

# The Challenges of Implementing IFRS 9

## PART 2

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### REGULATORY COMPLIANCE AND FINANCIAL STABILITY

Since our first IFRS 9 article was published back in the spring, banks worldwide have been progressing towards implementing the new loan loss provisioning standards. Initial feedback from banks as they complete “parallel run” type exercises site both higher credit reserve levels (this will vary by jurisdiction and depend on current state of the economy and provisioning levels) and increased reserve volatility (as we suggested would be the case in our earlier article); in fact, some global banks are seeing “surprisingly” high levels of volatility as they analyze parallel run results.

At the GRI we expect the transition to IFRS 9 to present challenges to the various stakeholders. There is a clear need for education and discussion across the financial services industry as we approach the implementation date this November.

In this paper we focus on the implications of IFRS 9 going forward, particularly as Canadian banks are required to “go live” in November. We divide the implications into two broad categories:

1. *Impacts on the economy in general, as the banks face a heightened level of pro-cyclicality in credit reserves.*
2. *Impacts on each of the banks, as they adapt their risk and control frameworks into an IFRS 9 accounting paradigm.*

The first issue we will discuss here is the impact of IFRS 9 on the economic cycle. IFRS 9 will likely have second order (and likely unintended) impacts, the next time the economy enters recession, as banks will be forced to tighten their lending and balance sheet standards more (and more quickly) than in past cycles. As banks

tighten lending standards it causes the magnification of the normal economic cycle, and when an economy is highly levered (as is currently the case in Canada) this magnification is further amplified. This pro-cyclicality was clearly evident in the 2007/2008 economic crisis, but was also a significant feature in the recessions of 1981 and 1991, and will be more intense the next time the economy falls into recession, as IFRS 9 further intensifies credit provisioning.

As the banks prepare to migrate to the new IFRS 9 standards, we should all be aware that this pro-cyclicality is about to be significantly increased. In fact one can make the case for a “perfect storm” the next time Canada and the global economy faces a recession. Banks will have migrated to IFRS 9, which means credit charges will hit harder and earlier as the economy slows down:

- *In a normal economic course downturn, demand will shrink, revenue growth will slow or reverse at many firms, and unemployment will increase as firms reduce staff to deal with the economic pressures.*
- *As a result, consumer delinquencies will start trending upwards, and credit ratings of business clients will start to be downgraded.*
- *Under IFRS 9 the implications of the above will start to be amplified, as bank's consumer and business clients start to migrate to “stage 2”, requiring a move to Lifetime Expected Credit Losses (which on average are approximately 2.5x higher than annual credit losses, and which will vary by loan / portfolio based on actual loan characteristics), putting further pressure on bank earnings.*

- Borrowers are then left struggling to both make their payments and refinance credit requirements at maturity, which then becomes a vicious cycle back through the IFRS 9 provisioning requirements.
- Overlay on top of all this is a massively levered Canadian consumer and global economy (refer to our paper back in the fall, “Low Rates and Ever Higher Debt”), and you can see the potential for the “perfect credit storm” hitting the Canadian economy.

Note that under IFRS 9, banks must also include downside / adverse scenarios (i.e. negative economic scenarios, but not as severe as stress tests) and probabilities to determine if there has been a “significant increases in credit risk” since origination (the trigger for moving credits to Stage 2, and increasing provision requirements from 1 year to lifetime). As the downturn becomes more likely, a self-fulfilling prophecy will take a hold, as banks tighten credit standards, which causes the economy to cool further, which causes a further wave of client migrations to stage 2, and so on. Offsetting this impact we be clients who can refinance their credit lines, as such refinancing resets them back to stage 1; we expect banks and clients will extend significant efforts towards refinancing under IFRS 9 in order to mitigate its impacts.

The increased levels of credit provisions (and their volatility) will also impact the banks enterprise risk management framework. As the banks adopt IFRS 9, starting in Canada this fall, they will need to update their risk appetite framework, stress testing framework, capital management processes and approach to credit risk models. The banks will also need to focus on communicating the impacts and ongoing implications of IFRS 9 on their financial results to the Board and investor community.

The Banks will need to work through the implications of IFRS 9 on their risk appetite framework. As the GRI outlined in the roll out of our Enterprise Risk Management Framework earlier this year, the Risk

Appetite Framework is a complex process which serves as a key linkage to the Bank’s strategy. The Risk Appetite Framework includes both quantitative measures (and targets) and qualitative statements (and objectives). As just one practical matter, most banks set a credit risk target in the form of a credit loss ratio, which equals the loan loss provision divided by total loans and acceptances. For the Canadian Banks this ratio is publicly disclosed:

PROVISION FOR CREDIT LOSS (PCL) RATIOS (BPS) - 2016	
Royal Bank of Canada	29
TD Bank	41
Bank of Montreal	23
Canadian Imperial Bank of Commerce	31
Bank of Nova Scotia	50
National Bank	38

Figure 1: Credit loss ratios (publicly disclosed loan loss provision divided by total loans and acceptances)

But as noted earlier, IFRS 9 will cause loan loss provisions to increase and become more volatile, and therefore will require a re-think of the credit metric targets and limits, and the implications of a breach. Should the target be reset each year on a point-in-time basis, or should it be set as a peak level through a credit cycle? Should a breach require a tightening of lending standards and other mitigation steps (e.g. purchase of credit protection? Portfolio sales?), or is it more of a guiding principle?

Banks will also need to consider the impacts of IFRS 9 on their stress testing frameworks. Let’s consider the U.S. Fed’s CCAR (Comprehensive Capital Analysis and Review) process, as it is quite public. When the U.S. adopts its version of IFRS 9 (called Current Expected Credit Losses, or CECL statistics), banks will need to adjust their stress testing models to reflect the new accounting standards, which moves credit losses up earlier in the cycle (and very likely over provisioning through the crisis, followed by reversals). The adjustment to the new standard for the

stress testing process could well be the “canary on a coal mine”, as banks will reflect higher losses sooner in their stress scenarios.

The banks approach to credit risk modeling is already being adjusted, as they manage the conversion to IFRS9. The following chart summarizes some of the new standards banks will be facing (and compared to the Basel Capital Accord):

**PERFORMING ASSETS AND UNDERPERFORMING ASSETS  
(WITH A SIGNIFICANT INCREASE IN CREDIT RISK)**

		IFRS 9	CECL	BASEL
PD	Measurement period	12 month (Stage 1) Lifetime (Stage 2)	Lifetime	12 months
	Cycle Sensitiveness	Point-in-time, considering forward looking information, including macroeconomic factors		Economic cycle
LGD/ EAD	Measurement	Neutral estimate, considering forward looking information, including macroeconomic factors		Downturn estimate

While we detailed some of the modeling challenges in our initial paper (including the development and ongoing maintenance of two sets of books – capital and accounting), banks are also facing operational risks in this area; many banks are citing the lack of qualified, quantitative analysts to build their models. Compounding this issue is the need for a second validation team (an important internal control and regulatory requirement) in each bank, to vet the models and parameters being used for both accounting and capital purposes.

These implementation questions lead us back to a GRI article published in the spring of 2017 on the shadow banking system (see Sheila Judd’s article “Shadow Banking: Non-bank Credit Intermediation Heightens Risks for the Global Financial System”). Is it possible banks will no longer be the natural holder of the (now more volatile) loan portfolios, and will credit portfolio managers be looking to sell the more risky/vulnerable loans to institutions with less sensitivity to quarterly accounting results, such as hedge funds and private finance companies? As Sheila noted in her paper, such institutions are far less regulated than banks, and therefore a migration of loans to the shadow banking system should be viewed with caution.