Implementation of IFRS 9 *Financial Instruments*

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Content

1 Overview

2 IFRS 9 implementation approach

3 Preliminary key differences between IFRS 9 and the Exposure Drafts proposed by Bacen

4 Key challenges & issues

COMITÊ DE PRONUNCIAMENTOS CONTÁBEIS

1. Overview

Overview

Overall requirements for banks in Brazil:

- Banks in Brazil are required to prepare their financial statements in accordance with a regulatory accounting framework issued by Brazilian Central Bank (Bacen);

- Bacen endorses some accounting standards issued by CPC (equivalents to IFRS) as part of its accounting framework. CPC 48 (equivalent to IFRS 9) will not be endorsed (see topic 3);

- Banks with audit committee are required to present annual consolidated financial statements prepared in accordance with IFRS as issued by IASB (audit committee is required for banks with equity higher than BRL 1 billion, approximately USD 250 million);

- Financial statements prepared in accordance with IFRS as issued by IASB are considered supplemental information;

Overview

Bacen is proposing the following exposure drafts as part of its regulatory accounting framework:

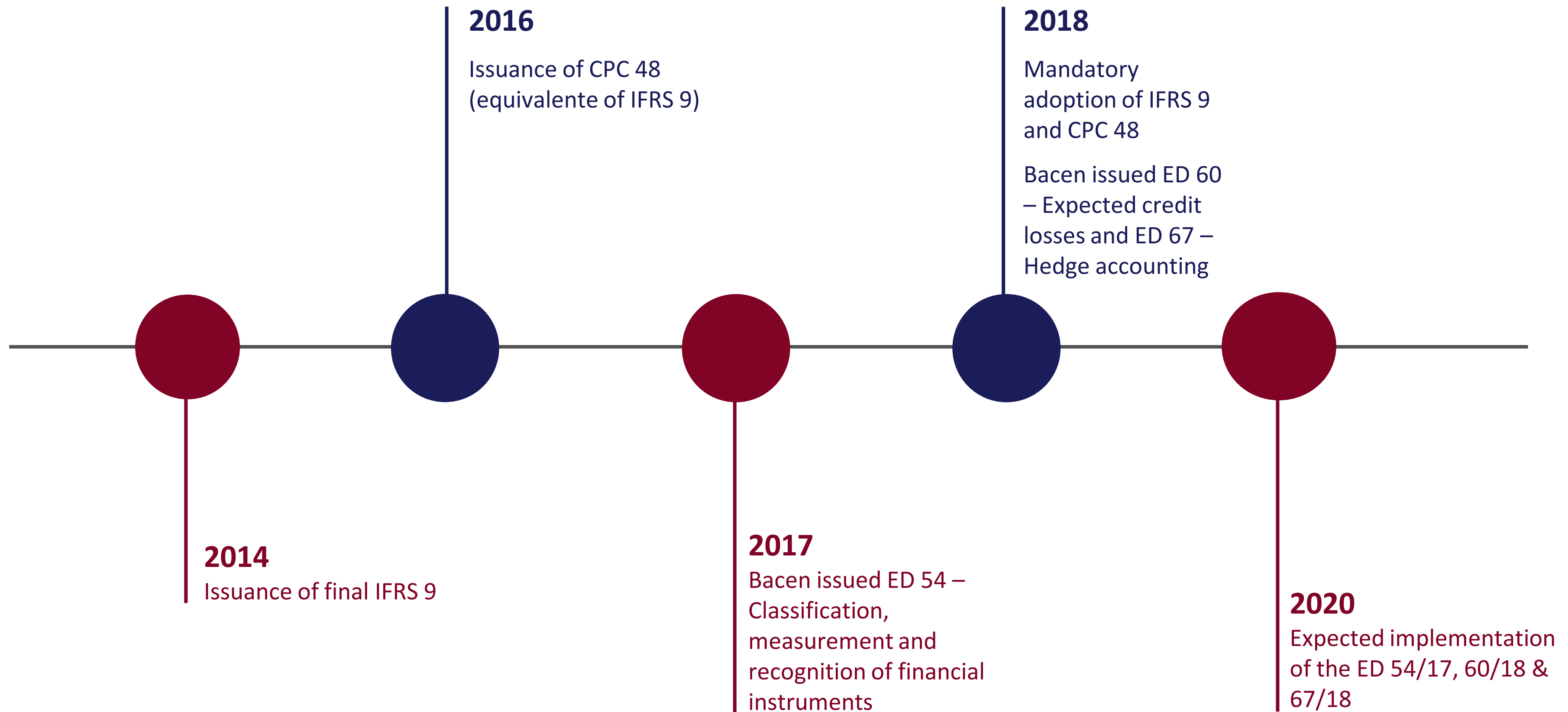
- Exposure Draft 54/2017 – Classification, measurement and recognition of financial instruments
- Exposure Draft 60/2018 – Expected credit losses
- Exposure Draft 67/2018 – Hedge accounting

The adoption is mandatory for periods beginning in 1st January 2020.

This presentation was prepared based on the Exposure Drafts ("ED") published by Bacen for comments, therefore, the final standards are subject to modification or the ED are subject to be not issued. Also, this presentation does not reflect the view of Brazilian Government or Brazilian regulators (Monetary Policy Committee and Bacen).

2. IFRS 9 Implementation Approach

Convergence to IFRS 9 in Brazil



3. Preliminary key differences between IFRS 9 and the EDs proposed by Bacen

Preliminary key differences between IFRS 9 and the EDs proposed by Bacen

ED 54/2017 and ED 60/2018

1. Fair Value Option is permitted only for financial assets;
2. "Stop accruing" interest of any financial assets in which there is no repayment in the last 90 days or less in case the of objective evidence that the contractual cash flow obligations will not be fulfilled;
3. Hybrid contracts for financial liabilities - must be analyzed as a single instrument and measured at FVTPL;
4. Business model can only be changed every semester and must be approved by the Board of Directors;
5. Expected Credit Losses – prescriptive guidance with minimum pre-determined percentages by credit rating and aging to recognize the expected credit losses;
6. Initial application for periods beginning on 1st January 2020 (expected);

IFRS 9

1. Fair Value Option is permitted for financial assets and liabilities;
2. "Stop accruing" is not applicable;
3. Hybrid contracts for financial liabilities – the embedded derivative may require to be separated from its host;
4. Business model can be changed at the first day of the first reporting period following the change in business model that results in an entity reclassifying financial assets;
5. Expected Credit Losses – recognized based on the entity´s judgment;
6. Initial application for periods beginning on 1st January 2018;

Preliminary key differences between IFRS 9 and the EDs proposed by Bacen

ED 54/2017 and ED 60/2018

7. Expected Credit Losses

   a) Trigger to Stage 2 – rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due is not permitted and mandatory ratting downgrade

   b) Trigger to Stage 3 – for all non-performing assets*

8. Write-off – Bacen provided a prescriptive guidance based on the aging at default with a minimum provision for stage 3;

9. Renegotiation – renegotiation of financial instruments written-off will follow the Bacen's prescriptive guidance, must be threated as non-performing and classified at Stage 3 with 100% loss allowance;

10. Credit Risk Deterioration - All individual financial instruments provided to the same customer are affected by the evidence of any credit-impaired operation.

IFRS 9

7. Expected Credit Losses

   a) Trigger to Stage 2 – more 30 days overdue with rebuttable presumption is permitted and there is no mandatory ratting downgrade;

   b) Trigger to Stage 3 – more than 90 days overdue and subjective analysis;

8. Write-off – based on no reasonable prospects of recovering any further cash flows from the financial asset (Loss Given Default);

9. Renegotiation – is classified based on judgment which may be classified at Stage 2 or Stage 3;

10. Credit Risk Deterioration - Credit risk assessed on a customer basis which has previously been assessed to have increased significantly, does not result necessarily in lifetime Expected Credit Losses being recognized on all individual financial instruments provided to the same customer.

* Overdue > 90 days or qualitative analysis.

Preliminary key differences between IFRS 9 and the EDs proposed by Bacen

ED 67/2018

1. Effectiveness assessment – Monthly basis;
2. Consolidated financial statements – Hedge accounting is allowed only if the hedge is applied in the standalone financial statements whose protected risk has effectively been transferred to the external counterparty of the group;
3. Conversion - Mandatory conversion to the new rule will not allow to maintain the previous requirements equivalent to IAS 39. The macro hedge adoption is not considered, which could lead banks to exclude relevant transactions;
4. Effective date - 1stJanuary 2020;
5. A Project plan to comply with the new requirements must be approved by the Board of Directors by Q1-2019 which should be disclosed in the 1st semester 2019*;

IFRS 9

1. Effectiveness assessment - Each reporting date or upon a significant change in the circumstances affecting the hedge;
2. Consolidated financial statements – Hedge accounting can be applied on standalone and/or consolidated financial statements;
3. Conversion - Accounting policy choice to either continue to apply IAS 39 until the macro hedging project is finalized or apply IFRS 9
4. Effective date - 1stJanuary 2018

* Bacen requires two full sets of FS under BR GAAP each year – June and December

4. Key challenges & issues

Key challenges & Issues

➢ **Bacen's additional requirements**

- Data processing capacity is a challenge, mainly due to specific requirements in recognizing the Expected Credit Losses ("ECL") resulting in additional/duplication of data to comply with IFRS and Bacen. In addition, small possibility to "tropicalize" the ECL given the prescriptive guidance based on overdue aging.
- Restructuring the Risk Management in accordance with regulator requirements;
- Management accounting – additional costs to adapt current internal reports to reflect the new requirements;
- Potential tax impacts due to Bacen's specific guidance to "Stop accruing" revenue interests in financial instruments up to 90 days overdue (actually revenue interests is recognized up to 60 days overdue).

➢ **IFRS 9 requirements**

- Business model and SPPI Test
  - High level of judgment to identify and segment the portfolios;
  - Ensure that the same rules are applied to different operations as it is recorded in several different legacy systems;
- Difficulty in obtaining historical and prospective data, specially small & medium financial institutions;
- Systems - Buy or internal development of suitable fully segregated systems for the accounting classifications, perform SPPI test and ECL calculation;
- Internal Controls: identify, develop, perform and review the new key controls (ex: inputs, processing, outputs, reconciliation to the G/L, and others);
- Training: Complex to transfer knowledge to professionals involved.

Thank You