

IFRS 9 - Two Sides of the Coin



Financial institutions accounting under international financial reporting standards must adopt IFRS9 – “Financial Instruments” by January 1st 2018.

IFRS9 in some respects takes us ‘back to the future’ – once again FIs must account for impairments to financial instruments on an expected-loss, rather than an incurred-loss, basis.

So IFRS 9 changes the way we account for expected losses, not necessarily how we calculate them. Of course, FIs should have credit risk models that are as good as they can be, given the many challenges to creating sophisticated predictive models, such as:

- The absence of history or of comparable history (newer institutions, or those whose credit products or business models have changed recently)
- Low-default portfolios, where even over time defaults are few and far between
- The absence of reliable data on idiosyncratic business models (specialist banks and specialist products)
- The cost and infrastructure requirements needed to build models to internal ratings-based (IRB) standards, and the initial and ongoing regulatory scrutiny they attract

...and so on.

But IFRS9 is not about credit risk modelling per se: the Standard itself says explicitly (at 5.5.17)

“An entity shall measure expected credit losses of a financial instrument in a way that reflects...reasonable and supportable information that is *available without undue cost or effort about past events, current conditions and forecasts of future economic conditions*” (our emphasis).

So if you are currently content that your credit risk modelling is as good as it can be, this side of the IFRS9 coin holds few if any challenges. The **other side of the coin**, however, certainly does.

For example, for UK FIs with under £5bn in assets there are 6 mandatory FINREP reports required, demanding in total no less than 12 attributes per exposure:

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|--|---|
| 1. Exposure Type | 7. Purpose of Loan |
| 2. Classification (amortised cost versus FVOCI versus FVTPL) | 8. Collateral Type |
| 3. Obligor Type | 9. Subordination Status (Yes/No) |
| 4. Measurement Basis (collective versus individual) | 10. Performance status (Performing versus Non-performing) |
| 5. Impairment Stage (1, 2, or 3) | 11. Credit Risk Status (Low/Not Low) |
| 6. Product (e.g. credit cards, financial leases etc.) | 12. Write-off/Recovery Status |

And this is purely for FINREP purposes. In addition, essential infrastructure and functionality required by IFRS9 for any institution must also incorporate provision for:

- the place where, and the method in which, data is stored (potentially large volumes over long periods),
- into which the 12-month and lifetime probabilities of default, and the loss-given-default, credit conversion factor and exposure-at-default percentages are fed, in order to be able to calculate expected credit losses,
- where parameters are set for automatic movement between impairment stages, according to each institution's own business rules,
- where Impairment Stage and ECL can be overridden, for individual counterparties and accounts respectively (by those authorised to do so),
- from which regulatory returns and internal MI are produced,

...etc.

And firms must make determinations and judgment calls on the policies and interpretational issues raised by the Standard, which will need to:

- Be documented as policy (and consequently given effect by supporting process and assurance mechanisms),
- Be subject to review, annually or more often if exposure profiles change
- Evidence sanction by the Board (or the Board Audit Committee) and
- Withstand scrutiny by auditors and supervisors.

Therefore, in many if not most FIs, at least as much attention needs to be focussed on the governance and administration of IFRS9 as on expected credit loss modelling.

These are all issues we have had to address and resolve in the course of developing the KnowCo IFRS 9 technical solution, from initial business model classification, through all of the steps above, to the production of compliant regulatory returns.

So, in order to avoid reinventing many wheels, by all means call us for an initial, informal discussion.

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