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# REQUIREMENTS FOR THE CLASSIFICATION OF EXPOSURES IN BANKS AND THE APPLICABLE ACCOUNTING FRAMEWORK IN THE LIGHT OF IFRS 9

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**Abstract:** The report focuses on changes to the adoption and application of IFRS 9 in banking. The approach to determining allowances for impairment of credit and other exposures, the factors for significant credit risk increase as well as the modeling capabilities of the processes are considered.
**Keywords:**classification of exposures; bank's business model; measurement of financial assets; cash flows on loans; probability of default; loss given default

The Brief History of the Implementation of IFRS 9 /The International Accounting Standards Board (IASB) published the final version of IFRS 9 "Financial Instruments" on July 24, 2014, with the standard coming into effect on 01/01/2018/, the first studies on the financial crisis were made in 2008. In November 2009, the first phase related to the classification and measurement of financial assets was issued, and in 2010-2011, the Council adopted structural changes to IFRS 9 and postponed its adoption. In November 2013, a chapter on "Hedging" was added and only in 2014 was the final version released. In addition to the text of the Standard and its Annex B – Guidelines for Application (AG), other accompanying documents have been developed in the application of IFRS 9: Basis for Conclusions (BC), Implementation guidance-IG, BIS Guideline on Accounting for Expected Credit Losses, Local Regulations, Potential changes and clarifications on specific topics are expected by the end of 2017. By Commission Regulation (EU) 2016/2067 of 22 November 2016, Regulation (EC) No 1126/2008 was amended in accordance with Regulation (EC) No 1606/2002 of the European Parliament and of the Council the European Parliament.

The introduction of the new IFRS 9 requires significant changes in a number of parameters from the banking information systems and implies the implementation of the regulatory requirements for the classification of exposures and the requirements of the applicable accounting framework as regards the calculation of impairment provisions.

The review of the current IAS 39 and the new IFRS 9 allows to mark some major differences between them, namely:

– They do not cover the scope (there are only minor additions);

– There is also no significant difference with regard to recognition and derecognition, except for the fact that banks have to pay attention to write-off requirements insofar as they have a material effect under IFRS 9;

– Regarding the classification and measurement of financial assets, a new rating and rating model based on the bank's business model (portfolio level) and the characteristics of the contractual cash flows of the financial asset is required;

– There are no changes in the classification and measurement of financial liabilities. New requirements are required to account for changes in the fair value of an entity's own debt;

– With regard to embedded derivatives, the presence of an embedded derivative should be assessed in hybrid contracts where the underlying contract is a financial liability or an asset that is not covered by IFRS 9;

– With respect to impairments, significant changes are required to model expected loss;

– When reporting hedging, the new model approaches hedge accounting to risk management. An accounting policy choice is required to apply the model in IAS 39 in its entirety or fair value accounting in applying IFRS 9.

The major changes imposed by the new standard are related to the classification and measurement of financial assets and liabilities in accordance with the business model adopted by the respective bank; the measurement and accounting of expected credit losses and credit impairment depending on the degree of credit risk; hedging and accounting for hedged exposures.

The approach to classifying and evaluating financial assets requires establishing business models at the portfolio level, selecting a valuation option (if not available), setting the cash flow characteristics (SPPI test) at the asset level.

When choosing a business model, a distinction is made between whether the financial instruments are held for the purpose of collecting contractual cash flows or whether they are held for the purpose of collecting contractual cash flows and selling.

Depending on this, the rating category is determined – in the first case, the category is at amortized cost and in the second - at fair value in other comprehensive income. In both cases, cash flows represent only principal and interest payments. The new point in IFRS 9 is that certain modifications of the relationship between principal and interest are permissible. Assets held for the purpose of collecting the contractual cash flows at amortized cost have an option to report at fair value through profit or loss (in the case of accounting discrepancies). In the case of assets held for the purpose of collecting the contractual cash flows and sales reported in other comprehensive income, the new point is that a fair value option at fair value through profit or loss has also been given (in case of accounting inconsistencies).

There are also two options for accounting for financial assets – the first option requires a Fair Value Business Test – IFRS 9 Accounting Disparities, such as debt instruments meeting amortized cost reporting requirements or FVTOCI. In the second option, reporting is at fair value in the other comprehensive income that is valid for equity instruments, but the option option is irreversible. The requirement is that the assets are not held for trading purposes and that they are not contingent assets recognized by the acquirer in business combinations when IFRS 3 is applied.

The current IAS 27 model recognizes assets at cost as well as IAS 39 AFS (at cost). The new model is again reported under IAS 27 at cost, but under IFRS 9 – FVTPL or FVOCI (option). If the entity has measured at cost (in accordance with IAS 39), investments in equity instruments that are not tradable in an active market or in similar instruments, it shall measure those instruments at fair value at the date of initial application. Any differences between the fair value and the fair value should be recognized in retained earnings (or, if appropriate, in other equity) in the reporting period, including the date of initial application.

A very important point in connection with the application of the new standard is the need for the bank to determine the business models for securities management. In general, two basic business models are perceived:

- A model of a securities held for the purpose of collecting the contractual cash flows / in this model the securities are reported at amortized cost, with a fair value option in profit or loss (in the case of accounting discrepancies);
- Business model for securities held for the purpose of collecting the contractual cash flows and selling / in this business model the securities are reported at fair value in other comprehensive income, with a fair value option in profit or loss (in the case of accounting discrepancies ), which is a new moment.
- So eg. securities held for collection and sale purposes (fair value in other comprehensive income) contribute to the achievement of the business model by collecting contractual cash flows and sales; providing more frequent and bulk sales while at the same time achieving liquidity targets as well as managing yields, managing assets / liabilities.
- Other business modeling strategies that allow reporting of a securities at fair value through profit or loss may be adopted.

If a bank has chosen to measure an equity investment at fair value in other comprehensive income, as permitted by paragraphs 5.7.5 of IFRS 9, it shall disclose: • which equity investments are measured at fair value in the other comprehensive income; • the reasons for this choice; • the fair value of each such investment at the end of the reporting period; • Dividends recognized during the period, separately for investments derecognised during the period, and for investments held at the end of the reporting period, • Any accruals of accumulated equity gains or losses and the justification for them.

As regards the business model for loans, IFRS 9 also requires an analysis of the business model used to realize cash flows on loans. This business model should reflect both the intention of the management as well as past practice and future actions. After analyzing the business model for credit management, it is necessary to set limits and reasons for future sales of loans.

At a later stage, it is important to make a factual assessment based on how assets are managed. The assessment is not based on intentions regarding individual assets. It is subject to direct observation based on the Bank's standard activities; the key being in the way cash flows are realized.

At the asset level, it is necessary to establish the cash flow characteristics (SPPI test). It is important to note that under IAS 39 the classification and measurement were determined at the level of a separate instrument.

An important point in relation to the reporting and impairment of credit exposures is the determination of the impairment indicators. The most important of these can be grouped around the following information:

- External rating showing default or impending / credit quality step 6 under Regulation (EU) 575/2013);
- The debtor is classified in default in accordance with the bank's default policy;
- Significant overdue liabilities to public creditors or employees;
- Significant decrease in the value of the collateral in cases where the sale of the funded asset is required to repay the loan (eg commercial real estate);
- Overdue over 90 days of any credit at debtor level (subject of threshold / materiality criterion);
- Breach of agreed terms / conditions from which the bank has not given up;
- The debtor's exposures are defined as "non-performing exposures" in accordance with the policy adopted to determine the bank's restructured and non-performing exposures;
- Likelihood of insolvency - there are clear indications that the debtor should be declared insolvent or subject to another financial rehabilitation;
- Receivable, reflected as a balance sheet item, is the subject of court proceedings or is awarded to the bank but not collected;
- The debtor has requested extra funding from the bank due to financial difficulties;
- Another bank has declared a loan for early payment;
- A collateral implementation procedure has started;
- Credit event announced by the International Swaps and Derivatives Association;
- A legal entity within the group of connected clients of the debtor (including the debtor's subsidiaries) has filed an application for bankruptcy;
- Bond trading (temporarily) has been suspended on the main market due to rumors or facts of financial difficulty;
- Extinction of an active market for the funded asset due to financial difficulties;
- 5 year credit default swaps (CDS) were over 1000 bps. within the last 12 months;
- Capital has been reduced by 50% during the reporting period due to losses;
- Significant decrease of over 50% in turnover or loss of main client;
- Significant drop of more than 50% in expected future cash flows;
- The debt servicing ratio is below 1.1
- Negative EBITDA in 2 consecutive years;
- EBITDA reduction of more than 50% in one year;
- Negative capital;
- Activity generating losses over the past 2 years.

In connection with the improvement of the information security, a number of new input parameters are introduced which will be used in the model for calculating the amount of impairment:

**PD** – Probability of default. Assigned to the borrower / product.

**LGDuncovered** – Loss given default (on non-performing part of the exposure). Assigned to credit product level.

**CCF** – current cash flow (degree of off-balance-sheet utilization at the time of default). Assigned to credit product level. It is applicable only to off-balance sheet commitments and is used to off-balance-sheet commitments as of the balance sheet date at the time of default. Expresses the ratio of the portion of the current undrawn amount of commitment that could be utilized and be due to the outstanding debt at the time of default to the total uncommitted amount of the engagement.

Effective interest rate **(IRR)** – interest rate of return (an existing calculation algorithm

Collateral) - As regards collateral in the information system, the following two new input parameters are added to the types of collateral:

- Term of realization in number of months;
- Expenses for realization - percentage value of the market valuation of the collateral.

Both parameters as values are assigned by collateral types at collateral level, which should be able to be changed upon entering or changing collateral at transaction level. The parameters are used to calculate the present value of the expected cash flows from the realization of the collateral (using the effective interest rate of the respective exposure).

Parameters PD, LGDuncovered and CCF have a percentage value and are allowed to change their values. Initial entries and subsequent changes to their values should be kept as a story.

The next phase in the development of the model is the definition of phases of credit exposures in accordance with IFRS 9.

For this purpose, a new classification is introduced to determine the credit risk stage at the credit level that is relevant to the asset classification in accordance with IFRS 9 and the determination of the amount of impairment.

**Phases**

Phase 1 – No significant increase in credit risk relative to initial recognition

Phase 2 – Significantly increased credit risk against initial recognition

Phase 3 – Impaired credit exposures

The phases are determined on the basis of an indicative Classification Matrix according to the criteria for the delay of amounts due, restructuring data and the current information on the degree of credit risk:

A new term “Credit risk” is introduced, which basically takes into account the change in credit risk at the client level. The degree of credit risk is determined by the client’s analysis, which is documented on paper and results in one of three values:

• “No significant increase in credit risk”

•”Significant increase in credit risk”

• “Impaired Credit Exposures”

Restructuring flag - A loan to which restructuring measures have been applied is marked as a restructured loan (LOSS NEW MARKER / FLAG) for a period from the date of the last restructuring to the repayment of six successive installments (reported after the restructuring) for which it is not overdue exceeding 30 days. Following the fulfillment of this condition (the NEW MARKER / FLAGS) and the credit is considered a non-restructured credit for the purpose of classification under IFRS 9. Important for the purposes of providing information on the process is to maintain a record of the restructurings, which may contain all the annexed credit exposures and to be charged daily. The Registry will also make it possible to use at a later stage the regulatory classification of non-performing exposures, which sets different test deadlines.

The credit exposure classification process includes debt processing, restructuring data, and current credit risk information. A loan to which restructuring measures have been applied is marked as a restructured loan (LOSS NEW MARKER / FLAG) for a period from the date of the last restructuring to the repayment of six successive installments (post-restructuring) for which past due over 30 days. After the fulfillment of this condition (THE NEW MARKER / FLAG PASS) and the loan is considered unstructured for the purpose of classification under IFRS 9. In the case of restructuring, the loan is classified as follows:

1) if, at the date of the restructuring, the loan was in Phase 3, it remains in Phase 3;

2) if, at the date of the restructuring, the loan was in Phase 2, it remains in Phase 2;

3) if, at the date of the restructuring, the loan was in Phase 1, it is classified in Phase 2.

The application of restructuring measures has an impact on the classification of exposures, depending on the stage of their application and their nature, as shown in the figure below:

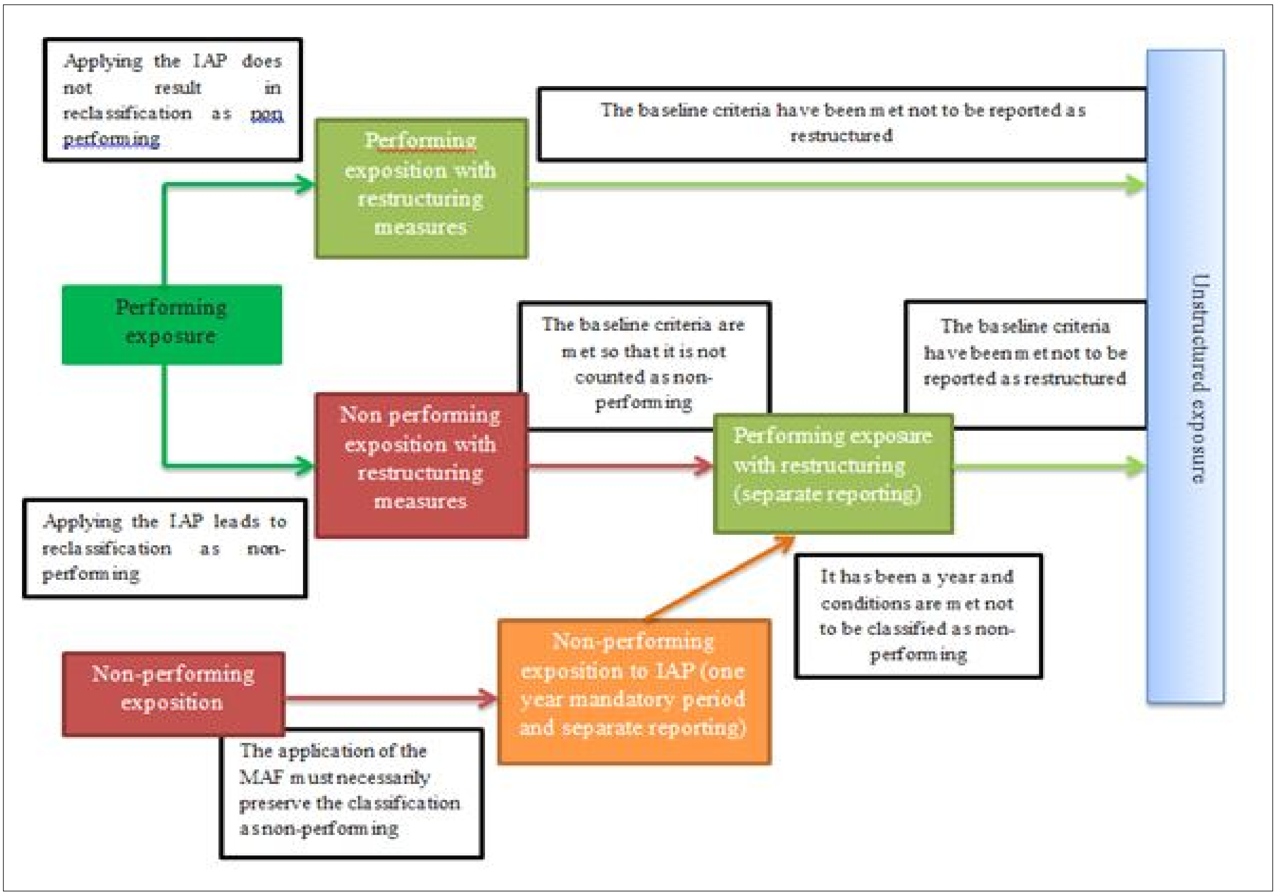


**Fig. 1** Application of restructuring measures

The introduction of the new IFRS 9 also requires changes in the conversion parametersin the "Classification and Impairment" (KO) technology to the banking information system (BIS). The changes are related to the introduction into the BIS of the regulatory requirements for classification of the exposures as well as the requirements of the applicable accounting framework with respect to the calculation of allowances for impairment.

The main objectives of the required changes to the "Classification and Impairment" technology are compliance with the requirements of the regulatory and applicable accounting framework as well as of the recommendations of the asset quality review report for:

- Applying the regulatory requirements for the classification of exposures;
- Applying quantitative indicators and thresholds as indicators for impairment;
- Implementation of collective impairment, incl. and for exposures less than 30 days past due.

"Classification and impairment" technology should be able to classify exposures to calculate allowances for impairment under the Exposure Classification Algorithmsand for the calculation of provisions for impairment.

## RECLASSIFICATION IFRS 9

The reclassification procedure for credit exposures includes the processing of liabilities, restructuring data and current credit risk information. Reclassification can be done in the following way:

1) Current Phase 2 credit

2) A credit with a current Phase 2 is reclassified to a lower Phase 1 (2- > 1) when executed the following conditions:

• All overdue credit obligations are repaid in full;

• There is no active flag for restructuring, ie. in cases of restructuring are6 consecutive repayment installments (reported after the restructuring) for 6 months which is not allowed over past 30 days. / no restructuring measures imposed

The current credit risk of the client is: “No significant increase in credit risk”.

3) Current Stage 3 credit;

A current Phase 3 credit is reclassified to Phase 1 (3-> 1) when executed the following conditions:

• All overdue credit obligations are repaid in full;

• Following the clearing of all arrears, three more consecutive debts are settledrepayment installments for which overdue payments of over 30 days are not allowed;

• There is no active flag for restructuring, ie. in cases of restructuring are6 consecutive installments (reported after the restructuring) are repaid, for which overdue payments of over 30 days are not allowed;

• The current credit risk of the client is: “No significant increase in creditrisk “

## IMPAIRMENT

1. Required parameters for calculating the amount of impairment

- PD
- LGDuncovered;
- CCF – applicable to off-balance sheet commitments
- Effective interest rate (IRR) – an existing calculation algorithm

## DETERMINATION OF PD, LGDUNCOVERED AND CCF PARAMETERS

The values of PD, LGDuncovered and CCF are determined on the basis of historical data and expected changes in macroeconomic indicators. They are calculated out of the system as their values are updated once a year, or more frequently, under circumstances that require themchange.

For each cash flow date, calculate: PDi for the relevant period (day, month, etc.);discount factor; estimated amortized exposure value at the default date;engagement size.

Due to the different accounting treatments, a separate impairment loss is to be calculated for balance sheet liability and provision for off-balance sheet liability (reported in other liabilities).

Present value of expected cash flows from collateral realization (LV): discounted collateral values are calculated by discounting the market value of collateral with their realization expense (% of prudent valuation) and discounted with the IRR of the loan (converted to monthly IRR) for the period =term for realization of the respective type of collateral (in months).

1) The amount of the provision / impairment:

The amount of impairment for a particular period is calculated as follows:

Expected credit loss for the period between two dates =(MAX ((EAD – LV), 0)) * PDi for the period * discount factor * LGL_uncovered

(1) If the credit is in phase1 ==>, all current expected values are summed credit losses up to one year from the reporting date;

(2) If the credit is in Phase2 ==>, all current expected values are summed credit losses over the entire credit period.

(3) If the credit is in Phase3 ==> the expected credit loss at the current momentis calculated as follows:

(MAX ((EAD – LV), 0)) * 100% * LGL_uncovered.

### REFERENCES

1. Commission Regulation (EC) No 2016/2067 of 22 November 2016 for The amending Regulation (EC) No 1126/2008 Adopting Certain International Accounting Standards In Accordance With Regulation (EC) No 1606/2002 of the European Parliament and of the Council on International Financial Reporting Standard 9

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