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Financial Services Briefings

Issue 15 November 2014
MICA (P) 029/02/2014

Foreword

The accounting for financial instruments is changing.

In July 2014, the International Accounting Standards Board issued the completed version of IFRS 9 *Financial Instruments* which will replace IAS 39 *Financial Instruments*: Recognition and Measurement. IFRS 9 (2014) provides revised guidance on the classification and measurement of financial assets, an expected credit loss model for calculating impairment and the general hedge accounting requirements.

In Singapore, the Accounting Standards Council is expected to adopt the final version of IFRS 9 without modification effective from 1 January 2018.

IFRS 9 is likely to have pervasive impact to financial institutions. While the effective date may seem a long way off, all companies – especially financial institutions, will need to start assessing the possible impact and begin planning for transition to the finalised standard.

Similarly, companies need to understand the time, resources and changes to systems and processes that are needed. An early decision will allow companies to develop an efficient implementation plan and inform their key stakeholders.

In this issue, we offer our thoughts on the impact and implications of the finalised standard to financial institutions.

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Contents

IFRS 9 – Accounting for financial instruments: Impact on financial institutions -

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Among the wave of accounting standards that were recently issued, IFRS 9 - the new Financial Instruments accounting is likely to have the most pervasive impact on financial institutions.

IFRS 9 changes the method in which entities classify their financial instruments. Such changes may result in more financial instruments being recorded at fair value with gains and losses recorded through profit or loss, and hence potentially increasing income statement volatility. In addition, the new impairment requirement is expected to result in a larger and more volatile impairment allowance for bad debts. As a result, regulatory capital ratios may also be significantly affected.

In Singapore, the Accounting Standards Council (ASC) is expected to adopt the final version of IFRS 9 without modification effective from 1 January 2018.

The complete standard includes three components: classification and measurement, impairment, and hedge accounting. We outline the summary of the key requirements and the potential implications to financial institutions.

Classification and measurement

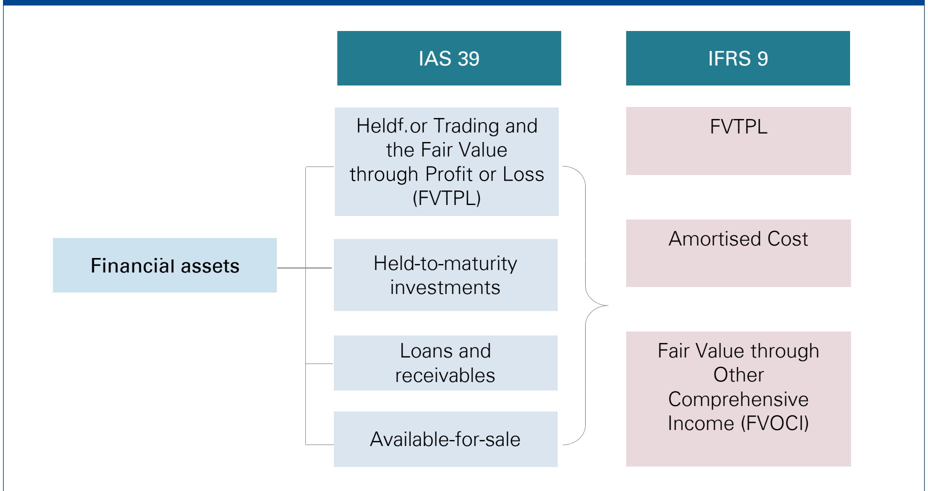
Simplif Simplifying the requirements of IAS 39 Financial Instruments: Recognition and Measurement was one of the objectives of the IASB when it embarked on the financial instruments project. The final version ofIFRS 9 retains a similar mixed measurement model. However, there are now three classification categories as seen in Figure 1.

Although the permissible measurement categories under IFRS 9 appears similar to IAS 39, the criteria for the classification of financial assets into the appropriate measurement category are significantly different. The basis for classification under IFRS 9 depends on the contractual cash flow characteristics of the financial assets and entity's business model, whereas under IAS 39, management intent is the key criterion.

In determining the classification of financial assets, one of the criteria is whether the contractual cash flows from the financial asset are solely for payments of principal and interest (the 'SPPI' criterion). The standard defines interest as main considerations for time value of money and credit risk associated with the principal amount outstanding.

A financial asset that does not meet the SPPI criterion is always measured at FVTPL unless it is a non-trading equity instrument where the entity may irrevocably present subsequent fair value changes in other comprehensive income (OCI). However, as a departure from the current available-for-sale (AFS)

Figure 1. Three classification categories in IFRS 9



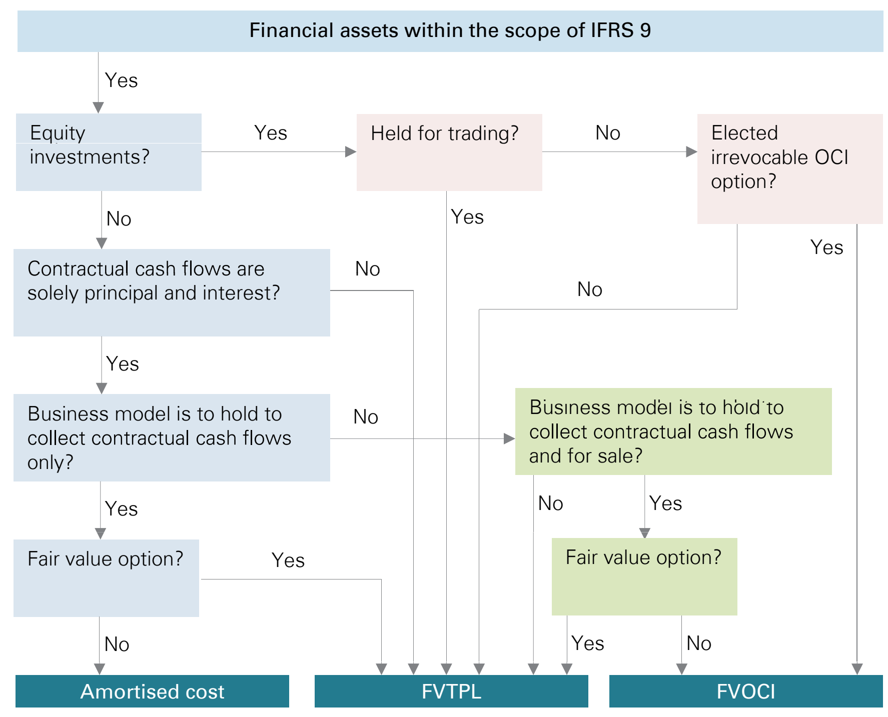
classification on equity instruments, gains and losses are never reclassified into profit or loss even upon disposal.

Another key criterion in determining the classification is the business model assessment. The entity will need to determine whether the business model of the portfolio holding the asset is to collect contractual cash flows, to trade, or to both collect and trade. The determination on the appropriate classification of a financial asset is based less on instrument by instrument management intent, but more fact-based on how the portfolio is being managed. The following Figure 2 illustrates the classification determination.

Unlike IAS 39, hybrid financial asset with a host that is a financial asset within the scope of IFRS 9 are classified in their entirety and are not subject to bifurcation requirements. Therefore, we expect most hybrid financial assets that are separated under the current requirements to be likely classified in its entirety as fair value through profit or loss (FVTPL). This may add income statement volatility from investments in convertible bonds, commodity linked deposits and others which may have been bifurcated under current IAS 39.

The classification and measurement of financial liabilities remain largely unchanged from IAS 39, except for the presentation of gains and losses on financial liabilities that are designated at FVTPL on initial recognition. For such liabilities, the change in the fair value that is attributable to changes in own credit risk is recognised in OCI.

Figure 2. Determining the classifications of financial assets under IFRS 9



Impairment of financial assets

One of the main criticisms of the current IAS 39 incurred loss model is that due to the requirement for objective evidence of an impairment before an impairment could be recorded, the impairment amount tends to be too little and too late.

IFRS 9 aims to address this criticism by replacing the incurred loss model with the expected loss model that is forward looking. This change is likely to cause substantial impact to banks that are adopting IFRS 9.

Dual measurement model

IFRS 9 uses a dual measurement approach. If the credit risk of a financial asset has not increased significantly since its initial recognition, the financial asset attracts a loss allowance equivalent to 12-month expected credit loss. If the credit risk of a financial asset has increased significantly, it will attract a loss allowance equivalent to lifetime expected credit loss, thereby increasing the amount of impairment recognised.

The expected credit loss will be based on the probability of a default occurring in the next 12 months and the expected credit losses that will result from that default. In most cases, this is expected to be a subset of the lifetime expected loss.

Significant increase in credit risk

A financial asset will switch between 12-month and lifetime expected loss whenever there is a significant increase in credit risk. IFRS 9 does not specifically define what it considers to be significant increase in credit risk. Entities will have to decide how they will define this key term in the context of their instruments as a policy election.

A move from a12-month expected loss measurement to a lifetime expected loss may result in financial statement volatility. Defining the significant increase in credit risk is one of the most critical and difficult judgment areas in the model.

Calculation differences between Basel and IFRS 9 Despite having a similar framework with Basel requirements, banks adopting Basel will need to calibrate their calculation to comply with IFRS 9 as the specific measurement requirements are different. One significant difference between the two requirements is Basel PD is based on through the economic cycle, while the IFRS 9 requires a point estimate PD.

Hedge accounting

The current hedge accounting requirements under IAS 39 have been criticised as being too rigid and difficult to apply in practice. The strict eligibility requirements under IAS 39 cater only to static one-to-one hedges and the prescriptive 80 percent to 125 percent effectiveness requirement.

This requirement focuses more on a backward looking assessment rather than forward looking assessment, resulting in an accounting for hedges that is not in line with the entity's risk management practice and financial statements that do not reflect the entities' hedging activities. The IASB aims to better align financial statements with risk management in the new IFRS 9.

The summary of changes in IFRS 9 as compared with IAS 39 is as illustrated on the right. For banks, one of the most anticipated segments of hedge accounting is on macro hedging. The IASB has carved out its deliberations on macro hedge accounting as a separate project outside of IFRS 9 and it is currently in progress.

Impact to financial institutions

Given the changes above, we highlight below some of the potential impact that financial institutions can expect from the adoption of IFRS 9:

Application and Operational Complexity

- Classification and Measurement
  In some cases, entities may want to consider re-aligning their portfolio allocation to achieve the appropriate classification. Early assessment and impact simulation may be beneficial in helping entities understand the impact of their portfolio of financial assets.
- Impairment
  Operationalising the new IFRS 9 impairment methodology will likely require changes in system calculation and require different historical data sets to be captured to be able to calculate IFRS 9 based on 12-month and lifetime expected loss. The system will also need to be able to capture whether significant increase in credit risk has occurred or reversed.
- Hedge Accounting
  Adoption of the new hedge accounting requirement requires alignment of risk management strategies and policies to accommodate IFRS 9 which will require greater detail on defining objective, identification and measurement criteria.

Next step

With the finalisation of the standard, impact assessment and implementation projects can now begin in earnest. All companies – especially those in the financial sector, will need to start assessing the possible impacts and begin planning for transition.

IFRS 9 will be mandatorily effective for annual periods beginning on or after 1 January 2018. The general transition requirement is for retrospective application in accordance with IAS 8 with certain exemptions depending on circumstances.

Given the extent of the changes and the potential impact for financial institutions, we recommend the following next steps:

- **Awareness and education –** Employees in the finance, operation, front office and other business function that may be affected by the changes must be updated on the new standard. The new standard may change how entities account for transactions and impact new structures.
- **Impact / gap assessment –** An impact assessment on classification and impairment, including simulation of results would help management to communicate the potential financial impact of the adoption to stakeholders early. Given the potential increase in volatility, understanding and quantifying the impact early would be beneficial.
- **Transition planning –** To the extent that system changes need to be made, portfolio of investment needs to be re-allocated and historical data needs to be tabulated, the time and effort required could be substantial. Proper planning ahead of the initial adoption is critical.

Summary of changes

	IAS 39	IFRS 9
Life span of hedging relationships	• **Designation** – To qualify for hedge accounting, the hedge has to be highly effective retrospectively and prospectively, in the range of 80% to 125%. • **Continuation** - Hedge accounting must be terminated if the hedge is no longer effective within the arbitrary 85% to 125% bright lines. • **Discontinuation** - Hedge accounting can be terminated voluntarily.	• **Designation** - Hedge qualification will be based on qualitative, forward-looking hedge effectiveness assessments, rather than the arbitrary 85% to125% bright lines currently in IAS 39. • **Continuation** - Hedging relationships may need to be rebalanced, without terminating hedge accounting, due to certain changes in circumstances. • **Discontinuation** - Voluntary termination of otherwise qualifying hedging relationships will be prohibited.
Additional qualifying exposures	• Hedging of risk component of a non-financial item (except for foreign currency risk of a non-financial item) is prohibited. • Hedging of group of items that constitute a net position and layer components in fair value hedge are prohibited. • Hedging of derivatives is prohibited.	• Risk components of non-financial items (e.g. commodity price risk, freight rate) and non-contractually specified inflation may be hedged risks. • Net positions and layer components of items may be hedged items. • An aggregated exposure (a combination of a non-derivative exposure and a derivative) may be a hedged item.

Regulatory and accounting updates -

Regulatory Updates

Financial Institutions

Commercial Banks (MAS Notice 626)
Merchant Banks (MAS Notice 1014)
Finance Companies (MAS Notice 824)
Securities, Futures and Fund Management (MAS Notice SFA04-N02 & SFA13-N01)
Financial Advisers (MAS Notice FAA-N06)

Prevention of Money Laundering and Countering the Financing of Terrorism (AML/CFT)
On 1 July 2014, the above notices were amended to clarify financial institutions' (FI) obligations under the AML/CFT requirements in relation to the Personal Data Protection Act ("PDPA").

The amendments affirm individuals' rights under the PDPA to access and correct personal data that they have provided to an FI. Aside from certain specified personal data, FIs are not obliged to provide individuals access and correction of any other personal data, including information obtained from third party sources for verification purposes.

Commercial Banks / Merchant Banks / Finance Companies

Commercial Bank (MAS Notice 646) / Merchant Bank (MAS Notice 1116) Foreign Exchange Conversion in China via the Renminbi Clearing Bank for the Settlement of Eligible Cross-Border Trade
With effect from 1 August 2014, a participating bank is no longer required to perform quarterly audits of internal policies, procedures and controls in respect of the verification of eligible cross-border trade. Neither does the participating bank need to submit quarterly declarations to the Monetary Authority of Singapore (MAS) to certify whether it has conducted any foreign exchange conversion and if it has been compliant with the requirements as set out in the notices.

Borrowers Who are Individuals and Who Own Residential Property Gazetted for Acquisition (August 2014)

MAS issued a circular to provide clarity on the application of MAS Notices on Residential Property Loans and MAS Notices on Computation of Total Debt Servicing Ratio for Property Loans to borrowers who are individuals and own a residential property gazetted for acquisition, where the date of the Notice of Land Acquisition is 15 August 2014 ("the Individual").

Key clarifications include:
- Granting a credit facility to the Individual with Loan-to-Value limit of up to 80 percent, subject to certain conditions;
- Where the Replacement Property is a HDB or an EC purchased directly from a Property Developer, the financial institution need not apply the mortgage servicing ratio limit of 30 percent and

- Granting a credit facility to the Individual for the purchase of the Replacement Property without the need to apply the "borrower-to-be-a-mortgagor" rule.

Securities, Futures and Fund Management and Financial Advisers

Securities and Futures (Reporting of Derivatives Contracts) (Exemption) Regulations 2014

The regulations were introduced on 26 June 2014 to exempt holders of Capital Markets Service License (CMSL) that carry on the business of fund management or real estate investment trust management from the reporting of specified derivatives contracts, provided that the managed assets of these asset managers do not exceed S$8 billion as at the end of their most recent completed financial year.

The exemption is also extended to an approved trustee of a collective investment scheme managed by either a holder of CMSL who is exempted above, a Registered Fund Management Company or a person who carries on the business of fund management, in respect of a specified derivatives contract which it enters into in its capacity as such trustee.

Securities and Futures (Offers of Investments) (Collective Investment Schemes) Regulations Lodgement Practice Note for Collective Investment Schemes

On 29 July 2014, the regulations and lodgement practice note was updated to reflect the revised requirements and procedures for authorisation/ recognition applications of Collective Investment Schemes.

Code on Collective Investment Schemes

The Code on Collective Investment Schemes (CIS) was updated on 25 August 2014 to add a new chapter under "Recognised Schemes" in relation to schemes offered under the ASEAN CIS Framework.

Accounting Updates

Continuing hedge accounting after derivative novations

Laws and regulations on over-the-counter (OTC) derivatives are changing in several jurisdictions, requiring or providing incentives for entities to novate many OTC derivatives to a clearing counterparty.

FRS 39 Financial Instruments: Recognition and Measurement requires an entity to discontinue hedge accounting if the derivative hedging instrument is novated to a clearing counterparty – unless the hedging instrument is being replaced as part of the entity's original documented hedging strategy.

The amendments to FRS 39 are effective for annual periods beginning on or after 1 January 2014. The revised standard provides relief from discontinuing an existing hedging relationship when a novation that was not contemplated in the original hedging documentation meets the following criteria:

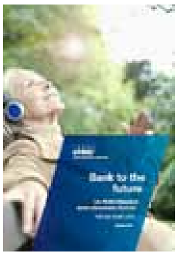
1. The novation was made as a consequence of laws and regulations.
2. A clearing counterparty becomes a new counterparty to each of the original parties.
3. Changes to the terms of the derivative were limited to those necessary to replace the counterparty.

Although the amendments are applied retrospectively, if an entity had previously discontinued hedge accounting as a result of a novation, then the previous hedge accounting (pre-novation) for that relationship cannot be reinstated.

Global topics -

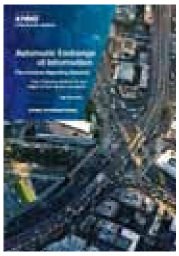
From burden to competitive advantage - Regulatory change and transformation in financial services (September 2014)

Report that discusses how to turn the complexities of regulatory transformation into an opportunity.



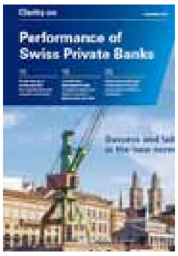
Bank to the future - UK Performance Benchmarking Report - Half year results 2014 (September 2014)

A KPMG report summarising the 2014 mid year results of the UK's five largest banks: Barclays, HSBC, Lloyds Banking Group (Lloyds), Royal Bank of Scotland (RBS) and Standard Chartered (SCB).



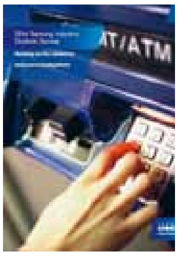
Automatic Exchange of Information - The Common Reporting Standard (September 2014)

A publication examining the OECD Common Reporting Standard (CRS) and how, these new standards will affect financial institutions around the world. The report will also discuss on the steps financial institutions should take to achieve compliance cost-effectively.



Clarity on Performance of Swiss Private Banks (August 2014)

A study by KPMG and the University of St. Gallen (HSG), which analyses the annual reports of 94 Swiss private banks, assessing their financial performance to identify success factors in the banking industry.



2014 Banking Industry Outlook Survey – Banking on the Customer (July 2014)

The publication provides an overview of the current challenges and opportunities for banks. It is based on a survey of 100 banking industry executives in the United States conducted during the second quarter of 2014.

Compliance Risk Management Survey – A Point of View (July 2014)

KPMG conducted the Compliance Risk Management Survey to give respondents insights into the current state of development and integration of the CRM programs in place among their peers and the broader financial services industry.

IFRS Newsletter - The Bank Statement Q2 2014 (July 2014)

The Q2 2014 issue of the quarterly banking newsletter provides updates on IFRS developments that willaffect banks and considers the potential accounting implications of regulatory requirements.

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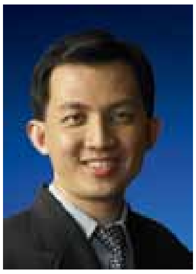

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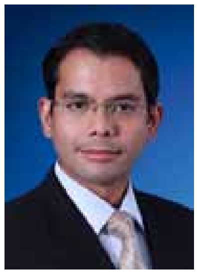

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