IFRS 9: Key changes and impact on Islamic FI's

AAOIFI-World Bank Islamic Banking and Finance Conference

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Why a new standard was required?

- Users told International Accounting Standards Board ("IASB") that IAS 39 was difficult to understand, apply and interpret

- Users requesting principle-based and less complex standard

- In 2005 IASB and Financial Accounting Standards Board ("FASB") began work, resulting in responses to a discussion paper in 2008, that led to IASB adding this project to its active agenda

Criticism of the current Incurred Loss Model (IAS 39)

- No recognition of future expected losses ("**too little too late**")

- Income recognition ignores expected losses ("**front loading of financing revenue**")

- Heterogeneous methods of impairment/ estimates undermine the comparability of financial statements

IFRS 9 overview

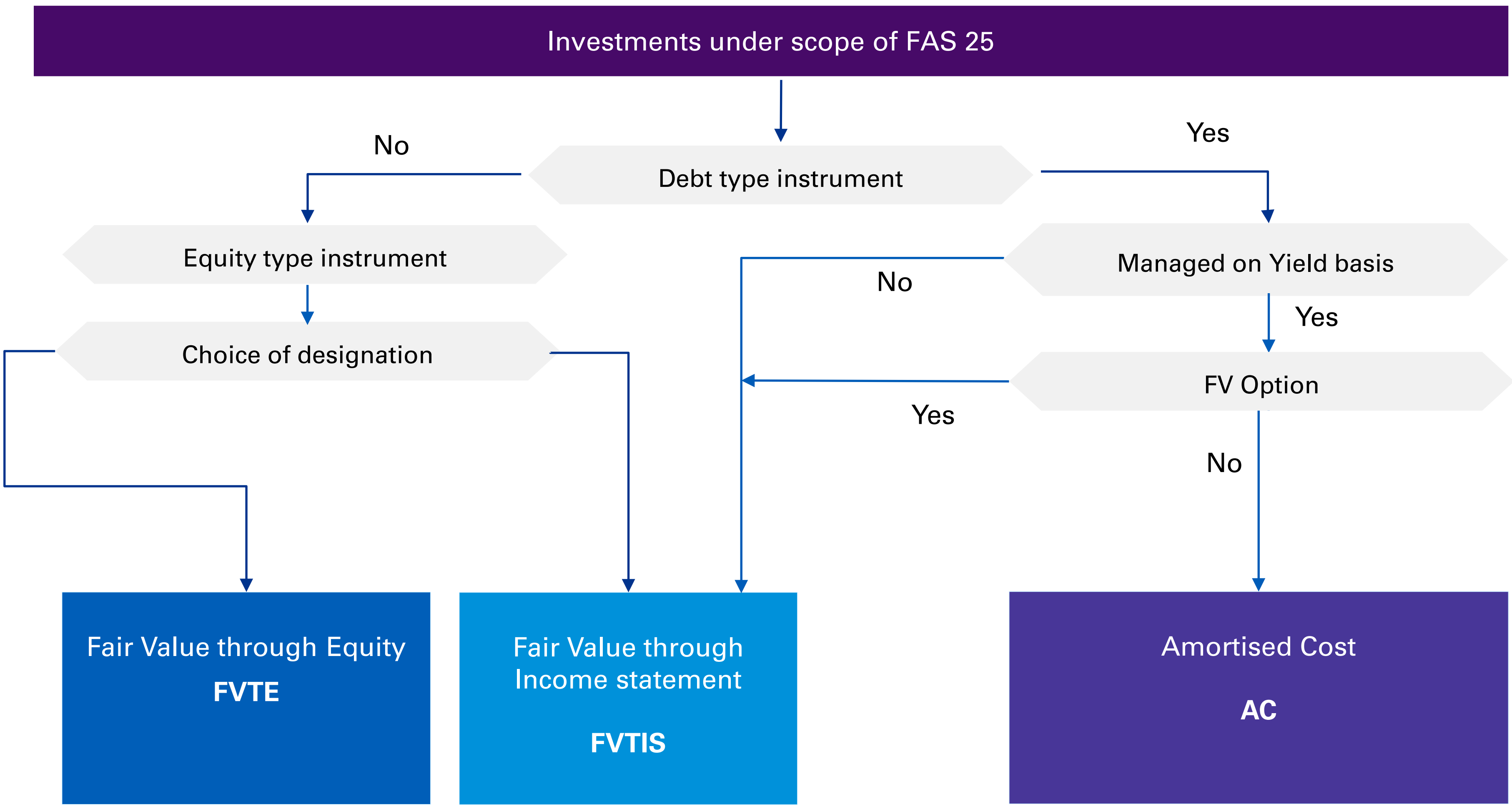
Version	Inhalt	Carried over from IAS 39	Effective Date
IFRS 9 (2009)	New accounting rules for **Classification and Measurement** of financial assets and financial liabilities	Rules for recognition and derecognition of financial instruments; only minor amendments.	• Entity shall apply IFRS 9 for annual periods beginning on or after January 1, 2018. • Early application permitted but generally requires application of all entire standard at the same time (exception: FVtPL) • No requirement regarding comparatives; Provision: requires availability of reliable data
IFRS 9 (2010)			
IFRS 9 (2013)	New rules for the use of **Hedge Accounting**		
IFRS 9 (Complete Standard)	Amendments to the 2009/2010 draft regarding Classification and Measurement Introduction of new **Expected Loss Model** for recognition and measurement of loan loss allowances		

The new IFRS 9 standard also amends IFRS 7 “Financial Instruments: Disclosures“ due to newly imposed disclosure requirements

KPMG

Classification and measurement

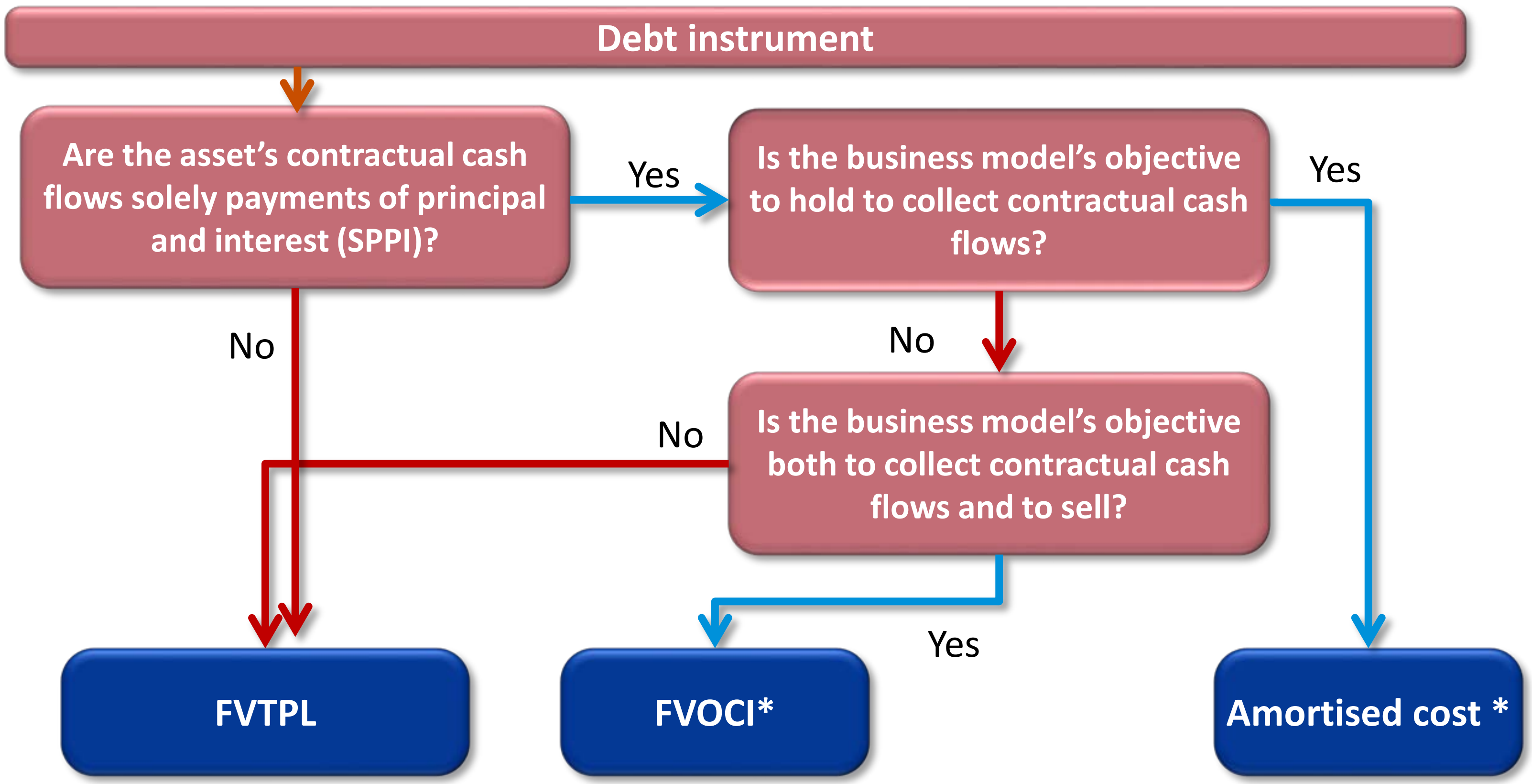
Reminder: FAS 25 classification and measurement



What has changed?

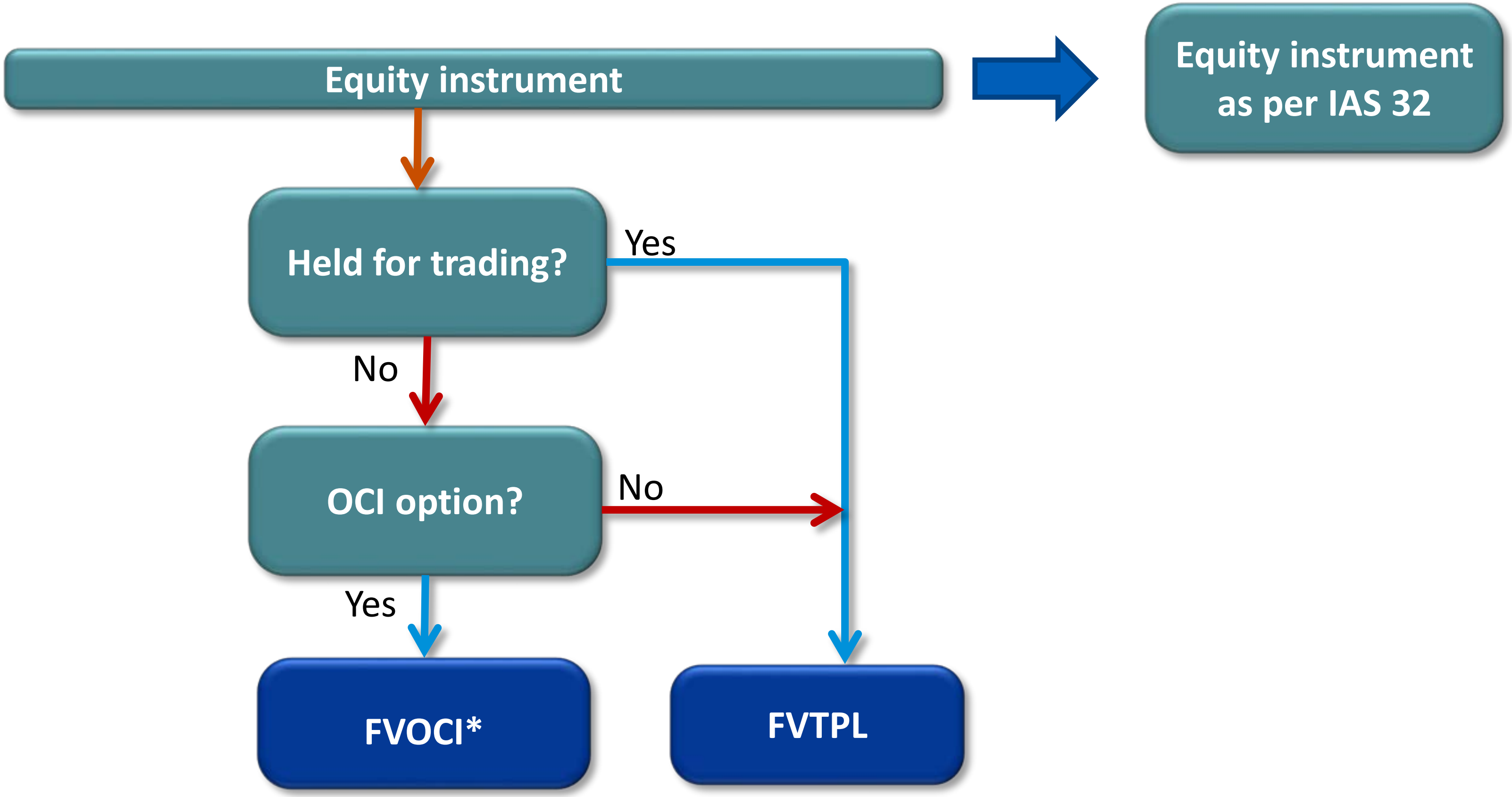
IAS 39	IFRS 9
FVTPL (D/E) - Trading - Designated	**FVTPL** (D/E) - Trading - Designated
HTM (D) At amotised cost	**Amortised cost** (D)
AFS at cost (E)	**Fair Value Through OCI** (D) – with recycling
AFS at fair value (D/E)	**Fair Value Through OCI** (E) – No recycling

Principles of Financial Asset Classification - Debt



* Subject to FVTPL designation option - if it reduces accounting mismatch

Principles of Financial Asset Classification -Equity



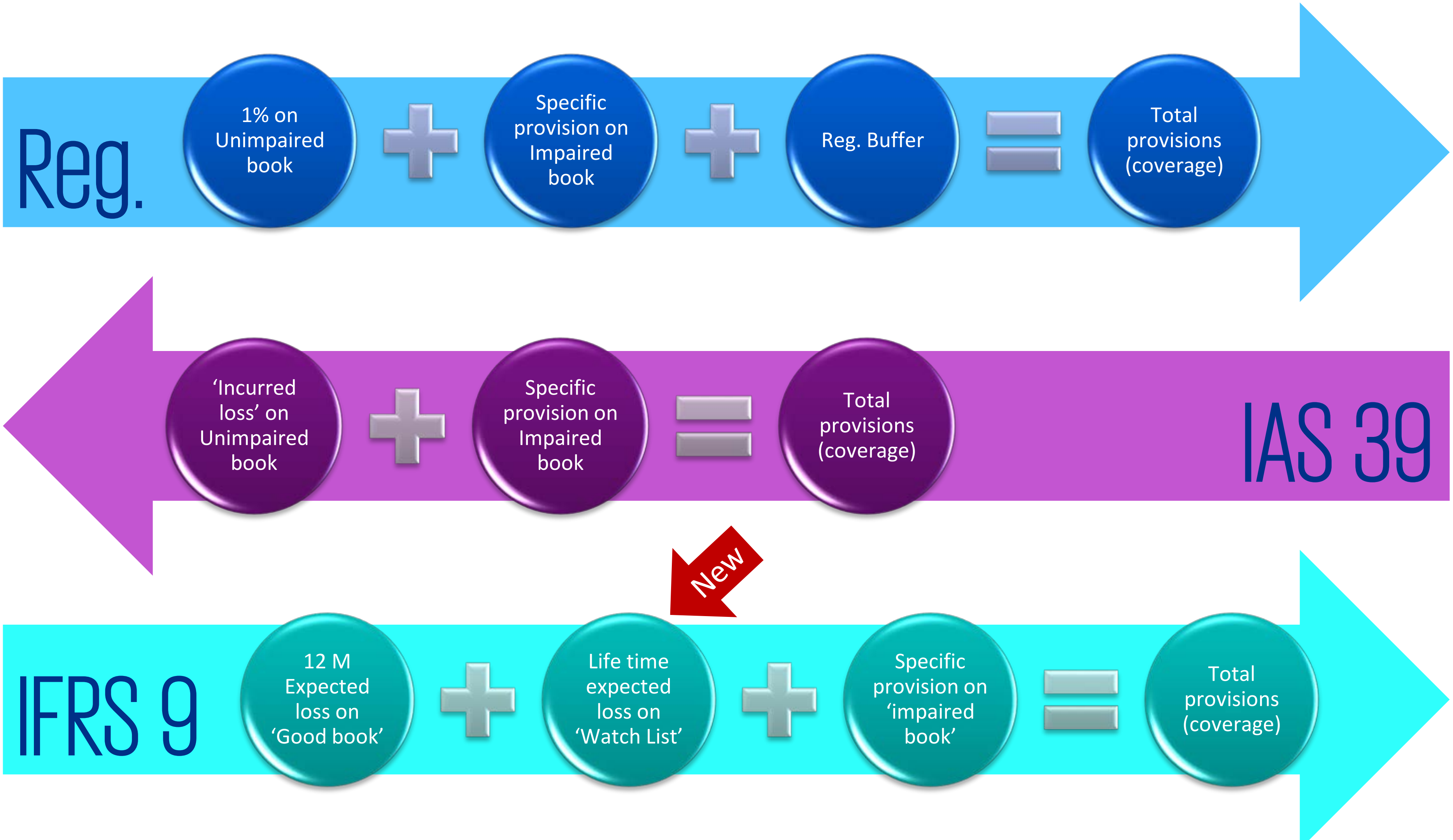
Amounts recognised in OCI are not reclassified to profit or loss on de-recognition and no impairment loss recognised in profit or loss.

Key differences between IFRS 9 and FAS 25

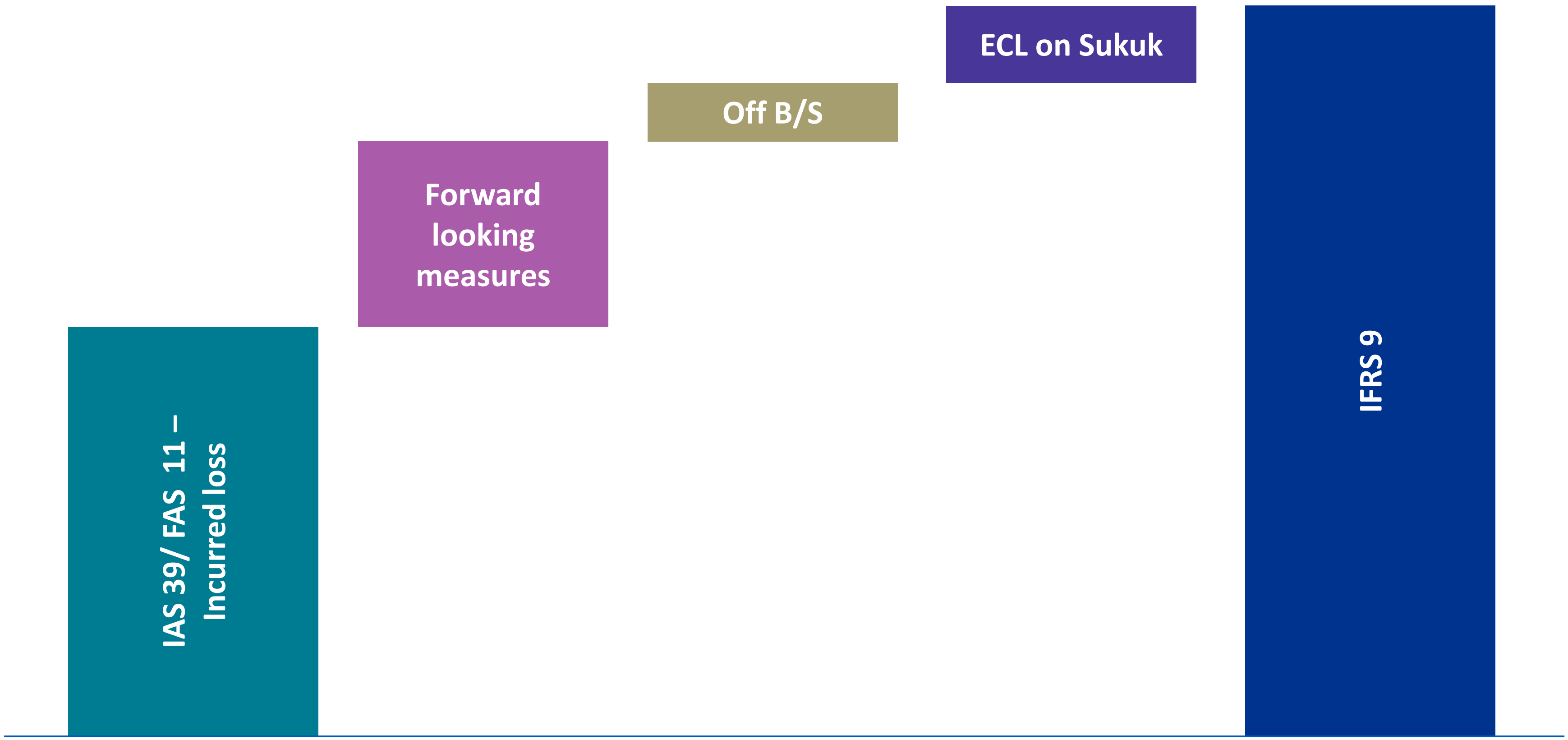
	IFRS 9	FAS 25
Scope	All financial assets and liabilities	Debt type and Equity type investment assets
Measurement categories	Fair value or AC	Fair value or AC Cost less impairment for some unquoted equity.
Criteria for classification of financial assets (debt type)	Debt: Business Model, SPPI test	Debt: Yield basis or otherwise
Criteria for classification of financial assets (equity type)	Irrevocable election at inception as FVOCI	FV through equity is permissible with recycling on sale/ disposal
Recycling of gains on sale	No recycle for equity. Yes – for debt	AAOIFI does not have OCI. Recycle for both debt and equity permissible.
Impairment guidance on FVOCI equity assets	Not Applicable	Significant or prolonged
Guidance on impairment assessment of financial assets measured at amortised cost (expected credit loss)	✔	✘

Expected Credit Losses

Current provision models - snapshot



IFRS 9 ECL Model in a nut shell



3 Stages of portfolio categorization under IFRS 9

	Stage 1	Stage 2	Stage 3
Definition	Upon credit origination, with no significant deterioration in credit quality	If credit risk increases significantly after origination & resulting credit quality is not considered low credit risk	Credit impairment or incurred loss has occurred - Similar to IAS 39 impairment model
Similar to	Performing Loans	'Underperforming' loans but not yet impaired (WATCH LIST)	'Nonperforming' and current incurred loss model under IAS 39
Provide for	12 month Expected Loss	Lifetime Expected Loss	Lifetime Expected Loss
Assessed as	Collective Provisioning	Collective Provisioning	Specific Provisioning

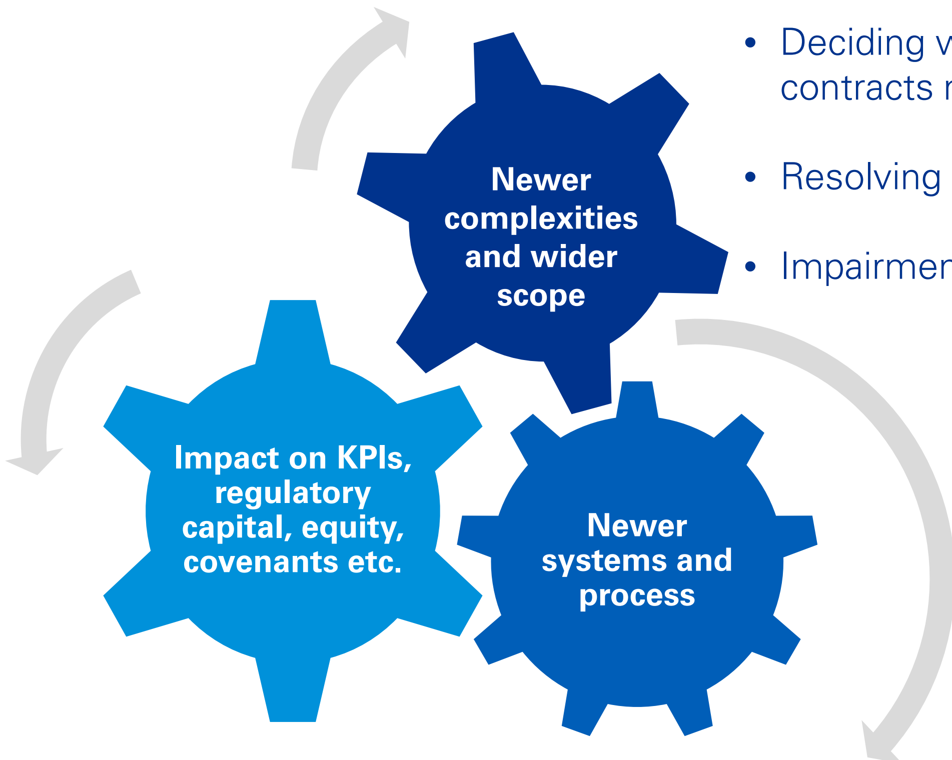
Cost less impairment (FAS 25) vs Fair Value (IFRS 13)

Variable	Impairment test	Fair value as per IFRS 13
Cash flow projections	Highest and best use as per stated investor plans and exit at favorable conditions	Highest and best use as per perspective of market participant and current market conditions
Expected term of exit	Based on current arrangements and short term positive views	Longer and based on highest IRR value to investor
Risk adjustments / perception	Intrinsic and long tail view – reflects strategic association with the asset and management confidence	Market perception, typically higher and short turnaround view of an incoming investor, factors current illiquidity and economic risk perceptions
Expected return	Low to medium, and based on best value in use for bank and its investors	High, based on risk perception of an incoming investor
Final evaluation	Highest strategic value for bank and investors	Current market value on balance sheet date with adjustments for uncertainties as on that date. Typically the view of an opportunistic market investor

Key differences: FAS 11 and IFRS 9

Incurred loss vs Expected loss	▪ FAS 11 (similar to IAS 39) only permits recognition of "incurred losses" ▪ IFRS 9 requires recognition of expected losses
Scope and coverage	▪ FAS 11 does not cover all asset types (eg. separate guidance will be required for Ijara/ IMB receivables, Musharaka receivables etc) ▪ Guidance on collective vs specific provision should be clarified (especially considering nature of URIA funded portfolios)
Measure of loss	▪ IFRS 9 requires a measure of loss which distinguishes between 12 month and Life Time provisions. Also this is expected to be a discounted measure. ▪ AAOIFI currently does not define nor does it differentiate a measurement of loss allowances in different categories

Impact of IFRS 9 on Islamic Financial Institutions

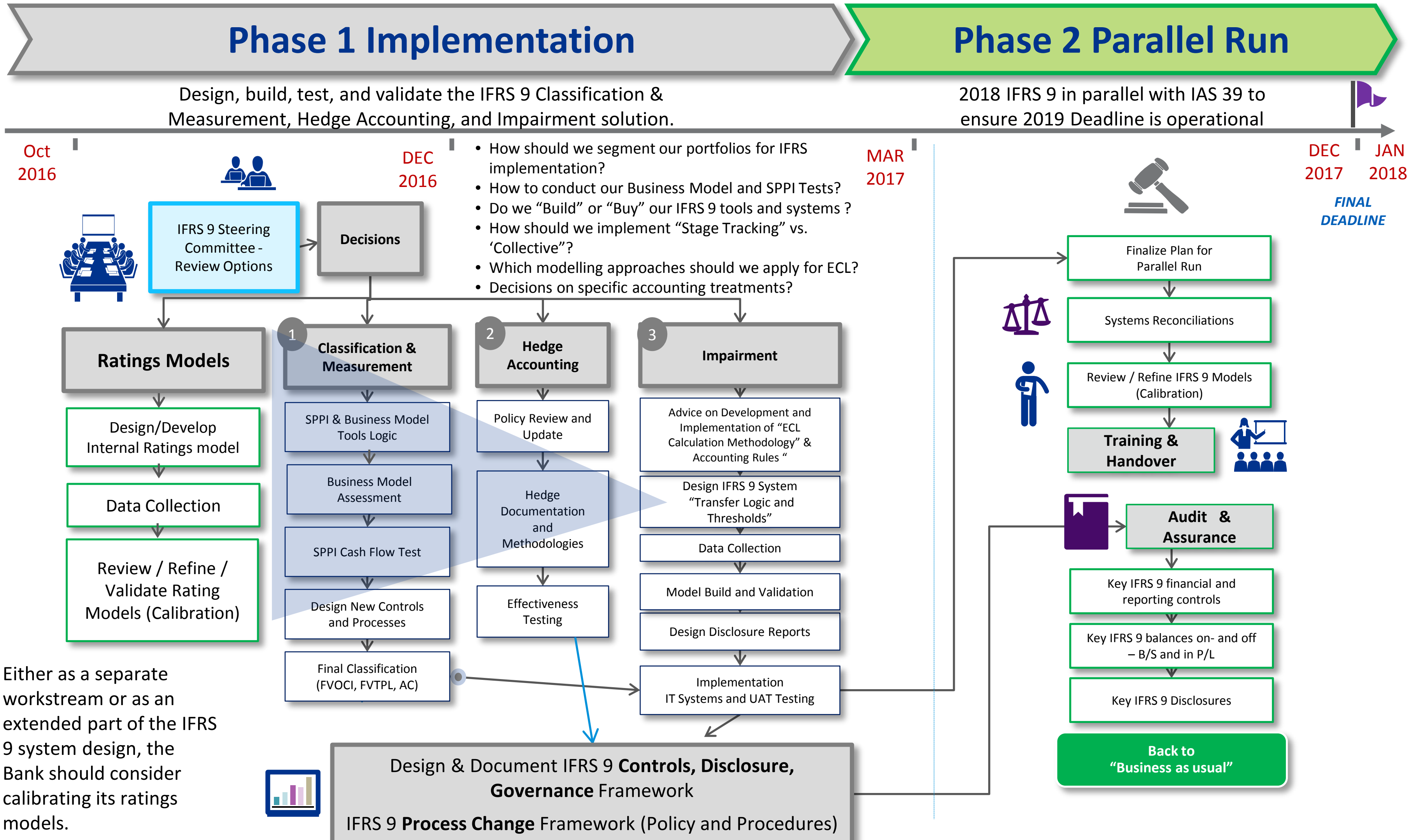


- Implementation of business model approach
- Deciding whether Islamic finance contracts meet the requirements of SPPI
- Resolving conflicts with shari'a principles
- Impairment assessment

- Classification of financial assets might affect capital resources
- P&L volatility
- Key performance indicators to be revised

- New process and system to consider allocation to appropriate category
- Expanded data requirements and calculations

The IFRS 9 Road Map



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