November 2015

REPLY AVANTAGE

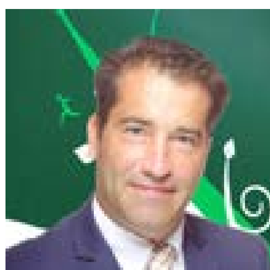
IFRS 9

THE NOVEL PARADIGM FOR CREDIT LOSS - IMPLEMENTATION CHALLENGES AND MARKET UPDATES

White Paper

THE AUTHORS

REPLY AVANTAGE



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About **Avantage Reply**

Established in 2004, Avantage Reply (a member firm of Reply) is a pan-European specialised management consultancy delivering change initiatives in the areas of Compliance, Finance, Risk and Treasury.

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Executive Summary

IFRS 9 *Financial Instruments* has recently been introduced as the new accounting standard, replacing IAS 39 *Financial Instruments: Recognition and Measurement*. IFRS 9 is designed to provide a more principle-based and less complex approach to financial assets classification, a forward-looking impairment model, and better linkage between accounting and risk management for hedge accounting[1].

The new standard contains a number of important changes that will have a substantial impact on banks. In particular, the impairment model introduced by IFRS 9 may represent the most significant shift in accounting since the last financial crisis. This model will have consequences for bank's financial statements and regulatory capital, and will result in greater provisions and earlier recognition of credit losses. It is also expected to have a substantial impacts on the volatility of the profit and loss (P&L) statement.

Overall, the International Accounting Standard Board ("IASB") fieldwork results have revealed that the transitional impact of IFRS 9 on impairments will range from 20% – 250%, with stressed impairments up to 400%. SME portfolios are expected to increase in the range of 0% – 50%. It is expected that IFRS 9 will increase overall loan loss provisions by at least 30%[2].

Transitioning to the new standard is a monumental task. Implementation – now occurring at most large institutions – requires considerable systemic and process change, increased portfolio segmentation, new types of data, and potentially, the need to integrate credit risk management and accounting systems.

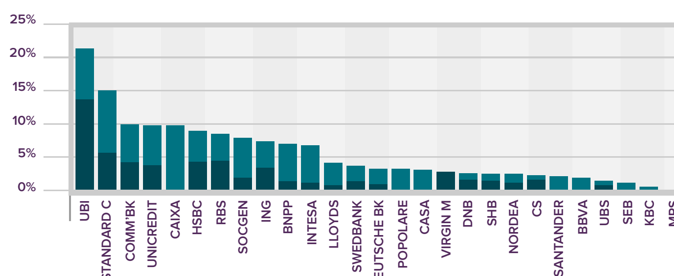
This publication does not intend to present the normative aspects of IFRS 9, nor does it share methodological thoughts on credit modelling aspects. Rather, it focuses on key market updates and timelines on the road to the EU endorsement and highlights Avantage Reply's view on key management decisions related to IFRS 9 implementation.

This publication offers valuable commentary from a broad spectrum of stakeholders including the standard setter, regulators and market participants. It targets C-Level Officers through the IFRS 9 Primer section, which outlines upcoming regulatory impacts and a case study. The remainder of the paper covers more technical topics and is appropriate for Accounting and Risk management staff.

Greater volatility within profit or loss

It is anticipated that the new expected loss model introduced by IFRS 9 will result in increased volatility within the P&L. A recent survey from Barclays Equity Research[3] provides IFRS 9 provisioning impacts per stage for various European banks as shown in Figure 1:

Figure 1: IFRS 9 provisioning impacts per stage on the tangible book values



This volatility depends on various modelling decisions, particularly the design of transfer criteria from stage 1 to stage 2, at which provisions need to be raised from a one-year to a lifetime expected loss. For example, if an entity recognises 'significant credit deterioration' early, e.g. using Probability of Default (PD) downgrade criteria (which is one option in IFRS 9) it may increase its P&L volatility year on year. Alternatively, such an event may encourage management to act quicker to avoid the undesirable 'cliff effect', i.e. a sudden increase in provision level for a group of assets when credit risk increases significantly. This may occur if lifetime loss is recognised too late.

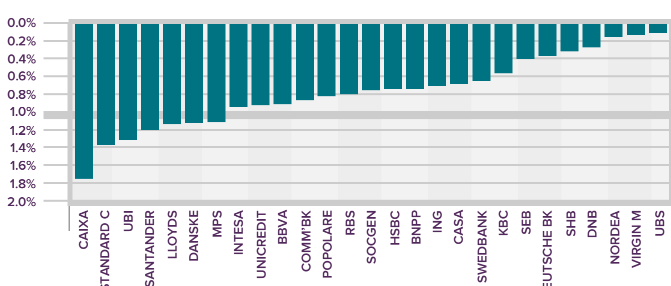
A robust testing process during implementation can mitigate this trade-off between volatility and 'cliff effect'. This process will allow the back-testing and benchmarking of model output and will involve profit or loss sensitivity analysis at regular intervals. It is crucial to involve Finance and Risk Senior Management in these key design decisions.

Critically, it seems only a few banks[4] are currently anticipating increasing provisions in order to spread IFRS 9 impacts across the lead-time to 2018. Given their significant impact on P&L, portfolios with 'lifetime' provisions should receive the highest attention. Other banks are concerned that IFRS 9 provisioning may also lead to more expensive loan growth[5], for example, in unsecured loan books with higher PDs and loss given defaults (LGDs) (and, consequently, higher expected losses). Analysis is currently taking place to try to optimise the impacts of IFRS 9 adoption, both in terms of statements of changes to equity and P&L.

Regulatory capital and leverage ratios: diverse impacts

Furthermore, IFRS 9 will impact on banks' regulatory capital and Basel III leverage ratios. However, Standardised Approach (SA) and Internal Ratings-Based (IRB) approach banks will be affected differently, as illustrated in figure 2.

Figure 2: IFRS 9 impacts on 2015 CET 1 ratios



The leverage ratio under Basel III is defined as the ratio of capital measure (Tier 1 Capital ('Core Tier 1, or CET1')) divided by Net Exposure measure. The ratio should reach 3% at a minimum as currently proposed during the transition period.

Standardised Approach (SA) Banks

For SA banks, any impairment loss on a loan based on income statements has a direct impact on Core Tier 1 capital, as it reduces retained earnings. As Tier 1 capital and total net exposure reduce equally, leverage ratios should also decline. In fact, the increased non-collective provision stock upon IFRS 9 transition would reduce the Core Tier 1 capital, but if classified as 'collective impairment', the cumulative provisions could be eligible as Tier 2 capital (up to 1.25% of risk-weighted assets). An example is the provisions for incurred, but not reported, losses on a performing commercial portfolio.

Internal Ratings-Based (IRB) approach Banks

For IRB banks and portfolios, the Basel III framework requires any shortfall in the eligible provisions relative to expected losses to be deducted from Tier 1 capital[6]. The same amount is deducted in the ratio from the exposure measure. As such, the larger provision stock is less likely to impact on Tier 1 capital. This is because the provisions shortfall absorbs any capital impact, i.e. the provision shortfall and Tier 1 capital reduction cancel out. As total net exposure stays the same, leverage ratios should, in turn, remain unchanged.

Tier 2 surplus provisions – increased care required

We advise C-Level Officers to carefully consider surplus provisions considered as Tier 2[7], be they IRB loans or collective provisions. Capital impacts will depend on precisely how the surplus provisions interact with other typically Stage 2 provisions and when netting can occur. Detailed operating guidance on this issue is not fully clear. For example, in the presence of surplus provisions, it is questionable whether some Stage 2 provisions need to be raised at all. When Stage 2 provision methodology is independent of provision surplus, this degree of implicit capital relief could be lost if the IRB provision shortfall is deducted from CET1.

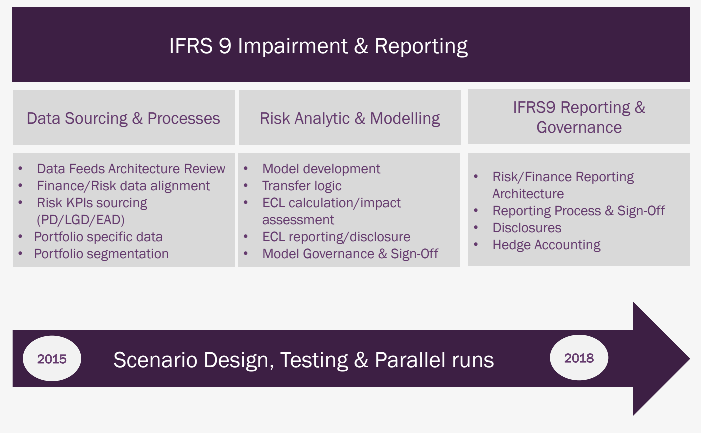
Implementation costs and systemic change

Finally, implementation costs are material. Implementation – now taking place at most large institutions – requires changes to systems and processes, greater segmentation of portfolios, new types of data and potentially, and integration of credit risk management systems with accounting systems. Moreover, regulatory planning should be taken into account – for example, it is expected that the ECB 2015 stress test will require EU banks to include the effects of already-announced regulatory, legal or accounting changes into their projections. This means that IFRS 9 impacts may fall within scope (similarly to announced requirements for UK banks by the Prudential Regulatory Authority).

Aware of these numerous challenges, banks' CFOs have significantly ramped up their IFRS 9 budgets – sometimes between €1m and €5m. They have also voiced concerns about the project risk linked to a lack of technical resources required to face the tight deadline of January 2018 (IFRS 9 mandatory effective date, i.e. 2017 annual financial reports for many banks).

How Avantage Reply can help

Implementing the substantial changes required by IFRS 9 within these timeframes may prove to be a daunting task for many banks. However, Avantage Reply is well placed to guide institutions through this challenging process – in particular, adapting to the new Expected Credit Loss model. Through assisting many of our clients in converting to IFRS 9, as well as our extensive work in credit risk modelling, we have gained strong insight into how IFRS 9 can be adopted smoothly.



1 IFRS 9 *Financial Instruments*: Project Summary. July 2014.

2 IASB ED 2013/3 *Financial Instruments: Expected Credit Losses*. 19 July 2013.

3 Barclays Research. *European banks: re-visioning provisioning*. September 2015.

4 In particular, the well capitalised banks or banks lagging in their impairments.

5 Since under IAS 39, the loan impairment rate typically falls as bank grows its loan book.

6 Basel Committee on Banking Supervision. *Frequently asked questions on Basel III monitoring*, REVISED. September 2012.

7 Notably, Danske bank decided not to benefit from surplus netting. Rather, the bank opted to exclude any surpluses within Tier 2 to avoid the Danish FSA increasing their Pillar 2 solvency.

IFRS 9 primer

IFRS 9 was issued in July 2014, replacing IAS 39 as the new standard for the accounting of financial instruments. IFRS 9 brings together the 'classification and measurement, impairment and hedge accounting phases of the International Accounting Standards Board's (IASB's) project'[8]. It is designed to provide a 'logical', principle-based classification and measurement approach for financial assets, a single, forward-looking impairment model, and a better link between accounting and risk management for hedge accounting[9].

IFRS 9 comprises of three phases:

- **Phase 1: Classification and Measurement.**
  This covers allocation of financial instruments within the different sections of the balance sheet and their related measurement (i.e. for assets: amortised cost, fair value through other comprehensive income or fair value through P&L).
- **Phase 2: Impairment.**
  This topic is covered in depth in this publication. Significantly, IFRS 9 applies a forward-looking 'expected loss', rather than 'incurred loss', model.
- **Phase 3: Hedge Accounting.**
  This introduces a general model for micro hedging that aims to better represent the impact of risk management activities on an entity's financial statements. Macro fair value hedging or portfolio hedging is not included in the present standard. In the meantime, there is an option to continue applying IAS 39 until completion of the separate standard over macro hedging.

Applying IFRS 9 is mandatory from 1 January 2018. For European firms, IFRS 9 remains subject to EU endorsement. A final decision is expected during Q4 2015.

Expected loss versus incurred loss in a nutshell

Under IAS 39, impairment of financial assets was triggered by the occurrence of a loss event (incurred loss model). In contrast, IFRS 9 contains no loss event or impairment triggers. Instead, entities are required to schedule provisions on financial assets from the first reporting date after their initial recognition (expected loss model).

It was felt by many in the industry that IAS 39 and the incurred loss model addressed credit risk "too little, too late". In response, the expected loss model under IFRS 9 is designed to be more responsive to changes in credit risk and consider loss from a forward-looking perspective. **The change from an incurred to an expected loss model is a fundamental shift in accounting approach.**

The expected loss model implies that the provision calculation will be directly linked to changes in credit spreads/ratings, which will lead to greater volatility in financial results than the current loss model. Provisions will also be larger, as not only past but also future loss events are taken into account.

The expected credit loss model will require considerable changes in data, processes and governance[10]. Moreover, if synergies are to exist with IRB approach models, material adjustments will be required to ensure compliance with the accounting requirements.

These adjustments include:

- Using point-in-time probabilities of default (versus through-the-cycle)
- Incorporating all available data in risk estimates
- Ability to calculate lifetime expected losses (versus one-year probability of default (PD) through the cycle as per Capital Requirement Directive IV)
- Considering portfolios under Standardised Approach

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8 IFRS. IFRS 9 *Financial Instruments: Project Summary*. July 2014.

9 Ibid.

- Removing conservatism layer from Basel models
- Discounting expected cashflows
- Behavioural modelling rather than end date of the contract.

In the Appendix, we provide an overview of the main changes of the IFRS 9 Impairment model as compared to IAS 39.

On the road to EU endorsement

The IASB has set up the IFRS Transition Resource Group (ITG) to support stakeholders in transitioning to the new impairment requirements. This group is comprised of experts from banks, audit firms and various supervisory bodies. The next section highlights key implementation issues discussed and their related outcomes.

The European Commission (EC) requested endorsement advice on IFRS 9 from the European Financial Reporting Advisory Group (EFRAG) in December 2015. On 16 September, EFRAG concluded that IFRS 9 met all endorsement criteria and advised for it to be adopted in the EU[11]. Key messages of the endorsement advice are provided in the EFRAG section of this publication on page 16.

10 EFRAG. *Endorsement advice on financial instruments.* 15 September 2015.

11 Ibid.

IFRS 9 implementation Stand out issues

The IFRS Transition Resource Group for Impairment (ITG)

The IFRS Transition Resource Group for Impairments on Financial Instruments (ITG) is a discussion group that supports stakeholders on implementation issues arising from IFRS 9 impairments. The ITG will not issue guidance directly. Rather, following ITG meetings, the IASB will then determine the course of action to be taken on each issue.

The first ITG meeting was held on 22 April 2015. Among the eight agenda items discussed, issues included: scope, economic forecasts, expected credit losses following de-recognition, and revolving credit facilities. Discussions have led to clarity on several implementation issues, while others still require further consideration. A summary of the issues discussed and the anticipated next steps are provided in the following table.

Table 1 – ITG April meeting items and next steps

ITG Agenda Ref #	Topic discussed	Anticipated next steps
1	The maximum period to consider when measuring expected credit losses	No further action expected
2	Forecasts of future economic conditions	ITG will propose to the IASB that educational material on adjusting/non adjusting events under an expected loss model be developped
3	Loan committment - scope	No further action expected
4	Revolving credit facilities	ITG will continue to consider this area including the need for the IASB to develop implementation guidance to assist with consistent interpretation and application
5	Assessment of significant increase in credit risk for guaranteed debt instruments	No further action expected
6	Measurement of expected credit losses for an issued financial guarantee contract	No further action expected
7	Expected credit losses - measurement date	No further action expected
8	Measurement of expected credit losses in respect of a modified financial asset	No further action expected

Source: IASB

ITG meetings: key issues discussed

A number of significant items were discussed by the ITG during their April and September meetings. Key issues and their developments are outlined below.

A) Forecasting future economic events

In April, the ITG discussed how to incorporate *future* economic events in assessing credit risk and credit losses. A distinction was made between:

- Modelling and financial reporting date; and
- Financial reporting date and date of accounts sign-off.

Modelling and financial reporting date

Operational practicality and timing is of central relevance to this issue. A consensus was reached that *substantive information* regarding future economic conditions revealed between the modelling date and reporting date *should be reflected* in the assessment of expected credit losses at the reporting date[12].

The ITG stressed that strong governance and process frameworks are necessary to support this. These frameworks should allow organisations to develop consistent economic forecasts through internally and externally available intelligence and expert judgement.

Financial reporting date and date of accounts sign-off

The ITG noted that, given the lack of guidance within IFRS 9, entities should apply IAS 10 – *Events After The Reporting Period* to assess whether or not events occurring after the reporting date impact upon their financial statements. ITG members agreed that there was a need to exercise judgement on a case-by-case basis. The ITG also emphasised that conclusions and considerations should be well documented, which should also aid IAS 10 assessments.

The ITG suggested to the IASB that educational material on adjusting/non-adjusting events under an expected loss model be developed to assist organisations with the transition to IFRS 9.

B) Revolving credit facilities

In relation to *revolving credit facilities*, the ITG was asked to consider:

- The appropriate *period* to calculate expected credit losses on loans that are in credit stage 1 and stage 2; and
- The *initial recognition date* for assessing significant increases in credit risk.

Calculating the period for expected credit losses for revolving credit facilities

The ITG reviewed how entities could determine the correct period for measuring expected credit losses for revolving credit facilities. It was emphasised that IFRS 9 requires the assessment of the period over which the entity is exposed to credit risk. This period would be reduced by the identification of expected defaults or by proposed credit risk management actions, such as the reduction or removal of undrawn limits[13].

12 EFRAG. Endorsement advice on financial instruments. 15 September 2015.

13 IFRS 9.5.5.20 and B5.5.40

The ITG discussed how an entity can estimate the credit losses over a period in which it is exposed to expected credit losses that would not be mitigated by credit risk management actions. Discussions focused on how to define the 'period of exposure to credit risk' versus 'mitigated credit risk management'. However, consensus was not reached. One view of ITG members favoured a reduced period when credit risk mitigation is significant, with the other preferring to assess the long-term 'behavioural life' of the financial asset.

An example was provided of credit card holders in which the issuer undertakes monthly assessments of customer behaviour, such as analysing *payment profiles* and information provided by *third parties*, but does not perform annual credit reviews. When relying solely on monthly assessments, it is improbable that this bank would terminate the facility unless strong evidence exists to suggest that the customer is in default.

Overall, ITG members noted that there is diversity in credit risk management in this area. They also noted that risk management differs from accounting, and that significant judgement would be required to properly estimate expected credit losses on revolving credit facilities.

Calculating the initial recognition date of significant increases in credit risk
In April, the ITG seemed to suggest that the initial recognition date for significant increases in credit risk for revolving credit (card) facilities should be based upon the first recognition of the original undrawn facility. However, several ITG members noted that determining the *date of initial recognition* in this context could be extremely challenging. This is because there can be numerous changes made over the course of a customer relationship, such as replacing the type of card, changes in credit limits, expiry and renewal, and so on.

The ITG acknowledged that it is important to determine whether such an event gives rise to de-recognition under IFRS 9, and the recognition of a new financial instrument. Such an assessment will require considerable judgement.

In the case of recognition of a new financial instrument, the ITG agreed that a change in the date of initial recognition to correspond with the new instrument would be required.

September 2015 meeting

The ITG met on 16 September 2015 to discuss the following topics:

- Determining significant increases in credit risk where loans are assigned an internal credit risk rating
- Interpreting changes in the risk of a default over the next 12 months when assessing significant increases in credit risk
- Measuring expected credit losses for revolving credit facilities
- How forward-looking information (economic forecasts) can be incorporated in the assessment
- Update on Basel guidance on accounting for expected credit losses.

Regarding determining significant increases in credit risk, the ITG emphasised that the aim under IFRS 9 is to recognise lifetime credit losses following a significant increase in credit risk. As such, any recognition of increased risk should be based on *relative*, rather than *absolute* measures. The ITG also stressed that relying

solely on behavioural indicators to assess significant increases of credit risk would be insufficient – in particular, this method would fail to adequately capture future credit risk.

The ITG also stressed that IFRS 9 does not stipulate any set approach for determining expected increases in credit risk. As such, entities can utilise changes in the risk of default occurring over the upcoming 12 months as a proxy to assessing lifetime default probability.

The issue was discussed whereby an institution has a history of allowing customers of revolving credit facilities to exceed their contractually agreed limits. In this case, it was asked whether the potential exposure at default used to assess expected credit losses should include potential exposures beyond the contractual credit limit. The ITG stressed that, in practice, credit risk for revolving credit facilities extends past the contractual period for the loan, and can also surpass the agreed contractual credit limit. However, the ITG notes that the definition of credit losses in IFRS 9 does not take into account cash flows outside of the contractual terms.

In terms of forward-looking information, the ITG was asked whether forward-looking information should be considered in impairment reviews on a differentiated basis (i.e. differently between countries, banks, etc.) and how to determine what is 'reasonable and supportive' information. The ITG concluded that forward-looking information was relevant to different portfolios in a variety of ways, and should be used as such. The ITG agreed that determining 'reasonable and supportive' information could prove challenging for banks, and that significant judgement is required here.

In addition, a Basel representative confirmed that Basel guidance on expected credit losses would be forthcoming before the year-end of 2015 (probably in October/November).

The next ITG meeting is scheduled for 11 December 2015.

Avantage Reply Comments

Avantage Reply is able to raise issues faced by our clients during IFRS 9's implementation and to ensure that these items are on the ITG's agenda.

Please also note that the Enhanced Disclosure Task Force confirmed standardised disclosure templates that could be used by banks to report the IFRS 7 impairment disclosures (as subsequently revised after IFRS 9).

EFRAG's perspective

The European Commission (EC) officially launched the IFRS 9 endorsement process in December 2014. On 15 September 2015, the European Financial Reporting Advisory Group (EFRAG) concluded that IFRS 9 met all endorsement criteria and therefore advised for it to be adopted in the EU[14]. EFRAG recommends that 'all businesses other than those carrying out insurance activities are required to account for their financial instruments in compliance with IFRS 9 in 2018', with 'businesses carrying out insurance activities permitted to do so in compliance with IFRS 9 from the same date[15].'

In the following section, we highlight the key messages of EFRAG's final endorsement advice for the EC.

EFRAG's final endorsement advice on IFRS 9: Key messages

Following draft endorsement advice issued to the EC in early May 2015, EFRAG released its final endorsement advice on 15 September 2015. Some key messages are outlined below.

Improvement to financial reporting

EFRAG concluded that IFRS 9 would generally improve the quality of financial reporting. EFRAG identified that IFRS 9 would be an improvement over the existing requirements of IAS 39 in the accounting for basic lending instruments, in the impairment of financial assets and hedge accounting, and will also enable different but relevant accounting for financial instruments other than basic lending instruments[16]. This would further support an improved efficiency of capital markets, including the insurance industry if the effective date of IFRS 9 were to be aligned with the effective date of the future *Insurance Contracts* standard for insurers. EFRAG's overall conclusion is that IFRS 9 is conducive to the European public good.

Early application option retained

The early application option contained in IFRS 9 was retained. EFRAG recognises that many financial institutions may not be able to adopt the standard early because of the implementation time and effort that may be needed given the extensive use of financial instruments. However, it was noted that the implementation of IFRS 9 will be less burdensome for many corporates. EFRAG maintains that these corporates should be able to adopt the standard early to benefit sooner from the improvements introduced.

Proposed approach on new impairment model accepted

EFRAG accepted the new impairment model because it results in an earlier recognition of expected credit losses and hence addresses the weakness of an incurred loss model. EFRAG assessed that the proposed approach could strike an acceptable balance between the cost of implementation and the underlying economics, while meeting the need to provide earlier for expected credit losses as expressed by financial regulators and other constituents.

15-16 Ibid.

However, they were concerned that proposals would require significant implementation and ongoing costs[17]. EFRAG believes that entities need to implement the new requirements with the required degree of reliability[18], so that improvements materialise in practice.

Avantage Reply Comments

It was reported to us by several institutions that cumulated implementation costs are on the rise – some reported that these costs have doubled over the past 12 months. Additionally, it is emerging that there is a lack of technical resources available – both internally and externally – to implement the changes. This is particularly problematic given the complexity of the changes and the lack of clarity over acceptable interpretations of the new rules and the interaction with capital. This could have a significant impact on business models and implementation planning.

Post-implementation review

EFRAG is of the opinion that a post-implementation review should be carried out at the earliest possible date after the implementation of the standard. EFRAG intends to closely monitor implementation and enable reporting on any unforeseen or unanticipated consequences that may need to be addressed in the post-implementation review.

Relationship with the future IFRS 4 *Insurance Contracts* standard

Upon the EC's request, EFRAG considered the interrelationship between the future requirements for the accounting of insurance contracts and IFRS 9. EFRAG recognises that the mismatch in timing of the effective dates of IFRS 4 *Insurance Contracts* and IFRS 9 may create disruptions in the financial reporting of insurance activities, which will make financial reporting less comprehensible for users while increasing costs for issuers[19]. In the draft endorsement, EFRAG's cost-benefit analysis makes a strong case for the deferral of IFRS 9 for entities undertaking insurance activities that apply cost models to their insurance liabilities. Following this, EFRAG advised the EC to request the IASB to defer the effective date of IFRS 9 for insurers and align it with the effective date of the new *Insurance Contracts* standard[20].

However, in the final endorsement, EFRAG noted that a significant majority of users interviewed expressed a strong preference for having IFRS 9 and the future *Insurance Contracts* standard implemented at the same time. EFRAG therefore recommends that IFRS 9 be required for all businesses other than those carrying out insurance activities in 2018, with businesses carrying out insurance activities permitted to apply IFRS 9 from the same date. EFRAG acknowledges that the IASB is exploring a range of options to address the non-alignment of the effective dates of IFRS 9 and the future *Insurance Contracts* standard, which may include deferral. EFRAG maintained that the impact of the non-alignment of the effective dates of the two standards would vary between companies. They therefore advised that any mitigation action should be granted on an optional basis.

17 EFRAG. EFRAG comment letter on the IASB ED Financial Instruments: Expected Credit Losses. 9 July 2013.

18 According to EFRAG, information has the quality of reliability when it is free from material error and bias and can be depended upon by users to represent faithfully what it either purports to represent or could reasonably be expected to represent, and is complete within the bounds of materiality and cost. (Source: EFRAG FIWG conference call 21 April 2015, Paper 01.03).

19 EFRAG. Endorsement Advice on IFRS 9 Financial Instruments. 15 September 2015.

20 IFRS. Staff Paper: REG IASB Meeting. May 2015.

The IASB's new temporary measures: 'deferral' and 'overlay' approaches

On 23 September, the IASB decided to consult on temporary measures for the commencement dates of IFRS 9 and the future *Insurance Contracts* standard.

These temporary measures would amend IFRS 4 *Insurance Contracts,* giving companies that primarily issue insurance contracts the option to defer the effective date of IFRS 9 until 2021 (the 'deferral approach').

This approach would also give insurers who implement IFRS 9 the option to remove some of the accounting mismatches and temporary volatility in P&L that could occur before IFRS 4 *Insurance Contracts* is brought into effect (the 'overlay approach').

The IASB is currently deliberating on IFRS 4 *Insurance Contracts.* A final standard is expected to be issued in 2016.

The IASB advised that an Exposure Draft setting out these measures will be published within three months for public consultation. They also emphasised that if confirmed after the public consultation, the measures will not affect companies that do not issue insurance contracts.

At the October meeting the IASB discussed how those measures would apply to first-time adopters and set the comment period. The package of proposed temporary measures would amend IFRS 4 to:

- Permit a reporting entity whose activities are predominantly insurance a temporary exemption from applying IFRS 9 until the earliest of the entity's adoption of the new insurance contracts Standard or 1 January 2021 ('the Deferral Approach');
- To give entities issuing insurance contracts that implement IFRS 9 the option to remove from profit or loss some of the accounting mismatches and temporary volatility that could occur before the new insurance contracts Standard is implemented ('the Overlay Approach').

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On the horizon: Upcoming regulatory impacts

Many banks intend to base their IFRS 9 expected loss models on their existing internal ratings-based (IRB) processes and models for calculating regulatory capital. Those doing so should be aware of the planned programme of regulatory changes that will affect IRB models over the coming years.

The BCBS draft guidance on expected credit loss model

When implementing IFRS 9, reporting entities will also need to take into account supervisory expectations, as published by the Basel Committee on Banking Supervision (BCBS).

In February 2015 the BCBS issued for consultation its **Guidance on accounting for expected credit losses**[21]. It introduces 11 fundamental principles for sound credit risk practices associated with implementation and application of expected credit losses accounting to drive consistent interpretations and practices.

Out of the 11 principles, eight relate to the Supervisory requirements for sound credit risk practices that interact with expected credit loss measurement, and three relate to the Supervisory evaluation of credit risk practices, accounting for expected credit losses and capital adequacy. The final BCBS guidance is expected for Q4 2015.

In the next section we focus on the following aspects of the Consultative paper: the use of practical expedients, the model validation requirement, and the impact of deficient credit risk practices on the bank capital adequacy. Finally we touch briefly upon the impact for US GAAP reporters and the upcoming quantitative Impact Studies.

Use of practical expedients

For banks reporting under IFRS 9, the Consultative paper provides useful guidance on certain aspects of the ECL requirements in the impairment sections of the standard. These include the loss allowance at an amount equal to 12-month ECL, the assessment of significant increases in credit risk, and the use of practical expedients. The Committee regards many of these practical expedients[22] as inappropriate for use by internationally active banks because – given their business – the cost of obtaining relevant information is not considered by the Committee to be likely to involve ‘undue cost or effort’. A few observers believe the aim of limiting these options should improve the usefulness of information resulting from applying the impairment requirements, but oppose removing practical expedients simply to have a more conservative solution.

21 Basel Committee. Guidance on accounting for expected credit losses (Consultative Document). February 2015.

22 IFRS 9 includes a number of practical expedients or operational simplifications, intended to ease the implementation burden for a wide range of companies. This recognises that IFRS 9 will be used by a variety of entities, including firms outside the banking industry. Some of the practical expedients include: limiting the information set which an entity must consider in measuring ECL, the exception for “low” credit risk exposures which may be excluded from the test of “significant increase in credit risk” and the 30-days-past-due rebuttable presumption.

Avantage Reply Comments

Some experts doubt that limiting practical expedients would improve consistency across banks. Avantage Reply believes that banks will likely develop their own policies rather than rely on the thresholds set in practical expedients (such as the 30-days-past-due rebuttable presumption). An exception to this may be the 'low credit risk' exemption that banks will likely apply to avoid lifetime expected loss calculation.

Credit risk assessment model validation requirements

Following principle 5, banks should have policies and procedures in place to appropriately validate its internal credit risk assessment models. The BCBS further states that a sound model validation framework should include, but is not limited to, the following elements:

- A sound governance framework
- Clear roles and responsibilities
- Adequate scope that should include a review of model inputs, model design and model outputs/performance
- A comprehensively documented validation process, which is reviewed on an annual basis
- An independent review of the model validation process by independent parties (e.g. internal or external auditors)[23].

Avantage Reply Comments

Avantage Reply welcomes the BCBS initiative to introduce requirements for the validation of banks' internal credit risk assessment models.

Impact of deficient credit risk practices

To the extent that credit risk assessment or measurement deficiencies are significant or are not remedied on a timely basis, the BCBS expects that the supervisor should consider whether such deficiencies should be reflected in supervisory ratings or through a higher capital requirement under Pillar 2 of the Basel capital framework. For example, if a bank lacks appropriate credit risk assessment policies, systems or controls, the supervisor may consider these deficiencies when assessing whether the bank's capital position is adequate in relation to its risk profile[24].

The BCBS further states that the supervisor should consider how these deficiencies affect the level of reported allowances and, when deficiencies exist, should discuss this with the bank and take further appropriate action when necessary.

23 Basel Committee. Guidance on accounting for expected credit losses (Consultative Document). February 2015.

24 Ibid.

Avantage Reply Comments

Avantage Reply enables institutions to anticipate changes to overcome deficiencies and control the impacts with solid arguments. Shortcomings or simplifications are typical in modelling. Through our extensive experience and peer benchmarking insights, Avantage Reply is able to quickly produce estimates or proxies to address these deficiencies. Institutions are therefore able to better underpin the magnitude and sign, and adjust important business measures conservatively. Governance further strengthens the remedy for the deficiency through independent 2nd and 3rd line of defence reviews. As a result, these adjustments are often recognised as sufficient remedies or only slightly adapted by the competent authorities.
With the right assistance, institutions can continue to manage their business in the driver's seat.

US GAAP Firms and Quantitative Impact Studies

The guidance, when finalised, will target banks applying either IFRS or US GAAP. The US accounting requirements on expected credit losses are not yet finalised – it therefore remains to be seen whether the BCBS will prepare similar guidance on supervisory requirements for jurisdictions applying US GAAP.

Finally, regulatory bodies are signalling their desire to start the IFRS 9 Quantitative Impact Study (QIS) in 2015, six months earlier than expected. Some players in the industry expect that the QIS will assess prudential impacts coming from the accounting requirements, but nothing concrete has been announced yet.

Avantage Reply Comments

For more details on BCBS's draft guidance on the ECL model, please refer to the Practice Note published by Avantage Reply in March 2015: BCBS's view on the new impairment model under IFRS 9.

The EBA's Programme to enhance IRB models

Many banks intend to base their IFRS 9 expected loss models on their existing internal ratings-based (IRB) processes and models for calculating regulatory capital under Basel II/III. Those doing so should be aware of the planned programme of regulatory changes that will affect IRB models over the coming years. In the next section, we outline the main problems with the use of internal models from a regulator's perspective. We also provide a short overview of the planned regulatory response by the European Banking Authority (EBA).

EBA concerns about the IRB approach

The EBA believes that the IRB framework has proven its validity as a risk-sensitive approach to measuring capital requirements and encourages the implementation of sound risk management practices[25]. The recent Capital Requirements Regulation (CRR[26]) did not materially change the IRB approach. However, there are concerns about the degree of flexibility that the IRB framework allows and that this has compromised comparability in capital requirements.

25 EBA. Summary report on the comparability and pro-cyclicality of capital requirements under the Internal Ratings Based Approach in accordance with Article 502 of the Capital Requirements Regulation. 17 December 2013.

26 CRR (Regulation 575/2013): Articles 142-191

In December 2013 the EBA published reports on comparability and pro-cyclicality of capital requirements under the IRB[27]. These identified:

- Significant divergences in institutions' approaches (substantially driven by non-risk based drivers e.g. definitions, modelling choices, etc.); and
- Significant divergences in supervisory approaches, particularly with regard to definition of default, PD and LGD calibration, treatment of defaulted assets and scope of the IRB approach.

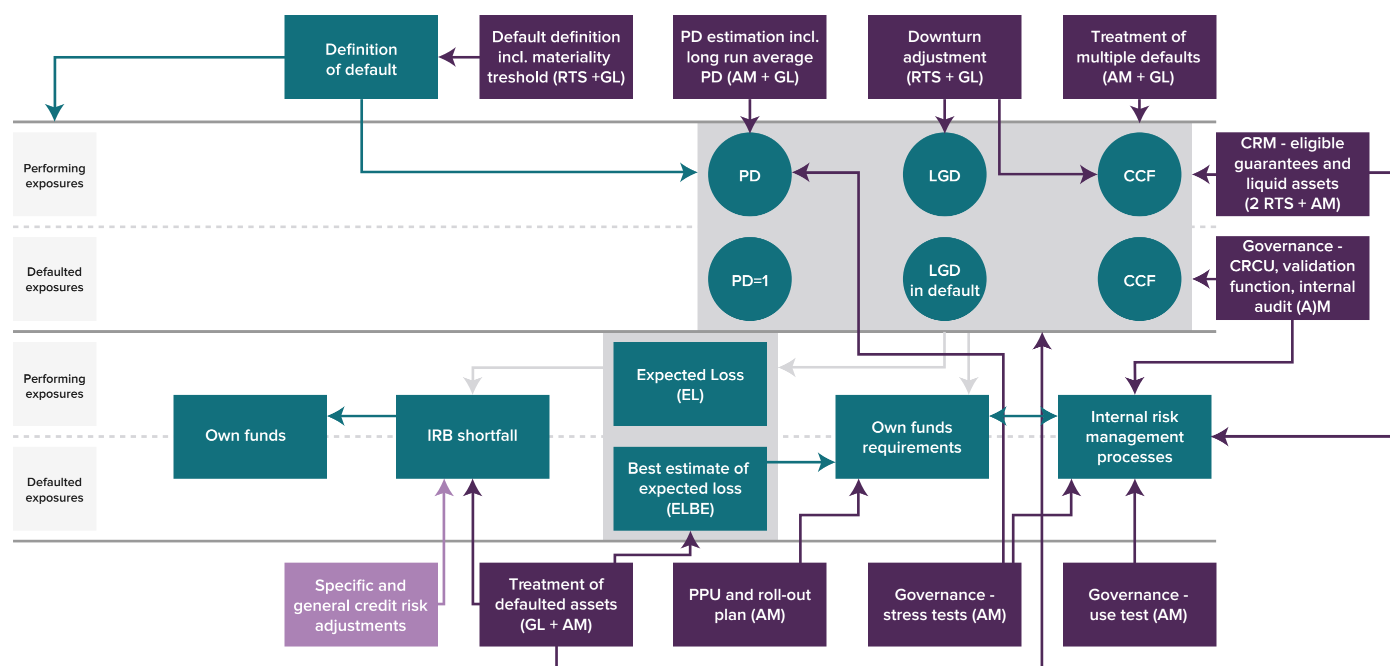
In April 2015[28] the EBA expressed its lack of trust regarding the use of internal models, arguing that models are used to ensure low capital requirements, i.e. that regulatory arbitrage by some institutions may occur. Additionally, in the UK, lower capital requirements associated with IRB approaches have been cited as a barrier to entry for challenger institutions and flagged as a potential competition risk.

These concerns are reflected in recent regulatory developments, including a more challenging model approval process and increasingly more stringent requirements for low-default portfolios (which essentially force banks to revert to conservative assumptions where they hold insufficient loss data to support their models).

Planned regulatory response

The EBA have responded to these concerns by implementing a programme of regulation that affects almost every aspect of IRB credit risk models, as outlined in the diagram below.

Figure 6 – EBA's programme and IRB credit risk models



27 EBA. Summary report on the comparability and pro-cyclicality of capital requirements under the Internal Ratings Based Approach in accordance with Article 502 of the Capital Requirements Regulation. 17 December 2013.

28 EBA. The Future of the IRB approach, Public Hearing on EBA Discussion Paper. 8 April 2015

As set out in its Discussion Paper on the Future of the IRB Approach[29], the EBA plans to provide its regulatory response in four phases:

- **Phase one – Assessment Methodology**
  The EBA is currently consulting on technical standards on the specification of the assessment methodology for competent authorities regarding compliance of an institution with the requirements to use the IRB [30]. These will ensure that a consistent and rigorous standard is applied to the approval of IRB models by their regulators. The EBA expects to have final regulation in place by the end of 2015. Since only regulators will be directly affected, these will be adopted immediately.

- **Phase two – Definition of Default**
  Right now there are a range of different practices used for estimation of LGD in default: for example, differences in definitions of 'material default' and different qualitative assessments of the likelihood that the debt will be paid. The EBA is planning to issue technical standards to improve consistency in these areas. These are expected to be finalised by mid-2016 for implementation by the end of 2018.

- **Phase three – Risk Parameter Estimation**
  The EBA intends to issue technical standards to address inconsistencies observed in risk parameter estimations. These will address some of the following areas:
  - Use of expert judgement in calibrating PD in low-default portfolios
  - Treatment of incomplete workouts and assumptions around discount rates, costs, haircuts and cure rates for LGD models Application of LGD floors, Credit Conversion Factor estimation, rating update frequency, use of collateral, etc.

- **Phase four – Collateral**
  The EBA intends to issue technical standards to address inconsistencies observed in the recognition of collateral. It expects these to be finalised by the end of 2017 for implementation by the end of 2018.

Some firms may seek to base their IFRS 9 models on their IRB models, or to keep the modelling approach consistent between the two sets of models. These firms should be aware of this programme change, and will need to manage the impact of the IRB approach change on their IFRS 9 models.

29 EBA/DP/2015/01 DP

30 EBA/CP/2014/36

Case Study: Implementation of IFRS 9 at a major EMEA bank

The following case study explores the ongoing implementation of IFRS 9 Impairment at a major EMEA bank (hereafter referred to as 'the Bank'). The Bank's Head of Risk and Capital modelling provides some lessons learnt in terms of project structure, methodology, principles, modelling challenges and general progress so far.

Project structure and general implementation considerations

This large international bank operates worldwide and holds a leading position in numerous European markets. It consists of several hundreds of entities and subsidiaries and has multiple lines of business.

The IFRS 9 Impairment phase introduces new concepts and principles into the Bank's accounting framework. The requirement to have an accurate evaluation of modelling-based credit risk necessitates some evolutionary change. To achieve this, a single team manages the project with a global view of the inherent challenges and coordinates the relevant Risk and Finance personnel.

The program aims to address the global challenges posed by this standard across the whole Bank: data, processes, IT, reporting, etc., as well as Finance and Risk co-sponsorship. The effort is co-led by Global Risk, which leverages its expertise in credit risk measurement.

Two main streams are set up within the project team. The first ensures compliance with the standard, led by the normative accounting team and risk management for the modelling. The second deals with IT, processes and governance, which involve more stakeholders.

During the first half of 2015, the project team developed new concepts for the methodologies and defined clear targets for the organization and processes. A parallel run is planned before the go-live on 1 January 2018, with a target date of mid-2017.

Impact on the Bank's operating model

Overall, the Bank's systems require substantial overhaul, especially its accounting and management systems. These may be further impacted by the final guidance expected following the Basel Committee consultation paper ***Guidance on accounting for expected credit losses***[31] issued in February 2015. The Guidance outlines 11 principles defining the relationship between risk management and the Expected Credit Loss measurement (see above).

31 Basel Committee on Banking Supervision. Consultative Document Guidelines: Guidance on accounting for expected credit losses. February 2015

The Bank strives to avoid the creation of multiple disconnected systems and frameworks. To this end, the Bank has launched a high-priority project to more closely integrate its processes and methods.

There is already a shared responsibility between Risk and Finance for data collection and reporting. Data collection is implemented from the point at which a loan is granted and is carried out on a line-by-line basis.

Building blocks of model development

The Bank aims at building its framework based on four main principles: leveraging of the current structure, simplicity, proportionality and comparability.

Principle One: Leveraging of the current structure. The Bank identified various modelling options in compliance with IFRS 9 requirements, building on existing processes and in line with current market practices. To do this, the Bank conducted modelling and impact studies, and commenced work on the tool design and calibration of calculators. The Bank strove to leverage its existing processes to manage the interplay between accounting, regulatory and risk management processes. The Bank's point of view is that accounting should not change the risk management and monitoring practices, but be a tool with which to improve them.

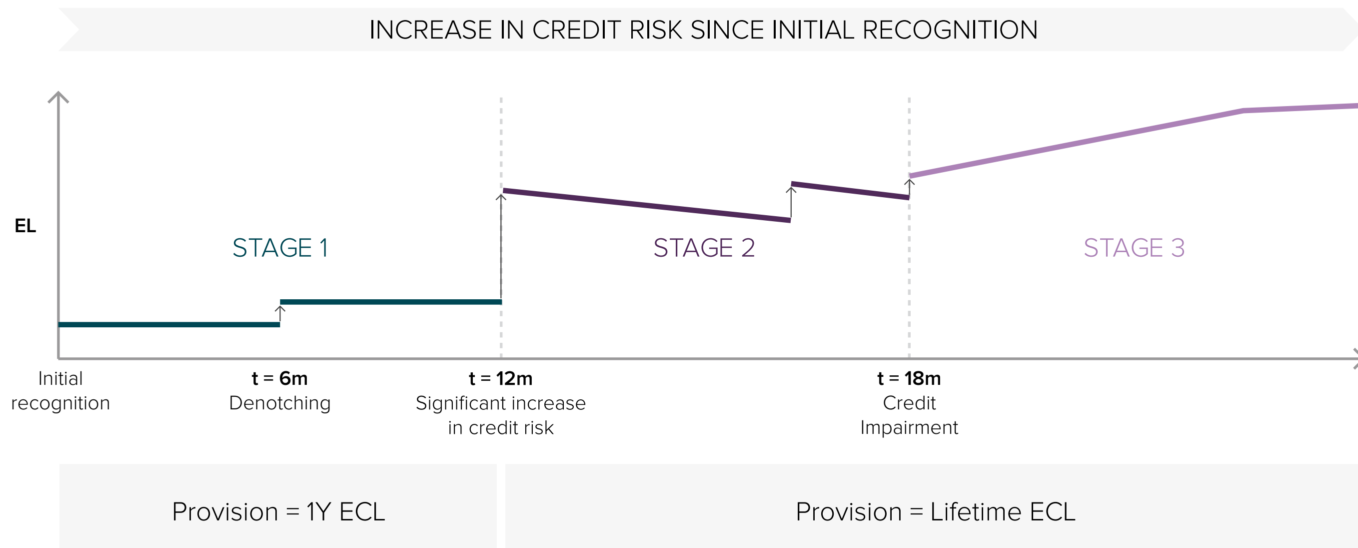
Principle Two: Simplicity. This criterion was used to avoid 'black box' effects and to leverage business knowledge as opposed to adopting a full automated framework. However, the Bank prefers to build a robust, auditable process from inception and an understanding of the provision variations.

Principle Three: Proportionality. The Bank uses the concepts of materiality and proportionality to ensure that the impairment framework is properly communicated and the implementation proceeds as expected. For the most significant entities in terms of exposure or credit risk, a 'reference' method is used. A simplified approach for less significant entities is considered where there is less data available.

Principle Four: Comparability. Finally, the Bank understands that comparability and benchmarking with peers plays an important role.

Some modelling challenges for the Bank

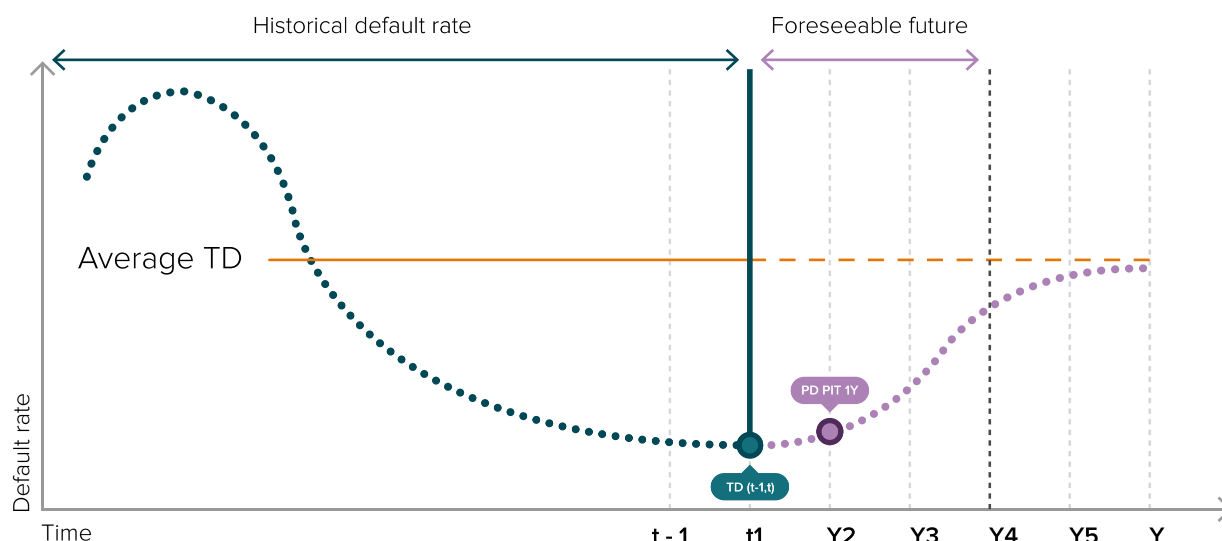
In terms of modelling, the main challenges for the Bank include:
- Transfer criteria
- PD calibration and
- Segmentation and forward-looking criteria.



Scheme 1 - EBA's planned regulatory response (Source: EBA)

The transfer to stage 2 – when there is a significant deterioration of credit risk – needs to be considered from the point at which a loan is granted. IFRS 9 calls for a comparison of risk levels between the date at which a loan is made and reporting dates. This should be calculated so that the comparison is up to date. The main goal is to capture defaulting loans correctly – as such, the Bank views Stage 2 as a transition state before default. The Bank plans to use a mix of absolute and relative risk assessments, as deterioration is always significant above a given risk level.

The underlying risk indicators used for the transfer criteria should be ones for which there are comprehensive historical data and performance assessments. This is the why the Bank prefers ratings, granting scores and behavioural scores, rather than probability of defaults (PDs).



It is now widely accepted that IFRS 9 PDs are not Basel PDs. Indeed, they differ in many ways. For instance, IFRS 9 PDs will have to include the current position in the economic cycle and economic forecasts up to the maturity of the loan (point 3Y in the graph above).

Segmentation and forward-looking modelling share similar challenges, including:

- Identification of relevant risk drivers
- Calibration, including a macroeconomic scenario over the foreseeable future.

For these reasons, the Bank works with these two components simultaneously.

Avantage Reply Comments

Some important lessons learnt from this case study include:

- Models should adopt a balanced approach. Some considerations include: global versus local, complexity versus clarity, accuracy versus timeliness, precision versus volatility.
- Depending on the materiality and proportionality of assets, different levels of sophistication of IFRS 9 models may be desirable within one reporting entity: for example, a reference method, an intermediate method and a simplified method.
- Models should not be overly complex. They must be auditable and explainable. Try to avoid full automation.
- Data availability will be a key element for successful modelling. Use active financial markets information where possible (market-implied information) and incorporate macro-economic forecasts where market-implied information does not exist, for example, in retail exposures.
- Implementing the new expected loss model requires several years of continued effort, from kick-off till completion, if the bank wants to fully benefit from the improvements in data, process, methodologies, organisation and reporting.
- The depth of changes required by IFRS 9 should not be underestimated, particularly with regards to the interplay between the level of provisions and the management of regulatory capital.
- This case study confirms that comparability of model outputs (e.g. level of stage 2 provisions) and benchmarking with peers is an important success factor.

How we can help

With extensive experience and expertise in finance, risk management and regulatory topics, Avantage Reply is well equipped to assist our clients in implementation of the IFRS 9, particularly the expected credit loss model. Having already assisted a number of clients in IFRS conversion, as well as credit risk modelling projects, we have developed unique insights into how best to support you in the IFRS 9 implementation process.

Avantage Reply provides many service offerings across the various dimensions involved in such projects, as outlined in the below table. Ad hoc workshops are also frequently organised on specific subjects.

PROGRAM MANAGEMENT FOCUS AREA	QUESTIONS TO CONSIDER	EXAMPLES OF ASSISTANCE WE COULD PROVIDE
Project Plan	What does your high level conversion plan look like? Will it satisfy your stakeholders, for example your analysts and investors? Does it address the questions identified in each of the four other focus areas?	• Credit risk Modelling • Project management of the implementation process • High level impact and accounting or operational diagnostics • Gap analysis • Target operating models • Drafting new accounting policies.
Resourcing	Do you have appropriate and available internal resources?	
Timescales	What are your key milestones and deliverables? Have you considered early adoption?	

Appendix

Overview of the main changes of the IFRS 9 Impairment model compared to IAS 39.

TOPIC	IFRS 9	IAS 39
Scope	• Financial instruments measured at amortised cost • Financial debt instruments at fair value through other comprehensive income • Lease receivables • Loan commitments (if not FVTPL[32]) • Financial guarantees (if not FVTPL).	• Financial instruments measured at amortised cost • Available-for-sale financial assets (including equity instruments)
Loss event	**Expected loss model:** Expected credit losses (ECL) are continuously re-estimated. Hence, there are no loss events or impairment triggers. An entity should recognise expected credit losses as distinct from initial recognition of financial assets. Estimates should incorporate past, current and forward-looking information.	**Incurred loss model:** Impairment is recognised only when a loss event occurs (i.e. an impairment trigger). When determining credit losses, an entity may only consider those credit losses that arise from past events and current conditions.

Determination of allowance loss	Only one model to determine the allowance loss: = PD * LGD * EaD * discount factor
	• 3-stage model:
	  • **Stage 1**: Performing (initial recognition)
	  • **Stage 2**: Underperforming
	  • **Stage 3**: Impaired
	If there is no significant deterioration of credit risk since initial recognition, a 12-month ECL is recognised (stage 1). If there is a significant increase of credit risk since initiation, a lifetime ECL is recognised (stage 2).
	As a consequence, IFRS 9 requires entities to 1) define what is a significant increase of credit risk and 2) be able to measure lifetime ECL.
		The determination of the allowance loss depends on the classification:
		• For Available-for-Sale financial assets, the impairment loss equals the unrealised loss (to be recycled from OCI[33])
		• For Loans & Receivables and Held-to-Maturity financial assets, the impairment loss is the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate.

TOPIC	IFRS 9	IAS 39
Collective or individual assessment	It is the entity's choice on either collective or individual assessment. The chosen approach should provide the best estimate and should not result in double-counting of credit losses.	• Financial instruments measured at amortised cost • Available-for-sale financial assets (including equity instruments)
Impairment reversal	All impairments are eligible for reversal	Assets that are individually assessed and for which no impairment exists are grouped with financial assets with similar credit risk statistics and collectively assessed for impairment. Usual practice for collective provisioning: IBNR[34] provision based on 'Emergence Period' Impairments may be reversed – except for equity instruments – if there is an objective credit improvement
Interest revenue (debt instruments)	If the asset deteriorates to the point that it is essentially impaired (Bucket 3), interest is calculated by applying the effective interest rate to the carrying amount net of the allowance balance to better reflect the yield on the asset.	Interest revenue is calculated for impaired debt instruments by using the effective interest rate, based on expected cash flows excluding expected credit losses.

32 Fair Value Through Profit or Loss

33 Recycling from Other Comprehensive Income (OCI) means reversing OCI entries and impacting the Profit or Loss statement

34 Incurred But Not Reported

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