Key challenges and focus areas

IFRS9 Implementation

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IFRS9 overview

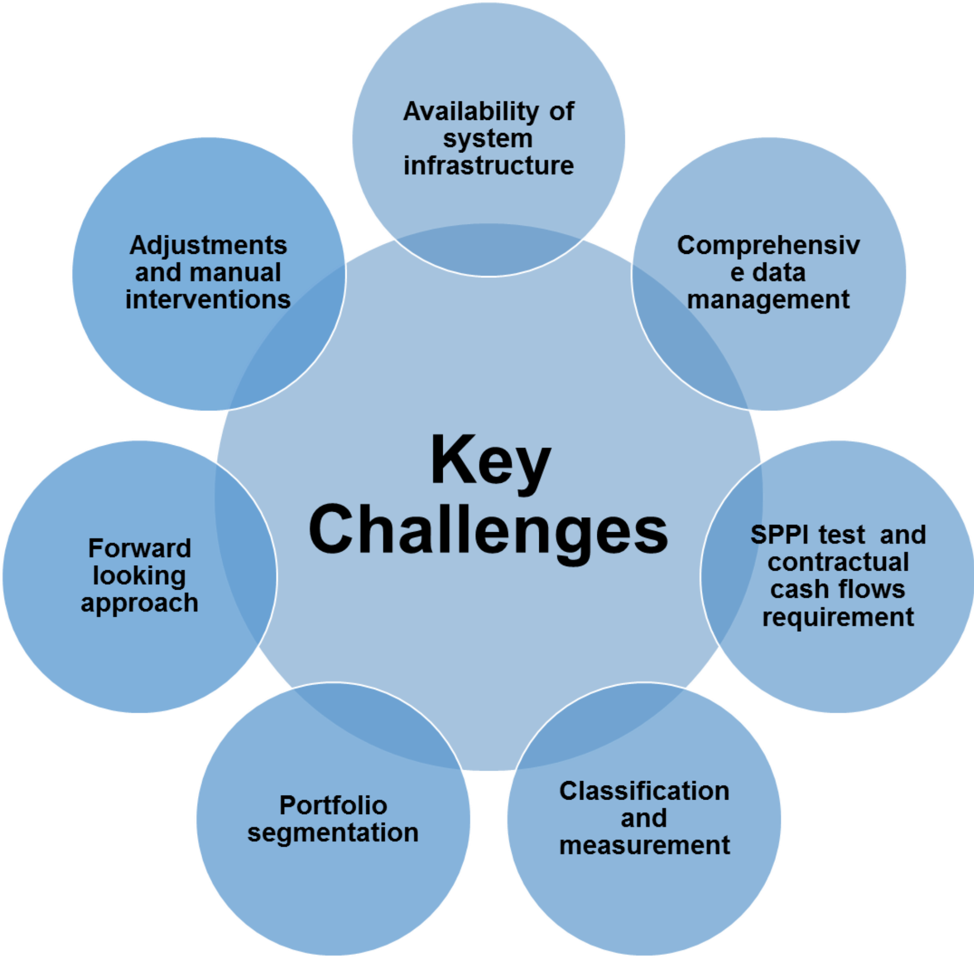
The International Financial Reporting Standard 9 (IFRS 9) will fundamentally change accounting practices by requiring firms to consider the impact of possible future events when calculating their capital provisions. With implementation timelines set for 1st January 2018, and parallel runs for the larger institutions scheduled to take place this year, most of the banks are currently at the most intense stage of preparation for the new regulatory standard.

As the Financial institutions the world over are gearing up for the January 2018 deadline for compliance with IFRS 9 and parallel run their after, post completion of multiple successful projects on IFRS9 implementation in middle east region, I3 consulting has analyzed and identified major challenges and pitfalls in IFRS9 implementation which a financial institution might face during the implementation.

The purpose of this paper is to talk about major challenges and key area of focus which a financial institution has to consider for successful and seamless implementation of IFRS9 and reporting correct disclosures on capital provisions to central bank.

Key challenges in implementation of IFRS9

During an IFRS9 implementation process, due to the complexity of IFRS9 standard a financial institution can face challenges. I3 consulting has prior project experience of successful implementation of IFRS9 at major financial institutions in Middle East region, and would like to talk about some of the key challenges which came across during past journey, to help the financial institution to get prepared and get IFRS9 compliant. Some of the key challenges are addressed below:



- **Availability of system infrastructure** – As per IFRS9 requirements, the standard will require complicated calculations to be performed for the final ECL calculations, as future horizons/periods are required to be considered till the maturity of the instrument and at least 3 economic situation at a contract level. These calculations will definitely need to use a large amount of data for processing the calculations. In turn, this requires a robust and flexible systems infrastructure in place for initiating the implementation. So, financial institution must ensure timely availability of required infrastructure

- **Comprehensive data management** – As IFRS9 does not look straight forward in terms of the approach required to be implemented for the computation of provisions. It requires not just historical data but also requires future data for macro-economic forecast. Not all the data required for IFRS9 will be readily available within Risk and Finance departments, so bank needs to ensure the availability and collection of all required data points and primarily risk and finance team should have same level of understanding on data definitions. For avoiding any data issues it is suggested to perform early data gaps and quality analysis on the existing data and additional data requirements. Key data dimensions can be categorized as:

    - Historical data requirements at contracts level for impairment models
    - Future data requirements for macro-economic forecast
    - Contractual cash flows schedule at contract level
    - Additional data requirements for disclosure reports

  There are other data preparations as well which comes into the picture while performing end to end calculations of the impairment provisions like unutilized limits data should be available at contacts level, credit risk mitigants information should be readily available at contract level etc. For these type of calculations bank needs ensure that IFRS9 data model captures all the required data points in a well though structure and design

- **SPPI test and contractual cash flows requirement** – As per IFRS9 for the classification of debt instruments as Amortized cost, one of the mandatory test to be met is for SPPI assessment at contracts level, which means that the asset's contractual cash flows represent 'solely payments of principal and interest only. The required information is not available 100% of the instruments and business units are required to be involved for taking a decision for the classification

- **Classification and measurement** – Classification under IFRS9 for debt instruments is primarily driven by the financial institution's business model for managing financial assets and their contractual cash flows characteristics. A financial asset is measured at amortised cost if both of the following criteria are met i.e. The asset is held to collect its contractual cash flows and The asset's contractual cash flows represent 'solely

payments of principal and interest' ('SPPI'). Key issues which will have impact on the ECL are:

  - Reclassifications of assets and/or portfolios are highly likely to occur, as the criterial for classification & measurement are very different
  - Same financial institution can have more than one business model for managing similar financial instruments. For example, a financial institution can hold one portfolio of mortgages in order to collect contractual cash flows and another portfolio of mortgages (with similar characteristics) that it manages in order to sell/or to realise fair value changes

- **Portfolio segmentation** – As a financial institution has diverse nature of portfolios which are of different nature and characteristics, it becomes very important to have the segmentation of the portfolios done considering all the factors, characteristics and nature of products & services. Post portfolio segmentation it is critical to map the respective PD model with applicable portfolio, as this will have impact on the calculation of PIT PD for respective instruments. For this exercise business team needs to ensure that they determine proper segmentation criteria for portfolio segmentation.

  Also, an important thing to note is that the portfolio segmentation for the computation of PIT PD and ECL calculation can be different from the portfolio segmentation required for financial reporting, as for PIT PD calculation, responsibility of portfolio segmentation and mapping of applicable PD model ideally lies with risk team, however the financial reporting is performed based on the roll-up and portfolio consolidation logic used by finance team for their annual reporting. Both risk and finance team should communicate very closely to have this done in the required manner

- **Forward looking approach** – As IFRS9 is forward looking approach for the computation of specific provisions, it is very important to have macro-economic overlay on the PIT PD and PGD calculations. For this financial institution primarily needs to ensure at least 2 things:
  - Finalize the list of forward looking macro-economic factors which should be included in PD and LGD models based on model requirements
  - Availability of macro-economic forecast for future horizons. Forecast is required until the longest maturity date for an instrument in the bank's portfolio, though bank has an option to take forecasted values as constant after certain number of years, however it is advisable to adjust the forecasted values with the best available information about macro-economic situations

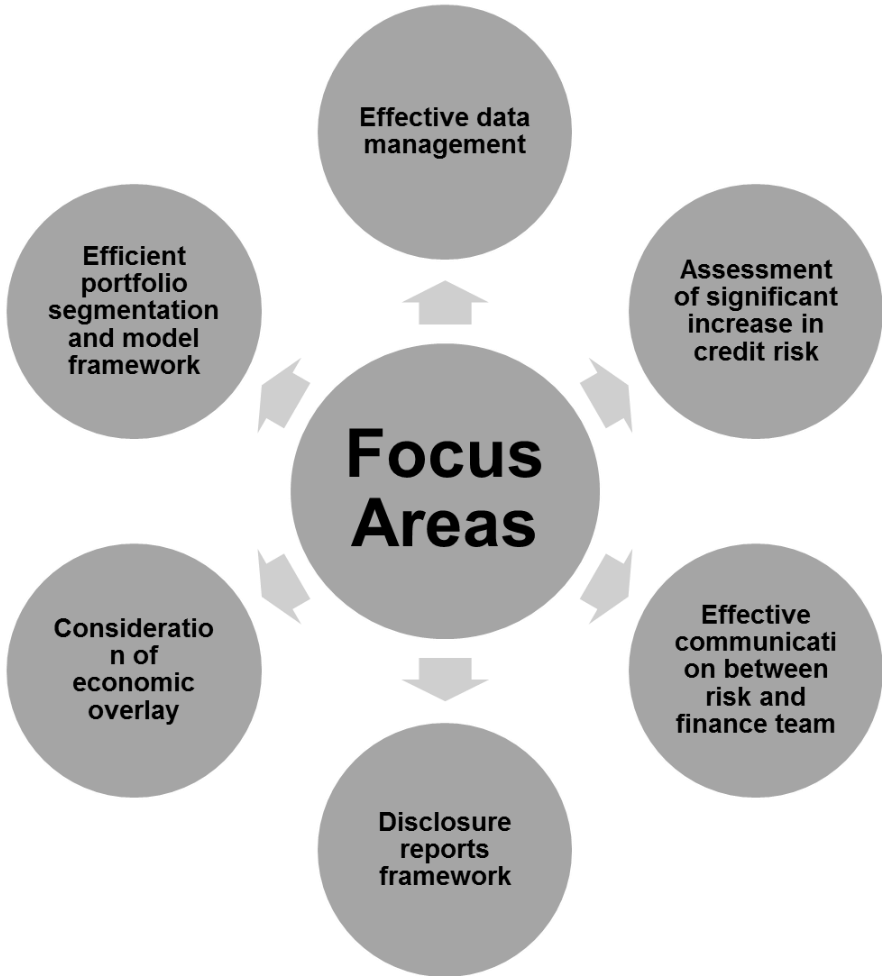
- **Adjustments and manual interventions** – IFRS9 involves complex calculations and for credit risk and finance team there are definitely some exceptions on which financial institutions would like to perform individual assessment. Based on the individual

assessment bank can override/adjust the stage of a contract and not keep the one calculated based on staging rules/criteria and accordingly final ECL for the contract will change. This process requires break in the automated calculations and for any financial institution to perform such adjustments it is very important to have the IFRS9 impairment calculation workflow or design in such a way that business gets the required information to review and perform individual assessment on such contracts. Bank needs to ensure that at what stage during the impairment calculation process the information on individual assessment at a contract level can be provided for the process to continue and perform final ECL calculations. Apart from this there are other circumstances as well where manual interventions can happen due to complex nature of process and calculations for IFRS9, like including some data fields which are not available in the source systems and are manually stored by risk/finance teams and in some situations bank also wants to adjust ECL values at a consolidated level, before reporting the capital provisions to central bank.

For this requirement, financial institutions needs to ensure that they have designed the IFRS9 calculations workflow or design, which provides functionality to perform such kind of manual adjustments

Focus area for successful IFRS9 implementation

Based on the learnings and experience i3 consulting had on previous implementations of IFRS9, we would like to talk about some major focus areas which will definitely help each financial institution in successful and seamless implementation of IFRS9 standard. Major ones are discussed below:



- **Effective data management** – Data management is the key for a successful implementation of IFRS9 impairment calculations. A financial institution needs to perform identification of data gaps and definitely perform data quality assessment on the data fields required for IFRS9. As all the data fields would not be readily available, so identification of new data requirements and ensuring the correct source systems for required data will help bank understand the scope and accordingly based on data fields bank will be in a position to define a data model design which is compatible to the available data and keeping in mind the end to end requirements and process flow, the structure should be defined to cater to the complex calculation requirements. Additionally, as specific data might be required for disclosure reports, like write off data, recoveries data and GL roll-up and mapping etc. so bank should ensure the completeness of the data as first step

- **Assessment of significant increase in credit risk** – When assessing whether the credit risk on a financial instrument has increased significantly since initial recognition, an entity shall use the change in the risk of default occurring on the financial instrument rather than the change in the expected credit losses or in loss given default ('LGD'). To make that assessment, an entity shall compare the risk of a default occurring over the remaining life of the financial instrument as at the reporting date with the risk of a default occurring over its remaining life as at initial recognition

If an entity choses to make the assessment by using probability of default ('PD') information, generally a lifetime probability of a default (over the remaining life of the instrument) would be used. But, as a practical expedient, a 12-month probability of a default can also be used if it is not expected to give a different result to using lifetime PD. A simple or absolute comparison of probabilities of a default at initial recognition and at the reporting date is not appropriate. All other things staying constant, the probability of a default of a financial instrument should reduce with the passage of time. So, an entity needs to consider the relative maturities of a financial instrument at inception and at the reporting date when comparing probabilities of a default.

An entity can assess significant increase in credit risk by comparing the ratings (internal/external) of a financial instrument. For this, comparison of rating at origination is performed with the final rating at reporting date of the instrument

- **Effective co-ordination & communication between risk and finance team** –IFRS9 implementation will definitely requires significant involvement from both risk and finance departments as final impairment reports are finance team responsibility, however risk team plays an important role in implementing risk based approach for impairment calculations. Their different backgrounds can also present a challenge, to Finance team in understanding 'Risk-speak' (and vice versa). Similarly, it can be a challenging situation for Risk team to understand the detailed requirements of IFRS 9 from disclosure reporting perspective and appreciate its differences from common risk

modelling practice. Thus, resource planning plays a key role in the successful and timely completion of IFRS9 implementation

- **Disclosure reports framework** – Financial institution needs to focus on the new qualitative and quantitative information which is mandatory for presentation of required disclosure reports to be submitted by each financial institutions under IFRS9 standard and needs to ensure that all the required data elements are identified upfront and stored for generation of respective disclosure reports. An entity might come up with some data gaps for this requirement, for which higher management needs to take proactive decision for either bridging the data gaps or agreeing on an alternate approach. IFRS9 disclosures represents and explains transition decisions and their resulting impact to investors and stakeholders

- **Consideration of economic overlay** – The major change between IAS39 and IFRS9 is that IFRS9 focuses and mandate forward looking approach for determining the provision numbers. For this requirement, determining the appropriate macro-economic variables which needs to be considered and effective judgement is made in defining the future economic conditions and respective forecasts for future events plays an important role

- **Efficient portfolio segmentation and mapping correct model framework** – Financial institution has different portfolios covered in their balance sheet which are under the scope of impairment calculations as per IFRS9 standard. It is very important for an entity to understand the size, behavior and characteristics of each portfolio and perform effective segmentation of each portfolio, which will definitely help the bank in mapping the correct and applicable model framework to each respective portfolio for the calculations of PD, LGD, EAD which will finally defines impairment numbers for each instrument

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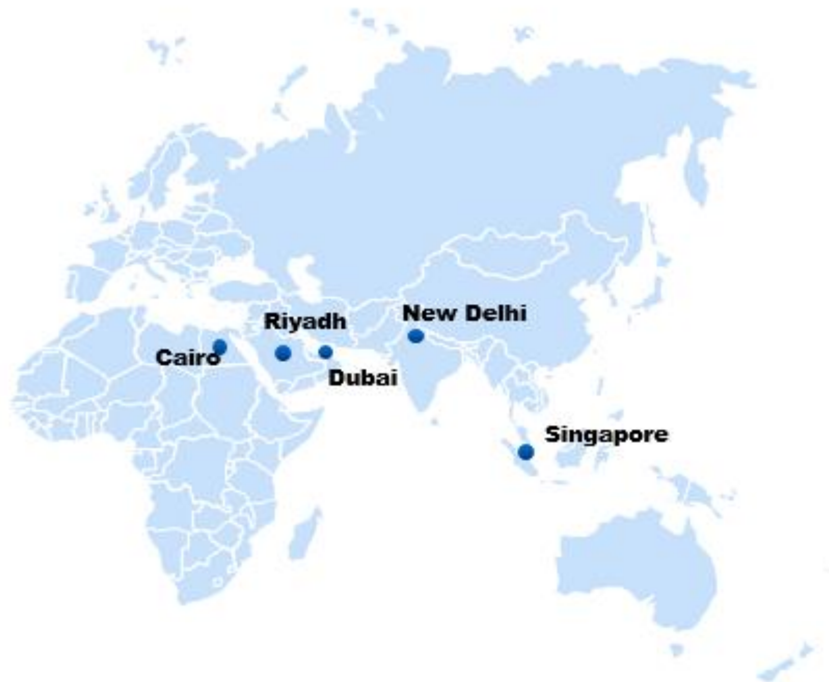

About i3 Consulting Private Limited

i3 Consulting Private Ltd. was founded in August 2006. i3C is a business consulting firm, which uses analytics as one of its core strengths to deliver to clients across the globe. We come with a rich experience in consulting in the domain of marketing, risk, strategy, corporate finance and process improvement. Our experience goes a long way in helping our clients to design, reinvent and align their corporate strategy to the big picture.

Adding true value to the client's business through our high impact solutions, we enable growth and attainment of goals. Our strengths are analytics, business understanding and industry knowledge across multiple functions, industries and geographies.

Today, we are a fast growing organization with a team of 50+ people and are expanding our footprints in different parts of Middle East and North Africa (MENA) and Asia. Currently we have our offices in New Delhi, Singapore, Cairo, Dubai and Riyadh.

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