IFRS 9 and the new loan impairments regime

Assuring your implementation is on track

What is the new loan impairments regime?

The new international accounting standard IFRS 9 changes the way impairments are recognised and reported by businesses. It takes a more forward looking view and requires businesses to estimate potential future credit losses based on probabilities.

In the wake of the financial crisis, the accounting profession was criticised for its treatment of financial instruments on banks' balance sheets. Particular concerns were raised about the rules for recognising impaired assets, which essentially allowed banks to delay recognition until there was positive evidence a loss had been incurred.

Many stakeholders felt this was 'too little too late' and called for a more forward-looking measure of expected losses. International Financial Reporting Standard 9 (IFRS 9) seeks to address these issues by fundamentally rewriting the accounting rules for financial instruments. It introduces:

- a new approach for financial asset classification
- a more forward-looking expected loss model for impairments
- new requirements for hedge accounting.

The new loan impairments regime is having a particularly significant impact on all firms operating under international financial reporting standards. The regime is coming into force with the introduction of IFRS 9 on 1 January 2018. For firms required to submit ICAAPs, the estimated impact must be included in their 2017 submission to regulators.

Key considerations

The new regime has significant financial and operational implications, and is both costly and complex to implement. While larger firms are well advanced in their implementation projects, many medium and small organisations are still grappling with the intricacies of the new requirements.

Implementation will impact a wide range of activities across business and control functions including:

What are the changes?

The new impairments regime is having a significant impact for firms. It now extends to:

- All exposures not subject to fair value through profit and loss
- Assets not previously considered in loss provisions, such as bank deposits
- Leases and guarantees

Key changes include:

- New requirements to provide against potential future losses, even on good credits
- Probabilities must consider a range of possible outcomes
- Macro-economic forecasts used to assess performance of each credit in different scenarios
- Three-stage profiling of credit risk
- Two-tier forecast horizon based on staging assessment

Strategy:
- Business model
- Risk appetite
- Pricing implications

Stakeholder engagement:
- Senior management/board
- Auditors
- Regulators

Governance:
- Policy framework
- Board and committee oversight
- Organisational model

Models:
- Suitability/proportionality
- Linkage with existing capital models
- Model governance controls

Risk management controls and monitoring:
- Early warning indicators
- Risk limits
- Client relationship management

Data and systems infrastructure:
- Appropriate data sources (internal and external)
- Data warehousing and integrity controls
- Maintenance and update cycle

HR:
- Employee incentives
- Performance management
- Staff training

Transition arrangements:
- Impact analysis
- ICAAP disclosure
- Capital phasing

What are the technical challenges?

The new rules introduce substantial complexity into impairment calculations. Even for small firms who may adopt a simplified approach, the scale of the project should not be underestimated. As a minimum, firms need to address the following challenges.

Calculating Probabilities of Default (PD)

- PD data must be sourced for all exposures, whether rated or unrated. This includes assets previously not considered in loss provisions, such as government bonds and bank deposits
- PDs need to consider a range of potential outcomes, with each outcome itself being probability weighted. This requires the capability to forecast both macroeconomic variables as well as entity specific risks
- PD models need to support both 12-month and lifetime forecast horizons

Assessing Loss Given Default (LGD)

- LGD must be assessed for each exposure and take into account a range of different default scenarios
- Recovery rate assumptions need to be supported by historical data
- Collateral is modelled separately, taking into account estimated time to foreclose and realise proceeds
- Multiple loss outcomes must be individually present valued using each asset's unique effective interest rate (EIR)

Establishing appropriate definitions

- All exposures must be categorised into one of three stages. The staging assessment requires banks to define what constitutes a 'Significant Increase in Credit Risk' (Stage 2) as well as reviewing their definition of 'Default' (Stage 3)
- For variable maturity products, or instruments that contain optionality, the definition of 'lifetime' will need to be established

Upgrading systems architecture

- Systems will need to be capable of applying appropriate ECL factors to each exposure
- Maintaining PD and LGD data for a changing portfolio will create new demands on banks' data warehousing infrastructure
- Controls to ensure the ongoing integrity of data must be established

Case study

Case study: UK subsidiary of a large international banking group

Our client is a UK subsidiary of a large international banking group, who required a simplified solution to achieve compliance with the new impairment rules. Given their relatively straightforward business model, our client required a cost effective approach which was proportionate to the limited scale and complexity of their activities.

Our subject matter experts analysed client exposures and proposed a simplified approach to sourcing the necessary PD and LGD data. We provided a roadmap to implement the new rules in a straight forward and manageable fashion.

How can we help?

Grant Thornton has worked closely with the accounting standard setters and industry groups throughout the development of IFRS 9. Our Business Risk Services team supports clients' internal audit functions in assuring their firms' implementation plans, drawing on in-house expertise spanning all aspects of IFRS 9 implementation.

We offer assurance services tailored to the scale and complexity of our clients' implementation projects:

- Gap analysis against the new rules – including assessment of the existing credit risk management framework and a roadmap of next steps
- Impact assessments – including review of strategic implications, capital planning and revisions to policy frameworks
- Impairment modelling – including forward looking PD and LGD models, identification of credit deterioration triggers and linkage to existing capital models
- Pre-implementation assurance – including review of implementation plans against best practice, assessing project governance and control frameworks, as well as evaluation of design specifications against new requirements
- Post-implementation control reviews – including assessment of operating effectiveness of new control frameworks

Our team offers the full range of relevant technical expertise, including credit risk management specialists, quantitative modelling analysts, financial services consultants (for retail, commercial, and investment banking), technical accounting experts and programme management practitioners.

We are fully flexible in the way we support clients. We can work as consultants to provide a full independent assurance service on all or part of your firm's implementation. Equally, we can provide subject matter experts to work alongside your in-house audit team to provide the necessary technical input to support your assurance programme.

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