Complying with International Financial Reporting Standard (IFRS) 9

The Client: A national bank in South East Asia

Users: The business, risk management, and finance groups

The IFRS 9 accounting standard now requires firms to factor in future expected credit losses to calculate provisions for investment portfolios, loan books, and trade receivables. This change calls for forward-looking analytics, introducing new challenges in terms of data availability, modeling, and reporting. A South East Asian bank needed to comply with IFRS 9 by the end of 2018, and was looking for a viable solution that could be quickly implemented and used to credibly explain its credit risk assessments to regulators and auditors.

Pain Points:

To reflect the IFRS 9 approach, the bank needed to convert historical probabilities of default (PDs) to ones that were point-in-time, incorporating various macroeconomic scenarios. As a smaller-sized financial institution, the bank didn’t have the internal resources nor adequate default data by sector to meet this requirement. It was critical that it identify an off-the-shelf solution that represented a well-recognized methodology for handling IFRS 9, and enabled its internal team to confidently defend their risk management process.

The Solution:

S&P Global Market Intelligence (“Market Intelligence”) met with business executives at the bank and discussed a framework that could provide a globally-accepted methodology to transparently and effectively calculate underlying credit risk.

The suggested approach used Market Intelligence’s Credit Assessment Scorecards, which are Excel®-based tools that use forward-looking qualitative factors, converging trends, and relationships between key drivers to derive a credit score. The scores are mapped to long-term,
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through-the-cycle PDs that are based on approximately 37 years of S&P Global Ratings default, transition, and recovery history¹.

By using these Scorecards, it was possible to cover low-default asset classes to obtain an assessment of the credit quality of the bank’s counterparties and their respective PDs. In addition, this approach enabled the bank’s team to input qualitative information based on their own expert judgement, making the output more bank and regional specific.

The IFRS 9 standard requires firms to use forward-looking PDs to calculate expected losses. Given this, the bank needed to adjust the long-term, through-the-cycle PDs, which are smooth, using different macroeconomic scenarios to create point-in-time and lifetime PDs, which move up or down depending on the credit cycle. The bank’s team utilized Market Intelligence’s Credit Cycle Projection Overlay to make this adjustment.

This overall approach using Market Intelligence’s Scorecards along with the Credit Cycle Projection Overlay enabled the bank to meet two reporting needs: one that adhered to the regulatory capital requirement, and one that adhered to IFRS 9. For regulatory capital, the long-term PDs using the Scorecards determined the provisioning that was necessary. For IFRS 9, the additional step of the credit cycle adjustment using the Overlay captured the potential impact on the bank’s profitability to provide a more forward-looking view of provisioning needs.

Key Benefits:

Scorecards are an ‘out-of-the-box’ solution, which facilitated a speedy implementation for the bank to comply with IFRS 9. In addition, the bank valued three important aspects of the Market Intelligence solution:

1. **An approach that is useful and relevant for low default portfolios.** Scorecards can be used when there is a lack of internal data available to construct statistical models that can be calibrated and validated.

2. **Transparency.** The bank team needed to demonstrate to their internal stakeholders, regulators, and auditors that they had a good understanding of how the credit assessments were derived. Since the Scorecards are Excel based, the bank team was able to view the entire credit scoring process, including the use of parameters, weights, etc. In addition, in-depth model development and maintenance documentation provided by Market Intelligence helped explain how the Scorecards were developed, the use of data, any limitations, and overall performance.

3. **On-going support.** The Market Intelligence team provided on-site training to ensure that there was knowledge transfer on methodologies and applications. Support continues to discuss the implementation of the scorecards into the bank’s risk framework and any queries that may arise in helping the bank meet its regulatory requirements.

¹S&P Global Ratings does not contribute to or participate in the creation of credit scores generated by S&P Global Market Intelligence. Lowercase nomenclature is used to differentiate S&P Global Market Intelligence PD credit scores from the credit ratings issued by S&P Global Ratings.

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