The Challenges of Implementing IFRS 9-Impairment

EXECUTIVE SUMMARY

Note: We are providing a more comprehensive Executive Summary with this article, as the main body is a bit more detailed and accounting technical; we expect the Executive Summary provides a comprehensive overview for most readers, and the main body goes into detail for those with a more technical interest.

Additionally, this article provides an overview of IFRS 9 and its potential impacts. We intend to follow this up with an article in the second quarter focussing on operational and implementation challenges.

Canadian Banks and credit unions are in the midst of implementing one of the most challenging accounting changes in recent memory, when they move from an Incurred Loss (IAS 39) to an Expected Credit Loss (“ECL”) (IFRS 9) accounting standard.

The Canadian banks will adopt the new standard on November 1st of this year (the start of the 2018 fiscal year), while the European banks will adopt in 2018; the US Financial Accounting Standards Board (FASB) published its final standard on Current Expected Credit Losses (CECL) in June 2016. The FASB’s new standard will take effect on January 1, 2020 for certain public banks, and in 2021 for all other banks, with early adoption permitted in 2019. These changes come into effect after years of global review and debate, with the goal of having a more appropriate level of credit losses recognized earlier in the credit cycle (following concerns raised during the financial crisis that provisions were “too little, too late.”)

As a result, loan loss provisions (i.e. the income statement charge) and its volatility could increase significantly, as they will respond much more directly to changes in credit risk trends (as indicated by a combination of credit models, loan ratings / other characteristics, economic trends and stress testing analysis – and thereby introducing significant judgement into the process). A Deloitte survey of global banks indicates that their Allowance for Credit Losses (i.e. the balance sheet reserve – which is built up via loan loss charges through the income statement, and drawn down by write-offs) could increase by up to 50% for some banks. Additionally, a recent survey carried out by the European Central Bank reported that loan loss provisions (i.e. the charge that goes through the income statement) could increase in a range from 18%-30%. And KPMG has reported that “credit losses are expected to increase and become more volatile under the new expected credit loss model. The number and complexity of judgements is also expected to increase.” The following graphic, provided by KPMG, outlines the significant change in provision for credit loss charges under the two methodologies:
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While there are significant details and changes in these new standards (see full article, below), the most fundamental change is that banks will now be required to take a provision on all loans in their banking book, as opposed to the current standard which requires objective evidence that the loan has become impaired before a reserve is established. So as new loans are originated an expected credit loss is calculated, based on a 12 month time horizon (i.e. considering the probability that the loan will default within one year – often a pretty low number). But then the banks will have to do a second analysis, as at each reporting period; they will have to assess each loan for a “significant increase in credit risk”, and when that occurs they will have to increase the provision to a Lifetime expected credit loss, where the probability of default time horizon extends from 12 months to the full term of the loan (and therefore more similar to a provision taken today against a defaulted credit). So one can see how loan loss provisions will increase and become more volatile under the new standard.

The changes will also significantly increase the complexity of the Bank’s credit risk systems and models. Interestingly, just as regulators are considering a fundamental overhaul and limitation on the use of credit risk models and parameters for capital management purposes, such models will become a key component in the new loan loss accounting standard. The expected loss model requires banks to build a new set of credit models (for the larger banks we observe mostly as extensions of their capital and stress-testing models; for smaller banks and credit unions who are not on the advanced Basel capital approach, this is a bigger challenge) and exercise significant judgement to determine loan losses at each reporting period. The IFRS 9 implementation also introduces operational risks, as complex models need to be built, vetted and maintained, and then coupled with significant estimations and judgement, in order to calculate the new allowance and loan loss numbers. In fact, although the ECL models may be built as extensions of the Basel capital models at some banks, the standards and requirements are different from the capital standards and therefore another set of books needs to be maintained.

IFRS will also likely have significant impacts on the banks capital levels. As higher and more volatile provisions are recognized through the income statement, they will flow through to and reduce retained earnings and thereby the capital ratios. There is a significant pro-cyclicality involved here, as a downturn in the economic / credit cycle will cause retained earnings to fall just as risk weighted assets are increasing (i.e. the capital rules also require risk weighted assets models to increase with a turn in the credit cycle, albeit more slowly); banks will therefore be pressured to curtail lending to protect their capital ratios, leading to a self-fulfilling cycle. Also, there is an asymmetric treatment of credit allowance reserves in the capital standards, where under provisioning (i.e. allowance reserve less capital model expected losses) leads to a haircut for the crucial Tier 1 Common Ratio, whereas an over provisioning (which could well occur under IFRS 9) does not provide a similar benefit (the benefit is recognized in the Total Capital Ratio, which is less of a binding constraint.)

So, banks and their shareholders have some significant challenges and operational questions ahead of them. Who will own the models and processes? Who will reconcile the various sets of books, and manage the asymmetry between capital, stress test and accounting treatment? Who will maintain the talent and systems to operate these complex systems going forward? How will the significant estimates and judgements be governed? And finally, who will educate the user community regarding the significant change in financial disclosure?

As this is such a significant change for both the banks and their shareholders, we plan to continue our research in this area, considering next the operational and implementation issues.
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Background and Scope

The implementation date for the new International Financial Reporting Standard (IFRS 9), issued in July 2014, relating to financial instruments and disclosures, is effective January 1, 2018. In January 2015, OSFI issued an advisory with respect to the early adoption of IFRS 9 for Domestically Systemically Important Banks (D-SIBs), requiring D-SIBs to adopt IFRS 9 for the annual period beginning on November 1, 2017. Thus, banks will be required to adopt IFRS 9 on November 1, 2017.

In June of 2016, OSFI issued a framework which provides application guidance to Federally Regulated Entities (FREs) applying International Financial Reporting Standard 9 Financial Instruments (IFRS 9), and is effective when IFRS 9 is applicable to FREs. Where necessary reference is made to the principles of OSFI’s Guideline throughout this paper.

IFRS 9 requires banks and other entities to change the methodology used for the measurement of the allowance for credit losses. The new principles based methodology requires the expected credit loss model to replace the rules based incurred loss model (i.e. International Accounting Standard (IAS) 39), which has been disfavoured primarily because it was slow in recognizing credit losses leading up to and during the 2008 financial crises. In the Guideline, OSFI states: “The move to Expected Credit Losses (ECL) accounting frameworks by accounting standard setters is an important step forward in resolving the weakness identified during the financial crisis that credit loss recognition was too little, too late. The development of the IFRS ECL accounting framework is also consistent with the April 2009 call by the G20 Leaders for accounting standard setters to strengthen accounting recognition of loan loss provisions by incorporating a broader range of credit information.”

The following graphic, provided by KPMG, outlines the significant change in provision for credit loss charges under the two methodologies:

While IFRS 9 applies broadly to classification and measurement, impairment and hedge accounting, this discussion paper primarily focuses on the impairment of bank loans.

Under the rules based Incurred Loss model, a loss allowance is not required until there is objective evidence that the loan is impaired. That could be either individually assessed (say for a large corporate borrower who is no longer making scheduled payments) or collectively assessed as part of a portfolio (say for credit cards, where a roll rate model is used to estimate losses already inherent in the portfolio). For example, Royal Bank of Canada (RBC) in Note 2 of its financial report for the year ended October 31, 2016, stated:

- “We assess at each balance sheet date whether there is objective evidence that the loans (including debt securities reclassified as loans) are impaired. Evidence of impairment may include indications that the borrower is experiencing significant financial difficulty, among other things. Whenever a payment is 90 days past due, loans other than credit card balances and loans guaranteed or insured by a Canadian government (Federal or Provincial) or a Canadian government agency (collectively, Canadian government) are classified as impaired unless they are fully secured and collection efforts are reasonably expected to result in repayment of debt within 180 days of the loans becoming past due. Loans guaranteed by a Canadian government are classified as impaired when the loan is contractually 365 days in arrears. Credit card balances are written off when a payment is 180 days in arrears.”
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We assess whether objective evidence of impairment exists individually for loans that are individually significant and collectively for loans that are not individually significant. If we determine that no objective evidence of impairment exists for an individually assessed loan, whether significant or not, the loan is included in a group of loans with similar credit risk characteristics and collectively assessed for impairment. Loans that are individually assessed for impairment and for which an impairment loss is recognized are not included in a collective assessment of impairment."

IFRS 9- Expected Credit Loss Model

Under the principle based, forward looking IFRS 9 ECL model, a loss allowance must be provided immediately on the origination of a loan. This results in an earlier recognition of credit losses compared to IAS 39. Subsequently, at each reporting date, an assessment is done to determine if there has been a significant increase in credit risk.

We will discuss the assessment process in detail below. Our discussion will make reference to the recommendations of IFRS 9 and the Guideline issued by OSFI. But before we do, let us now consider some of the peculiarities of ECL, starting with its definition, followed by its three main attributes namely: segmentation, staging and the measurement of the loss allowance:

ECL Definition

IFRS 9 defines expected credit losses as follows:

1. An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;
2. The time value of money; and
3. Reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions [IFRS 9.5.5.17].

The ECL model comprises two possible provision processes, either 12-months ECL or Lifetime ECL, depending on which stage the loan is in (see below). The 12-month ECL is “the portion of Lifetime ECL that represents expected credit losses that results from default events on financial instruments that are possible within the 12 months after the reporting date.” Lifetime ECL, on the other hand, are “the expected credit losses that result from all possible default events over the expected life of a financial instrument.”

I. Segmentation of the Portfolio.

To enable a reduction in the number of assessments to be performed, IFRS 9 permits an entity to group its exposures based on shared credit risk characteristics, in order to enable them to be assessed collectively for significant increases in credit risk. As the IFRS 9 standard states, “for the purpose of determining significant increases in credit risk and recognising a loss allowance on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics with the objective of facilitating an analysis that is designed to enable significant increases in credit risk to be identified on a timely basis. The entity should not obscure this information by grouping financial instruments with different risk characteristics. Examples of shared credit risk characteristics include, but are not limited to: credit risk ratings; instrument type; collateral type; date of initial recognition; remaining term to maturity; industry; geographical location of the borrower; and the value of collateral relative to the financial asset if it has an impact on the probability of default occurring.” (IFRS 9: B5.5.5)

OSFI, in Principle 3 of its Guideline, recommends: “A bank should have a credit risk rating process in place to appropriately group lending exposures on the basis of shared credit risk characteristics.” Further, paragraph 101 of the Guideline states: “Where a collective assessment is performed, exposures within that group must adhere to the requirements set out in Principle 3. Where information becomes available to management indicating that further or different segmentation within a group of lending exposures is required, the group should be split into subgroups and the measurement of the amount equal to 12-month ECL should be updated separately for each subgroup, in the case of transient circumstances, a temporary adjustment should be applied.”
Staging

Application of the impairment requirement at reporting date

Is the loan a purchased or originated credit impaired financial asset (On Origination)

Yes

No

Does the loan have a low credit risk at reporting date?

Yes

No

Has there been a significant increase in credit risk?

Yes

No

Is the low credit risk simplification applied?

Yes

No

Recognise lifetime expected credit losses

And

Is the loan credit impaired?

No

Yes

Recognized 12-months expected credit losses and calculate effective interest rate and always recognize a loss allowance for Lifetime expected credit losses (Stage 3).

Recognised 12-months expected credit losses and calculate interest revenue on the gross carrying amount. (Stage 1)

Calculate a credit-adjusted effective interest rate and always recognize a loss allowance for Lifetime expected credit losses (Stage 3).

Calculate interest revenue on the gross carrying amount (Stage 2)

Calculate interest revenue on amortised cost (Stage 3)

Adapted from IFRS

Staging is the most critical aspect of the loan impairment process. It is an assessment process that categorises an entity’s exposures into one of three buckets or stages based on whether or not there has been a significant increase in credit risk. The decision tree (above), which has been adapted from IASB, provides a diagrammatic representation of the three-stage process that bands exposures into performing, underperforming or credit impaired groups or Stage 1, Stage 2 or Stage 3 loans.

IFRS 9 requires an entity, at each reporting date, to carry out an assessment to ascertain whether there has been a significant increase in credit risk for each exposure (or group of exposures that share the similar credit risk within its portfolio). A significant increase assessment comprises a comparison of the risk of default at initial recognition to the risk of default at reporting date. Further, to assist entities in making the assessment of a significant increase in credit risk, IFRS 9 provides a non-exhaustive list of indicators that are relevant to such an assessment. These indicators include, but are not are limited to: a decline in the borrowers’ revenue, changes in external credit ratings, or significant changes in the value of collateral. (IFRS 9 B5.5.17) For banks using the Basel model, discussed below, the risk of default is the probability of default (PD).

In determining whether there has been a significant increase in credit risk, some entities may use available qualitative and non-statistical information, which may be sufficient to determine that a financial instrument has met the criterion for the recognition of lifetime expected credit losses. That is, the information does not need to flow through a statistical model or credit rating process in order to determine whether there has been a significant increase in the credit risk of the financial instrument. In other cases, an entity may need to consider other information, including information from its statistical models or credit ratings processes. Alternatively, the entity may base the assessment on both types of information, i.e. both qualitative factors and quantitative analysis, if both types of information are relevant. (IFRS 9 B5.5.18)

Further, in determining whether there has been a significant increase in credit risk, an entity must use all reasonable and supportable information which is available at the reporting date, without undue cost or effort, including information about past events, current conditions and forecasts of future economic conditions. For greater clarity, information that is available for financial reporting purposes is considered to be available without undue cost or effort. (IFRS 9 B5.5.49)

Stage 1

If, at the reporting date, there has been no significant increase in credit risk, the exposure continues to be classified in Stage 1 (performing) and a loss allowance equal to 12-months ECL continues to be provided. (IFRS 9 5.5.5)

Stage 2

If, however, there has been a significant increase in credit risk, an allowance equal to Lifetime ECL is
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provided. Typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example, a modification or restructuring) are observed. Consequently, when reasonable and supportable information that is more forward-looking than past due information is available without undue cost or effort, it must be used to assess changes in credit risk. A financial asset is past due when a counterparty has failed to make a payment when that payment was contractually due. However, there is a rebuttable presumption that there has been an increase in credit risk since initial recognition if contractual payments are more than 30 days past due.

Stage 3

On the other hand, a financial asset is in default or credit impaired when one or more events that have a detrimental impact on the estimated cash flow of that financial asset have occurred (e.g. if a borrower has filed for bankruptcy, or where a bank has granted a borrower a payment concession). IFRS 9 does not provide a definition of default, but requires entities to define default in a manner consistent with that used for their internal credit risk management. (IFRS 9 B5.5.37)

In paragraph 94 of its Guideline, OSFI recommends that the definition of default adopted for accounting purposes be guided by the definition used for regulatory purposes. Additionally, IFRS 9 B5.5.37, includes a rebuttable presumption that default does not occur later than 90 days past due. If there is objective evidence that the loan is in default, then an allowance equal to lifetime expected credit losses is provided and interest revenue is calculated on amortised cost.

There are two things that should be noted about the staging assessment process when compared to the Incurred Loss Model:

• Some exposures will migrate between the stages based on whether there has been a significant increase in credit risk or not. This will cause volatility in the loan allowance and reported earnings.

• The fact that a loss allowance must be provided for each exposure negates the necessity for a collectively assessed allowance (i.e. the incurred loss model includes a statistical assessment to estimate loans that are not yet reported as impaired, and a provision is booked on those loans as well – likely close to a 12-month expected loss, on average.)

Measurement of Expected Credit Losses

As set out in Principle 4 of OSFI’s Guidance -Adequacy of the Allowance, “A bank’s aggregate amount of allowances, regardless of whether allowance components are determined on a collective or an individual basis, should be adequate and consistent with the objectives of the applicable accounting framework.” Paragraph 51 further states, “Banks should implement sound and robust credit risk methodologies with the objective that the overall balance of the allowance is developed in accordance with the IFRS 9 framework and adequately reflects ECL with the framework”.

ECL are a probability-weighted estimate of credit losses (i.e. the present value of all cash shortfalls) over the expected life of the financial instrument. A cash shortfall is the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive. Because expected credit losses consider the amount and timing of payments, a credit loss arises even if the entity expects to be paid in full but later than when contractually due. (IFRS 9: B5.5.28)

For financial assets, a credit loss is the present value of the difference between:

(a) the contractual cash flows that are due to an entity under the contract; and

(b) the cash flows that the entity expects to receive. Both amount and the timing of the payments should be considered. (IFRS 9 B5.5.29)

IASB has not provided a basis for measuring expected credit losses but requires each entity to develop its own measurement tools. To compute the loss allowance for 12- month and Lifetime ECL, we expect most banks will use modified IRB (Basel II) measurements and stress testing models to derive the following components:

• Probability of Default (PD) is an estimate of the likelihood of default over a given time horizon.

• Loss given default (LGD) is an estimate of the loss arising on default. It is based on the difference between the contractual cash flows due and those that the lender would expect to receive, including from any collateral. It is usually expressed as a percentage of the EAD.

• Exposure at Default (EAD) is an estimate of the exposure at a future default date, considering
expected changes in the exposure after the reporting date, including repayments of principal and interest, and expected draw downs on committed facilities.

- Discount Rate (DR) - This is used to discount an expected loss (including recovery costs) to a present value at the reporting date using the effective interest rate (EIR) at initial recognition.

Examples of the 3 Stage model

The following three scenarios provide simplified examples of the three stages of the ECL model. Assume that ABC Bank (ABC) originates an A-rated 10-year amortising loan for $100 million. Given the credit risk of the borrower, and the economic outlook for the next 12 months, ABC estimates that the loan at initial recognition has a probability of default (PD) of 0.5 per cent over the next 12 months.

Scenario 1. 12-months ECL-Stage 1.

At the reporting date (which is before payment on the loan is due), there has been no change in the 12-month PD and ABC determines that there was no significant increase in credit risk since initial recognition. ABC determines that 25 per cent of the gross carrying amount will be lost if the loan defaults (i.e. the LGD is 25 per cent). The 12-month expected credit loss is therefore $125k (0.5% × 25% × $100 million), and this provision establishes their allowance reserve on the loan.

Scenario 2. Lifetime ECL-Stage 2.

At a future reporting date, historic data along with future economic estimates now project that there could be an economic downturn that would negatively impact the customer, resulting in a significant increase in credit risk compared to initial recognition; this results in a computed PD of 10% (representing a downgrade of the credit, say from A- to BBB+) over the life of the loan. ABC determines that LGD has increased to 35%. Assuming EAD continues to be estimated at $100 million, an allowance of $3.5 million is now required (10% × 35% × $100 million), resulting in a provision this quarter of $3.375 million (added to the allowance in Scenario 1 of $0.125 million, for a total allowance of $3.5 million.)

Scenario 3. Lifetime ECL-Stage 3.

Under this next scenario, at reporting date, assume that there is now objective evidence that the loan is credit impaired, and therefore probability of default of is now 100%. ABC determines that the EAD is still $100 million. The LGD is now projected at 50%. The allowance reserve required is now $50 million (100% x 50% x $100 million), with a provision in the quarter of $46.5 million (added to the allowance in Scenario 2 of $3.5 million, for a total allowance of $50 million.)

CONCLUSION

The date for the implementation of IFRS 9 is almost at hand, which will lead to higher and more volatile loan loss provisions going forward. The large global banks are also identifying accounting, risk management, credit risk modelling and overall management complexities that will make both implementation and ongoing management a challenge.

The Global Risk Institute believes that an additional key challenge will be communicating this significant change in earnings profile out to the market place, including the increased volatility in loan losses and therefore earnings.

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