Perspective

This is one of a series of articles where experts in assurance, reporting and regulatory matters discuss recent technical and policy developments in these areas.

Practical challenges of the new IFRS 9 impairment model for lenders

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In July 2014, the International Accounting Standards Board (IASB) published IFRS 9 Financial Instruments (2014) which in Australia is AASB 9. This standard introduces a new impairment model for financial instruments. IFRS 9 (2014) incorporates the final requirements on all three phases of the financial instruments projects – classification and measurement, impairment and hedge accounting and applies for annual periods beginning on or after 1 January 2018.

The new impairment model will have the most significant impact on financial institutions. It is likely to result in greater provisions and earlier recognition of credit losses. Implementation will require changes to systems and processes, greater segmentation of portfolios, and greater integration of the credit risk management systems with the accounting systems.

In February 2015, the Basel Committee on Banking Supervision (the Committee) issued a Consultative Document setting out draft guidance explaining how banks under prudential regulation are expected to implement the IFRS 9 impairment model for lending exposures.

The article discusses the practical challenges facing financial institutions when implementing the new impairment model.

Overview of the IFRS 9 impairment model

The IFRS 9 impairment model is based on changes in expected credit losses and involves 'three stages'. The different stages determine how impairment and interest revenue is recognised. It applies to financial assets that are measured at amortised cost (e.g. loans receivables, lease receivables, trade receivables) and other debt instruments that are measured under fair value through other comprehensive income (FVTOCI). It also applies to certain loan commitments and financial guarantee contracts.

In contrast to the current 'incurred loss' model in IAS 39 *Financial Instruments: Recognition and Measurement*, the new impairment model is more forward looking and no longer requires a credit event to have occurred before credit losses are recognised.

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After initial recognition of a financial asset, the 'three stage' expected credit losses (ECL) model applies as follows at the end of each reporting period:

- Stage 1: Credit risk has not increased significantly since initial recognition – recognise 12 months of ECL
- Stage 2: Credit risk has increased significantly since initial recognition – recognise lifetime ECL and interest is presented on a gross basis
- Stage 3: Financial asset is credit impaired (using the criteria currently included in IAS 39) – recognise lifetime expected losses but present interest on a net basis (i.e. gross carrying amount less credit allowance).

The recognition of impairment (and interest revenue) is summarised below:

Stage	1	2	3
Recognition of impairment	**12-month expected credit loss**	**Lifetime expected credit loss [(b)]**	
Recognition of interest	**Effective interest on the gross amount**		**Effective interest on the net (carrying) amount**

Figure 1 – Summary of the recognition of impairment (and interest revenue) under IFRS 9

A forward looking model

In estimating credit losses IFRS 9 requires entities to use all reasonable and supportable forward information and update as expectation changes. Entities must go beyond considering historical and current information and consider the impact of forward-looking information and macroeconomic factors in determining provisioning levels.

12-months of ECL

The Committee expects a nil allowance for the 12-month ECL to be rare. The Committee expects a bank to adjust its estimate of 12-month ECL on a timely basis (even if the financial asset remains in stage 1) to adequately reflect changes in credit risk.

Identifying significant increase in credit risk

The transition from 12-month ECL to lifetime ECL (i.e. from Stage 1 to Stage 2) - which results in higher provisioning levels, is based on the notion of significant increase in credit risk over the remaining life of the instrument. IFRS 9 provides a list of factors that can indicate increase in credit risk. Entities need to develop clear policies to identify the transitioning between Stage 1 and Stage 2 in a timely manner.

The Committee expects banks to not only consider the indicators in IFRS 9, but also other relevant information that indicate a significant increase in credit risk. Lifetime ECLs are generally expected to be recognised before a financial asset becomes past due. The Committee expects banks to adopt an active approach, allowing changes in credit risk to be identified on a timely basis.

Banks are expected to have a clear view of the interplay between macroeconomic factors and borrower attributes, and the level of credit risk in a portfolio. For example, for a large commercial property loan, it is expected that a bank would take into account the macroeconomic effect of the commercial property market and include interest rates and vacancy rates to determine whether there has been a significant increase in credit risk.

More segmented and dynamic portfolios

We expect the new impairment model will result in greater segmentation of loan portfolios. Banks are expected to group financial assets based on shared credit characteristics that are expected to react in a similar way to the current environment, forward-looking information and macroeconomic factors (e.g. by instrument type, credit risk ratings, collateral type, industry, geographical location, date of initial recognition, remaining term to maturity, value of collateral).

Groupings are to be re-evaluated and re-segmented whenever relevant new information (e.g. change in economic conditions) or bank's expectation of credit risk has changed. Where it is apparent that exposures in a group have experienced a significant increase in credit risk, that relevant group or subgroup will transfer to stage 2 as a whole even though it might not be possible to identify increase in credit risk on an individual exposure basis. Where changes in credit risk affect only some exposures within a group, those exposures must be segmented out of the group into relevant subgroups, to ensure that provisioning levels are appropriately updated.

Example: Portfolio of retail mortgages and personal loans

- Bank ABC provides mortgages and personal loans in Region Z.
- As part of the loan application process, customers provide information including, the industry within which the customer is employed, postcode of the property.
- The average loan to value ratio for all its mortgage loans is 80%.
- Bank ABC tracks probability of default occurring by means of past-due statuses.
- Region Z is a significant car manufacturing area.
- Bank ABC becomes aware of the declining profit of several major car manufacturers and anticipates the closure of several of the car manufacturers.
- Under IFRS 9 Bank ABC:
    - Segments the mortgage portfolio to identify borrowers who are employed by service providers to the car manufacturers, and recognise lifetime ECL for those mortgages (i.e. Stage 2) (even if no loans are past due yet).
    - For the mortgage loans portfolio, in estimating lifetime ECL, Bank ABC takes into account the expected recovery from the real estate. The ECL recognised on mortgage loans maybe small, even though the loans are in Stage 2.

Practical expedients

To reduce the cost of implementation, practical expedients have been included in IFRS 9:

- 30 day past due rebuttable presumption: Credit risk has increased significantly (and therefore the asset moves to stage 2 and lifetime ECL recognised) when contractual payments are more than 30 days past due.
- Low credit risk financial assets e.g. an asset with 'investment grade rating': It is assumed that credit risk has not increased significantly at each reporting date. This means that only 12 month ECL will be recorded.

The Committee expects internationally active banks to limit their use of practical expedients. The Committee views that significant reliance on past due information as a very low quality implementation of an ECL model. The Committee has strong expectations that banks will not use the 30-days-past due rebuttable presumption. The Committee notes that not all lending exposures that have an investment grade credit rating can automatically be considered low credit risk. Banks are expected to rely on their own credit risk assessment to evaluate the credit risk of a lending exposure.

Extensive system changes required

The Committee expects banks to incur significant costs in developing resources and systems in applying the new ECL model. It expects internationally active banks and banks with more sophisticated business lending models to have the highest-quality implementation. To the extent possible banks are expected to leverage and integrate information and processes used for risk management and capital adequacy purposes. Banks are expected to have processes in place to validate the accuracy and consistency of its credit risk assessment model.

Calling for implementation issues

The IASB has established a Transition Resource Group for Impairment of Financial Instruments (ITG). Wayne Basford of BDO has been appointed as a member of this group. Judith Leung was formerly a staff member at the IASB and was involved in the initial phase of the project at the IASB. If you would like to discuss any implementation issues on the new impairment model, please contact Wayne or Judith directly.