IFRS Update for Financial Services

KPMG AG, Zurich

19 April 2018

Agenda

IFRS 16 *Leases* – Challenges of the new standard

IFRS 9 *Financial instruments* – Pre-transition and interim disclosures

News from the IASB

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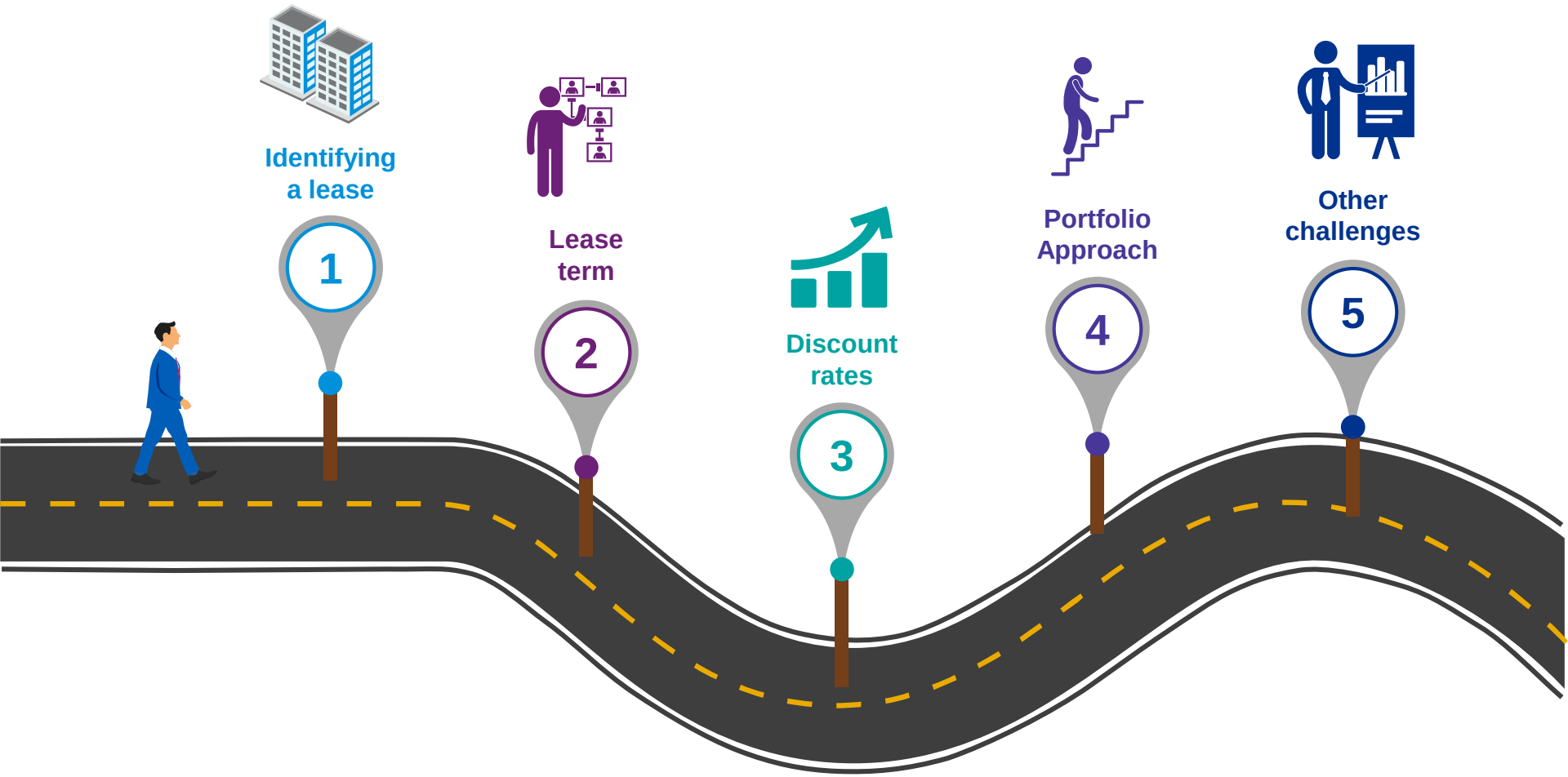
IFRS 16 *Leases*

Challenges of the new standard

IFRS 16 is mainly a "system" challenge…?



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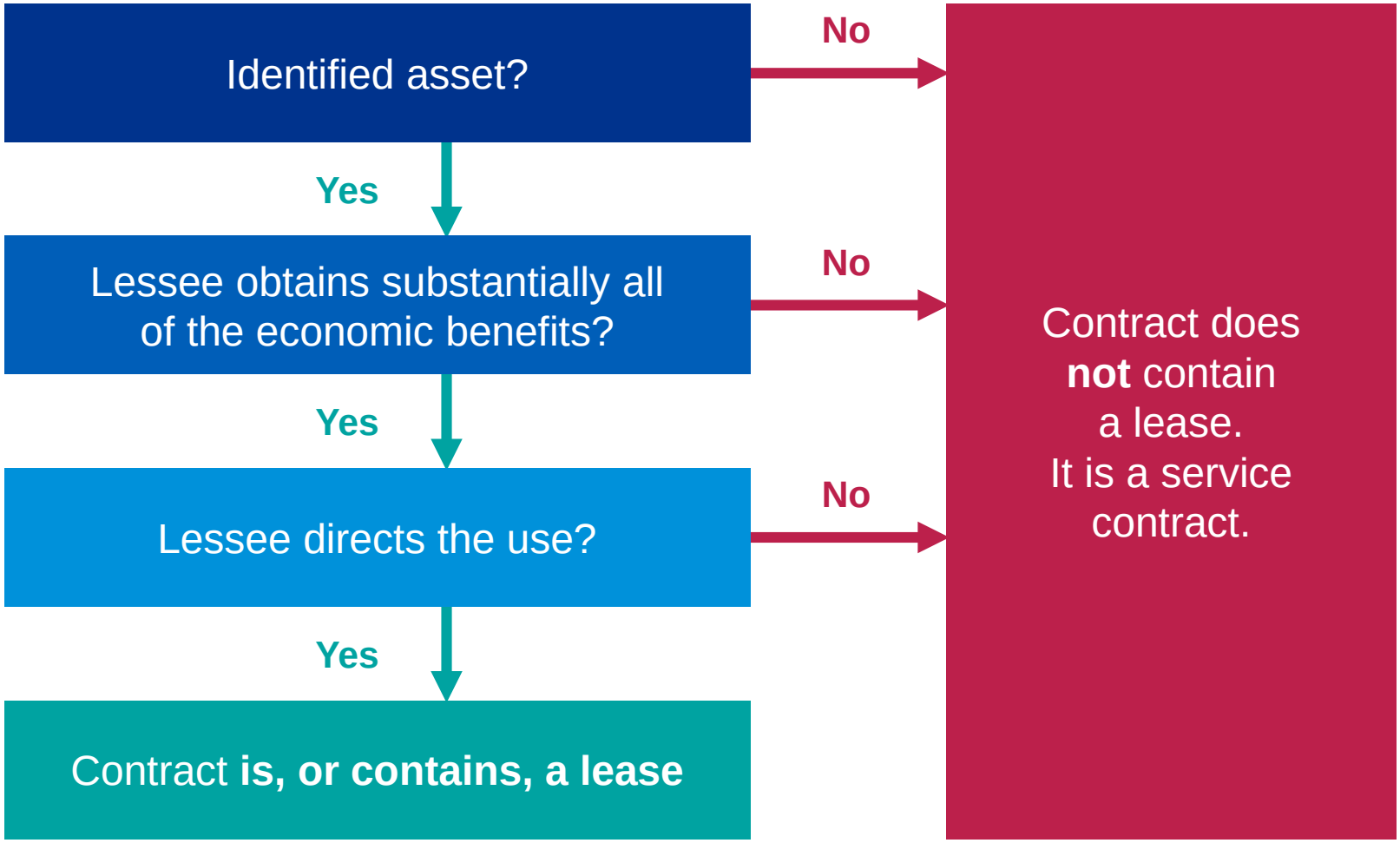
IFRS 16 – Identifying a lease

Identifying a lease - Overview



Identified asset

Real estate leases

Does a clause permitting a landlord to relocate a tenant at any time represent a substantive substitution right?

Generally, no.

Some real estate leases permit the landlord to relocate the tenant to alternative premises at any time – the landlord may use this right, for example, to move an existing tenant to another floor in an office building to accommodate a new tenant.

A key question in such cases is whether the landlord would **benefit economically** from the substitution, based on the facts and circumstances at inception.

Future events that, at inception of the contract, are not considered likely to occur are ***excluded*** from the evaluation of whether the supplier's substitution right is substantive.

Does a clause permitting a landlord to relocate a tenant if market rents increase or another tenant offers to pay a higher rent represent a substantive substitution right?

No.

Some real estate leases permit the landlord to relocate the tenant to alternative premises under certain circumstances. Substitution rights that can be exercised only on occurrence of a specified event – for example, if market rents increase or another tenant offers to pay a higher rent – are not substantive because the supplier ***does not have the practical ability*** to substitute alternative assets ***throughout the period of use.***

Substantially all of the economic benefits

Chloe Limited leases a three-storey building under a 10-year contract.

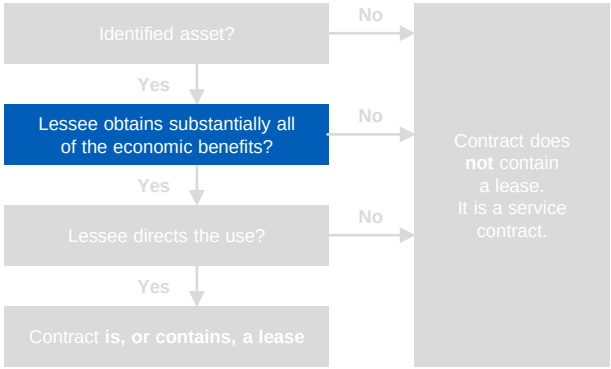
Since Chloe Limited does not need all the space covered by the contract, it decides to sub-lease one of the three floors.

Does Chloe Limited receive substantially all of the economic benefits?

Yes.

Chloe Limited receives substantially all of the economic benefits through its own use of two floors (the primary output) and sub-letting the third floor (other benefits). The customer and the supplier consider the primary output and other benefits to determine whether the criterion is met.

As previously mentioned, there is no defined threshold for ‘substantially all’. Therefore, judgement is required.



Exemption - leases of low value items

Which of the following transactions do not qualify for the low value exemption?

Lease of 10 laptops.

Lease of 8,000 laptops.

Lease of a five-year second-hand car with a market value of USD 4,500.

Lease of a twenty-year old Rolls Royce with a market value of CHF 40,000.

Lease of office furniture such as chairs and desks.

Lease of server modules to increase storage capacity of the main server. Each module is highly interrelated with the main server. The lessee would not lease the modules without also leasing the main server.

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IFRS 16 – Lease term

Lease term - a reminder

Lease term

- ***Non-cancellable*** period.
- Optional renewal periods if lessee ***reasonably certain*** to exercise.
- Periods after optional termination date if lessee ***reasonably certain not*** to exercise.

- ✓ **Determine the period for which the contract is enforceable.**
- ✓ **A lease is no longer enforceable when the lessee and the lessor each has the right to terminate the lease without permission from the other party <u>with no more than an insignificant penalty.</u>**

Case study 1 - estimating lease term

Bank A (lessee) enters into a contract with Base Limited (lessor) to lease a three-floor building in central Zurich. The lease contract does not have an expiry date, however it can be terminated by each of the parties with a 3 month notice period after the end of the first year of the lease. Bank A intends to stay in the building for the next 10 years and has invested significantly into leasehold improvements, which it intends to amortise over that 10 year period. After this period Bank A plans to move to a bigger property driven by the increase in its headcount. Bank A is aware of a development project which includes a five-floor building in central Zurich in 10 years time.

A 1 year and 3 months

B 10 years

Facts and circumstances need to be considered on a case by case basis

Case study 2 - Lessor options

Eddizon Limited (lessee) enters into a contract with Robbizon Limited (lessor) to lease a server. The lease is for 10 months and is automatically renewed for a further 6 months unless the lease is terminated by Robbizon.

A 10 months

B 16 months

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IFRS 16 – Discount rate

Lessee - Two possibilities...

The rate implicit in the lease, if readily available.

OR

The lessee's incremental borrowing rate.

Company A

'The rate of interest that a lessee would have to pay to borrow over a similar term,

and with a  **similar security, the funds necessary to obtain an asset of**

a similar value to the right-of-use asset in a similar economic environment.

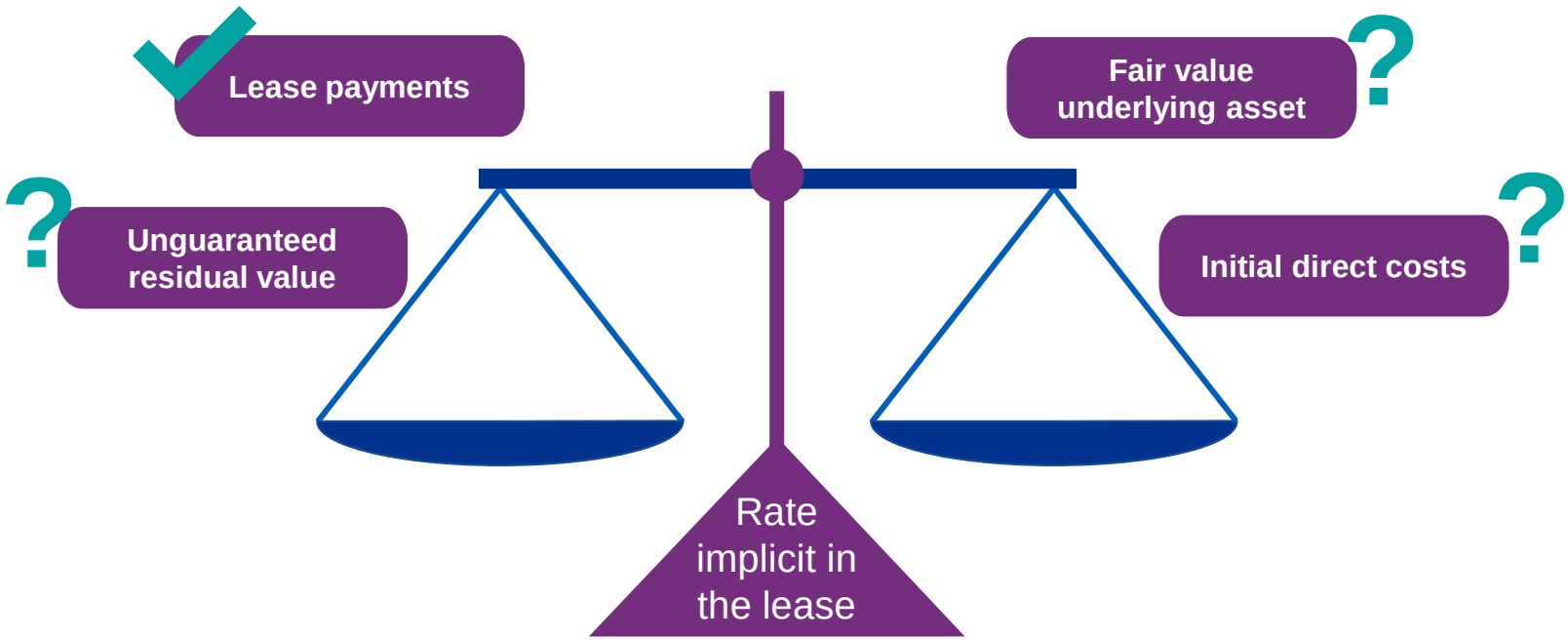
'Why is the discount rate important?'

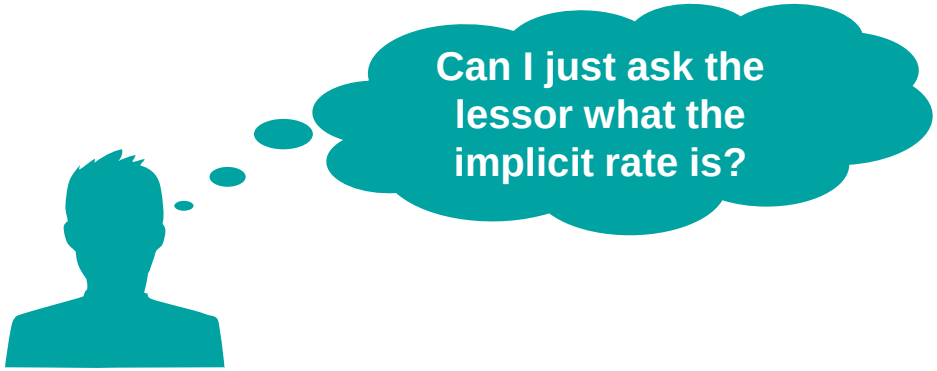
Discount rate	Lease liability (Five year lease x 10,000 CHF per annum)
3%	46,000
5%	43,000
7%	41,000
10%	38,000

Financial ratio impact - Lower or higher?

Ratio		Impact of a higher discount rate for a given lease.
Interest expense	↑	Higher, as discount rate is higher.
Net interest margin	↓	Lower, as interest expense will be higher.
RWA	↓	Lower, because the right-of-use asset and therefore total risk weighted assets will be lower.
Tier 1 capital ratio	↑	Higher, because risk weighted assets are lower.
Depreciation	↓	Lower, because right-of-use asset is lower.
Loan to assets ratio	↑	Higher, as the right-of-use asset and therefore total assets will be lower.

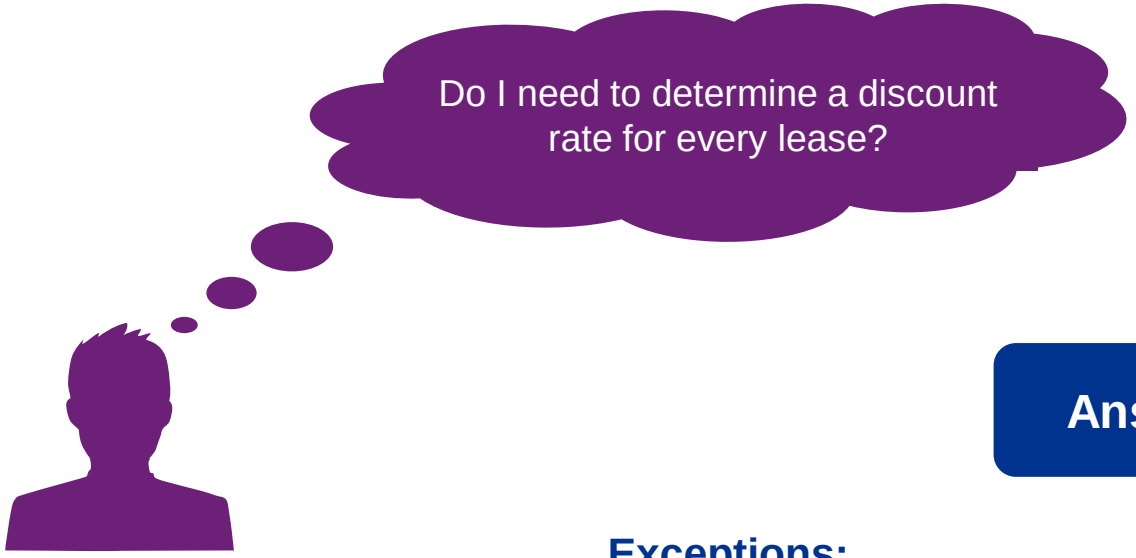
Lessee – What information is readily available?





Answer: You can, but the lessor may be unwilling to disclose it as it is a commercially sensitive figure.

Case study 1 – individual discount rates



Answer: Generally, yes.

Exceptions:

- **Lease is fully prepaid.**
- **All lease payments are variable and depend on sales or usage.**
- **Recognition exemptions.**
- **Portfolio approach.**

Case study 2 - WACC

Answer: WACC can only be used as an input when determining the incremental borrowing rate.

- **Term.**
- **Security.**
- **Value of the underlying asset in a lease.**

Case study 3 - Property lease

Answer: property yield can only be used as an input when determining the incremental borrowing rate.

✓ Property specific.

✗ Company specific.

Property yield

+ / -

Adjustments for

- **Length of the lease.**
- **Difference between the lessee's credit rating and the average credit rating of tenants in the market.**
- **Expectations about risks associated with the property's value that are unrelated to the lessee's performance.**
- **Other – e.g. currency of the lease.**

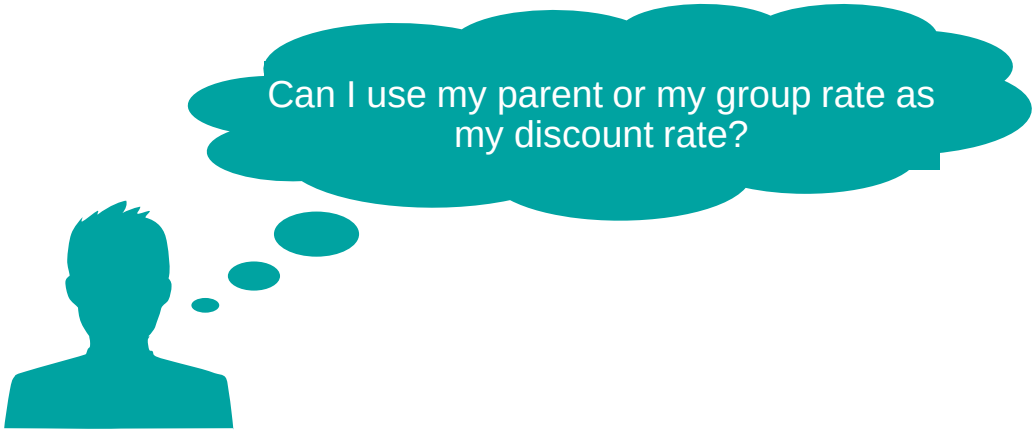
Case study 4 - Secured or unsecured rate

Answer: there is no industry consensus yet.

- **Previously we saw in the market that clients are using secured rates.**
- **However, recently, we have started seeing some clients trying to use an unsecured rate as their incremental borrowing rate.**

Document and agree methodology with your auditor in advance.

Case study 5 - Group situations



A group or parent rate can be used as an input (and would need to be adjusted) only in certain cases:

- ✓ Subsidiary does not have its own treasury function.
- ✓ All funding for the Group is managed centrally by the parent.
- ✓ Parent (indirectly) guarantees lease payments to the lessor.

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IFRS 16 – Portfolio approach

Applying the portfolio approach

«…an entity may apply this Standard to a portfolio of leases **with similar characteristics** if the entity reasonably expects that the effects on the financial statements of applying this Standard to the portfolio **would not differ materially** from applying this Standard to the individual leases within that portfolio. If accounting for a portfolio, an entity shall use estimates and assumptions that reflect the size and composition of the portfolio.»

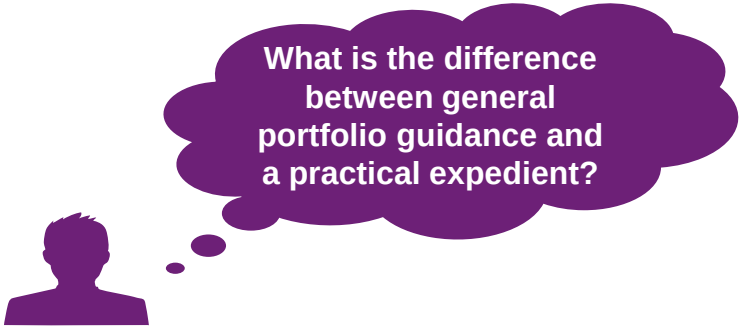
IFRS 16.B1

«…a lessee may use one or more of the following **practical expedients** when applying this Standard retrospectively…:

a lessee may apply a single discount rate to a portfolio of leases with reasonably **similar characteristics** (such as leases with a similar remaining lease term for a similar class of underlying asset in a similar economic environment).»

IFRS 16.C10 (a)

Case study - portfolio approach



At first glance, this practical expedient seems similar to the general guidance on portfolio application.

However, there are two key differences:

- **The general guidance on portfolio application can be applied only if the entity can demonstrate that the effect of applying the new standard to the portfolio is not materially different from applying it to individual leases. In contrast, the practical expedient on transition is available whenever the leases have similar characteristics.**
- **The practical expedient on transition refers to leases with 'a similar remaining lease term'.**

The hurdle for using the practical expedient on transition is lower than the hurdle for portfolio application of the standard subsequently.

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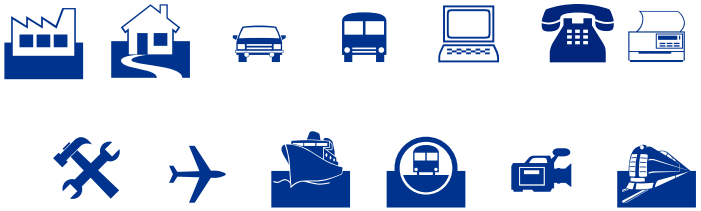
IFRS 16 – Other challenges

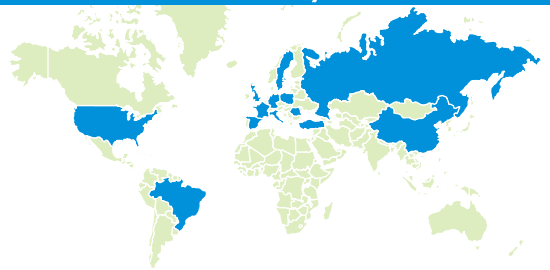
Challenges

High number of leases



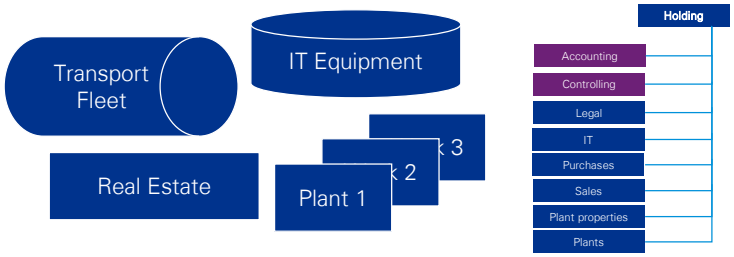
- Mass data
- Different types of contracts
- Processes for lease contract monitoring
- Comprehensive documentation

Low availability of leases



- Low group-wide transparency
- Local languages and local currencies
- Local legal requirement
- Decentralized areas of responsibility

Decentralized management of leases



- Stand-alone solutions
- Different IT systems
- Different responsibilities
- Data migration & interfaces

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IFRS 16 – Programme considerations

IFRS 16 Leases – How prepared are you? (1/2)

		✓	✗
1	Do you know which of your transactions are, or contain, leases?		
2	Have you decided which transition approach to use?		
3	Will you use any of the practical expedients (short-term or low-value leases)?		
4	Will you use portfolio approach?		
5	Have you decided on how you will determine your discount rate?		

IFRS 16 Leases – How prepared are you? (2/2)

		✓	✗
6	Do you have a database of all your leases?		
7	Who holds lease information for different types of leases?		
8	How complete is the information in your lease management software?		
9	Are your current disclosures of operating lease commitments complete and accurate?		
10	Do you have systems and processes necessary to calculate lease assets and liabilities?		

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IFRS 9 *Financial instruments* - Pre-transition and interim disclosures

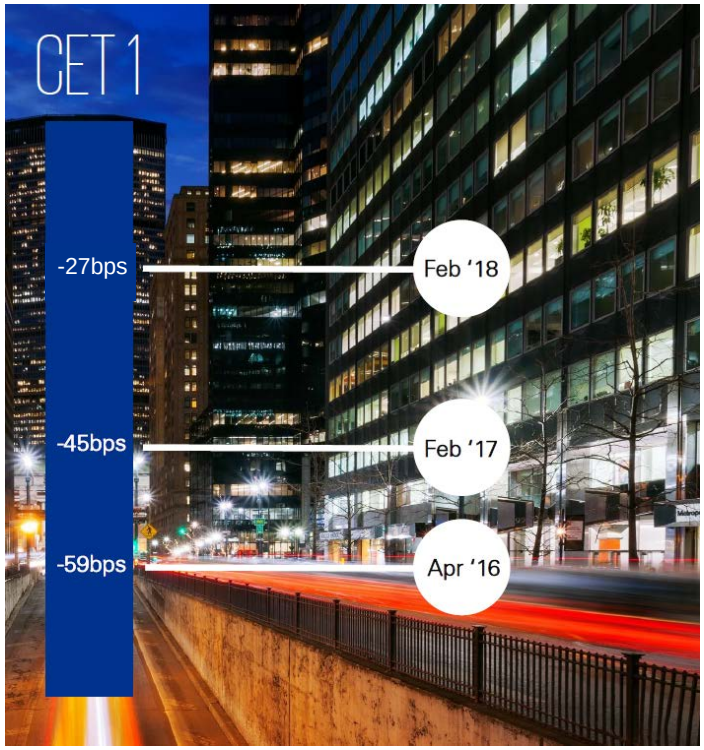
IFRS 9 *Financial instruments*

IFRS 9 *Financial instruments* – Pre-transition disclosures

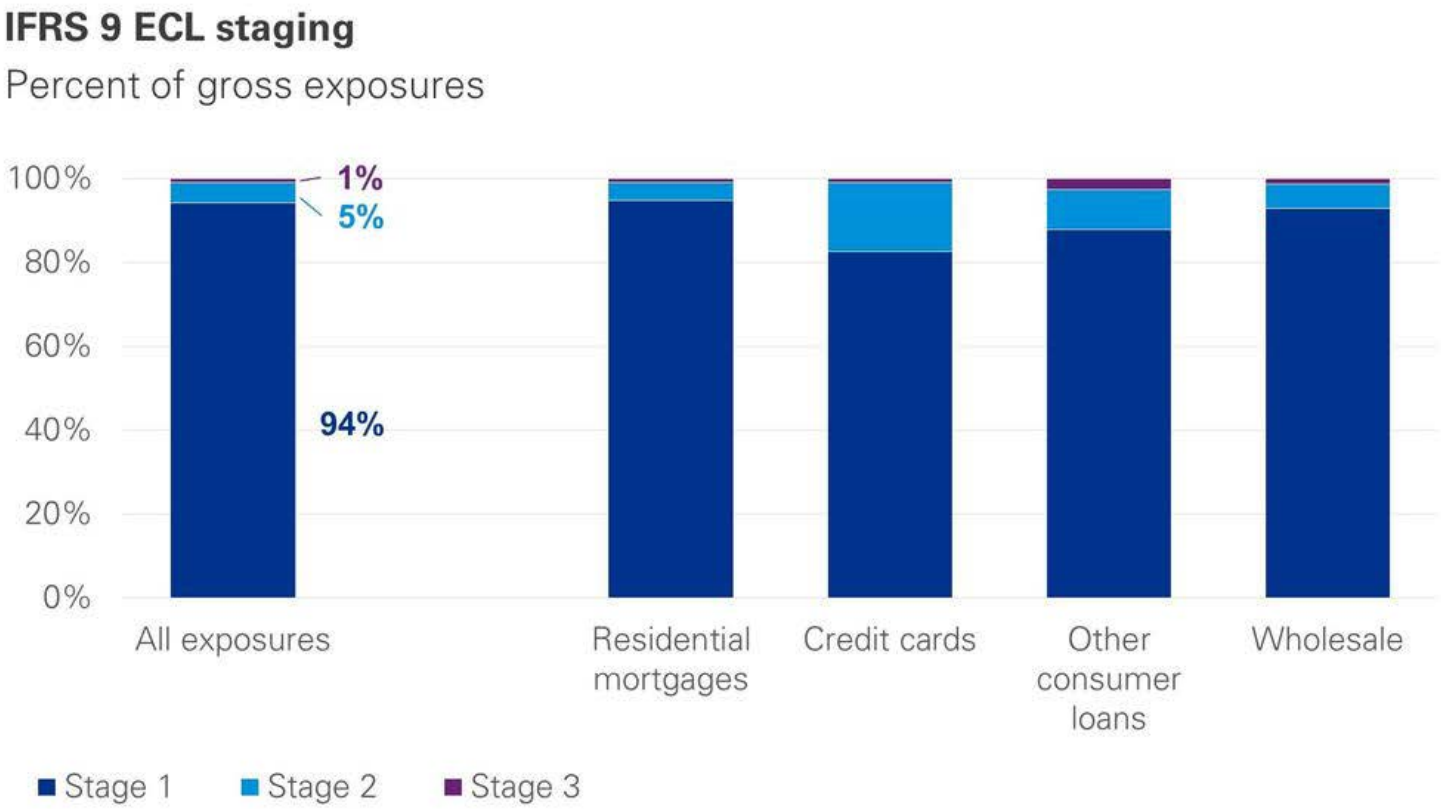
IFRS 9 *Financial instruments* – Interim disclosures

Fully-loaded CET 1 impact

- The 1st EBA impact assessment, conducted in April 2016 based on YE 2015 data, recorded a negative impact of 59 bps on CET1.
- The 2nd EBA impact assessment, conducted in February 2017 based on YE 2016 data, showed a smaller negative impact of 45 bps on CET1.
- The European banks that have disclosed their IFRS 9 transitional impact and were included in the EBA assessment have an average negative impact of 27 bps.
- The average impact of all banks included on the following two slides is 21 bps.



IFRS 9 in numbers - Impairment



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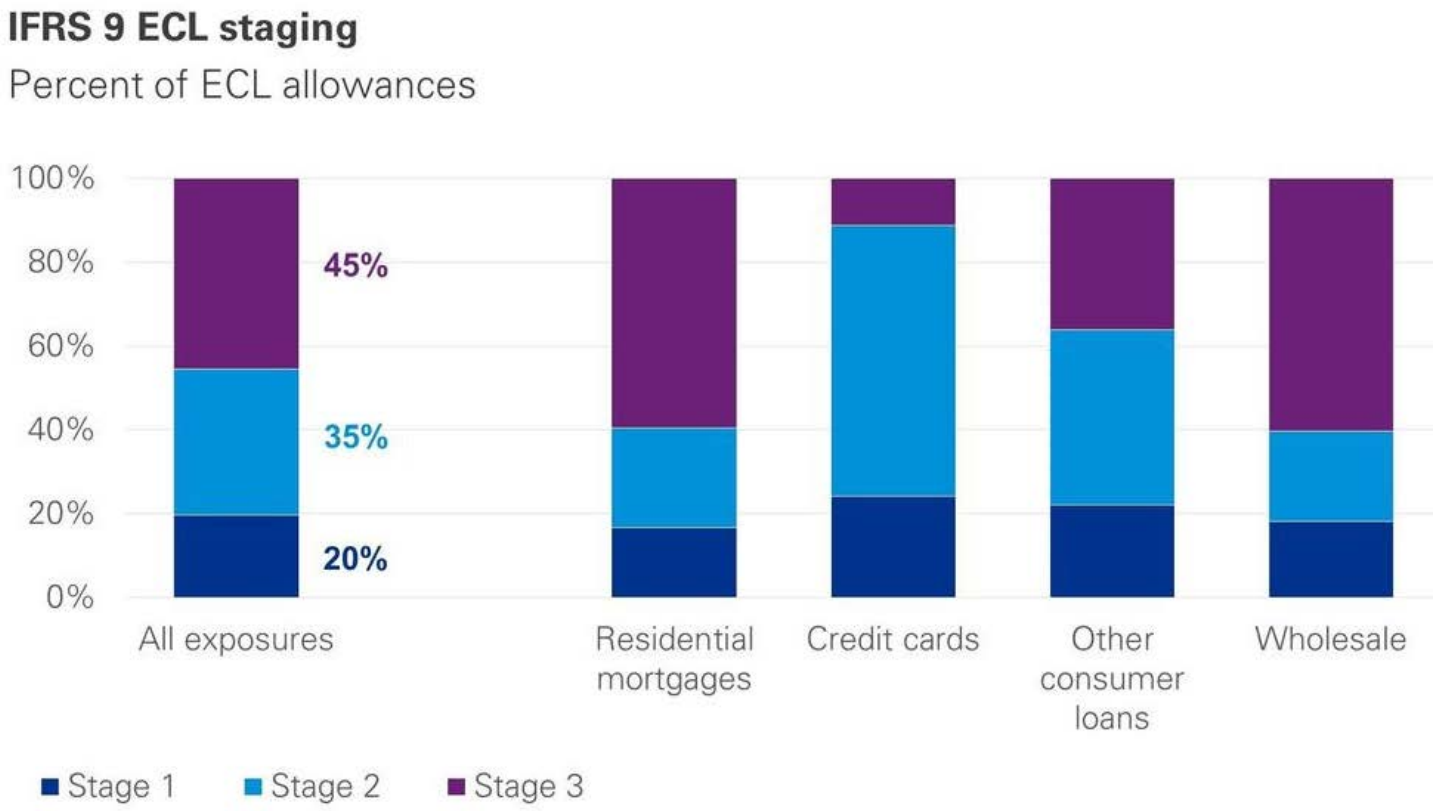
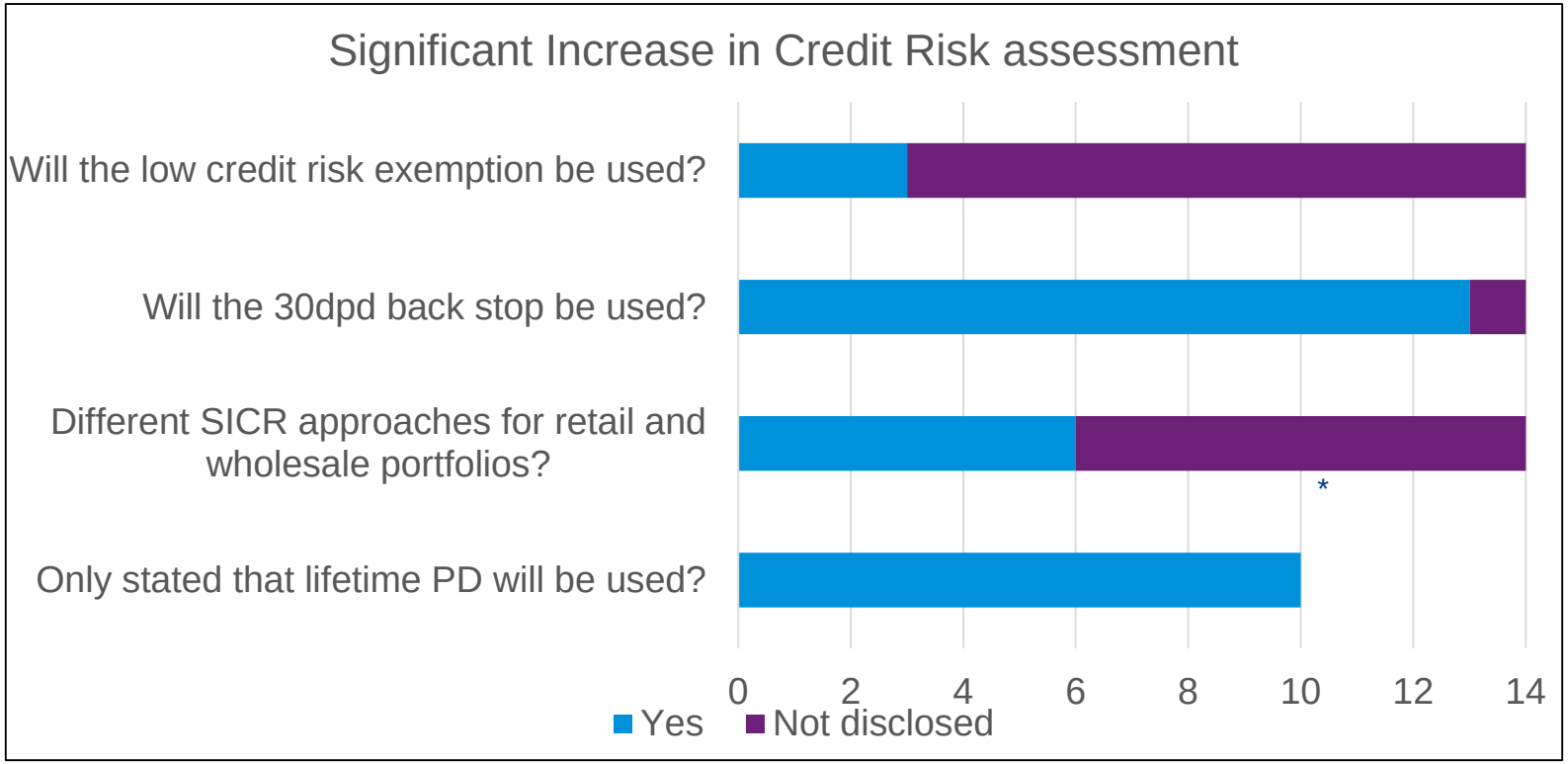


Assessment of a significant increase in credit risk (1/3)

Sample of 14 banks



*Three banks stated that they will use both 12-month and lifetime PDs for the Significant Increase in Credit Risk assessment while one bank did not provide specific disclosures.

Assessment of a significant increase in credit risk (2/3)

Sample of 14 banks

Different Significant Increase in Credit Risk approaches for retail and wholesale portfolios applied:

- **CIBC (**Canadian Imperial Bank Of Commerce)**:** " *For the majority of retail loan portfolios, SICR is determined based on relative changes in the loan's lifetime PD since its initial recognition. For the majority of business and government loan portfolios, SICR is determined based on* ***relative changes in internal risk ratings*** *since initial recognition*."
- **Toronto-Dominion Bank:** *" For retail exposures, significant increase in credit risk is assessed based on changes in the* ***12-month probability of default (PD)*** *since initial recognition. For non-retail exposures, significant increase in credit risk is assessed based on* ***changes in the internal risk rating*** *(borrower risk ratings (BRR)) since initial recognition."*
- **Bank of Novia Scotia:** *"For retail exposures, a significant increase in credit risk cannot be assessed using forward-looking information at an individual account level. Therefore, the assessment must be done at the segment level. Segment migration thresholds exist for each PD model by product which considers the proportionate change in PD as well as the absolute change in PD. [ ] The Bank uses a risk rating scale (IG codes) for its non-retail exposures. All non-retail exposures have an IG code assigned that reflects the probability of default of the borrower. Both borrower specific and non-borrower specific (i.e. macro-economic) forward looking information is considered and reflected in the IG rating. Significant increase in credit risk is evaluated based on the* ***migration of the exposures among IG codes****."*

Assessment of a significant increase in credit risk (3/3)

Sample of 14 banks

Quantitative measures mentioned in the context of transfers to Stage 2:

— **Santander UK:** *" A relative threshold of 100% (doubling the PD) has been applied across all portfolios, while absolute increase thresholds have been tailored to each portfolio."*

— **RBS (**The Royal Bank of Scotland)**:** *" At its simplest level RBS has developed criteria around a basic expectation that a doubling of the PD is the most appropriate threshold, with criteria varying by risk band. Other portfolio-specific thresholds are also used."*

— **HSBC:** *" The quantitative measure of significance [for wholesale portfolios] varies depending on the credit quality at origination, as follows:*

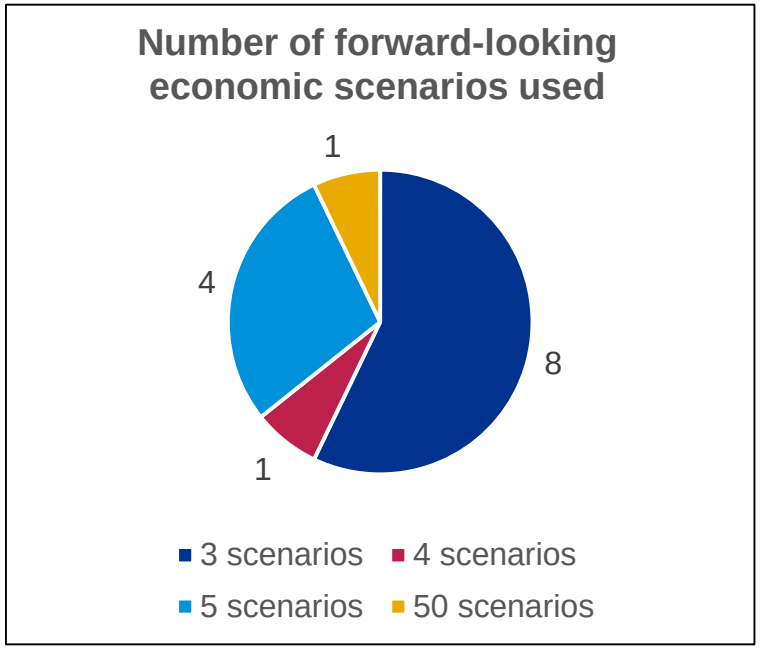
Origination CRR	Significance trigger – PD to increase by
0.1–1.2	15bps
2.1–3.3	30 bps
Greater than 3.3 and not impaired	2x

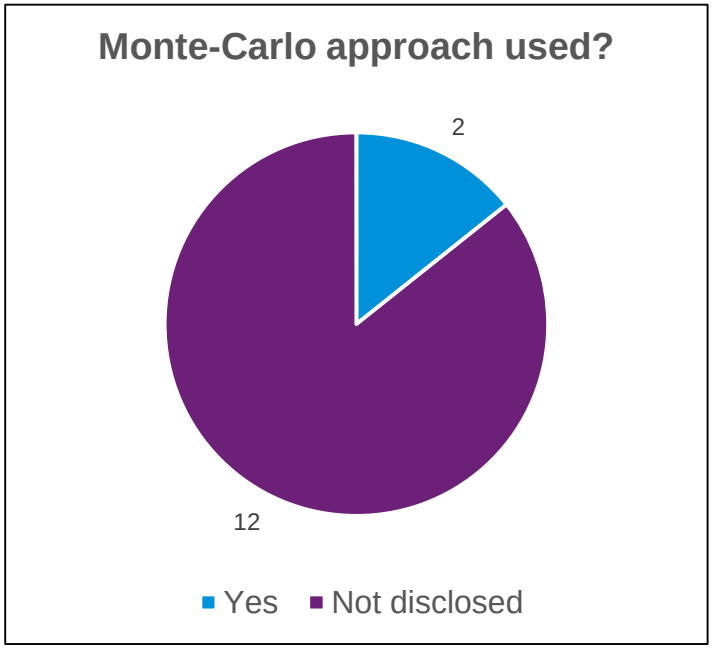
— **Danske Bank***: "For facilities originated below 1% in PD: An increase in the facility's 12-month PD of at least 0.5 percentage points since origination and a doubling of the facility's lifetime PD since origination For facilities originated above 1% in PD: An increase in the facility's 12-month PD of 2 percentage points since origination or a doubling of the facility's lifetime PD since origination."*

** Credit risk rating*

Incorporation of forward-looking information

Sample of 14 banks

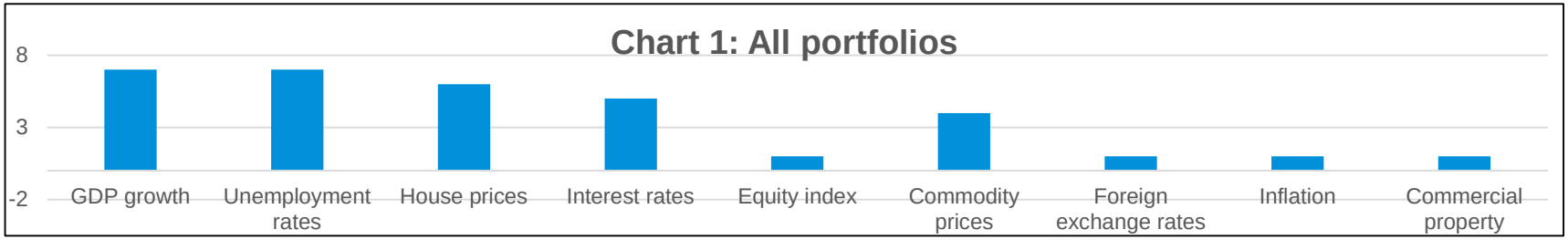


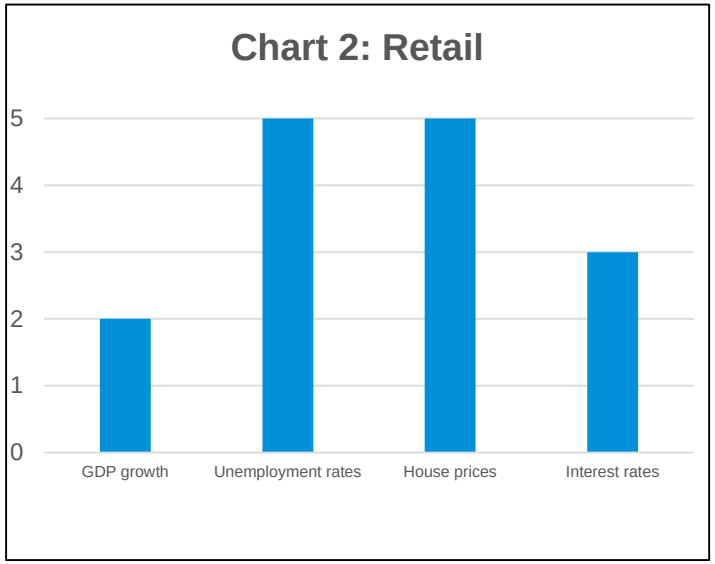


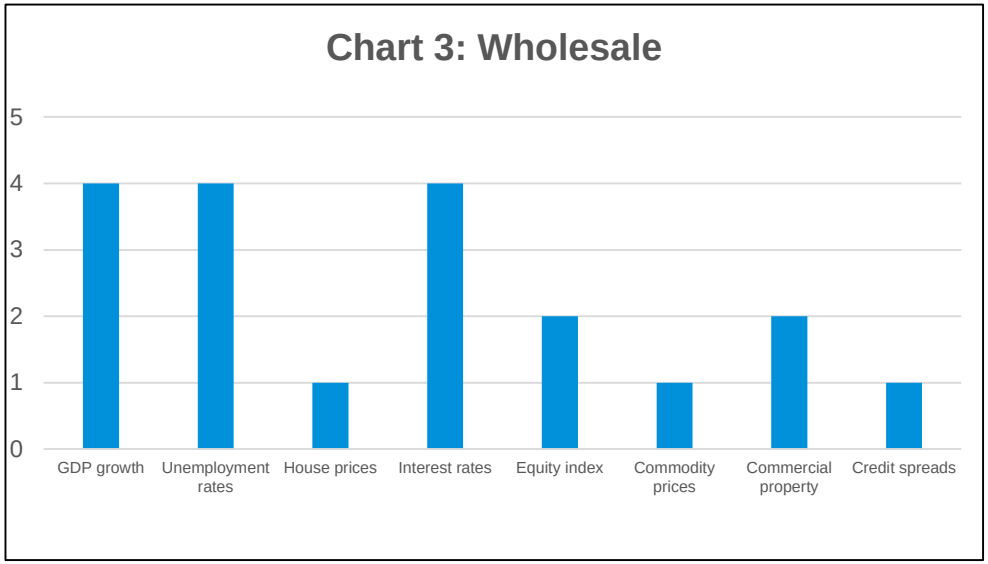
Macro-economic variables used in ECL models

Sample of 14 banks

The following graphs show disclosures made by banks about key macro-economic variables they used in their ECL models.

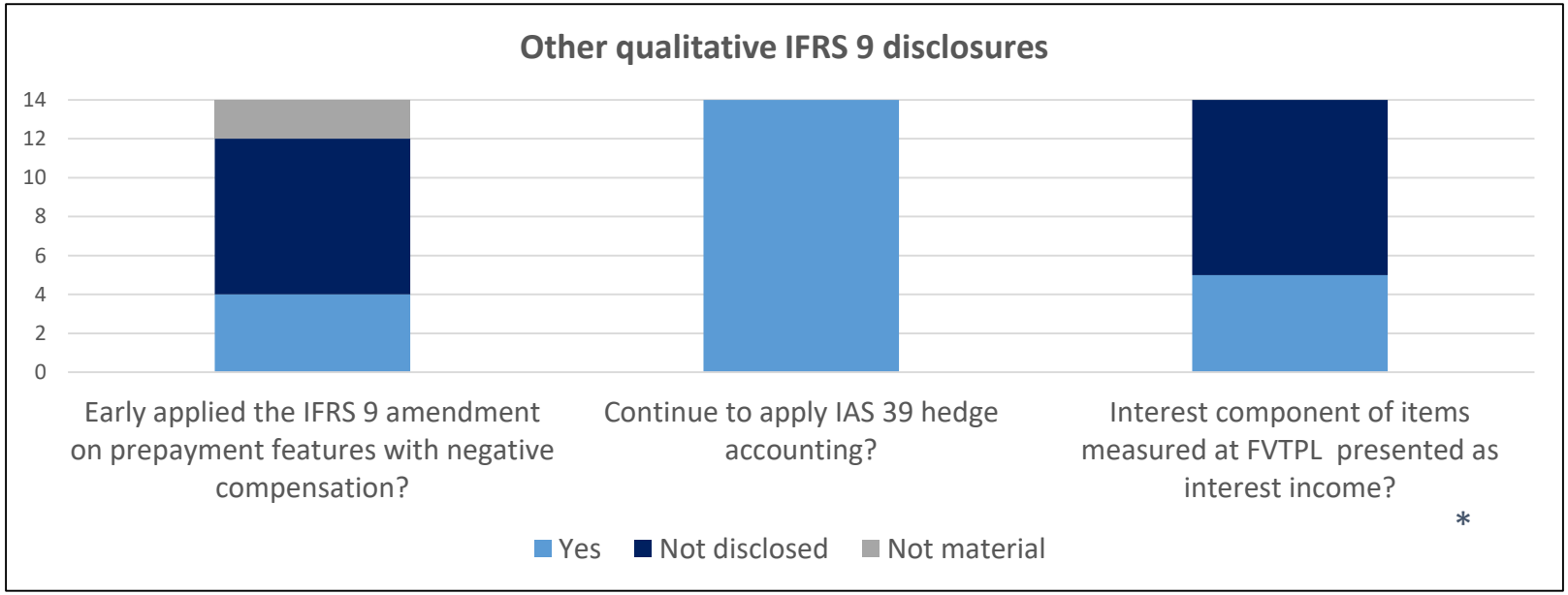






Other qualitative IFRS 9 disclosures

Sample of 14 banks



*Includes presentation in “Interest and similar income”

IFRS 9 *Financial instruments*

IFRS 9 *Financial instruments* – Pre-transition disclosures

IFRS 9 *Financial instruments* – Interim disclosures

Q1 2018 disclosures by Canadian banks

Disclosure of impact of IFRS 9 adoption as at the ***date of initial application***
5 Canadian banks

Opening balance sheet reconciliation from IAS 39 to IFRS 9.	■■■■■
Items previously designated as FVTPL but not designated under IFRS 9.	■■■□□
Designations made on adoption of IFRS 9.	■■■■■
Opening loss allowance reconciliation from IAS 39 to IFRS 9.	■■■■■
Analysis of opening loss allowance under IFRS 9 per class of financial instrument.	■■■■■
Changes in accounting policies.	■■■■■

Key: ■ Yes □ No

- Opening balance sheet reconciliation from IAS 39 to IFRS 9 showed separately reclassifications and re-measurements.
- Opening loss allowance reconciliation from IAS 39 to IFRS 9.

Opening balance sheet reconciliation from IAS 39 to IFRS 9 showed separately reclassifications and re-measurements

Reconciliation of consolidated balance sheet at 31 December 2017 and 1 January 2018

	Footnotes	IAS 39 measurement category	IFRS 9 measurement category	IAS 39 carrying amount at 31 Dec 2017	Other changes in classification	IFRS 9 reclassification to: Fair value through profit and loss	IFRS 9 reclassification to: Fair value through other comprehensive income	IFRS 9 reclassification to: Amortised cost	Carrying amount post reclassification	IFRS 9 remeasurement including expected credit losses[4]	IFRS 9 carrying amount at 1 Jan 2018
				$m	$m	$m	$m	$m	$m	$m	$m
Assets											
Cash and balances at central banks		Amortised cost	Amortised cost	180,624	–	–	–	–	180,624	(3)	180,621
Items in the course of collection from other banks		Amortised cost	Amortised cost	6,628	–	–	–	–	6,628	–	6,628
Hong Kong Government certificates of indebtedness		Amortised cost	Amortised cost	34,186	–	–	–	–	34,186	–	34,186
Trading assets	1, 3	FVPL	FVPL	287,995	4,329	9	–	(37,924)	254,409	1	254,410
Financial assets designated and otherwise mandatorily measured at fair value through profit or loss	2,5,6,7	FVPL	FVPL	29,464	313	10,055	(3)	(115)	39,714	32	39,746
Derivatives		FVPL	FVPL	219,818	–	–	–	–	219,818	–	219,818
Loans and advances to banks	1, 2, 3	Amortised cost	Amortised cost	90,393	(7,099)	(712)	–	–	82,582	(23)	82,559
Loans and advances to customers	1, 2, 3	Amortised cost	Amortised cost	962,964	(7,458)	(3,903)	–	24	951,627	(1,890)	949,737
Reverse repurchase agreements – non-trading		Amortised cost	Amortised cost	201,553	–	–	–	–	201,553	–	201,553
Financial investments	5	FVOCI (Available for sale – debt instruments)	FVOCI	332,240	–	(3,131)	83	(7,026)	322,166	(3)	322,163
	6	FVOCI (Available for sale – equity instruments)	FVOCI	3,917	–	(2,104)	–	–	1,813	–	1,813
	5	Amortised cost	Amortised cost	52,919	–	–	(80)	7,141	59,980	(457)	59,523
Prepayments, accrued income and other assets	1, 7	Amortised cost	Amortised cost	67,191	9,915	(214)	–	37,900	114,792	(15)	114,777
Current tax assets		N/A	N/A	1,006	–	–	–	–	1,006	–	1,006
Interests in associates and joint ventures	8	N/A	N/A	22,744	–	–	–	–	22,744	(213)	22,531
Goodwill and intangible assets	9	N/A	N/A	23,453	–	–	–	–	23,453	(79)	23,374
Deferred tax assets		N/A	N/A	4,676	–	–	–	–	4,676	38	4,714
Total assets				2,521,771	–	–	–	–	2,521,771	(2,612)	2,519,159

HSBC, Report to Transition IFRS 9, 1 January 2018

Opening loss allowance reconciliation from IAS 39 to IFRS 9

Reconciliation of impairment allowance under IAS 39 and provision under IAS 37 to expected credit losses under IFRS 9

		Reclassification to			Remeasurement		
	IAS 39 measurement category	Fair value through profit and loss $m	Fair value through other comprehensive income $m	Amortised cost $m	Stage 3 $m	Stage 1 & Stage 2 $m	Total $m
Financial assets at amortised cost							
IAS 39 impairment allowance at 31 Dec 2017							7,532
Cash and balances at central banks	Amortised cost (Loans and receivables)	–	–	–	–	3	3
Items in the course of collection from other banks	Amortised cost (Loans and receivables)	–	–	–	–	–	–
Hong Kong Government certificates of indebtedness	Amortised cost (Loans and receivables)	–	–	–	–	–	–
Loans and advances to banks	Amortised cost (Loans and receivables)	–	–	–	1	22	23
Loans and advances to customers	Amortised cost (Loans and receivables)	(31)	–	–	629	1,261	1,859
Reverse repurchase agreements – non-trading	Amortised cost (Loans and receivables)	–	–	–	–	–	–
Financial investments	Amortised cost (Held to maturity)	–	–	3	–	13	16
Prepayments, accrued income and other assets	Amortised cost (Loans and receivables)	–	–	–	–	47	47
Expected credit loss allowance at 1 Jan 2018							9,480
Loan commitments and financial guarantee contracts							
IAS 37 provisions at 31 Dec 2017							253
Provisions (loan commitments and financial guarantees)	N/A	N/A	N/A	N/A	74	210	284
Expected credit loss provision at 1 Jan 2018							537

HSBC, Report to Transition IFRS 9, 1 January 2018

Q1 2018 disclosures by Canadian banks

*Q1 2018 disclosures **at quarter-end***

Reconciliation of closing loss allowance under IFRS 9 per class of financial instrument	■■■■■
ECL stage analysis of gross carrying amounts per class of financial instrument	■■■■■
ECL stage analysis of loss allowances per class of financial instrument	■■■■■

Key: ■ Yes □ No

ECL stage analysis of gross carrying amounts per class of financial instrument

	Exposures subject to IFRS 9 ECL assessment [3]					
	Stage 1 £m	Stage 2 £m	Stage 2: Of which <=30DPD	Stage 2: Of which >30DPD	Stage 3 £m	Total £m
Retail Banking	170,785	10,885	9,760	1,125	2,263	183,933
- of which mortgages	149,310	9,884	8,891	993	2,004	161,198
Commercial Banking	22,651	866	786	80	388	23,905
Global Corporate Banking	23,001	109	109	-	372	23,482
Corporate Centre	56,819	250	212	38	20	57,089
Total	**273,256**	**12,110**	**10,867**	**1,243**	**3,043**	**288,409**

Santander UK, Report to Transition IFRS 9, 1 January 2018

ECL stage analysis of loss allowances per class of financial instrument

	IFRS 9 ECL					
	Stage 1 £m	Stage 2 £m	Stage 2: Of which <=30DPD	Stage 2: Of which >30DPD	Stage 3 £m	Total £m
Retail Banking	110	247	219	28	268	625
- of which mortgages	20	131	115	16	121	272
Commercial Banking	43	33	25	8	173	249
Global Corporate Banking	16	-	-	-	242	258
Corporate Centre	7	4	2	2	8	19
Total	**176**	**284**	**246**	**38**	**691**	**1,151**

Santander UK, Report to Transition IFRS 9, 1 January 2018

KPMG

News from the IASB

New Pronouncements - Effective date

Status: April 2018	2018	2019	2021
New standards and interpretations			
IFRS 15 Revenue from Contracts with Customers (Including clarifications to IFRS 15)	✓		
IFRS 9 Financial Instruments	✓		
Amendments to IFRS 9 – Prepayment features with Negative Compensation	✓		
IFRIC 22 Foreign Currency Transactions and Advance Consideration	✓		
IFRS 16 Leases		✓	
IFRIC 23 Uncertainty over Income Tax Treatments		✓	
IFRS 17 Insurance Contracts			✓

New Pronouncements - Effective date

Status: April 2018	2018	2019	2021
Narrow-scope amendments			
Annual Improvements 2014-2016 Amendments to IFRS 12 Disclosure of Interests in Other Entities	✓		
Transfers of Investment Property (Amendments to IAS 40)	✓		
Classification and Measurement of Shared-based Payment Transactions: Amendments to IFRS 2	✓		
Applying IFRS 9 *Financial Instruments* with IFRS 4 *Insurance Contracts* (Amendments to IFRS 4)	✓		
Amendments to IAS 28 – Long-term Interests in Associates and Joint Ventures		✓	
Annual Improvements 2015-2017 Amendments to IFRS 3 Business Combinations and IFRS 11 Joint Arrangements Amendments to IAS 12 Income Taxes Amendments to IAS 23 Borrowing Costs		✓	

Main items on the IASB's agenda

Analysis of IASB projects – IASB Work Plan at April 2018

Short term until June 2018

- Definition of a business (Amendments to IFRS 3)
- Classification of Liabilities (Amendments to IAS 1)

Medium term – expected in Q2 2018

- Accounting Policy Changes (Amendments to IAS 8)
- Improvements to IFRS 8 Operating Segments (Amendments to IFRS 8 and IAS 34)

Long term

- Goodwill and Impairment (DP or ED) H2 2018
- Dynamic Risk Management (Core Model) H1 2019
- Primary Financial Statements (DP or ED) H1 2019

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