Implementing IFRS 9 Impairment
Key Challenges and Observable Trends in Europe

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Agenda

- Regulatory and IFRS9 project status
- Key elements and challenges
- Conclusions
IFRS 9 Overview

IFRS9 compliance covers three pillars as shown in the below scheme:

- **Classification and management**
- **Impairment**
- **Hedge accounting**

- **Impairment models for the timely recognition of expected credit losses (ECL)**
- **Substantially-reformed models for hedge accounting**
IFRS9 and Regulatory Initiatives
Ongoing Discussion

BCBS Guidance on credit risk and accounting for ECL
■ Guidance on how the ECL accounting model should interact with a bank’s overall credit risk practices and regulatory framework

Dec ‘15

July ‘16

Oct. ‘16

Mandatory application of all requirements of IFRS 9 1st Jan 2018

BCBS Papers: regulatory treatment of provisions and transitional arrangements
■ The BCBS is proposing transitional arrangements under which the “capital shock” is phased in over a three to five year period
■ Further, BCBCS sets out a number of longer-term options to address the regulatory treatment of provisions

EBA consultation paper on draft guidelines on credit risk management practices and accounting for ECL
■ The paper aims at implementing the BCBS guidance in the EU
■ The draft EBA guidelines are expected to be finalized during the first quarter of 2017
IFRS9 and Regulatory Initiatives
Regulatory Treatment of Provisions and Transitional Arrangements

BCBS Consultative document: interim approach and transitional arrangements

- The consultative document released sets out the Committee's proposal to retain, for an interim period (from 3 to 5 years), the current regulatory treatment of provisions under the standardized and the internal ratings-based approaches.
- Because a distinction between general provisions (GP) and specific provisions (SP) does not exist under accounting frameworks, jurisdictions – for an interim period - would extend their existing approaches to categorizing provisions as GP or SP.

BCBS Discussion Paper: Regulatory treatment of accounting provisions

- Policy options for the long-term regulatory treatment of provisions under the new ECL standards (under discussion):
  1. To *retain the current regulatory treatment of provisions*, including the distinction between GP and SP, as a permanent approach.
  2. To introduce a *universally applicable* and binding *definition of GP and SP*.
  3. Fundamentally *change the current regulatory treatment of provisions* – remove the GP/SP distinction and introduce regulatory EL under SA.
IFRS9 Project Status
Degree of Preparation in Europe

- Most banks are closing design phase and starting the building phase.
- Larger banks tend to be more advanced in the implementation of IFRS9.
- Scale of IFRS 9 implementation for smaller banks is generally relatively smaller than for larger banks and/or.
- Smaller banks may have less available resources to invest (such as the lack of historical data and modelling capabilities, as well as limited IT and human resources).

Project Execution
European best practice

- The duration of the parallel run for impairment will vary across banks, ranging from less than 6 months to up to 1 year.

2016

Technical Analysis
models, processes, policies, systems, and data

2017

ECL Business Requirement
BR development for ECL implementation

Implement, and Impact analysis
At transition and over the cycle

Dry run
Technical and Functional Dry Run

Go live

2018

Go live
IFRS9 Project Status
Involvement of Departments and Responsibilities

- Most banks have created a **Steering Committee**, which consists (at a minimum) of representatives from both Risk and Finance, responsible for the implementation of IFRS 9 (with **Finance** mainly involved in **classification and measurement** and **Risk in impairment**)
- In other banks, the responsibility is either **jointly shared by Risk and Finance** or only that of **Finance**
- In certain banks, the responsibility is **shared between different departments** for different elements of the implementation of IFRS 9

The involvement of the **Board of Directors** and the **Audit committee** is more limited at this stage

**Senior management** is actively involved in the implementation of IFRS 9, as well **external auditors** who are consulted or informed about decisions taken

**Risk and Finance** are involved in the implementation of IFRS 9 for most banks. The **IT function** is also significantly involved.
Most banks will develop and implement centralized group-wide IFRS 9 methodologies, which will mainly include:

- the interpretation of aspects of IFRS 9, such as the indicators to be used for the assessment of a significant increase in credit risk
- the models to be used for the measurement of ECL
- the forward-looking information to be considered (including macroeconomic scenarios) by entities within a group

Banks will also take into consideration subsidiary-specific products/portfolios and local economic factors so that local specificities are considered.
IFRS 9 Project Status
Use of Existing Processes, Systems, Models and Data

Leverage off the existing regulatory and/or risk management models
- Applying PiT estimation under IFRS 9;
- Applying a lifetime PD under IFRS 9 (for stages 2 and 3);
- Removing prudential floors and downturn adjustments in the EAD and LGD estimations

Projection of macroeconomic information
- Leverage off stress test methodology and use stress test information to the extent that those methodologies and information are suitable for IFRS 9 purposes

Validation of models and back-testing
- Application of a similar validation process as used for the regulatory models or for the existing credit risk models

- Banks are generally looking to leverage off (to the extent possible) the existing governance processes and quality controls used in the current prudential framework and/or internally for credit risk management.

- Those banks that already use IRB approaches to some extent generally believe that existing processes, systems, models and data are likely to be in place and can be used for the purposes of IFRS 9 application.
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- **Key elements and challenges**
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Key Elements and Challenges in the Implementation of IFRS 9 Impairment

Strategic Environment

- Increase of provisions and P&L volatility
- Impact on own funds and interaction with prudential requirement

1. Impact on lending practices

Operational Environment

2. Data quality and availability
   - Governance and interaction of different departments
   - Adequacy of human resources/ expertise

Methodology Environment

3. Significant increase in credit risk: staging criteria
4. ECL methodology and input to ECL measurement
   - Model validation

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Many banks anticipate that IFRS 9 impairment requirements will have an impact on lending practices of banks in terms of the pricing of products, the maturity of the products and underwriting practices.

However, a significant number of banks already validate to use IRB model expect a minor change as the main elements of IFRS9 are already embedded in the pricing of products and risk management (leveraging on Basel “use test”).

- Definition of credit strategies taking into account a potential transition of the positions from stage 1 to stage 2
- Portfolios have to be simulated for multi-year periods, considering how the new absorbed risk effects volumes

- Early Warning system evolution
- Inserting in the monitoring dashboard of a series of indicators in order to prevent the migration from Stage 1 to Stage 2

- Coherence between lifetime risk parameters used for the purpose of risk-based pricing and provisioning purposes

- Align IFRS9 impairment process with other key related areas – e.g. Capital calculation; ICAAP (Stress test)
- Enhanced reporting to accommodate additional complexity and flexibility e.g. impairment bucketing
In terms of data availability, the main issue mentioned is the availability of historical data for IFRS 9 purposes and, in particular, determining:

- the credit risk (as reflected in the PD or rating) at origination for exposures that originated a long time ago
- exposures for which there could be limited data or default events in order to build a model (such as those exposures of high credit quality)

The consideration of forward-looking information is also described as a challenge under IFRS 9.

For most banks, data quality is the major risk. It will be necessary to ensure reliable data, to manage high volume and complex information, as well as to source historical information.
### Significant Increase in Credit Risk

<table>
<thead>
<tr>
<th>Description</th>
<th>Preliminary analysis</th>
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<tr>
<td>PD Change</td>
<td>• Relative or absolute increase of the PD at the reporting date compared to the original PD</td>
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<td></td>
<td>• Difficulties in deriving initial lifetime PDs for comparison</td>
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<td></td>
<td>• Range of solution approaches currently in implementation in banking industry</td>
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<tr>
<td>Rating migration</td>
<td>• Rating or credit score migration of an exposure PD at the reporting date compared to the original</td>
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<td></td>
<td>• Compare the rating classes of application models and behavioural models is the major challenge</td>
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<td>Past due information</td>
<td>• Information on exceeding threshold value (30dpd as a typical threshold)</td>
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<td></td>
<td>• Conservative interpretation of the transfer criterion depending on the portfolio</td>
</tr>
<tr>
<td></td>
<td>• Quite simple implementation</td>
</tr>
<tr>
<td>Qualitative information</td>
<td>• Watch list and forbearance criteria: position on watch list or with forbearance status indicate underperforming status</td>
</tr>
<tr>
<td></td>
<td>• Relevant qualitative criteria to be examined and added</td>
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- The majority of banks will use a combination of **qualitative and quantitative indicators**.
- The indicators used will depend mainly on the **asset class**, with differences mainly between:
  - **retail** (credit scoring and days past due used)
  - **wholesale** (rating and watch lists used)
  - **sovereign exposures** (market information and more expert judgement used)
### ECL Methodology and Input to ECL Measurement

#### General Trends Observed

- The majority of banks refers to the use of a PDxLGDxEAD or a Loss rate approach to measure ECL (at least for some portfolios), depending on the type of the exposure, materiality of the exposure, stage at which the exposure is classified under IFRS 9, collective or individual assessment, and the classification in the SA or IRB portfolio.

- Most banks expect that they may have to make additional adjustments (so called overlays) in their IFRS 9 models for the ECL estimation mainly to reflect the impact of any information not fully reflected in the model, to incorporate some specifications of some portfolios that cannot be captured by the models, or to correct some model deficiencies.

- The majority of banks intend to use the same definition of default for accounting and prudential purposes.

- **Low credit risk exemption** – Several banks are considering the application of the low credit risk exemption. The factors most commonly being considered in order to apply the exemption are the type of exposure (mainly debt securities), the credit risk of the exposure (mainly investment grade exposures) and the counterparty (governments, central banks and banks). In general, banks do not plan to apply this exemption to retail loans.
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Some Questions to Assess in Implementing IFRS9

Revising loss forecasting methodology is not a ‘one size fits all’ exercise
The decisions about the approach to IFRS 9 will depend on many factors ... 

- What is the current loss forecasting methodology and does it provide a sound foundation for IFRS9?
- What is the appetite for integrating IFRS9 with IRB models?
- Do data and models adequately capture Default risk at origination?
- Has your lending policy or collections strategy changed significantly in the recent past?
- Where can you re-use or augment; where should you start from scratch?
- Do you have robust processes for developing, validating, weighting economic forecasts?

... to determine the optimal path for the Bank
Conclusions

- **Implementation efforts are ongoing** (development of processes, systems, models and data) and are expected to be constantly evolving until at least the initial application of IFRS 9

- As IFRS 9 is both complex and principle-based there is scope for the **methodologies to vary between bank**

- **Results will strictly depend on the interpretation and application of some key elements** of IFRS 9 impairment requirements—such as the significant increase of credit risk

- **Progress in the guidance from competent authorities** – such as interactions of prudential requirements with IFRS 9 - will be linked to progress in the implementation by the Banks

- **Early engagement from IFRS 9 programs, with the impacted business areas** is crucial. This will be key to understanding and managing the impacts of **volatility** that will arise