Measuring expected credit losses;
- Trade and lease receivables and contract assets; and
- Presentation and disclosure

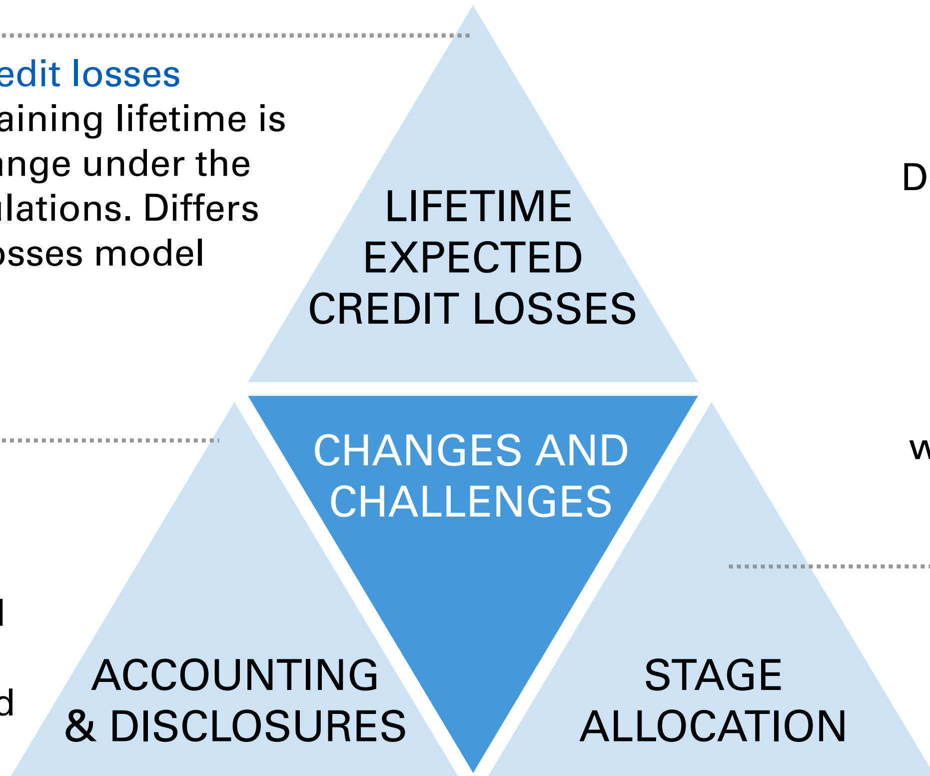
An overview of the new impairment model

Changes and challenges

Calculating expected credit losses especially over the remaining lifetime is the most significant change under the IFRS 9 impairment regulations. Differs from current incurred losses model

Determining the provision depends not only on the level of expected credit losses, but also an individual asset's credit deterioration over time, which must be monitored on an ongoing basis

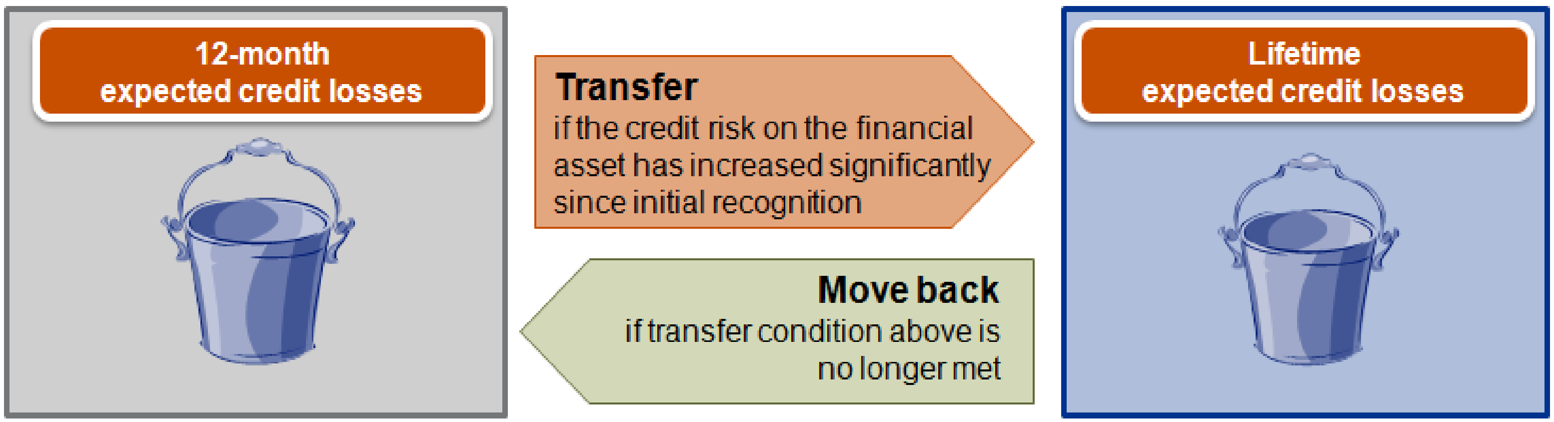
Extensive disclosure requirements require increased data models and merging of risk and accounting data, while accounting for defaulted assets becomes a complicated exercise



The challenges of IFRS 9 impairment extend beyond accounting and require changes to systems and processes

Dual measurement approach

Under the general principle, one of two measurement bases will apply depending on whether there has been a significant increase in credit risk since initial recognition.



Expected Credit Losses (ECL) = Present value of expected cash shortfall discounted at original effective rate – i.e. PV of difference between cash flows the entity expects to receive and the contractual cash flows.

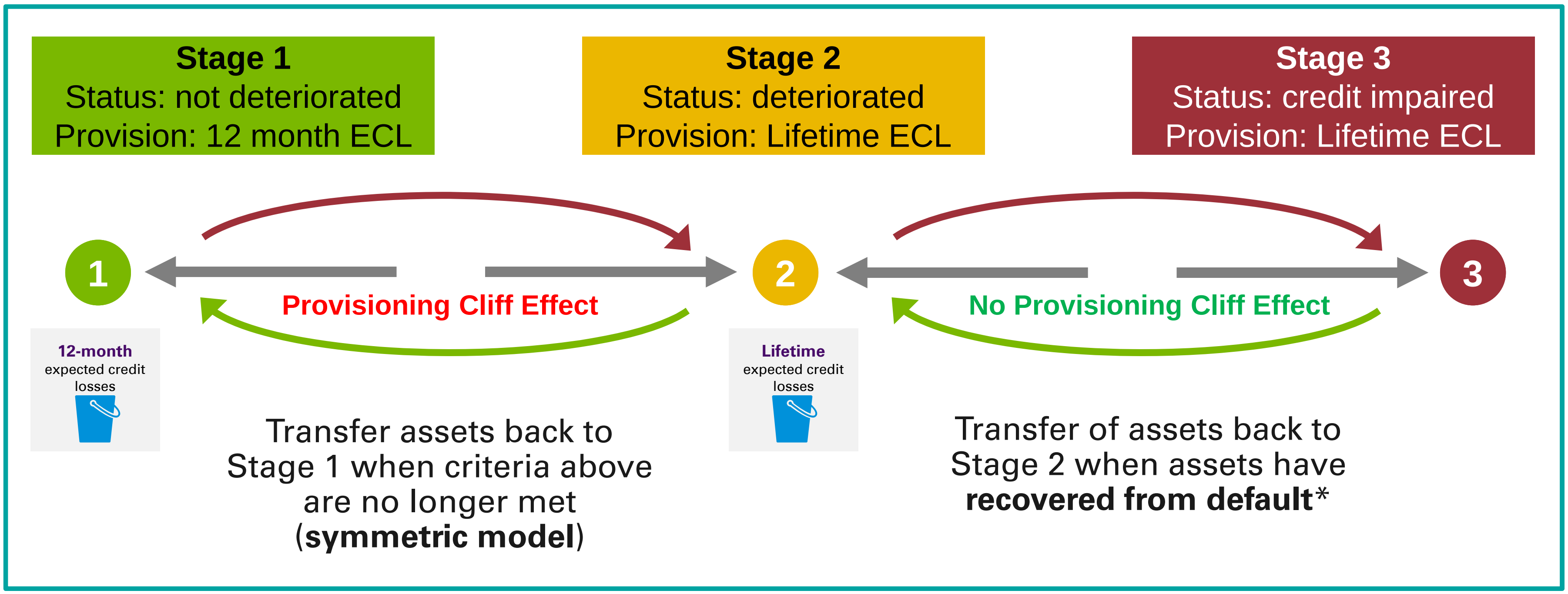
ECL is often depicted as follows:

ECL = **Probability of Default** (PD) x **Exposure at Default** (EAD) x **Loss Given Default** (LGD)

An overview of the new impairment model

When to transfer between stages

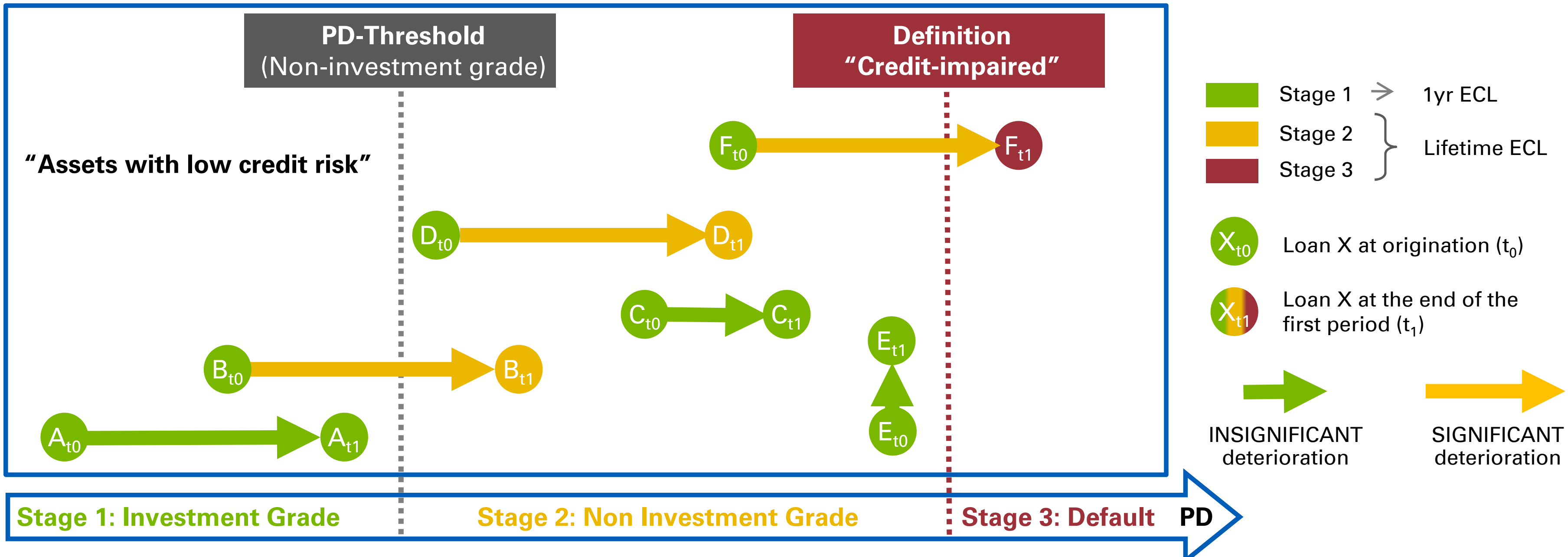
"Significant increase in credit risk" (undefined)



* Assets that are credit-impaired at acquisition or origination remain in Stage 3 until maturity

Staging of financial assets and migration

How does it work?



- The measurement basis would depend on whether there has been a significant increase in credit risk since initial recognition
- The assessment should be made at each reporting date
- **Credit impaired financial asset** (CIFA): one or more events that have a detrimental impact on the estimated future cash flows of that financial asset have occurred. It includes observable data. Similar to incurred loss model today.

Assessing credit risk

Step 1 Best available information on individual exposure level (*consistent with internal credit risk management*)	External credit ratings	• Appropriate as a key indicator • Not applicable for small cap / retail
	External market indicators (e.g. credit spreads)	• Appropriate as key indicator • Extracting the effects attributable to credit risk might be very complex • Not applicable for small cap / retail
	Other qualitative and quantitative indicators	• Corporate business: Appropriate key indicators • Retail business: Appropriate to complement dpd-information
	Delinquency information	• Combine delinquency status at a loan level with a review of forward-looking macroeconomic factors at a portfolio level
Step 2 Best available (macro-economic) forward-looking information?	**No** (typical case)	Identify risk indicators on portfolio level (go to Step 3)
	Yes (rare exception!)	No further activities required
Step 3 Additional portfolio-level information available?	Typically, a large variety of forward-looking (macroeconomic) factors that affect credit risk can be used as **portfolio-level indicators** to predict increased PD (relevant inputs may be region and loan to value (LTV) of mortgage loans, unemployment rates, etc.)	• Depending on the type and granularity of portfolio-level indicators, a segmentation into **homogeneous sub-portfolios with comparable credit risk** will be necessary; this is to ensure that only assets or specified groups of assets with increased credit risk will be transferred to Stage 2

Staging of financial assets and migration

Transfers between stages 1 and 2

Issue	Technical requirements

Relative transfer criterion:
 	
"Significant increase in credit risk since initial recognition"
	• No quantitative threshold or a bright-line for "significant increase in credit risk", making this one of the **most critical and difficult judgement areas** in the model.
	• Entities have to **consider the types of assets held** when defining 'significant increase in credit risk' and **appropriate parameters** considering the types of assets held.
	• For the assessment of credit risk an entity considers **reasonable and supportable credit risk-relevant information that is available without undue cost or effort**
	• **Different methods for the assessment of a "significant increase in credit risk" are allowed,** even if it does not include an explicit probability of a default occurring as an input, e.g. provision matrix approach or ratings
	• Depending on the risk profile, the test can be carried out based on solely qualitative and non-statistical information or a combination of qualitative and quantitative information. For that purpose, many criteria are listed that are eligible for the assessment of a significant increase in credit risk. **If using PDs, these should be point-in-time (PIT).**
	• The definition of "significant increase in credit risk" shall not be determined through an absolute credit risk-range (absolute increase in credit risk compared to original credit risk) but on a **relative measure (percent increase compared to original credit risk).**
	• Delinquency information may only be used for determining whether credit risk has increased significantly if there is no credit risk-relevant information that is more forward-looking without undue cost or effort. This is expected to be rare because **lifetime credit losses are generally expected to be recognized before a financial instrument is past due.** Also consider macroeconomic factors:
	  ◦ Rebuttable presumption of a significant increase in credit risk when contractual payments are more than 30 days past due ("30+dpd").
	  ◦ The presumption is rebutted if other persuasive information is available indicating that cedit risk has not increased significantly.

Transfers between stages 1 and 2 (cont.)

Issue	Technical requirements
Individual vs. group assessment	• **IFRS 9 does not specify application on an individual or collective basis**. The objective is to recognize lifetime expected credit losses for all financial instruments for which there has been a significant increase in credit risk since initial recognition - whether assessed on an individual or a collective basis. • Financial instruments **can be grouped** for assessing significant increases in credit risk on a collective basis, on the basis of shared credit risk characteristics. e.g. instrument type, credit risk ratings, collateral type, industry, geography, term to maturity etc. • Grouping drives level of granularity: **risk of too broad a grouping** is that all loans in group subject to transfer between stages together = higher provisions. Important when applying forward-looking factors in particular
Exception: No transfer of *"financial instruments with low credit risk"* (investment grade)	• As an exception, for financial instruments with a "low credit risk" **it may be assumed that credit risk has not increased significantly**. As a consequence, these financial instruments will remain in Stage 1 and an allowance for 12-month ECL recognized as long as credit risk is determined to remain "low" • The term "low credit risk" is largely consistent with globally understood definitions such as S&P´s "low credit risk". An external rating of "investment grade" is an example of a financial instrument that may be considered as having low credit risk • Regarding the transfer logic between Stage 1 and Stage 2 **the exception has the effect of an absolute PD-threshold**. Can also practically apply a rating threshold. • In case of a downgrade from an investment grade to a non-investment grade rating, the entity has to analyze if a significant increase in PD has occurred since initial recognition

Staging of financial assets and migration

Transfers between stages 1 and 2 (cont.)

Issue	Technical requirements

Measure for determining the "relative transfer criterion"	• **Only PD is relevant for determining whether there is a significant increase in the risk of default**. LGD is not considered when assessing whether there has been a significant increase in credit risk. That means that **even entirely risk-mitigated instruments have to be transferred to Stage 2 in case of a significant increase in PD**. The effect of risk mitigation is generally not considered for PD or staging
	• As a measure of the increase in credit risk, an entity shall compare the probability of a default occurring over the remaining time to maturity of the financial instrument as at the reporting date (PDt1) with the probability of a default occurring on the financial instrument for the same remaining period as determined as at the date of initial recognition (PDt0).
	• Because of the relationship between the expected life and the risk of default occurring, the change in credit risk cannot be assessed simply by comparing the change in the absolute risk of default occurring over time. **Risk of default decreases with the passage of time. If the risk of default remains unchanged despite the passage of time, that may indicate an increase in credit risk.**
	• As a **practical expedient** for financial instruments for which the risk of default is not concentrated at a specific point during the expected life, an entity may **use 12-month PD to determine whether credit risk has increased significantly since initial recognition** if changes in the risk of default occurring over the next 12 months are a reasonable approximation of the changes in lifetime risk of default. Entity needs to be able to demonstrate – at time of transition, and thereafter on an ongoing basis – that changes in 12 month PD approximate changes in lifetime PD. However, this approach may not be suitable for financial instruments with maturity more than 12 months when:
	  • Significant payment obligations only occur beyond the next 12 months; or
	  • Changes in macroeconomic and other credit-related factors are not adequately reflected in the next 12 months (or have a more pronounced effect beyond 12 months)

General requirements

Expected credit losses are an estimate of the present value of all cash shortfalls over the remaining life of the financial asset

An estimate of ECL reflects:

— an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes; and

— the time value of money

Probability-weighted amount **would always reflect at least TWO scenarios**: the probability that a credit loss results and the probability that no credit loss results

— always do this even if possibility of credit loss occurring is very low

— in practice it would not always be necessary to develop complex analysis

Practical expedient may be used if consistent with the general principles e.g. roll rates and provision matrices

Detailed requirements and challenges

Issue	Technical requirements
Model	• IFRS 9 does not prescribe a specific method to estimate 12-month or lifetime ECL. Rather, it acknowledges that the **methods used to measure expected credit losses may vary based on the type of financial asset and the information available** • As long as the general principles are considered (i.e. the best available information is considered) practical expedients that do not calculate a 12-month/ lifetime PD explicitly (e.g. provision matrix approach) may be used • However, in practice it **will not be possible to justify the use of such practical expedients if the entity uses PD for other purposes in the risk management and asset-liability management**
Definition of expected credit loss	• Expected Credit Loss = Present value of the **difference between contractual and expected cash flows** ("cash shortfalls") including both, principal and interest cash flows • The Default Definition should be applied **consistently with the entity's credit risk management practice and also considering qualitative indicators of default when appropriate**. Furthermore, there is a rebuttable presumption that default does not occur later than 90dpd

Discounting requirements	• To reflect the time value of money, expected cash flows shall be discounted to the reporting date (not expected default or another date) **using the EIR determined at initial recognition or an approximation thereof**.
	• If a financial instrument has a variable interest rate the current EIR shall be used.
	• Two approaches possible:
	  ◦ discount using current rate for full remaining term to maturity; or
	  ◦ discount using actual forecast variable index rate.
	• Lease receivables: Use the discount rate used in measuring the lease receivable in accordance with IAS 17

Measuring expected credit losses

Detailed requirements and challenges (cont.)

Issue	Technical requirements
Data modelling and scenario considerations	• The estimates should reflect the best available information that is **reasonably available without undue cost and effort** • Entities should use both **internal and external information** for estimating the ECL. This includes information about past events and current conditions as well as reasonable and supportable **forecasts of future events and macroeconomic conditions** • In case historical data is used it **needs to be adjusted on the basis of current observable data to reflect current conditions** and forecast future conditions. Statistical extrapolation of historic data alone is not sufficient in considering this requirement • In general the utilization of **average values across business cycles is not appropriate** as a point in time estimation of ECL parameters is required • Conservative **regulatory approaches won't be sufficient** on their own. The **estimation must reflect an unbiased and probability weighted range of different possible scenarios (at least two)** • Considering only the most likely outcome or the worst-case outcome is not sufficient • In some cases, relatively simple modelling may be sufficient, without the need for large number of detailed simulations of scenarios. For example, the average losses of a large group of financial instruments with shared risk characteristics may be a reasonable estimate of the probability-weighted amount
Requirements for data history	• Different from capital requirements - no specific requirements exist from an accounting point of view. The expectation of the IASB is based on the principle of best available information without undue cost and effort • Ideally the historic data used for the capital requirements may be used for ECL. This would also make a separate validation of the used data obsolete. However, further conceptual adjustments to the regulatory data-set have to be performed
Timeliness of ECL estimates	• The ECL estimates need to be updated at least on an interim basis/at each reporting date

Trade and lease receivables and contract assets

Simplified approach

IFRS 9 allows the use of practical expedients when measuring expected credit losses, providing a provision matrix as an example of such an expedient for trade receivables.

Lease receivables

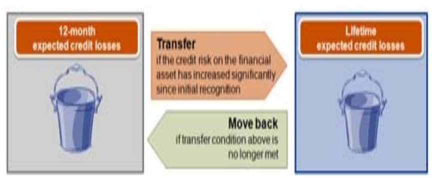
Trade receivables and contract assets <u>with</u> a significant financing component

Trade receivables and contract assets <u>without</u> a significant financing component

Policy election

OR

General approach



Simplified approach

Loss allowance always equal to lifetime expected credit losses.

Things to remember

New measurement model

Incurred credit loss model is changing to expected credit loss model, incorporating consideration of forward-looking information

Significant judgement

Key terms must be defined and principles-based guidance interpreted in a way that takes into consideration existing practices and holdings

Classification of financial assets

Expected credit loss model will only be necessary for some financial assets held at amortised cost or FVOCI

Tax impact

The CRA has not yet disclosed what (if any) changes will be necessitated in response to implementation of IFRS 9.

Presentation and disclosure

Presentation

IFRS 9 amends IAS 1 *Presentation of Financial Statements* to require the following line items to be presented in the profit or loss section of the statement of comprehensive income or in the statement of profit or loss:

- revenue, presenting separately interest revenue calculated using the effective interest method;
- Gains or losses arising from derecognition of financial assets at amortized cost;
- Impairment losses (including reversals) determined in accordance with IFRS 9
- Gains or losses arising on reclassification of a financial asset out of the amortized cost category and into the FVTPL category; and
- If a financial asset is reclassified out of FVOCI and into the FVTPL category, any cumulative gain or loss previously recognized in OCI that is reclassified to profit or loss.

Debt instruments measured at FVOCI

No loss allowance is recognised in the statement of financial position in respect of debt instruments that are measured at FVOCI, because the carrying amount of these assets is their fair value.

However, disclosures have to be provided about the loss allowance amount.

On December 31, 2015, Company z purchases a debt instrument with a fair value of 1000 and classifies it as measured at FVOCI. The instrument is not credit-impaired. Z estimates 12-month ECL for the instrument of 10. On initial recognition, Z makes the following entries:

	Debit	Credit
Statement of financial position – debt securities	1,000	
Statement of financial position – cash		1,000
Profit or loss – impairment loss	10	
OCI		10

At December 31, 2016, the FV of the debt instrument decreases to 950. Z concludes that there has not been a significant increase in credit risk since initial recognition and that the 12-month ECL are now 30. Accordingly, Z makes the following entries:

	Debit	Credit
Statement of financial position – debt securities		50[a]
Profit or loss – impairment loss	20[b]	
OCI	30[c]	

a. 1000 – 950, amount needed to state the debt security at FV as at December 31, 2016
b. 30 – 10, change in ECL since initial recognition
c. Balancing amount

Z also provides disclosures about accumulated impairment of 30.

Disclosures: classification and measurement

Similar to currently effective IFRS 7, under the changes introduced by IFRS 9 entities are required to disclose the carrying amounts of each measurement category of financial instruments either in the statement of financial position or in the notes.

For financial assets designated as FVTPL, entities are required to provide the same information about credit risk as is required for loans and recievables designated as FVTPL under currently effective IFRS 7

IFRS 9 extends the disclosure requirements for financial liabilities designated as FVTPL

If an entity has designated investments in equity instruments as FVOCI, it discloses:

- Which investments in equity instruments have been designated;
- The reasons for the designation;
- The fair value of each investment at the reporting date;
- Dividends recognized during the period, separately for investments derecognized during the reporting period and those held at the reporting date; and
- Any transfers of the cumulative gain or loss within equity during the period and the reason for those transfers

Disclosures: credit risk and expected credit losses

IFRS 9 introduces new disclosure requirements about credit risk for financial instruments to which the new impairment model is applied. These disclosures should be sufficient to enable users of the financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows.

To meet this objective entities have to:	
Disclose	• Information about an entity's credit risk management practices and how they relate to the recognition and measurement of expected credit losses – including the methods, assumptions and information used to measure expected credit losses • Quantitative and qualitative information to evaluate the amounts in the financial statements arising from expected credit losses – including the changes and the reasons for those changes, in the amount of expected credit loss • Information about the entity's credit risk exposure – including significant risk concentrations
Consider	• How much detail to disclose • How much emphasis to place on each of the requirements • The appropriate level of aggregations or disaggregation • Whether users of the financial statements need additional explanations to evaluate the quantitative information disclosed

Reduced disclosures apply to trade receivables, contract assets and lease receivables for which the loss allowance is always equal to lifetime expected credit losses.

Hedge accounting

Many existing concepts retained

- Three hedge accounting models:
  - Fair value hedge
  - Cash flow hedge
  - Hedge of a net investment
- Hedge documentation requirements
- Measurement of hedged items and hedging instruments
- Measurement of ineffectiveness

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More principles-based

- 80%-125% effectiveness bright-line removed
- No retrospective testing of effectiveness
- More items are allowed as hedged items, for example:
  - risk components of non financial items; and
  - net positions
- More items allowed as hedging instruments, for example:
  - Non-derivative financial instruments measured at FVTPL

In many instances hedge accounting will be less burdensome and there will be more scope to reflect internal risk management strategies

Some new complexities

- Explicit requirements for hedge accounting to align with an entity's risk management objective
- Hedge accounting cannot be voluntarily discontinued
- Introduction of a concept of "rebalancing"
- Potentially complex accounting for portions of derivatives excluded from hedging relationships (e.g. time value of an option)

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Transition

In this section

We will discuss issues related to transition, both generally and those specific to Canada’s P&C insurers, including:

- The IASB’s recent exposure draft;
- Interaction between IFRS 4 Phase II and IFRS 9; and
- Wider implications of IFRS 9 implementation.

Three approaches

In response to significant concerns about the differing effective dates of IFRS 9 (2018) and the forthcoming insurance contracts standard (2020 or 2021), the IASB has proposed amendments to existing IFRS 4, providing insurance companies with three possible approaches to the adoption of IFRS 9:

The deferral approach	Defer application of IFRS 9 and continue applying IAS 39 until the earlier of the fixed expiry date or adoption of the forthcoming insurance contracts standard.
The overlay approach	Implement IFRS 9 and reclassify the difference between amounts recognized in profit or loss under IAS 39 and IFRS 9 to OCI.
Implementation of IFRS 9	Apply IFRS 9 retrospectively in accordance with IAS 8, except as specified, for financial years beginning on or after January 1, 2018.

The IASB's recent exposure draft

The deferral approach

Temporary exemption from applying IFRS 9	
Eligibility	• Eligibility would be assessed **at the reporting entity level**; • **A fixed expiry date will exist** (date to be discussed May 2016); • An entity would be permitted to apply IAS 39 rather than IFRS 9 only if: – It had not previously applied any version of IFRS 9 (except own credit risk requirements in isolation); and – **Its activities are predominantly 'related to insurance'**
Predominance ratio	• An entity's activities are predominantly 'related to insurance' if: – Predominance ratio > 90%; or – Predominance ratio ≥ 80% and the entity can evidence that it does not have a significant activity unrelated to insurance **Predominance ratio** = (liabilities arising from activities related to insurance + other liabilities that are connected to those activities) / Total carrying amount of the entity's liabilities • IASB will provide examples of 'other' liabilities that are connected to those activities;
Date of assessment	• The annual reporting date between April 1, 2015 and March 31, 2016

The deferral approach (cont.)

Temporary exemption from applying IFRS 9	

Disclosures (cont.)	• The fact that it is applying the temporary exemption
	• How the entity concluded that it is eligible for the temporary exemption;
	• **The FV at the end of the reporting period and the FV change during the reporting period, separately for:**
	  – **Financial assets that do not meet the SPPI test; and**
	  – **All other financial assets**
	• The FV and the gross carrying amount under IAS 39 as well as information about credit risk exposure, including significant credit risk concentrations, for financial assets in the scope of the scope of this disclosure that do not have low credit risk as the reporting date
	• If the carrying amount of liabilities from contracts in the scope of IFRS 4 is not greater than 90% of total liabilities:
	  – Any other liabilities that are included in the numerator of the predominance ratio; and
	  – Information used to determine that the entity's activities are predominantly related to insurance

The IASB's recent exposure draft

The overlay approach

Application of IFRS 9 with a top-side adjustment	
Eligibility	• Entities that issue contracts within the scope of IFRS 4 are permitted, but not required, to apply the approach to financial assets which meet both of the following criteria: – **designated as relating to contracts that are within scope of IFRS** 4; and – **measured at fair value through profit or loss applying IFRS 9** but would not have been measured at fair value through profit or loss under IAS 39. • Qualifying financial assets **could include surplus assets** that an entity holds for the purposes of regulatory or internal capital requirements. • Regulation may restrict eligible assets by limiting those which can be designated FVTPL
Presentation	• For gains and losses for financial assets to which the overlay approach is applied, an entity would: – Present in profit or loss information that reflects the application of IFRS 9 with a single, separate line item for the overlay adjustment; – Present in OCI the overlay adjustment separately from other components of OCI, consistent with IAS 1; and – Disclose the effect of the overlay approach on individual line items in the notes to the financial statements.
Disclosure	• The fact that it has applied the overlay approach and the carrying amount and classes of financial assets to which the reclassified amount relates; • Its basis for determining the financial asset to which the overlay approach is applied • An explanation of the total amount reclassified from profit or los sto OCI in the reporting period in a way that enables users to understand how it is derived; • Additional disclosures if the entity has changed the designation of financial assets during the period; • The effect of reclassification on each individual line item in the statement of profit or loss

Implementation of IFRS 9

Full implementation of IFRS 9	
Effective date	• IFRS 9 is effective for annual periods beginning on or after January 1, 2018. Earlier application is permitted by the Standard, however, **OSFI is expected to issue guidance relevant to insurance entities**.
General transition requirements	• Retrospective application in accordance with IAS 8 with limited exemptions • Not applied to financial assets or financial liabilities that have been derecognized at the beginning of the reporting period in which an entity first adopts IFRS 9 - i.e. date of the initial application (DIA). • No requirement to restate comparative information – Difference between the previous carrying amount and the carrying amount at the beginning of the annual period that includes the DIA is recognized in the opening retained earnings (or other component of equity) – Only restate comparatives if, and only if, possible without the use of hindsight
ECL at transition	• An entity can approximate the credit risk on initial recognition by using the best information that is available without undue cost or effort • Exemptions from full retrospective application include: – If determining the credit risk of an asset at initial recognition would be onerous, measure provision at LECL; – If credit risk is low at DIA, entity may assume that credit risk has not increased significantly since initial recognition;

Choosing the right approach

Consider factors outside of the eligibility requirements, such as:

- Does IFRS 9 create temporary volatility significant enough to warrant a response outside of stakeholder communication and education?
- What approach are your
  - peers selecting,
  - regulators advocating; and/or
  - stakeholders receptive to?
- Does you election make sense in light of:
  - resource constraints;
  - your current year-end close process; and
  - projects currently underway within your organization?
- Regulation

Accounting policy choice: P&L or OCI

— Under current accounting, Canadian P&C insurers reflect volatility from the discounting of incurred claims in profit or loss. When assets are classified as available for sale, volatility from interest rate changes is reflected in OCI, resulting in a mis-match.

— Some P&C insurers mitigate this this mis-match by designating certain assets backing insurance contract liabilities as FVTPL.

— IFRS 4 Phase II provides insurers with an accounting policy choice to present the effect of changes in discount rates either in OCI or in profit or loss – ***YOUR CHOICE!***

	Current accounting		Proposed accounting	
Source of volatility:	*Financial assets measured FVOCI*	*Financial assets measured FVTPL*	*OCI option*	*P&L option*
Discounted claims liabilities	Profit or loss	Profit or loss	OCI	Profit or loss
Bonds classified as AFS (IAS 39) or fair value through OCI (IFRS 9)	OCI		OCI	
Bonds classified as held for trading or designated as FVTPL (IAS 39) or classified as FVTPL (IFRS 9)		Profit or loss		Profit or loss
	Possible mis-match			

Which approach should you choose?

Accounting policy choice: P&L or OCI

Which approach should P&C insurers choose…?

OCI option

- \+ Defers the effects of changing interest rates, presenting it in OCI and recognizing in profit or loss over time
- – More work, more complexity

P&L option

- \+ Less work and complexity
- \+ Less use of the OCI category
- – Less effective in isolating the effect of changing interest rates in some circumstances because "discount effects" can still affect income when:
  - *Credit spreads expand (e.g. in a financial crisis) affecting asset values much more than claims liabilities*
  - *the duration profile of investments differs from that of claims liabilities because interest rate changes will not affect assets and liabilities to the same extent*

Consider your next steps

With 3 other significant standards becoming effective over the next 5 years, now is the time to start to consider the wider implications on your business…

Accounting, tax and reporting

- Perform a comprehensive review of all financial assets, to ensure that they are appropriately classified and measured.
- Decide how the expected credit loss model will be applied to different financial assets, and how key terms such as 'significant increase' and 'default' will be defined in the context of the financial assets held.
- Develop appropriate impairment methodologies and controls to ensure that judgment is exercised properly and consistently and is supported by appropriate evidence.
- Put in place processes to collect additional data required.
- Perform a test run on the calculations that will be needed.
- Assess the impact on regulatory capital and tax requirements.
- Update accounting policy manuals.
- Identify additional disclosure requirements.

Systems and processes

- Upgrade accounting systems to ensure that they can capture fair value, amortized cost and any other information needed for classification and measurement.
- Decide which systems and processes need to be changed to collect new data and perform new calculations.
- Consider whether any data or calculations used for regulatory purposes – e.g. Basel III – may be used, and what adjustments are necessary.
- Evaluate the changes needed to key internal controls over financial and regulatory reporting.
- Perform a dry run of data collection processes, to help ensure the integrity of source data.
- Develop a transition plan for parallel runs, including reconciliations.

Business

- Assess the risks affecting business models and how their performance is evaluated.
- Evaluate the impact of accounting change on management compensation metrics, and performance targets and measures.
- Perform a comprehensive review of contractual terms.
- Assess the impact on KPIs and internal management reporting.
- Factor new expected credit loss requirements into stress testing.
- Assess the impact of accounting change on general business issues – e.g. contractual terms, risk management practices, treasury practices etc.
- Budget for necessary changes to people, processes and systems.
- Develop communication plans to minimize surprises for stakeholders.

People and change

- Set up a project team with representatives from credit, accounting, tax, regulatory and IT teams, and with an appropriate governance structure.
- Develop and execute training plans for employees across functions and locations.
- Ensure that the project provides realistic timescales and accountabilities.
- Assess how changes to processes may impact the way in which work is performed, including how teams are structured.
- Identify whether there is a need for additional staff with appropriate expertise, or a need to engage external help.
- Revise performance evaluation targets and measures, and communicate them to affected personnel.
- Embed knowledge – build a dry run into the adoption plan to test staff understanding.

Thank you

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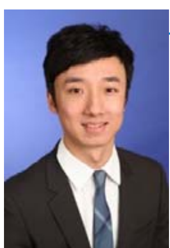

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Thank you

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