UPDATE ON FINANCIAL REPORTING for ONMICA

New Loan Loss Provisioning under IFRS 9

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Financial Reporting by MIEs: Why IFRS?

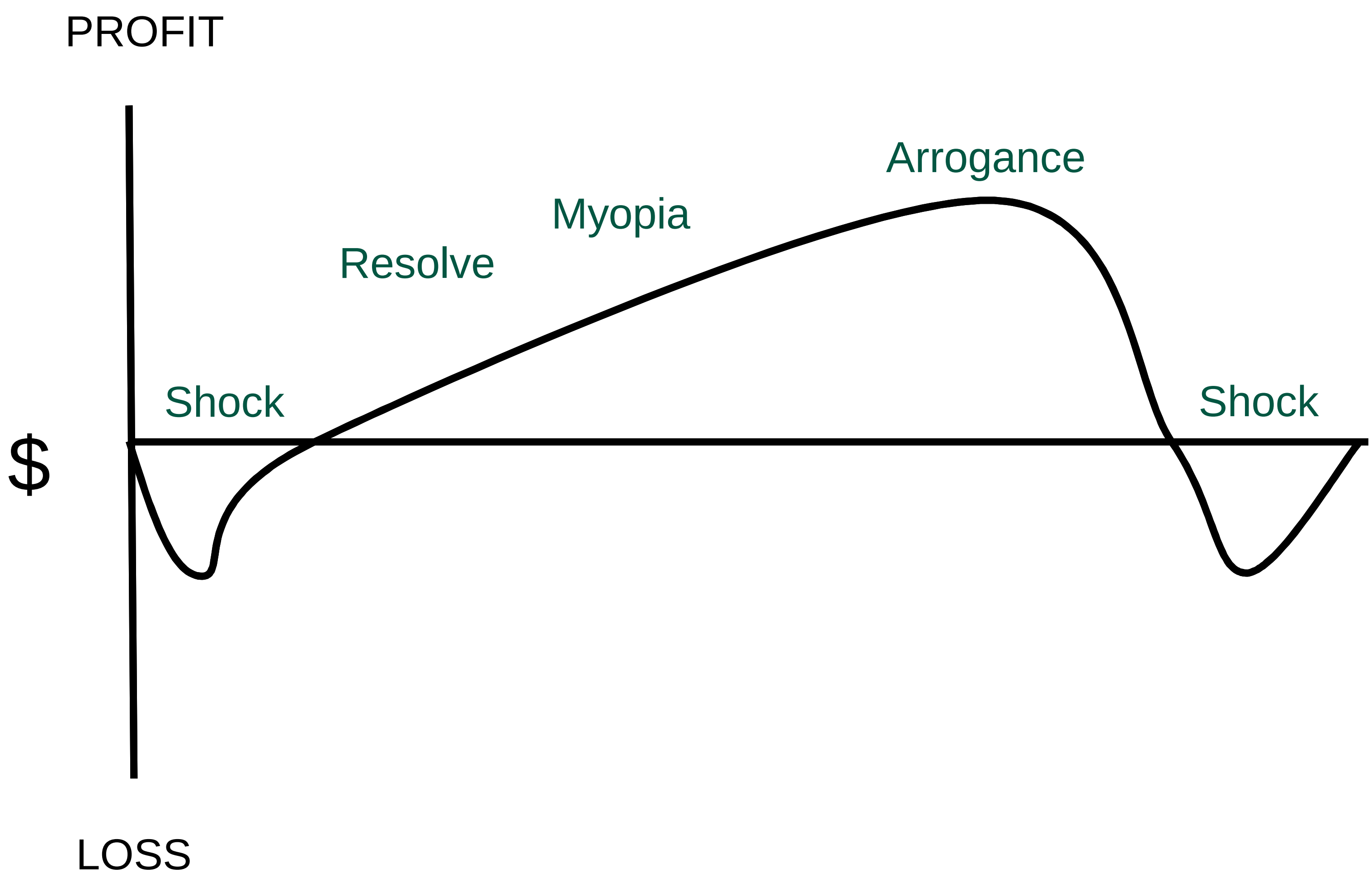
- New OM Exemption under NI 45-106 in-force January 13, 2016 in Ontario
- NI 45-106 now requires IFRS for all publicly accountable entities using the OM prospectus exemption
- MICs will need to include audited financial statements in their 2016 OMs.

Common Findings in FIs with Credit Problems

An FI's financial condition is significantly influenced by the economic well being of the markets it serves. Nevertheless, there are certain conditions that impact some FIs in those markets more than others.

- High rates of Loan Growth
- Lending to Businesses or into markets where the FI has insufficient experience
- Excessive concentrations or mismatches
- Lack of a well defined portfolio strategy, credit policy and credit process
- Lack of adequate checks and balances between lending, credit and loan review
- Insufficient training
- Aggressive sales incentives

STAGES OF A CREDIT CRISIS



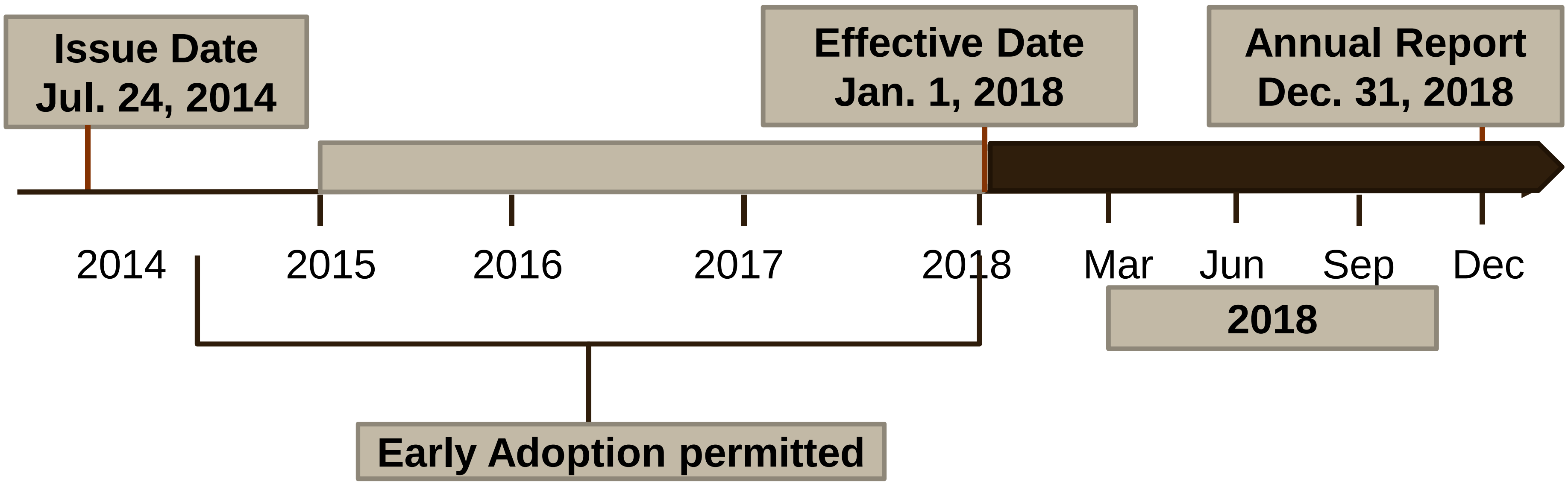
General Explanations of Systematic Credit Loss

History offers 2 general patterns of systemic credit loss:

1) Community or regional shocks
    - An FI's economic health is often a mirror image of the markets it serves
2) Disaster Myopia
    - Over the long term, growth, success, turnover, competition and a focus upon short term results sometimes erodes the resolve to maintain a strong and consistent credit culture

2008 Financial Crisis prompted the G20 to request robust accounting for loan provisions

IFRS 9 Financial Instruments
Effective Implementation Date



Classification of Financial Assets Under IFRS 9

Measurement categories:

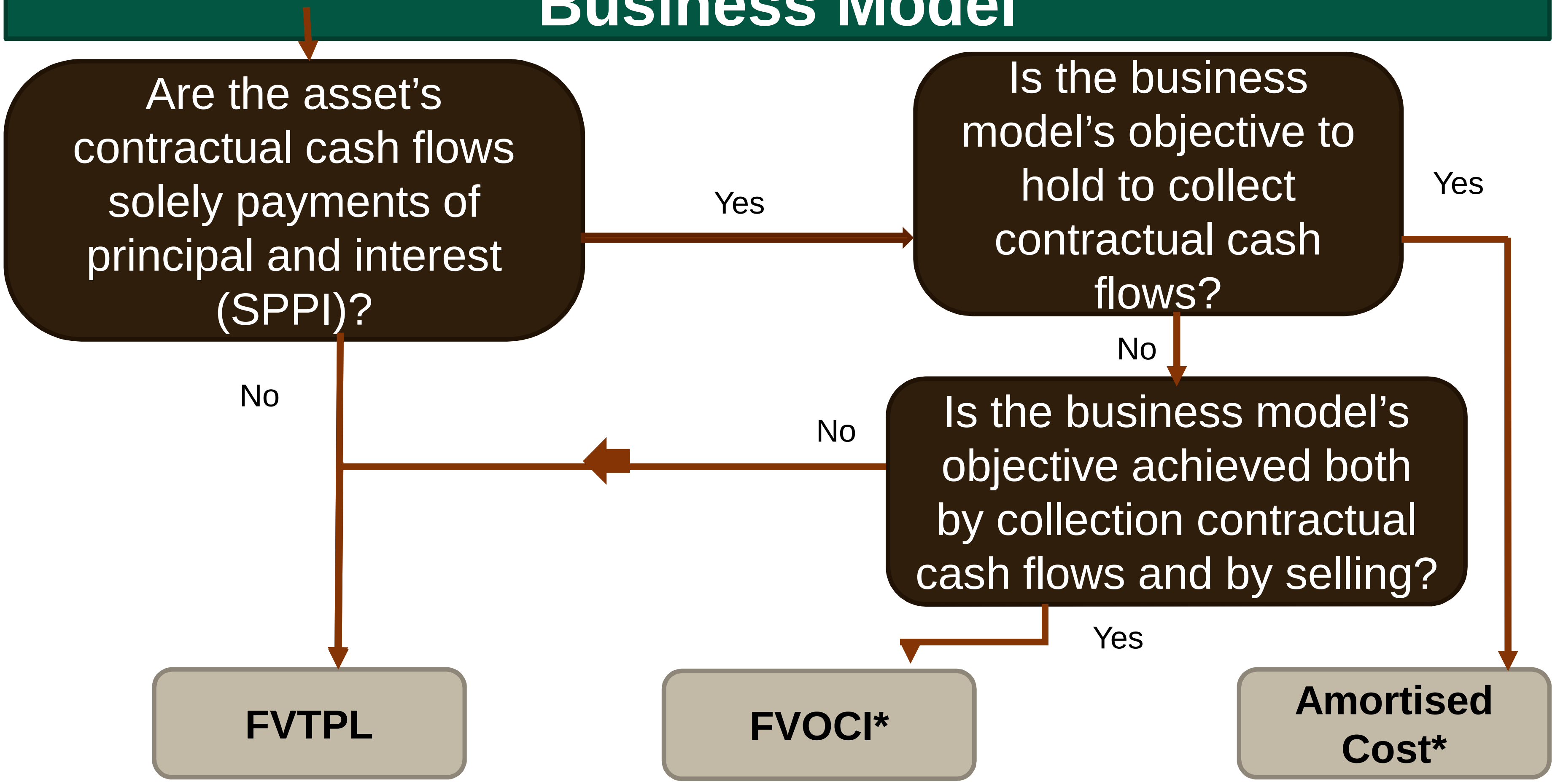
- The measurement categories are similar:

IFRS 9	IAS 39
FVTPL	FVTPL
Amortised Cost	Loans and receivables/HTM
FVOCI	AFS

Derivatives embedded in a financial asset are not separated under IFRS 9; the whole asset is assessed for classifications

Reclassification of financial assets is subject to strict conditions and expected to be very infrequent

Classification of assets is Impacted by your MIC's Business Model



Business Model Assessment

MIC Business Model	Key Features	Measurement Category
Mortgages held-to-collect	• The objective of the business model is to hold assets to collect contractual cash flows • Asset sales are incidental to the objective of the model • Typically low sales (in frequency and volume)	Amortised Cost*
Mortgages both held to collect and for sale	• Both collecting contractual cash flows and asset sales are integral to achieving the objective of the business model • Asset sales are integral to the objective of the model. Typically more sales (in frequency and volume) than held-to-collect business model	FVOCI*
Other business models, including: ➢ Trading ➢ Managed on FV basis ➢ Max cash via sale	• Business model is neither held-to-collect nor held to collect and for sale • Collection of contractual cash flows is incidental to the objective of the model	FVTPL**

*Subject to meeting the SPPI criterion and the fair value option
**SPPI criterion is irrelevant - assets in all such business models are measured at FVTPL

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Do the cash flows of MIC consist on only principal and interest?

Consistent with basic lending arrangements

	Definition
Principal	Fair value of asset on initial recognition
Interest	Consideration for: time value of money; credit risk; other basic lending risks (such as liquidity risk); other associated costs (such as administrative costs); and profit margin

The New Model for Loan Losses

Expected credit loss model

=

Past Events

+

Current Conditions

+

What's New?

Forecast of future economic conditions

Overview of the impairment requirements

Change in credit risk since initial recognition

	Stage 1	Stage 2	Stage 3
Impairment recognition	**12-month expected credit losses**	**Lifetime expected credit losses**	**Lifetime expected credit losses**
		When significant increase in credit risk occurs	
Interest revenue	**Gross basis**	**Gross basis**	**Net basis**
	'Performing'	*'Under-performing'*	*'Non-performing'*

12-month & lifetime expected credit losses Definitions

Credit loss - difference between all contractual cash flows that are due to an entity in accordance with the contract and all the cash flows that the entity expects to receive (ie all cash shortfalls), discounted at the original effective interest rate (or credit-adjusted effective interest rate for purchased or originated credit-impaired financial assets)

Expected credit losses (ECL) - weighted average of credit losses with the respective risks of a default occurring as the weights

What are 12-month ECL?

Portion of lifetime ECL representing lifetime cash shortfalls that will result if a default occurs in 12 months weighted by probability of that default occurring

What are lifetime ECL?

ECL that result from all possible default events over the expected life of a financial instrument

When to recognise?

When to recognise 12-month expected credit losses?

- No significant increase in credit risk since initial recognition; or
- Low credit risk (eg., ‘investment grade’)

When to recognise lifetime expected credit losses?

- Underperforming assets, ie., a significant increase in credit risk since initial recognition
- Non-performing assets, ie., asset is credit-impaired

Expected credit losses will be recognised for *all* financial instruments in scope at *all* times

Determining significant increases in credit risk

- **Change in credit risk <u>over the life</u> of the instrument – ie., risk of a default occurring** (not changes in expected credit losses)
  - No definition of default, but rebuttable presumption that no later than 90 days past due
  - Maturity matters
- **Compare to credit risk <u>at initial recognition</u>**
  - consider reasonable and supportable information, that is available without undue cost or effort, that is indicative of significant increases in credit risk
- Financial instruments that have low credit risk at the reporting date (eg., investment grade) – may assume credit risk has not increased significantly
- More than 30 days past due – rebuttable presumption that credit risk has increased significantly since initial consideration
- Where default patterns are not concentrated at a specific point, changes in risk of default over the next 12 months may be used if they are a reasonable approximation of the changes in the lifetime risk of a default occurring

Expected credit losses are updated at each reporting date for new information and changes in expectations even if deterioration is not significant

Examples of Factors to Consider when Assessing for a Significant Increase in Risk

- Significant change in what would charge for credit risk now because of changes in credit risk since initial recognition
- Changes in external market indicators of credit risk
- Actual or expected change in internal or external credit rating
- Actual or expected increase in the risk of default on another facility with the same obligor
- An actual or expected significant change in the operating results of a borrower
- Changes in how the bank manages the credit risk on the instrument
- Past due information

Determining significant increases in credit risk

Collective and individual assessment basis

- Assessment of significant increases in credit risk since initial recognition may be performed on a collective basis – eg., retail loans
- Use relevant, reasonable and supportable forward-looking information (if available without undue cost or effort) to assess changes in credit risk
- If no reasonable and supportable information available without undue cost or effort to measure lifetime expected credit losses on an individual instrument basis – measure on a collective basis
- Grouping financial instruments for collective assessment – examples of shared credit risk characteristics:
  - instrument type, credit risk ratings, collateral type, date of initial recognition, remaining term to maturity, industry, geographical location of the borrower, the value of collateral relative to the financial asset if it has an impact on the probability of a default occurring (eg., non-recourse loans in some jurisdictions or loan-to-value ratios).

Example: Assessing Significant Increase in Credit Risk on a Collective Basis

ABC MIC provides mortgages to finance residential real estate in a specific area

The area includes a mining community - largely dependent on the export of coal and related products

Significant decline in coal exports occurs and the closure of several coal mines is expected

The risk of a default occurring on mortgage loans to borrowers who are employed by the coal mines is determined to have increased significantly

ABC MIC segments its mortgage portfolio on the basis of industries of borrowers' employment – ie., a shared credit risk characteristic

Measurement of Expected Credit Losses (ECL)

ECL are a probability-weighted estimate of credit losses (ie., the present value of all cash shortfalls) over the expected life of the financial instrument:

- Maximum period is the maximum contractual period of exposure to credit risk
  - Include cash flows expected from collateral and other credit enhancements that are part of contractual terms

ECL shall be measured in a way that reflects:

- Unbiased and probability-weighted outcome: must consider possibility that credit loss will/will not occur
- Time value of money – discount at effective interest rate or an approximation thereof
- Reasonable and supportable information: available without undue cost or effort at the reporting date, reflecting:

Past events + Current conditions + Future economic conditions

Particular measurement methods are not prescribed

Reasonable and Supportable Information

- Include information about past events, current conditions and forecasts of future economic conditions.
- Borrower-specific factors:
  - ➢ changes in operating results of borrower, technological advances that affect future operations, changes in collateral supporting obligation
- Macroeconomic factors:
  - ➢ house price indexes, GDP, household debt ratios
- The data sources could be:
  - Internal data - credit loss experience and ratings
  - External data - ratings, statistics or reports

Historical information can be used as a base but must be updated to reflect current conditions and future forecasts

Example: Assessing Significant Increases in Credit Risk since Initial Recognition (Low Credit Risk)
Highly collateralised financial asset

- Company H owns real estate assets → financed by a five-year loan from Bank Z.
  - Loan-to-value (LTV) ratio = 50%
  - secured by a first-ranking security over the real estate assets
  - At initial recognition, the loan is not considered to be originated credit-impaired
- Subsequent to initial recognition:
  - Revenues and operating profits of Company H have decreased due to an economic recession
  - Expected increases in regulations have the potential to further negatively affect revenue and operating profit
  - These negative effects could be significant and ongoing
- As a result, Company H's free cash flow is expected to be reduced to the point that the coverage of scheduled loan payments could become tight. Bank Z estimates that a further deterioration in cash flows may result in Company H missing a contractual payment on the loan and becoming past due
- Recent third party appraisals have indicated a decrease in the value of the real estate properties, resulting in a current LTV ratio of 70%
- Record ECL, take new value of collateral into consideration

Example: **Recognition and Measurement of Expected Credit Losses**

12-month expected credit loss measurement using an explicit 'probability of default' approach

- **Assume recognition of lifetime expected credit losses appropriate**
- Entity B acquires a portfolio of 1,000 five-year bullet loans for $1,000 each (ie., $1million in total).
  - average 12-month Probability of Default (PD) = 0.5% for the portfolio.
  - Entity B uses changes in the Lifetime PD (LPD) to determine whether the credit risk of the portfolio has increased significantly since initial recognition because the loans have significant payment obligations beyond the next 12 months.
- Entity B determines → no significant increase in credit risk since initial recognition and estimates that the portfolio has an average LPD of 25%.
- The 12-month PD remains at 0.5% at the reporting date.
- Entity B measures the loss allowance on a collective basis at an amount equal to 12-month expected credit losses based on the average 0.5% 12-month PD.

Credit-Impaired Financial Assets

Evidence

- Significant financial difficulty of the issuer or the borrower
- Breach of contract, eg default or past due event
- Borrower granted a concession that the lender(s) would not otherwise consider
- Probable that the borrower will enter bankruptcy or other financial reorganisation
- Disappearance of an active market for that financial asset because of financial difficulties
- Purchase or origination of a financial asset at a deep discount that reflects the incurred **credit losses**

Single event or combined effect of several events

Main Judgements and Estimates in Applying IFRS 9

Impairment

- Determining whether there is a significant increase in credit risk since initial recognition
- Measurement of expected credit losses (ECL)
  - Determining whether loans will be paid as due – and, if not, how much might be recovered and when
  - Probability-weighting different scenarios
- Appropriately incorporating forward-looking information into the assessment of changes in credit risk and measurement of ECL
  - Determining whether a collective or individual and collective assessment is needed for portfolios of shared risk characteristics
- Determining the appropriate period over which to measure ECL for revolving credit facilities

Disclosures

Objective: enable users of financial statements to understand the effect of credit risk on the amount, timing and uncertainty of future cash flows

Quantitative	Qualitative
• Reconciliation of allowance accounts showing key drivers for change	• Basis of inputs, assumptions and estimation techniques used to: • Measure 12-month and lifetime expected credit losses • Determine 'significant increase in credit risk' • Determine 'credit-impaired'
• Explanation of gross carrying amounts showing key drivers for change	• How forward-looking information has been incorporated
• Gross carrying amount by *credit risk rating grades*	• Changes in estimation techniques or significant assumptions made and reasons for changes
• Maximum exposure to credit risk (net of collateral) and collateral for credit impaired financial assets	• Basis for grouping if expected credit losses were measured on a collective basis
• Modification to contractual cash flows	• Entity's default definition and reasons for selecting those definitions
• Contractual amount outstanding for assets written off but still subject to enforcement activity	• Write off policies, modification policies, collateral

Credit risk disclosures → refer to IFRS 7 *Financial Instruments: Disclosures*

Effective Date and Transition

Annual periods beginning on or after 1 January 2018
[early application of completed (whole) version permitted]

- Retrospective application required but transition reliefs provided
- On transition determine if instruments are at stages 1, 2 or 3 *unless* not possible to determine initial credit risk without undue cost or effort
  - If initial credit risk not used, recognise lifetime expected credit losses unless low credit risk
- Permit but not require restatement of comparatives
  - Restate if, and only if, it is possible without the use of hindsight
- Disclose information that would permit the reconciliation of the ending impairment allowances in accordance with IAS 39 and the provisions in accordance with IAS 37 to the opening loss allowances determined in accordance with IFRS 9
- 'Impracticable' exemption for interim periods

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