Regulation Asia

IFRS9

Regional Insights

2017 EMEA
Market Survey

September, 2017

S&P Global
Market Intelligence

Financial institutions in Europe, the Middle East and Africa have made significant progress towards the adoption of the IFRS 9 (the 9th International Financial Reporting Standard). The IFRS 9 Financial Instruments rule was introduced by IASB (the International Accounting Standards Board) in July 2014 to provide a model for classification and impairment of financial instruments as well as hedge accounting.

Regulation Asia survey and results

IFRS 9 adopts a principles-based approach to classification of financial assets and liabilities based on business models and cash flow. The Standard also provides for a single impairment model to facilitate the recognition of expected credit loss.

This new model also overhauls hedge accounting policies, which align accounting treatment with risk management activities, enabling entities to better reflect these activities in their financial statements. The changes also give users of financial statements better information about the use of derivatives for risk management purposes.

The new rule replaces IAS 39, which recognises loan losses at the point of default. IFRS 9, on the other hand, will require banks to estimate ECL (expected credit losses) on financial assets on an ongoing basis and provision for these.

Regulation Asia surveyed risk and finance professionals across Europe, the Middle East and Africa with respondents largely from the banking sector. The results detailed below derive from the survey as well as detailed conversations with several respondents.

Capital and income volatility

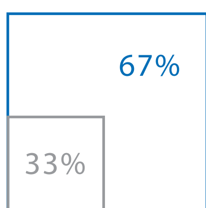
Banks in Europe expect the shift to ECL will increase earnings volatility and lower equity and CET1 (Common Equity Tier 1) capital. More than half the respondents expect an increase of at least 15% in total balance sheet allowances because of IFRS 9, and over 80% expect more volatile income.

In anticipation of potential capital shocks, banks are stepping up preparations ahead of the January 2018 deadline for IFRS 9 in Europe. Some are already producing their accounts under IFRS9 guidelines alongside current IAS 39 rules, according to an Italy-based analyst. The analyst also said some banks might cut dividend payouts or at least alter their payout plans until they have a better idea of earnings variations. They also reported a hit to loss-absorbing capital instruments.

"This is especially concerning in Italy given the level of doubtful loans in the banking system here. We expect, on average, that provisions will go up by between 20% and 30% compared to under the previous rules. CET1 should go down by about 50 basis points." they added.

An IFRS 9 lead at a global bank in the Netherlands also told Regulation Asia that the new rules will cause banks to re-consider their product line-ups. Depending on their duration, rating and guarantee, some products might become unprofitable.

"Longer term products that are typically not collateralised as well as some structured products will become less attractive to banks as they tend to be more vulnerable to economic shocks and changes in counterparties' ratings. We have had to do a granular review of our portfolio and weed out exposures that are vulnerable to Stage 2 migration to smooth out our P&L volatility," they said.



67 %

Expect no delay to January 1, 2018 deadline for financial reporting.

A finance department head at a Kenyan bank told Regulation Asia the capital impact of the new rules depends on whether an institution has been using an internal ratings-based approach or standardised approach under Basel II or III. The introduction of an ECL model for credit risk-sensitive exposure adjustments is likely to lead to an increase in accounting provisions and material decreases in capital.

"We are looking to raise additional capital in order to maintain our current credit risk profile. The regulator is also expected to include the impact of IFRS 9 in stress testing," they pointed out.

In the UK, the Prudential Regulation Authority has required the impact of IFRS 9 to be included in 2017 stress test submissions.

For corporates, however, income volatility could ease because of the new rules. A UK-based risk consultant says IFRS 9 might allow companies to re-examine hedging strategies by allowing component risks to qualify for hedge accounting. This could bring down earnings volatility since hedging costs can be posted to equity instead of profit and loss.

Both African banks which spoke to Regulation Asia do not expect the IFRS 9 rules to give a better picture of their financial risk profiles than under IAS 39. They face additional challenges around collecting data, setting triggers and defining defaults as well as the subjectivity involved in estimating expected losses, which mitigates any in-principle advantage of having a forward-looking model.

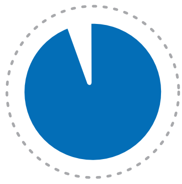
"Under IAS 39, we would defer full recognition of an allowance of the expected loss until the conditions for default or credit deterioration are met. However, under the expected loss model of IFRS 9, we will always have to recognise an allowance for the full credit loss at each reporting date even if the loss is to take place more than six or 12 months hence. This is bound to increase impairment provisioning significantly," one of the respondents said.

Data and modelling

Many respondents (23%) are concerned with meeting data requirements to support ECL modelling, with more than half reporting partial to substantial data gaps in ECL estimation. About 19% of respondents worry about the overall development of ECL models and a similar proportion attach importance to developing an internal systems infrastructure for ECL calculations and reporting. However, a significant number (43%) of respondents expect to have adequate internal capability to implement a compliance governance framework to support ECL modelling.

As with their Asia-based counterparts, respondents in EMEA consider the availability of corporate lending data as the most important challenge from a data perspective (27%). More than half see reconciliation between financial reporting and credit risk data as the biggest data challenge, with over a third identifying data integrity as the major hurdle.

About 40% of respondents are relying on internal resources to estimate forward-looking macroeconomic assumptions for their ECL model, with the figures dropping to 32% for external forecasts and 29% for regularly available forecasts. Due to having limited



96 %

96% of respondents are still in some stage of preparation.

48% of firms have already gone past the stage of model selection.

42% are already in the process of preparing for selection.

6% haven't started process but are confident of meeting January 1, 2018 deadline.

information in-house, many small to mid-sized institutions will likely take a simpler approach and rely on external economic forecasts. The bulk of respondents are considering developing an LGD (loss given default) solution for ECL calculations.

The Kenyan bank executive noted key assumptions within an ECL model will need to be incorporated into an institution's corporate governance framework and receive board and regulatory approval. The Dutch IFRS9 lead, meanwhile, suggested that banks would have to work closely with auditors and regulators to ensure that key model assumptions are reasonable, transparent and appropriately documented.

For example, in assessing multiple scenarios, different banks may use a range of complex methodologies (such as Monte Carlo simulation), but there is no consensus as to whether these are necessary or even desirable. Given the subjectivity and judgment required in model assumptions, regulators might not find comparable disclosures across banks. However, institutions will need to ensure any assumption or calculation methodology is transparent and auditable.

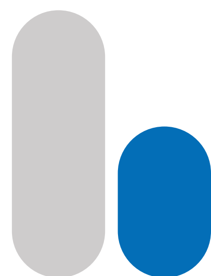
There is much more data required under the IFRS 9 impairment model than under IAS 39. The process to assess an increase in credit risk during the transition phase will require much more historical data than is currently available within some banks. "Risk data will further have to be vetted and comply to external audit standards as it will now be used for financial reporting," the Dutch IFRS 9 lead noted.

There is also concern about inconsistencies between US accounting rules and IFRS 9, with uncertainty as to whether US regulators will trust the balance sheets of European banks operating there. The interaction between different credit risk accounting standards and regulations could cause confusion on common definitions like LGD and EAD (exposure at default).

Preparation

More than half of respondents have started preparing for the new rules and almost 40% are nearly fully prepared as of the beginning of July this year.

Most banks agree that under IFRS 9's principles-based approach, they can better align hedge accounting with their risk management strategies. Nine out of ten expect the introduction of ECL to remedy



48 %

Shift in expectations for timescale required to accommodate the production of ECL (expected credit loss) number (May. 68%; July 48%).

The least prepared firms:
Asset Managers (50%)
Non-bank finance companies (44%,)
insurance (42%,) retail and commercial banks (61%)
all expect to need an extension.

at least some gaps in their existing credit risk management practices. However, the transition process has been challenging for smaller banks, according to the UK-based risk consultant, requiring extensive collaboration across accounting, risk and reporting as well as internal and external audit.

"A review of technology to best automate hedge accounting and compliance reporting, calculating and reporting ECL, rebalancing derivatives as hedged instruments requires sophisticated valuation and risk control processes, which smaller banks have previously not had to do," they said.

Some banks are taking the opportunity to conduct a parallel run with IAS 39 to improve their IFRS 9 operating model. Larger institutions, according to the UK-based risk consultant, are introducing the operating model in phases: most firms have begun the phasing process. It is important to get risk and finance working together on solutions and understanding each other. It is also necessary to maintain operational flexibility during development as issues arise during the parallel run period.

Organisations which have previously implemented Basel II or stress-testing programs are leveraging extant models and data systems for IFRS 9 implementation, suggested the Kenyan banker. But, they warned: "Smaller balance sheets will require much more custom-built modelling for IFRS 9."

Systems infrastructure

Although most respondents (over 70%) expect the January 2018 deadline for reporting under IFRS 9 to remain, a little over half expect to extend their firms' timelines for reporting.

IFRS 9 will require complex calculations to be done over short timescales, using a large amount of data. Banks that spoke to Regulation Asia said preparing the systems infrastructure required for this has been a big challenge, especially for parts of their present frameworks that are inflexible.

The risk consultant based in the UK said banks will need to take a high level, strategic look at IT requirements. Short-term adjustments and other temporary solutions will not work with legacy systems, they pointed out, so these need to be overhauled or scrapped completely to prepare for the new rules.

> *Risk management professionals with a specific skillset are and will continue to be in great demand, not just among banks, but also corporates, regulators and auditors.*

Almost half of respondents expect to spend more than USD1 million on IFRS 9 implementation. "The financial outlay can be significant and smaller banks might find it harder to take this hit. And the cost of IFRS 9 implementation will continue beyond the transition stage into ongoing operational processes and financial reporting," one said.

They added that processes such as forecasting, validation and modelling will need niche and specialised resources which will also cost money. Risk management professionals with a specific skillset are and will continue to be in great demand, not just among banks, but also corporates, regulators and auditors. Furthermore, front-office staff will need to be trained to assume risk-based roles.

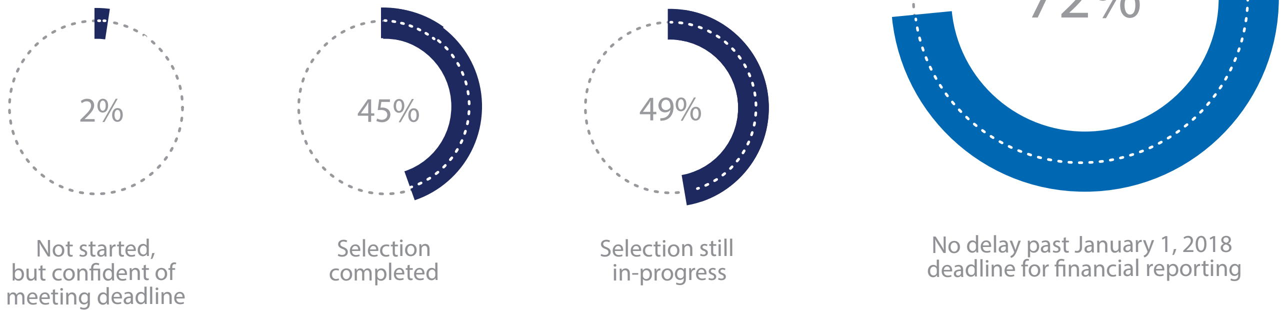
As the Dutch banker put it: "We are training our retail and branch level staff in the ways of risk. They need to be much more diligent about monitoring loan quality and changes in customer behaviour, conveying this information upstream as soon as possible to prevent products from migrating to Stage 2 and hitting our capital.

"They will need to stay with the loan long after its origination and manage it actively. They will also need to be well versed in risk capital management and financial restructuring."

Europe
Regional Insights

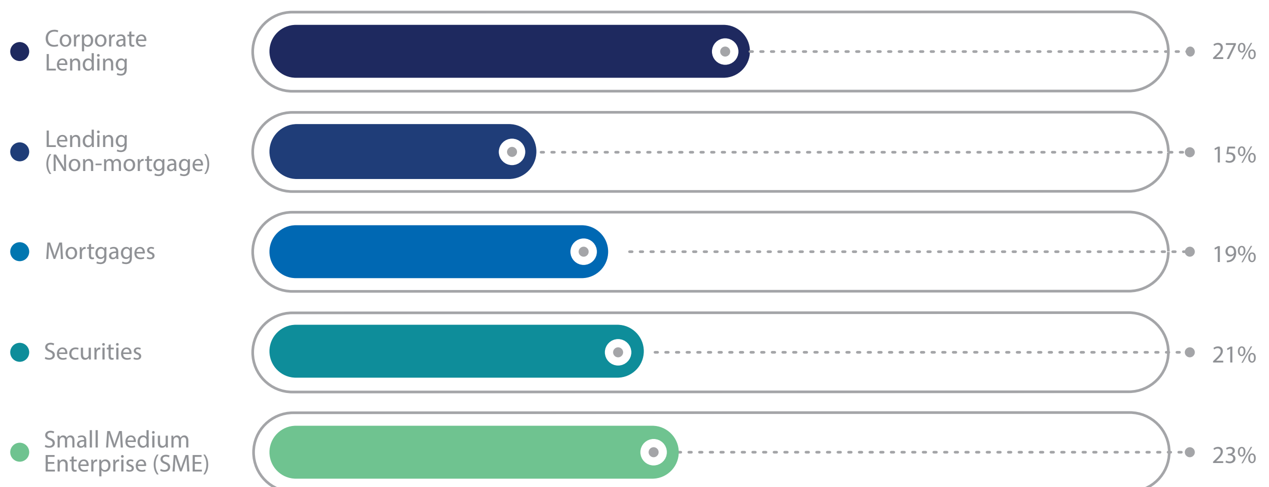
Europe
Status of model selection

45% of firms have already gone past the stage of model selection, with the remainder already in the process of preparing for selection (49%) or not having started process but confident of achieving the January 1, 2018 deadline (2%).



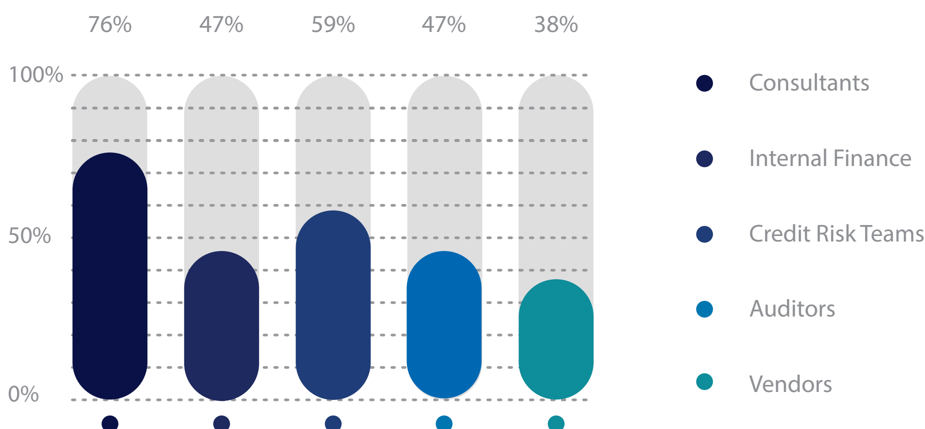
The most pressing data challenges

Across all jurisdictions corporate lending data increasingly cited as the biggest challenge. Likewise, SME data continues to be problematic to the majority of insitutions.

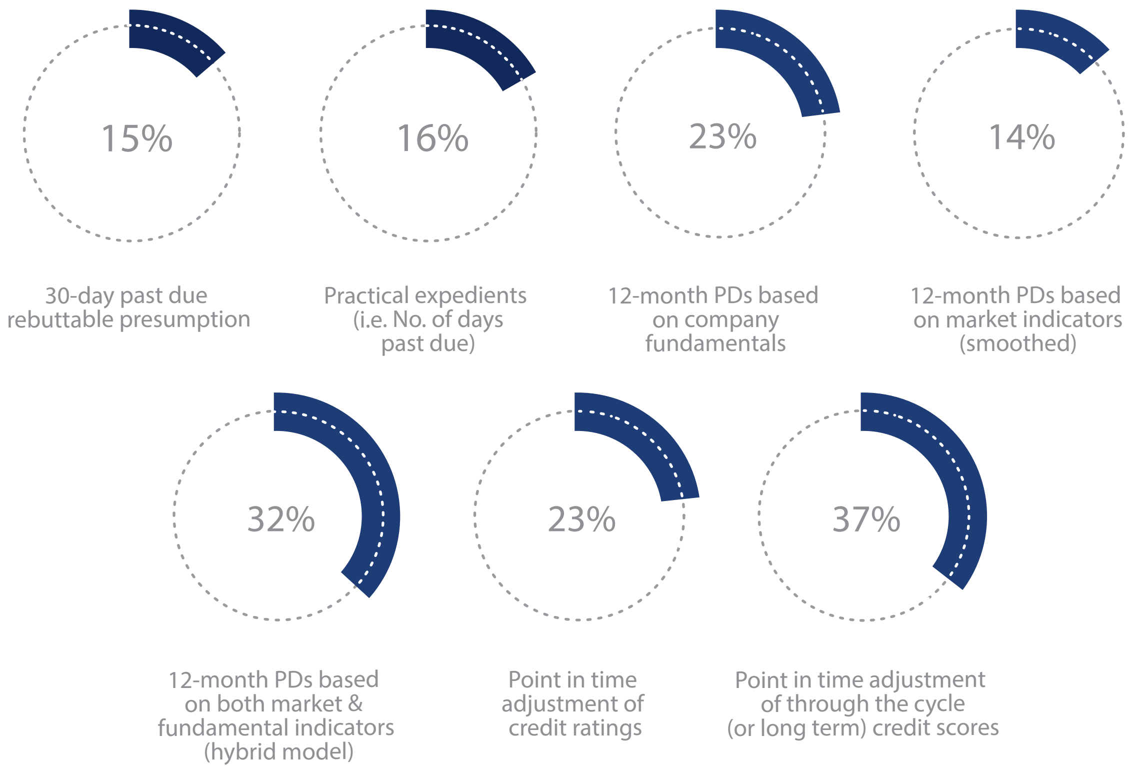


Most common tools and resources

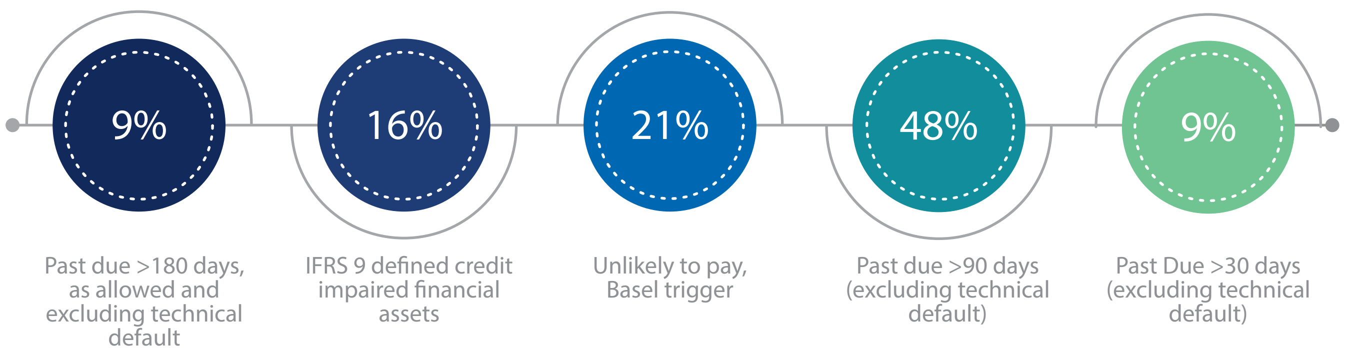
The majority of firms are reliant on a combination of internal resources and external consultants (75%). Banks appear to prefer to partner internal teams with external experts to bridge technical skill gaps.



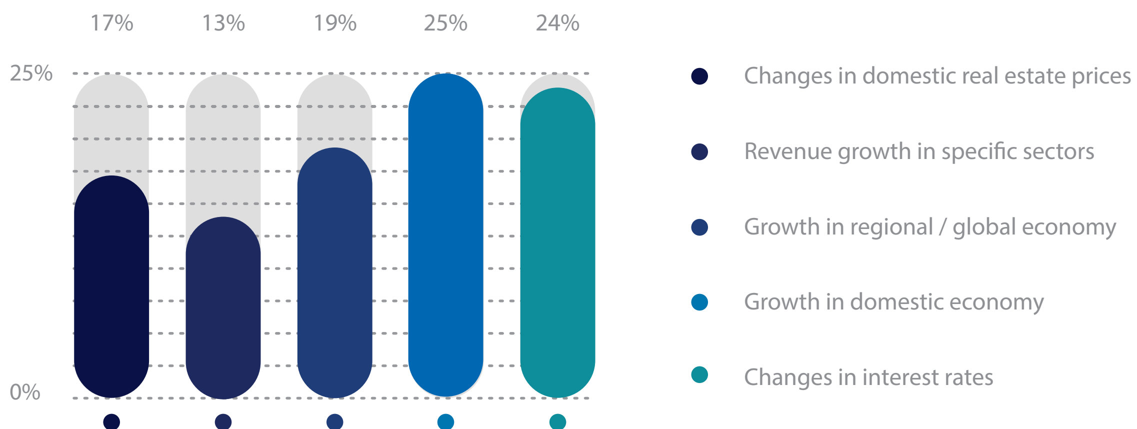
Most commonly used inputs in PD forecasting



Most commonly used definitions of default

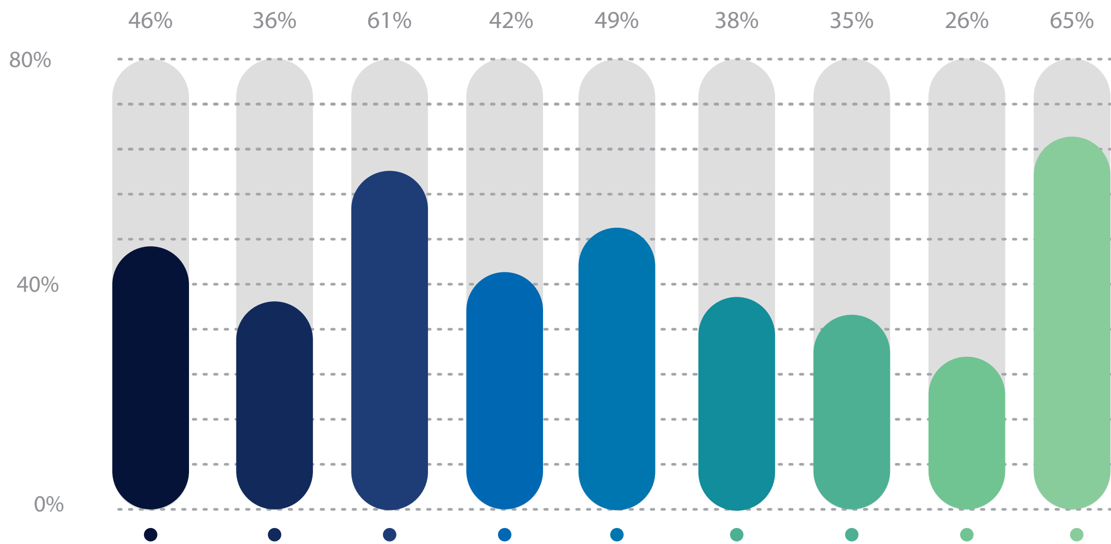


Most commonly used macroeconomic scenarios for ECL calculations



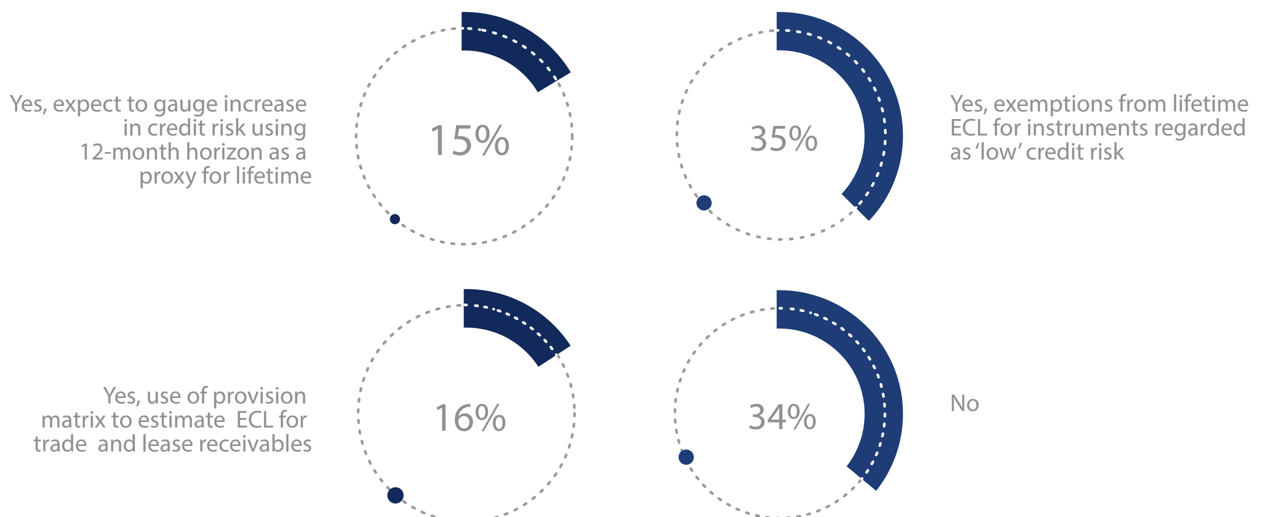
- Changes in domestic real estate prices
- Revenue growth in specific sectors
- Growth in regional / global economy
- Growth in domestic economy
- Changes in interest rates

Most commonly used definition of movement between Stages 1 and 2



- Significant changes in the value of the collateral or guarantees supporting the obligation
- Changes in the rates or terms of existing financial instruments
- Significant change in the financial instrument's external credit rating
- Significant adverse change in the regulatory, economic, or technological environment of the borrower
- Significant increases in credit risk on other financial instruments of the same borrower
- Significant changes, actual or expected significant change in the quality of credit enhancement
- Significant changes in internal price indicators of credit risk
- Significant change in the operating results of the borrower
- Internal credit rating downgrade

Use of practical expedients



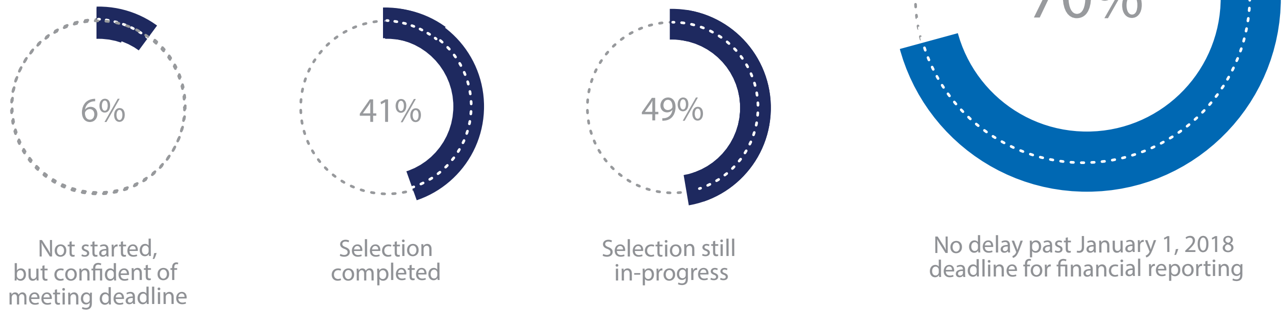
MENA

Regional Insights

Middle East & North Africa

Status of model selection

41% of firms have already gone past the stage of model selection, with the remainder already in the process of preparing for selection (49%) or not having started process but confident of achieving the January 1, 2018 deadline (6%).



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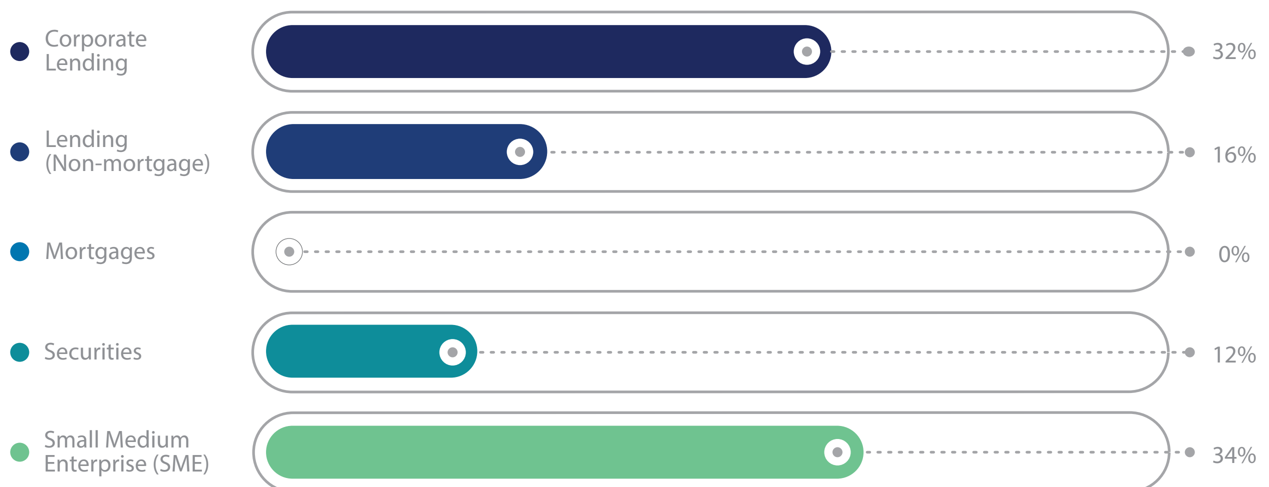

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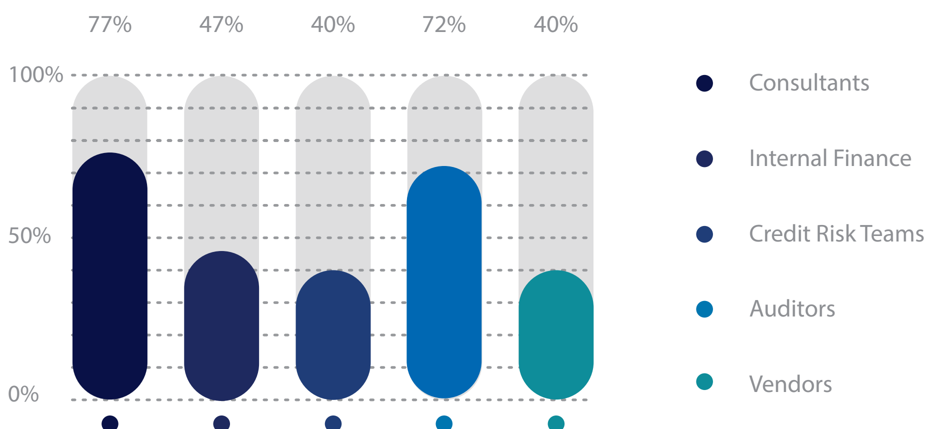
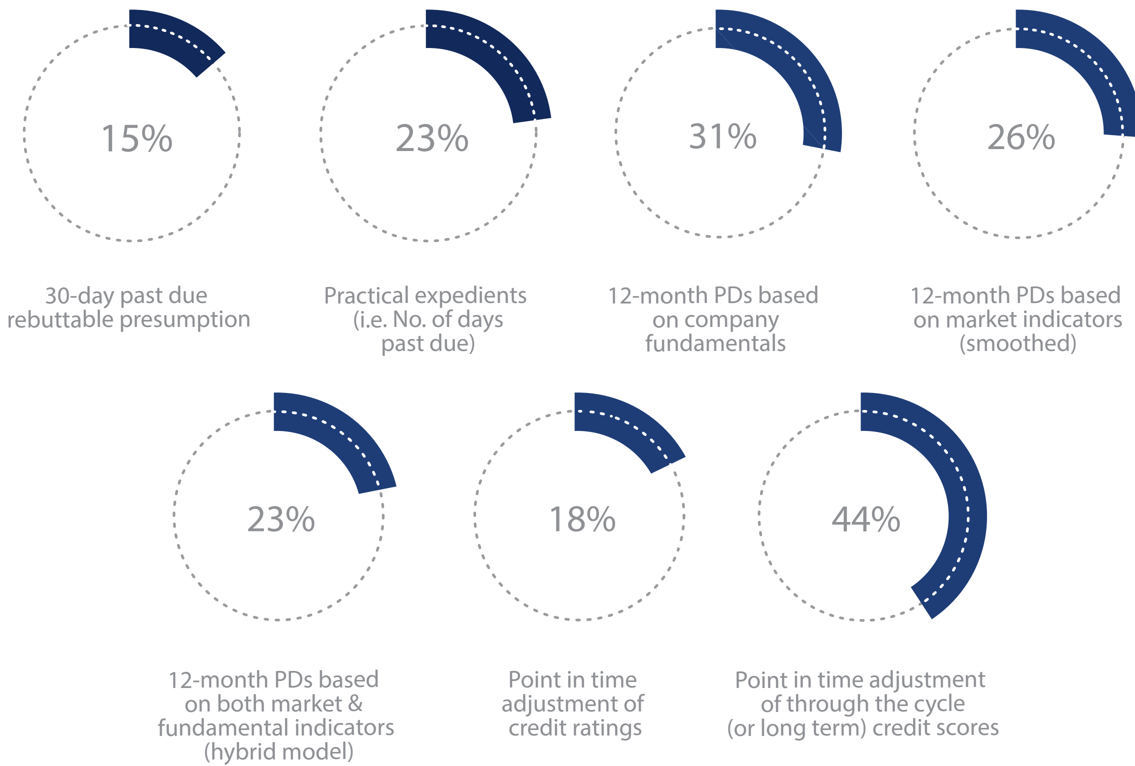


Most commonly used inputs in PD forecasting



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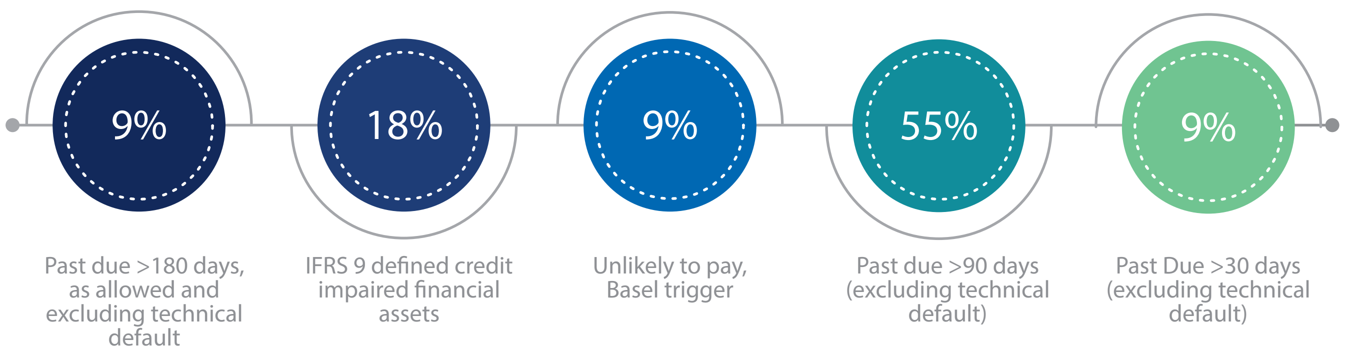

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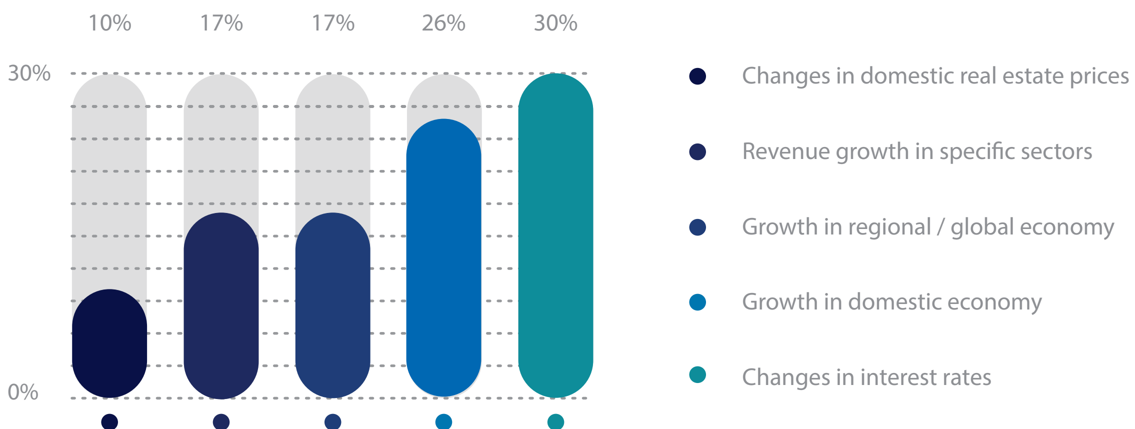
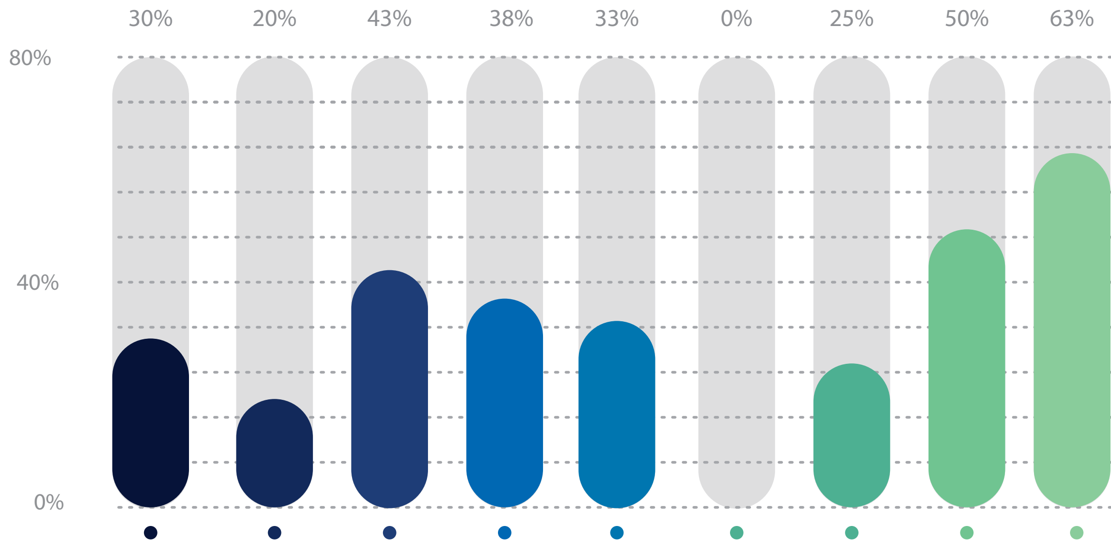


Most commonly used definition of movement between stages 1 and 2



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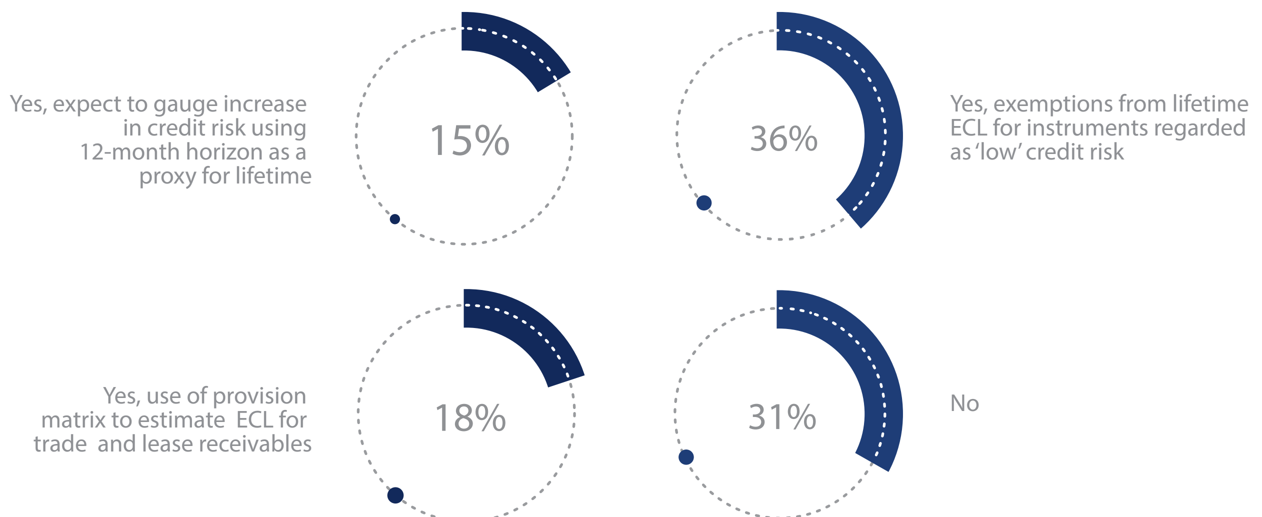

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