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ACCOUNTING AND ASSURANCE

IFRS 9: Top 5 reasons why IFRS 9 is about process, not accounting

Bridging the gap from theory to practice

IFRS 9, Financial Instruments is effective for years beginning on or after January 1, 2018, and is making waves across the financial sector, with particular impact to entities with significant loan portfolios, such as credit unions, banks and private lenders like mortgage investment companies (MICs). This publication will outline the top 5 processes and system issues entities must address to successfully adopt an ECL model of impairment.

IFRS 9—The Basics of the ECL Model

IFRS 9 fundamentally shifts the approach entities must take when analysing loans for impairment and also how that impairment is measured by shifting from an "incurred loss" model under IAS 39 to an "expected credit loss" (ECL) model under IFRS 9. The ECL model requires entities to estimate future losses on loans, regardless of whether a loss event has occurred. This is inherently complex in that it requires entities to make estimates concerning future, uncertain events.

Additionally, IFRS 9 introduces a "three stage" model for impairment summarized below:

IAS 39: "incurred loss" model			
versus			
IFRS 9: "expected loss" model			
Stage	**1.** No significant increase in credit risk since initial recognition	**2.** Significant increase in credit risk since initial recognition	**3.** Credit impaired
Recognition of impairment	12 month expected credit loss	Lifetime expected credit loss	

Movement between the stages is affected by the relative movement in credit risk since initial recognition. Loans are initially categorized into stage 1 where ECL is measured based on losses driven by defaults occurring in the next 12 months. Once the credit risk on a loan has "increased significantly," ECL is measured based on the lifetime ECL.

Implementation—With change comes opportunity

Implementing this model to be compliant with IFRS 9 raises a number of complexities for entities from a system and process perspective. Numerous underlying concepts in the ECL model require information that may not be readily available to entities. Additionally, while regulators and associations of related entities are offering guidance on the implementation of IFRS 9, it is still primarily a principal-based standard, and determining how compliance should be achieved at each entity will still be different.

Adopting an ECL model for impairment may offer unanticipated opportunity for improvements to processes, including loan underwriting standards, pricing, risk appetite and monitoring of credit risk on an ongoing basis.

It's important that entities understand that the ECL model doesn't just bring a change to the balance sheet and profit or loss. Our Top 5 reasons why IFRS 9's ECL model is more about process, rather than accounting are:

#1: Old data may be new to you

Many entities may start measuring ECL using historical data as a starting point and then updating them with forward-looking information (see point #2). As the saying goes, the best predictor of future behaviour is past behaviour, however, systems may:

- Not track the information by appropriate loan groupings (see point #3);
- Not track the necessary data historically at all;
- Not provide it in a format that easily interfaces with necessary systems;
- Not identify the default event that led to the eventual loss;
- Not track some measure of credit risk at initial recognition and on an ongoing basis (see point #4); or
- Not have been subject to the same level of internal control scrutiny and/or audit as other systems in the past.

The integrity and validity of underlying data that drives ECL accounting must be verified. Additionally, systems may need to be customized to allow the information to be manipulated in a manner that makes it useful as a base for ECL calculations. This may require the input of an entity's IT, credit and finance departments, as well as external consultants to validate the resulting modifications.

#2: The crystal ball: forward looking information

A fundamental difference between IAS 39 and IFRS 9 is the requirement to make estimations of future losses, despite the triggering event leading to those losses not necessarily having occurred yet. Forecasts of future events are inherently uncertain, and will require entities to develop methodology that complies with the requirements of IFRS 9. Even if an entity starts estimating ECL based on historical data, these figures have to incorporate estimates of future events that impact ECL.

This will entail determining which economic factors affect which loans in an entity's portfolio. For example, projections of unemployment rates may affect residential mortgage defaults in a community in a more direct way than commercial real estate loans.

Forward-looking information may also need to come from sources outside of the entity, which have to be validated both for their accuracy and validity, as well as whether the applicable metric actually affects expected credit losses in the applicable portfolio in a direct and measurable manner.

There will inherently be an element of judgment required in incorporating forward-looking information, however, entities must develop protocols and systems in terms of what data is used and how it is incorporated into the measurement of ECL. Additionally, these processes must be sufficiently documented to support sufficient and appropriate audit evidence for entities' financial statement audits, as ECL methodology is guaranteed to be a key area of estimation and audit focus.

#3: When is enough, enough? Stratifying the loan portfolio

In order to make the measurement of ECL meaningful, the data used to calculate it needs to be segmented in such a way that groups of loans that share common risk characteristics are analysed together. Segmentation to an appropriate level of granularity is key when incorporating forward looking information, as using too heterogeneous of a population would not provide ECL that is responsive to particular risks.

Stratifying the portfolio may require loan portfolio customization since the categories that an entity decides are required to be stratified may not be tracked and logged. This presents particular difficulty if an entity wishes to use historical data as a base for their ECL model, since historical data may not be readily classified into the categories required by the entity. To improve this process prospectively, entities must also consider what types of information must be tracked at the time of loan origination (e.g. specific industry, geography or other client-specific data that drives ongoing credit risk).

#4: The work doesn't stop in 2018: Ongoing monitoring

Once an entity has designed its processes and systems to comply with the ECL methodology, the work must continue, as compliance is an ongoing exercise. Data must continue to be validated, especially when systems are updated or new products are introduced. Forward-looking information must be regularly evaluated to determine whether probability of default is still responsible to the factors identified. The level of stratification in the portfolio must also be monitored if more products are introduced, or the sensitivity to risks changes. For example, demographics of employment in a region may shift to different industries, meaning unemployment rates in certain industries may become more or less meaningful over time.

Additionally, one of the most complex aspects of the ECL model is monitoring the movement between stage 1 and 2 in the impairment model; i.e. 12-month vs. lifetime ECL, which is triggered when a significant increase in credit risk occurs. For many types of loans (e.g. residential mortgages), entities may have very little information about the ongoing credit risk of borrowers other than whether they are current on their scheduled payments.

Developing systems to monitor ongoing credit risk will likely require the input of the credit department and changes to processes, such as loan origination and renewal procedures, as well as consultation to determine what information is available to be incorporated into the ECL methodology.

#5: It takes a village; Cross-department involvement

IFRS 9 requires cross-departmental cooperation on a scale that is unique compared to past accounting standards. The adoption of IFRS 9 is likely to have a more significant impact on ongoing processes and systems than the adoption of IFRS in 2011. Even if the financial reporting department is driving the process, a significant component of their work effort will be in managing the change process for the IT and credit departments, as all parties work towards a common goal of compliance, as well as improving overall credit risk management.

Implementation cannot be left until shortly before the year-end in which the standard becomes effective, as nearly every entity will have holes in its processes and data that need to be filled in order to comply. Additionally, the comparative figures will need to be restated, and a number of transitional elections exist to expedite the transition process, however, the options that will be taken must be planned well in advance.

There's no time like the present

The effects of IFRS 9 will require major retooling of systems, processes and the entire complement of an organization's staff and resources.

For more information on this or other issues facing your business, please contact your local BDO office.

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