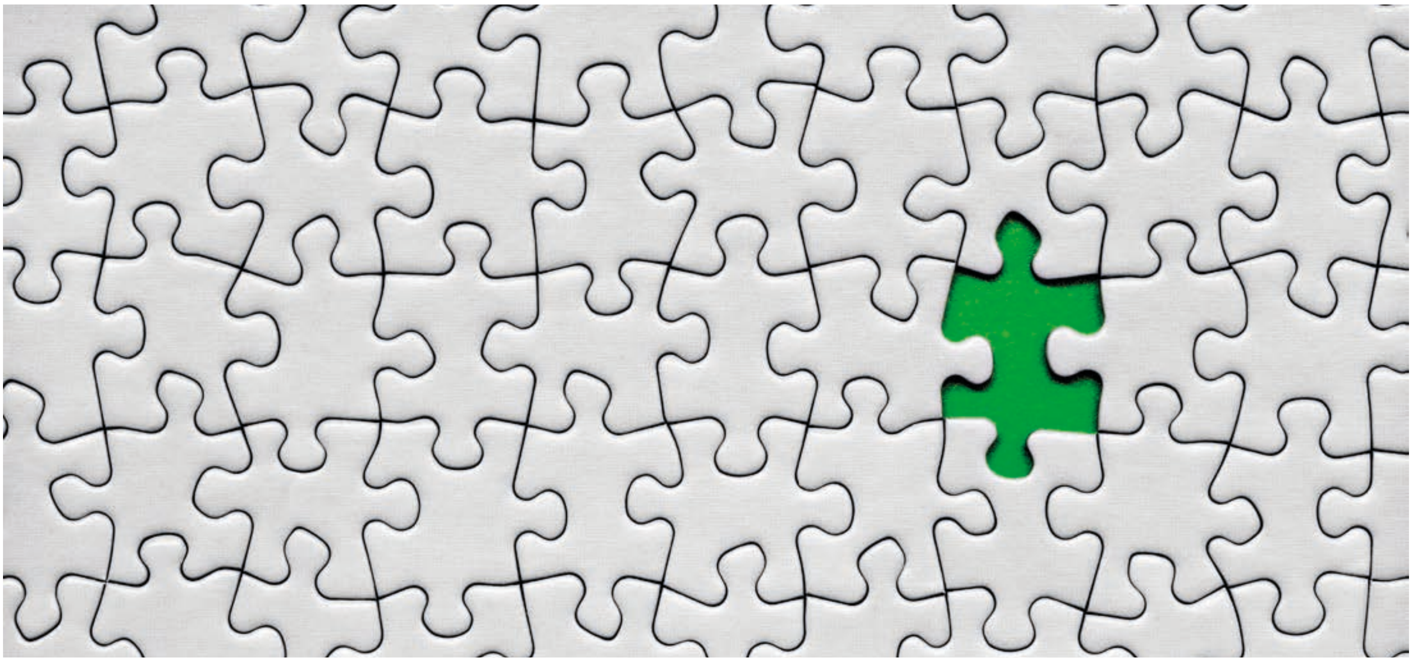

IFRS 9: the challenges for Securitisation entities

The introduction of IFRS 9: Financial Instruments will create new challenges for securitisation entities. Whilst there is a significant financial reporting impact, other stakeholders in the securitisation market need to consider the wider business challenges.

In this publication we set out some of the key considerations for securitisation market participants, specifically focusing on SPE financial reporting. The requirements of IFRS 9 will also have implications for transaction agreements and the pricing for the ongoing monitoring and financial reporting of portfolios.

It is anticipated that larger banks and originators are more likely to be currently considering the effects of IFRS 9; however, this standard and the effects will be equally applicable to smaller originators reporting under IFRS and many SPEs.

A brief overview of IFRS 9

In July 2014 the International Accounting Standards Board (the IASB) issued the final version of IFRS 9 *Financial Instruments (IFRS 9).* IFRS 9 replaces IAS 39: *Financial Instruments and Measurement (IAS 39)*. It is anticipated that IFRS 9 will have a direct, quantifiable impact on loans loss allowances thus affecting the operating margin, but also an indirect but material impact on existing operating models – most notably modelling, infrastructure and data requirements.

The mandatory effective date of the standard is 1st January 2018 (subject to EU endorsement requirements).

The new reporting requirements

The key areas of IFRS 9 accounting that are likely to have the greatest impact for securitisation participants relate to:

- the classification and measurement of financial assets;
- a new impairment model which will impact the level of provisioning; and
- significant additional financial statements disclosures.

Through this paper we highlight some of the key accounting aspects and considerations that are likely to be applicable for the various market participants involved in SPE financial reporting. Other changes, such as hedge accounting, have not been considered within this publication. For further detail on these aspects, please refer to the latest Deloitte publication, IFRS 9 Financial Instruments[1].

Classification and measurement

The classification and measurement of financial assets are dependent on the contractual cash flows of the asset and the business model within which the asset is held; this is an area where changes have been introduced by IFRS 9. Whilst there is a fair value option to fair value through profit or loss (FVTPL) that can be elected, for entities to classify and measure at amortised cost they will need to pass the following tests:

- Business model test: The financial asset is held within a business model whose objective is to hold financial assets to collect their contractual cash flows (rather than to sell the assets prior to their contractual maturity to realise changes in fair value); and
- Contractual Cash flow Characteristics test: The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal amount outstanding.

In addition to FVTPL and amortised cost measurement, there is a measurement at fair value through other comprehensive income (FVTOCI) which is required when the business model is to hold financial assets to collect their contractual cash flows and to sell – this also has the same contractual cash flow characteristics test described above. FVTPL is intended to capture trading portfolios; FVTOCI may capture portfolios where there is less frequency selling.

Impairment

IFRS 9 is expected to result in notable changes to loan loss allowances at transition. Furthermore, the potential for ongoing volatility from remeasuring the loss allowances after transition is greater than with IAS 39. This is due to the loss allowance being measured on the basis of expected credit losses, rather than incurred credit losses, so is more forward-looking and reliant on macro- and micro-economic forecasts.

With the exception of purchased or originated credit-impaired financial assets (e.g. acquired distressed debt) which have their own measurement requirements under IFRS 9, expected credit losses are required to be measured through a loss allowance at an amount equal to:

- 12-month expected credit losses (lifetime expected credit losses that result from those default events on the financial instrument that are possible within 12 months after the reporting date); or
- lifetime expected credit losses (expected credit losses that result from possible default events over the life of the financial instrument).

A key element within IFRS 9 is the term ‘significant increase’ in credit risk. A loss allowance for lifetime expected credit losses is required for a financial instrument if the credit risk on that financial instrument has increased significantly since initial recognition. IFRS 9 provides guidance on what a significant increase might be but it is the entity that will need to define and disclose what a ‘significant increase’ is, being mindful that it is a critical judgement.

The approach to calculating interest income on the financial asset will depend on whether the asset is deemed to be credit impaired. If it is credit impaired, interest income is determined based on the carrying amount net of the loss allowance. If it is not credit impaired, interest income is based on the gross carrying amount before taking into account the loss allowance. IFRS 9 provides guidance as to what is considered to be credit impaired.

1 This newsletter provides a high level summary of IFRS 9 Financial Instruments, focusing on the areas which are different from IAS 39 Financial Instruments: Recognition and Measurement. It can be seen online at http://www.iasplus.com/en-gb/publications/uk/need-to-know/need-to-know-ifrs-9-financial-instruments-high-level-summary

Financial statement disclosures
IFRS 9 amends the requirements of IFRS 7 *Financial Instruments: Disclosures,* introducing a number of new disclosures relating to classification and measurement, impairment and hedge accounting.

The classification and measurement disclosures include a requirement to analyse gains and losses resulting from the derecognition of financial assets measured at amortised cost. The credit risk disclosures will require information on credit risk management and credit risk, with significant focus on the following:

- Credit risk management practices and their relation to the recognition and measurement of expected credit losses;
- Quantitative and qualitative evaluation of the amounts in the financial statements arising from expected credit losses; and
- An entity's credit risk profile including significant credit risk concentrations.

Transition and wider considerations
The standard is to be applied retrospectively upon transition; however restatement of comparatives is not required. On the date of transition, management is required to disclose information surrounding the reconciliation of impairment allowances between IAS 39/IAS 37 and IFRS 9.

Entities need to be aware that consolidation requirements have not changed and that holders of securitisation notes will need to apply the new requirements on contractually linked instruments. These are specific classification and measurement requirements designed for investors of asset-backed notes where the classification partly depends on the degree of subordination of the notes held relative to all notes issued by the issuer.

What does this mean for securitisation market participants?
The requirements of IFRS 9 will pose challenges for those responsible for the key financial reporting decisions and judgements, data collation and monitoring, and loss allowance modelling that will support the application of IFRS 9. The entity's business model and the contractual cash flows characteristics associated with the financial instruments will be key areas of focus in applying IFRS 9 at transition and thereafter.

The business model
The business model assessment is highly judgmental and will depend on the facts, circumstances and the intentions of the entity as to how it manages its financial assets in order to generate cash flows.

Under IFRS 9 the entity's business model determines whether cash flows will result from selling the financial assets, collecting contractual cash flows or both. As with IAS 39, the determination of what the asset is in the SPE will depend on whether the asset is recognised by the SPE or continues to be recognised by the originator.

The transaction documents, such as the prospectus for a securitisation, will specify the intention with regards to the assets acquired. It will be important to ensure that transaction documents are compatible with the business model applied in practice given the assessment of the business model will drive the measurement of the assets for the buyer.

Contractual cash flows characteristics
The Contractual Cash flow Characteristics (CCC) test is more prescriptive and will depend on the specific contractual terms of financial assets. Entities will need to assess whether contractual cash flows are solely payments of principal and interest to be potentially eligible for measurement at amortised cost or FVTOCI. Judgement is needed to assess whether a payment (or non-payment) of a contractual cash flow that only arises as a result of the occurrence (or non-occurrence) of a contingent event leads to the instrument failing the contractual cash flows characteristics test. An entity should consider what risk leads to the occurrence of the contingent event and whether that risk is consistent with risks associated with a basic lending arrangement.

The contractual cash flows characteristics assessment should consider all the contractual terms of the instrument, not just those contractual cash flows that are most likely to fall due. When an asset may be prepaid, the contractual cash flow characteristics assessment requires consideration of the contractual cash flows both before and after the timing of the prepayment option, irrespective of the probability that the instrument may be repaid prior to maturity.

The preparers of issuer financial statements will need to have access to the underlying asset contractual information to determine that the contractual cash flows test is met. This information is often held by asset servicers and will need to be made readily available to the responsible parties.

De-recognition
Although the de-recognition requirements have not changed from IAS 39, determining where securitised assets lie and when the initial recognition date is will be critical for the assessment of significant deterioration in credit risk. IFRS 9 requires an assessment, at reporting dates, on whether there has been a significant increase in credit risk since initial recognition for debt instrument assets measured at amortised cost or FVTOCI.

Roles and responsibilities for assessing impairment
The monitoring, measuring and reporting requirements are more extensive when compared to IAS 39. Therefore defining and communicating these responsibilities early will help ensure a successful transition to IFRS 9. Key areas that should be considered for assessing assets for impairment include the responsibilities for:

- defining and monitoring the stage allocation of assets for determining the loss allowance;
- defining default for determining the comparison in the probability of default at initial recognition of the asset and at the reporting date;
- the assessment of significant credit deterioration;
- obtaining and maintaining data, at both origination and over the life of the financial asset, for monitoring, measurement and reporting; and
- the calculation of expected loss (probability-weighted, forward-looking and inclusive of macro- and micro-economic factors).

The ownership, and governance, of the data relating to the underlying assets and whether responsibilities have been outsourced to third parties will be factors critical to the successful discharge of the above responsibilities.

Ensuring transaction documents support the long-term retention of and access to data to support provisioning decisions will be important. The parties responsible for the financial reporting of existing securitisation structures may need to consider whether new agreements support access to such data.

The directors of issuers will need to have a mechanism in place to assess the control environment of third party service providers to be able to place reliance on data impacting impairment assumptions. Listed entities will also need to disclose the main features of the internal control and risk management systems in relation to the financial reporting process.

Modelling and data requirements
Entities will need to develop approaches that are capable of monitoring the credit risk to assess whether there has been a significant deterioration in credit risk since origination. The assessment, and therefore the data, required for IFRS 9 will need to consider past events, current conditions as well as future forecasts. This forward-looking information should be probability-weighted and should include macro and micro-economic scenarios.

This is far greater than is currently required under IAS 39 and will require the assignment of responsibility and governance within the securitisation structures. Those responsible will need to consider the following:

- The assessment for credit deterioration is performed at initial recognition and at each reporting period so there is a need to record origination data for new loans and source origination data for existing loans;
- Sourcing and incorporating macroeconomic factors and generating forward-looking scenarios will need to be done in a well governed environment and will be dependent on a sound understanding as to how future macro-economic scenarios drive the credit risk on loans;
- In order to determine a significant increase in credit risk and perform the measurement of credit losses the quality of data will be critical to complying with the requirements of the standard; and
- Enhanced disclosure requirements under IFRS 7 following the introduction of IFRS 9 may place additional burden on data capture and storage. Loss allowance data is not always retained at an instrument level given portfolio provisions will often need to be performed but will need to be obtained in the case of assets that become credit impaired. Upgrades could be required to ensure data storage supports impairment and reporting requirements.

Service providers
The above requirements will have implications for the resourcing and pricing of support services by the parties involved in maintaining asset information and for those responsible for providing financial reporting services to securitisation entities. There will also need to be an assessment of whether the approach can be replicated across similar asset classes or whether a more bespoke approach is required for certain entities.

Operating costs are often agreed at the inception of the transaction and service providers will need to consider whether the pricing of such services is consistent with the level of additional work that will be required as a result of the new standard.

It is therefore essential to start considering the effects and specific responsibilities of parties involved as soon as possible. As auditors will need to assess the proposed approach to implementing IFRS 9 against the requirements of the standard, it is advisable that discussions with auditors occur prior to the mandatory effective date of the standard.

What can Deloitte do to assist?

Given IFRS 9 creates business-wide challenges a project of this importance and size will require careful and proactive management both within the organisation and the management of the communication of the impact of IFRS 9 with stakeholders. A successful major change programme such as this will depend on a clear-cut programme management structure with well-defined roles and responsibilities. Entities will need to consider budget allocation, resourcing and a potential parallel run to ensure the challenges are met.

We have dedicated securitisation team of over 50 people at Deloitte. Within Deloitte we are aware of the significant changes and challenges entities are facing with IFRS 9 and through this team and our IFRS 9 experts, we can support your IFRS 9 conversion through:

- IFRS 9 gap assessments.
- Project management of the conversion process.
- Business impact studies.
- Design and target operating models.
- Strategic adviser roles.
- Implementation assistance.
- Accounting advice.
- Design, build or review of IFRS 9 impairment models and methodology.
- IT and data support.
- A review of the suitability of processes and controls.
- Independent review of management's proposed solutions.
- Implementation assistance.
- Template and model financial statements.

Contacts

Please contact our team for further discussions, questions or insight surrounding securitisation market participant and the effect of IFRS 9.

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