14 August 2018

IFRS 9 Financial instruments: Technical Paper

Introduction

IFRS 9, 'Financial instruments' has been introduced by the International Accounting Standards Board (IASB). The standard became mandatorily effective for the annual periods beginning on or after 1 January 2018. IFRS 9 replaces IAS 39, 'Financial Instruments – Recognition and Measurement' and will affect the classification and the measurement of financial assets and liabilities.

H&T ("the Company") will apply IFRS 9 from 1 January 2018. The Company plans to restate comparatives on initial application of IFRS 9 and will do so in their unaudited consolidated interim statements for the six months ended 30 June 2018. The full impact of adopting IFRS 9 on the Company's financial statements will depend on the financial instruments that the Company has during 2018 as well as on economic conditions and judgements made as at the year end.

The implementation of IFRS 9 will not change the Company's business model. We have established credit risk management practices in place and we actively assess the impact of lending on recoveries on specific customers and customer segments. Where we see changes in conditions we take mitigating actions, including the revision of risk appetites and credit scorecards. We will continue to evaluate the terms under which we provide credit facilities within the context of customer requirements and regulatory requirements.

This paper summarises the impact of the accounting change on the Company's financial statements.

Classification and measurement

With respect to the classification and measurement of financial assets, the number of categories of financial assets under IFRS 9 has been reduced compared with IAS 39. Under IFRS 9 the classification of financial assets is based both on the business model within which the asset is held and the contractual cashflow characteristics of the asset.

There will be no impact on the financial statements in respect of the classification and measurement of financial assets. This is because the personal loans and pawnbroking trade receivables balances will continue to be measured on amortised cost under IFRS 9.

There will be no change in the accounting for any financial liabilities.

Impairment

The impairment model under IFRS 9 reflects *expected* credit losses, as opposed to only *incurred* credit losses under IAS 39. Under the impairment approach in IFRS 9, it is not necessary for a credit event to have occurred before credit losses are recognised. Instead, an entity should account for expected credit losses and changes in those expected credit losses. This change in accounting policy will result in earlier recognition of credit losses compared with IAS 39. The amount of expected credit losses should be updated at each reporting date. Under IFRS 9 there will be a material increase both in gross revenue and impairment for Pawnbroking and Personal Loans.

The IFRS 9 impairment charge recognition is in three stages:

Stage 1 – at initial recognition, and for each subsequent reporting period when there has been no significant increase in credit risk since initial recognition, recognise 12-month expected credit losses;

Stage 2 – recognise lifetime-expected credit losses if there has been a significant increase in credit risk since initial recognition;

Stage 3 – recognise incurred losses for credit-impaired assets.

In respect of the pawnbroking loan receivable the short-term nature of the agreement results in 12-month expected credit losses being the same as lifetime-expected credit losses. The Company's estimate of the loss allowance for these assets as at 31 December 2018 is £4.8m (31 December 2017: £5.5m) greater compared with IAS 39.

In respect of the personal loan receivable the Company recognises a loss allowance for 12-month expected credit losses where the loan is not in arrears, as the loan falls into arrears the loss allowance will be based on the lifetime-expected credit losses as there has been a significant increase in credit risk. The Company's estimate of the loss allowance for these assets as at 31 December 2018 is £3.9m (31 December 2017: £3.3m) greater compared with IAS 39.

The financial impact of the above is summarised as follows:

IFRS 9 Financial Impact on Pawnbroking:

Under IAS 39, income interest was accrued to the extent that it was deemed recoverable. Under IFRS 9 income continues to accrue on the gross (unimpaired) loan balance until the balance is held in Stage 3 impairment. Once in stage 3, interest (and associated impairment charges) are no longer accrued. As such, under IFRS 9 a greater interest income and associated impairment charge will be recognised on pawnbroking assets.

	6 months ended 30 June 2018 £'000	6 months ended 30 June 2017 £'000	12 months ended 31 December 2017 £'000
IAS 39			
Period-end net pledge book[1]	52,609	49,372	52,924
Average monthly net loan book	52,560	48,801	50,794
Revenue	15,471	14,708	29,670
Impairment	0	0	0
Revenue less impairment	15,471	14,708	29,670
Annualised Risk-adjusted margin[1]	*58.9%*	*60.3%*	*58.4%*
IFRS 9			
Period-end net pledge book[2]	47,847	44,027	47,451
Average monthly net loan book	47,836	43,521	45,637
Revenue	20,092	18,874	38,465
Impairment	(3,910)	(4,409)	(9,167)
Revenue less impairment	16,182	14,465	29,298
Annualised Risk-adjusted margin[2]	*67.7%*	*66.5%*	*64.2%*
Change: IFRS 9 from IAS 39			
Period-end net pledge book[2]	(4,762)	(5,345)	(5,473)
Average monthly net loan book	(4,724)	(5,280)	(5,157)
Revenue	4,621	4,166	8,795
Impairment	(3,910)	(4,409)	(9,167)
Revenue less impairment	711	(243)	(372)

<u>*Notes to table*</u>

1 – Includes accrued interest

2 – Revenue less impairment as a percentage of average loan book

IFRS 9 requires additional impairment on the pledge book. The net effect of the grossing up of income and higher impairment charge compared with IAS 39, results in an increased revenue less impairment H1 2018 of £0.7m and decreased revenue less impairment H1 2017 and FY 2017 of £0.2m and £0.4m respectively.

IFRS 9 Financial Impact on Personal Loans:

As before, under IFRS 9 income interest is recognised on the gross (unimpaired) loan balance, with impairment then recognised on this grossed up balance for a longer period than under IAS 39. The result is higher interest income and impairment charge.

	6 months ended 30 June 2018 £'000	6 months ended 30 June 2017 £'000	12 months ended 31 December 2017 £'000
IAS 39			
Period-end net loan book	21,694	11,835	18,256
Average monthly net loan book	20,253	9,852	12,797
Revenue	7,267	4,165	10,012
Impairment	(3,534)	(1,981)	(4,271)
Revenue less impairment	3,733	2,184	5,741
Annualised Risk-adjusted margin[1]	*36.9%*	*44.3%*	*44.9%*
IFRS 9			
Period-end net loan book	17,757	10,013	14,922
Average monthly net loan book	16,639	8,316	10,711
Revenue	10,566	6,672	15,574
Impairment	(7,443)	(4,823)	(11,679)
Revenue less impairment	3,123	1,849	3,895
Annualised Risk-adjusted margin[1]	*37.5%*	*44.5%*	*36.4%*
Change: IFRS 9 from IAS 39			
Period-end net loan book	(3,937)	(1,822)	(3,334)
Average monthly net loan book	(3,614)	(1,536)	(2,086)
Revenue	3,299	2,507	5,562
Impairment	(3,909)	(2,842)	(7,408)
Revenue less impairment	(610)	(335)	(1,846)

Notes to table

1 – Revenue less impairment as a percentage of average loan book

IFRS 9 requires additional impairment on the loan book. The net effect of the grossing up of income and higher impairment charge compared with IAS 39, results in decreased revenue less impairment H1 2018 of £0.6m (F1 2017: £0.3m and FY 2017: £1.8m).

Summary

The introduction of IFRS 9 only changes the timing of profits made on a loan. The business's underwriting and scorecards will be unaffected. The ultimate profitability of the loan is the same under IAS 39 and IFRS 9 as is the cashflow generated. In a rapidly growing product such as Personal Loans, the impact of IFRS 9 will be greater, a higher proportion of profits recognised later, than for a stable book.

The Group's bank covenants and its underlying cash generation are unaffected by IFRS 9, as they are calculated based on accounting standards in place prior to the introduction of IFRS 9.