# Implementing IFRS 9 : Global Insights

## Presentation to the Members of CA Bangladesh

Presenter : Rajith Perera| Partner | EY

Accounting Standards Committee Chairman

Financial Reporting Implementation & Interpretation Committee Chairman

## Course Agenda

- IFRS 9 impairment modelling
- Key Components of ECL Determination
- Aspects of Credit Risk Management

The objectives of the course are:

1. Understand IFRS 9 impairment requirements
2. Get acquainted with IFRS 9 modelling techniques
3. Learn validation techniques for IFRS 9 models
4. Understand how to create MIS based on ECL

**Innovate to Win!**

# Key Challenges faced by Banks

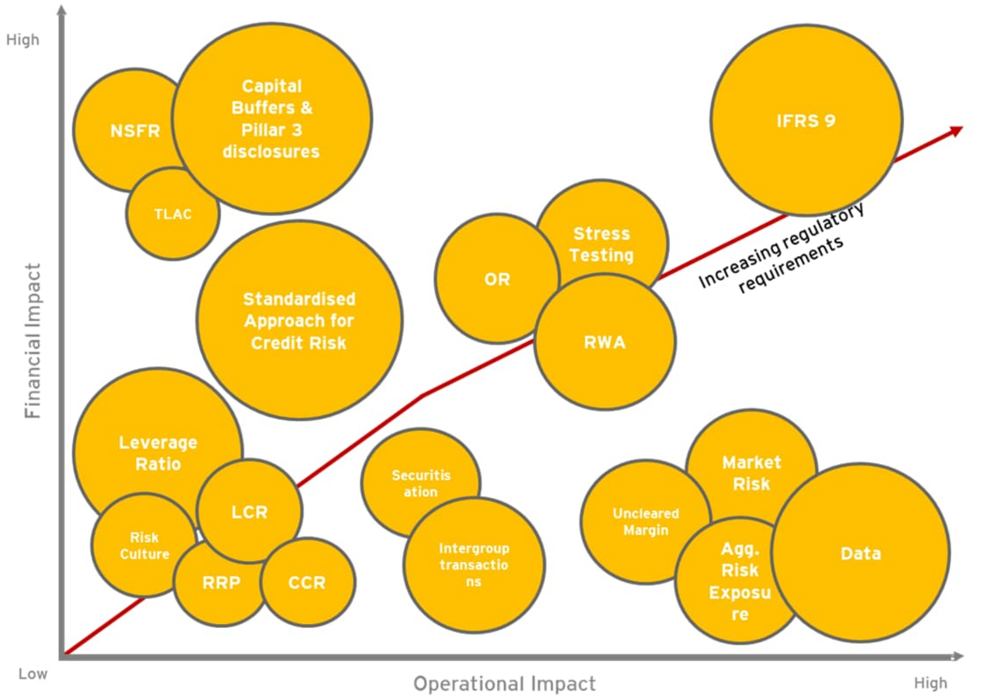
Innovate to Win!

- Demand in Reporting: Regulatory reporting is becoming increasingly detailed, required at increased frequencies and is expected to be in a state of continual change for the foreseeable future
- Granularity of Data: Regulations, both future and present require data at an increased grain and frequency; a level of detail not typically provided to central Risk and Finance systems.
- Increased Costs: The requirements and the typical response commonly result in compounding costs, incurred for both project implementation and ongoing BAU
- Segregation of Duties: In the face of such growing requirements the Risk resources have been diverted towards meeting immediate regulatory requirements. There is little capacity to consider and adopt new techniques, technology and approaches.
- Impact on structuring businesses: Banks are facing challenges in segmenting and structuring their businesses in line with growing regulatory requirement

How do meet these challenges?

- ✓ Building a strong technology platform
- ✓ Ensuring there is a robust governance framework which supports periodic challenge and review
- ✓ Revisiting segmentation of portfolios
- ✓ Streamlining processes to reduce cost and effort
- ✓ Building data infrastructure capabilities to meet data granularity requirements

## Regulatory Landscape




*Note: The size of the bubble indicates the implementation challenge for meeting the regulatory requirements*

# Challenges faced in implementing IFRS 9

Practical challenges faced by Banks during Implementation

**1** Lack or absence of strong Models
- For some of the Bank's while conducting the validation, it was observed that existing models were not robust enough to provide accurate ECL estimates for PD and LGD
- No existing models

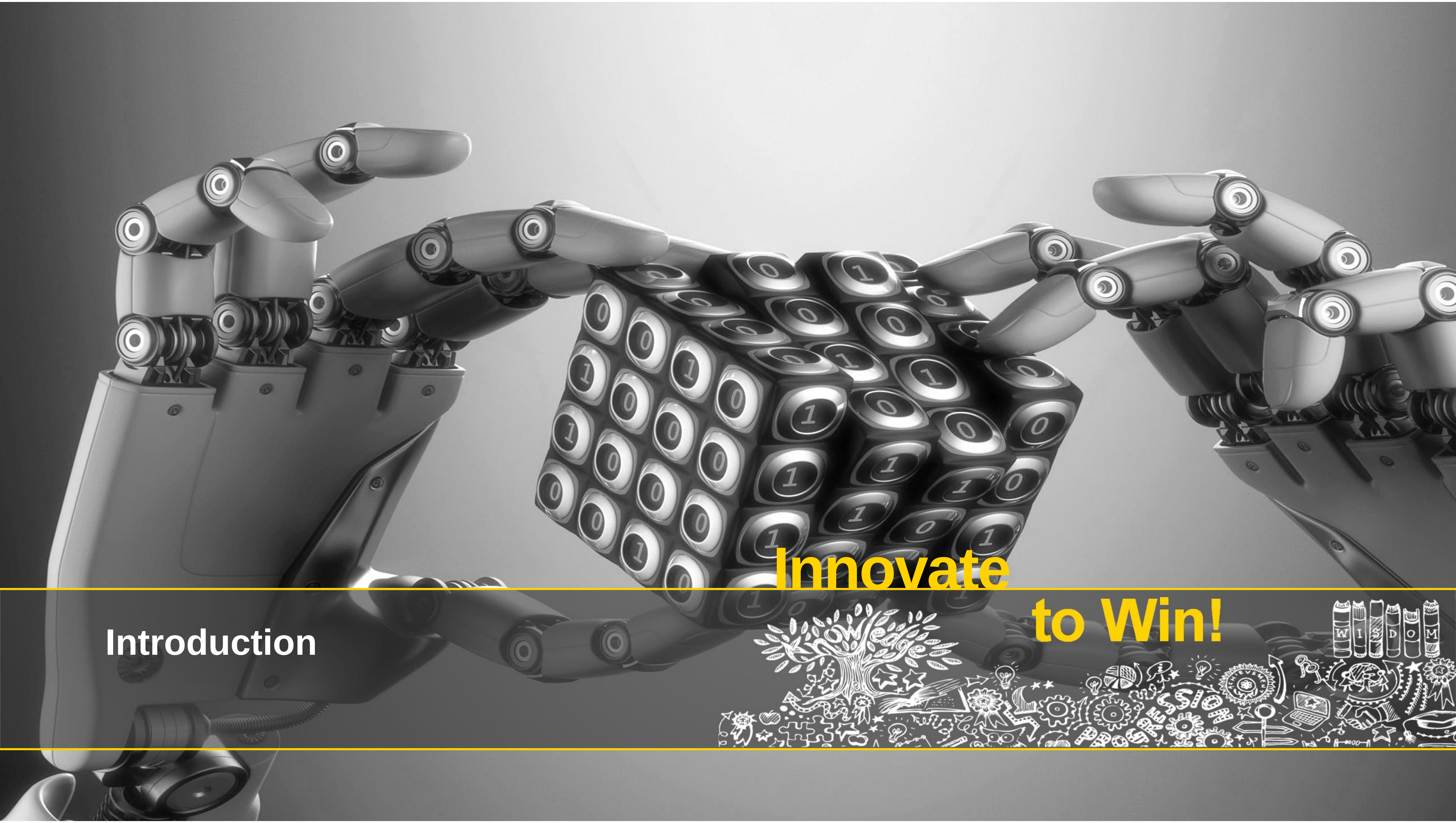
**2** Governance
- Clear definition of roles and responsibilities within the different functions of the bank
- IFRS 9 principles embedded within the policies and procedures
- Model Ownership

**3** Availability of empirical data
- Concerns observed include sparsity of recovery data more than default data
- Data availability constraints can limit discriminatory power of models, distribution of observations (Poisson) - may not be tractable, difficult to back-test PD estimates

**4** Forward looking
- Not enough historical data differentiation available to make a probability-weighted best estimate outcome
- Macro-economic factor correlation to observed defaults may be weak

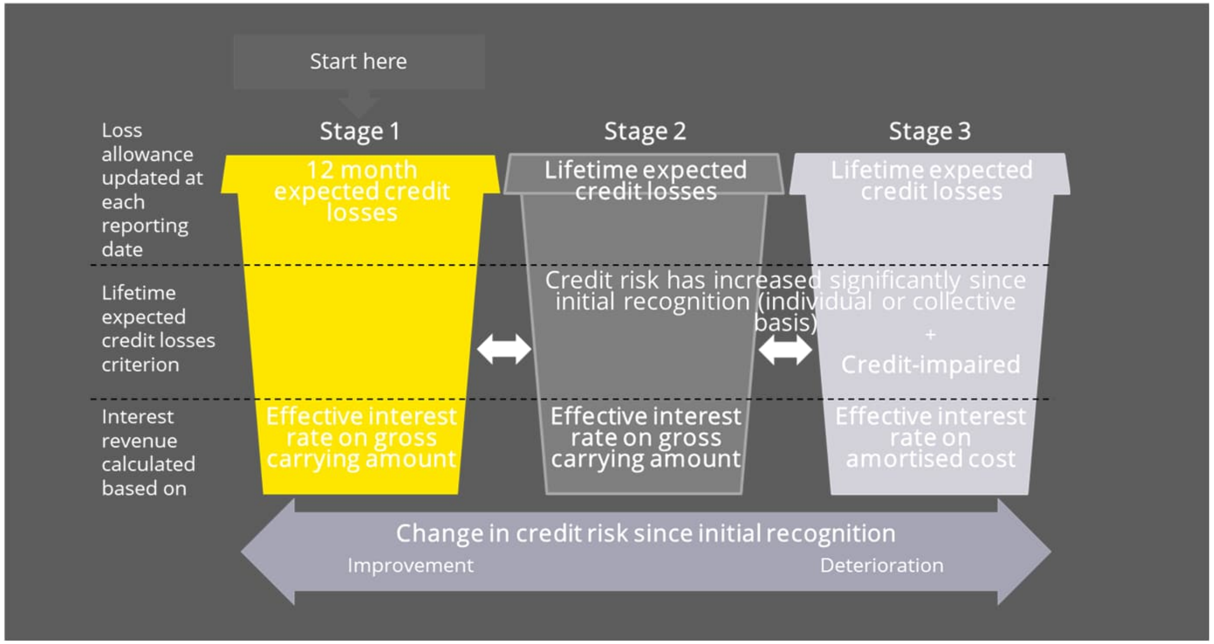
**5** Risk to Finance Reconciliation
- Impairment Modelling data set reconciliation with the financial reports is a bigger challenge as the size of bank increases

**6** Standardized portfolios or Lack of internal historical experience
- Segmentation of the portfolio can be a challenge due to constant strategy changes (new product, etc..)
- Development of accurate methodology based on type of portfolio




# Introduction

# Expected Credit Loss Implications




## Segmentations

## Reb. Presumption

- 30 DPD SICR
- 90 DPD of Default

| | |
|---|---|
| Current | Stage-01 |
| 1-30DPD | Stage-01 |
| 31-60DPD | Stage-02 |
| 61-90DPD | Stage-02 |
| 90> | Stage-03 |

## Management overlays

## Building Macro Economic Scenarios

## What impacts staging

## Deployment of proper collection strategy

## Elevated Risk Industries

# Measuring Expected Credit Losses

**Unbiased and probability-weighted estimate**

**Best available information**

**Information about past events** + **Information about current conditions** + **Reasonable and supportable forecasts**

**The time value of money**

# Model Functionality

$$LECL_t = \sum_{t=1}^{T} S_{t-1} \cdot PD_t \; x \; EAD_t \; x \; LGD_t \; x \; EFA \; x \; D$$

### $\mathbf{S_{t-1}}$: Survival function

$S_{t-1}$ is the probability that a customer has not defaulted or prepaid their balance in a previous period.

It is calculated as:
$S_{t-1} = \prod_{1}^{t-1}(1 - PD_{t-1} - PP_{t-1})$
where PP = prepayment

### $PD_t$ : Probability of Default

Likelihood that a borrower will not be able to meet its debt obligations over the course of the next 12 months

- Point in time and forward looking
- Counterparty level and refreshed on a frequent basis
- Key driver in stage allocation

### $EAD_t$ : Exposure at Default

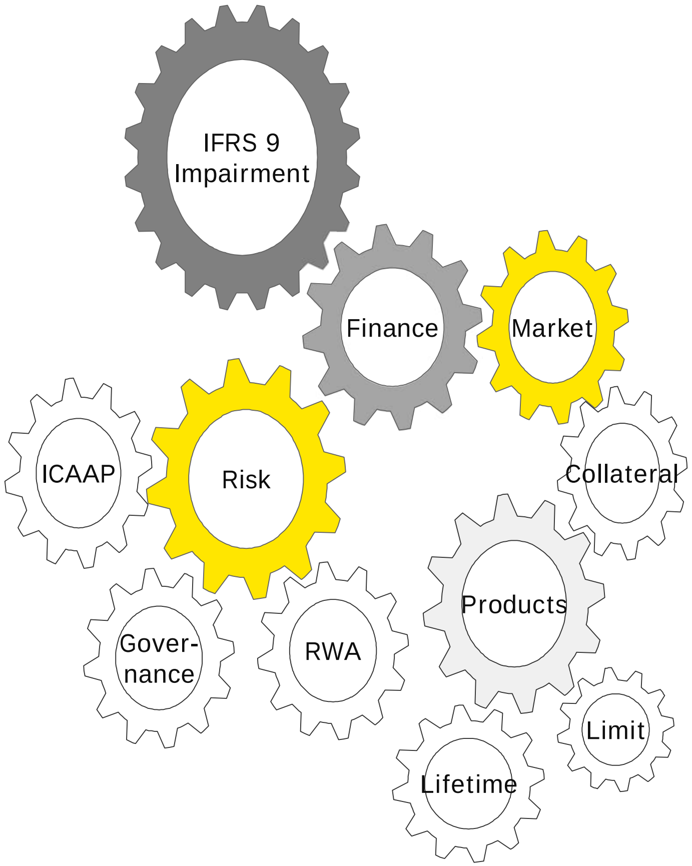
The estimated outstanding exposure at the time of a default

- Only contractually irrevocable undrawn commitments should be considered
- Point in Time
- No embedded regulatory conservatism
- Amortisation and prepayment should be modelled

### $LGD_t$ : Loss Given Default

The percentage of exposure at risk that is expected not to be recovered in the event of default

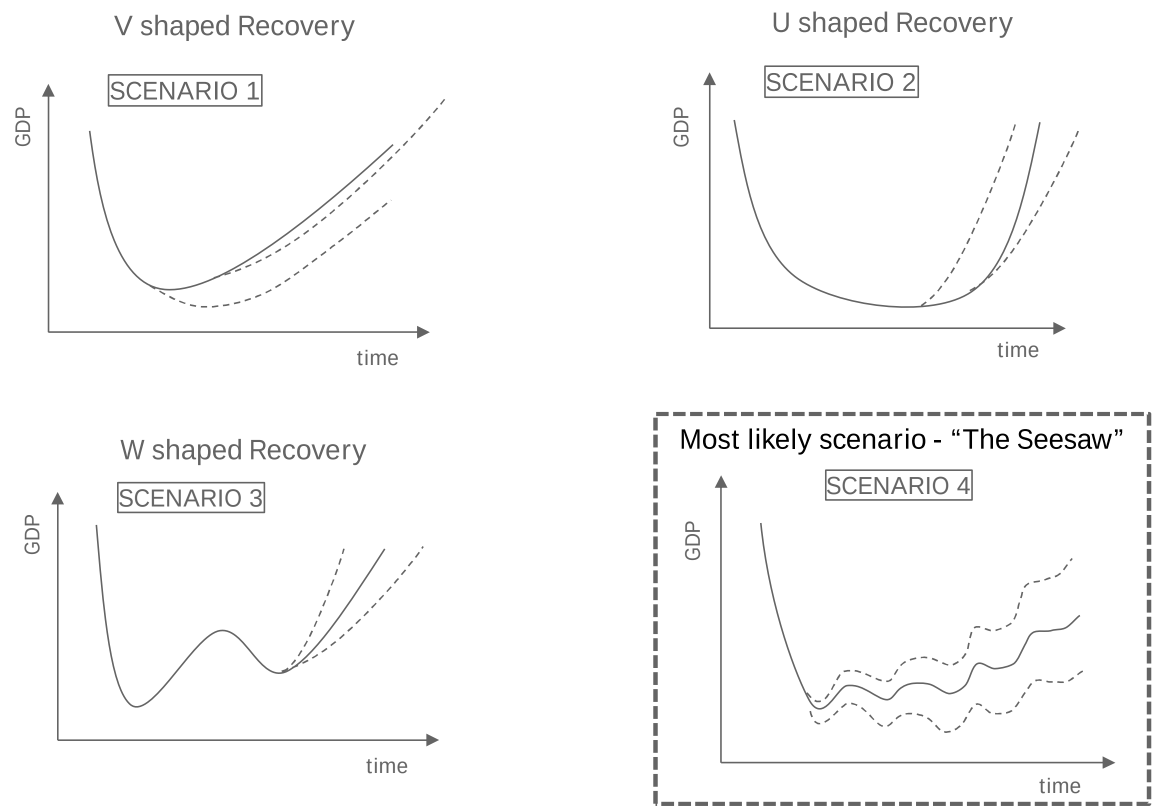
- Not downturn and no regulatory add-ons
- Forward looking
- Time variant (static values may be acceptable for some portfolios
- EIR used for discounting purposes



# Economic Scenario – Management Overlay

## How to establish the Economic Scenarios

### Economic Scenarios




Normalization period

### Qualitative

POLITICAL STABILITY

BUSINESS CYCLES

POLICY RELATED


# Importance of creating MIS for Decision Making

# Credit Risk Management Information System (MIS)

The objective of Credit MIS is to enable the management assess the performance of the bank and make faster decisions in relation to credit risk to benchmark the existing process with industry leading practices.

Following ECL information can be included in a credit MIS report.

1. Elevated risk industries
2. Industry Analysis
3. Quarterly Staging Comparison
4. Geographical Analysis
5. Off Balance sheet limit utilization

# Quarterly Staging Comparison

By analysing quarterly staging movement of bank's loan portfolio, management would be able to gain valuable insights and will enable taking necessary actions to mitigate credit risk in the future.

**ECL Information**

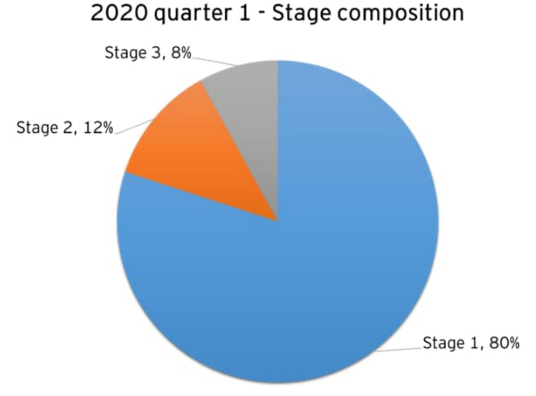
- Expected Credit Loss for the period
- Staging composition

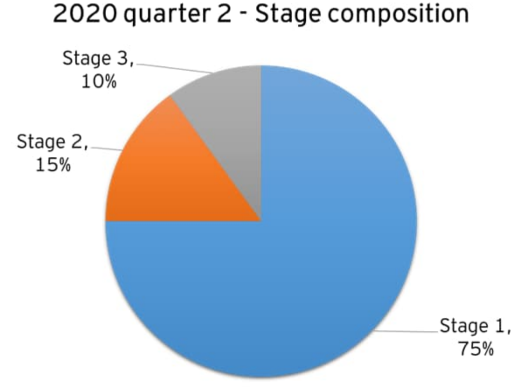
**Insights**

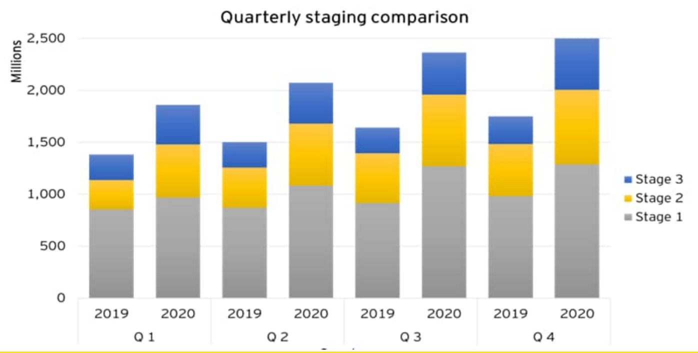
- Adverse staging movement
- Competitive advantage in the market

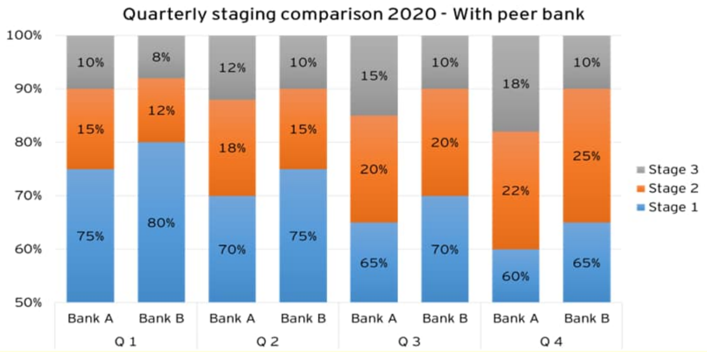
**Actions**

- Strengthen credit granting process
- Strengthen on going credit monitoring
- Changes to the recovery channels and techniques



# Staging Analysis

Inefficiencies in monitoring process

Effectiveness of the recovery methods being used /lack of customization of recovery methods.

Causes for staging deterioration

Inability to identify the warning signals both at individual borrower level and the industry level

Deficiencies / lack of monitoring the credit grated or lack maintaining the relationship with borrowers

Deficiencies in the customer on boarding process

## Action Plan

- Stringent customer on boarding process through development and validation of application scoring models and scorecards
- Effective credit monitoring using behavioural scoring techniques and early warning signals
- Implementation recovery tools to facilitate customize recovery techniques based on the customer segment/ delinquency status

# Key Lessons Learnt

# Lessons learnt


***Governance***

- IFRS 9 impacts the entire organisation (i.e. not just Finance)
- Tight and ongoing interaction of Accounting Policy, Finance, Risk, Technology and other functions is required
- Knowledge transfer from project team. Particularly if third party vendor are engaged to assist with the implementation. Some FIs did not manage to perform more than 1 parallel run. The effectiveness in a “Business As Usual” (BAU) is critical part of successful implementation.
- Inadequate involvement from senior management stakeholders may cause lack of ownership on the IFRS 9 numbers.

# Lessons learnt

2

### Modelling/Approach

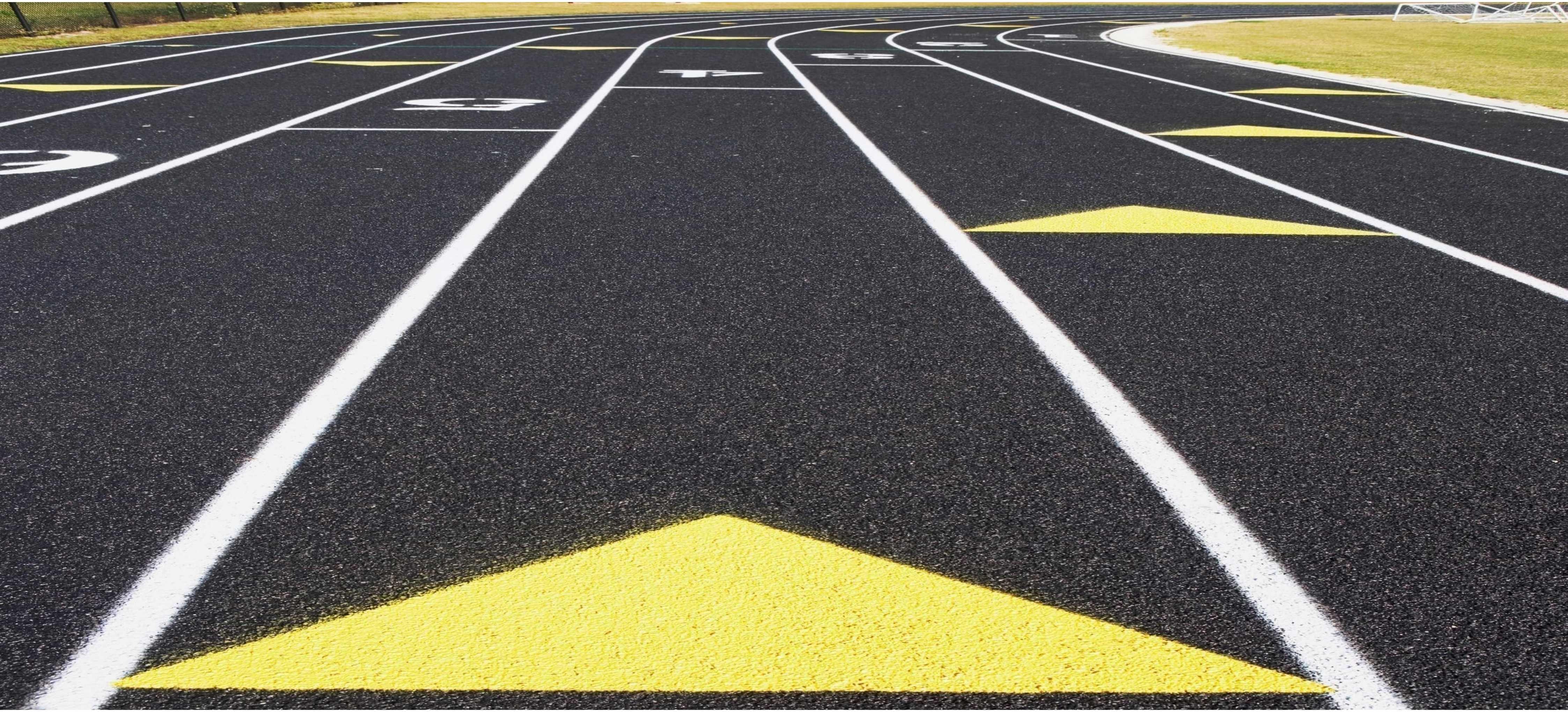
- Clear trade-off between simplistic and sophisticated approaches
- Judge the right level of proportionality
  - Reference to 'undue cost and effort' in IFRS 9
  - Consider regulatory expectations
- Leverage existing tools and practices where suitable
- Transition from tactical to strategic solutions (i.e rating based approach)
- (Re)assess application of practical expedients and emerging peer practice as required
- Budget/time constraints may have caused implementation shortfalls that require remediation
- Consideration of new products/ new business in year of implementation and whether IFRS 9 model methodology is able to accommodate the changes.

3

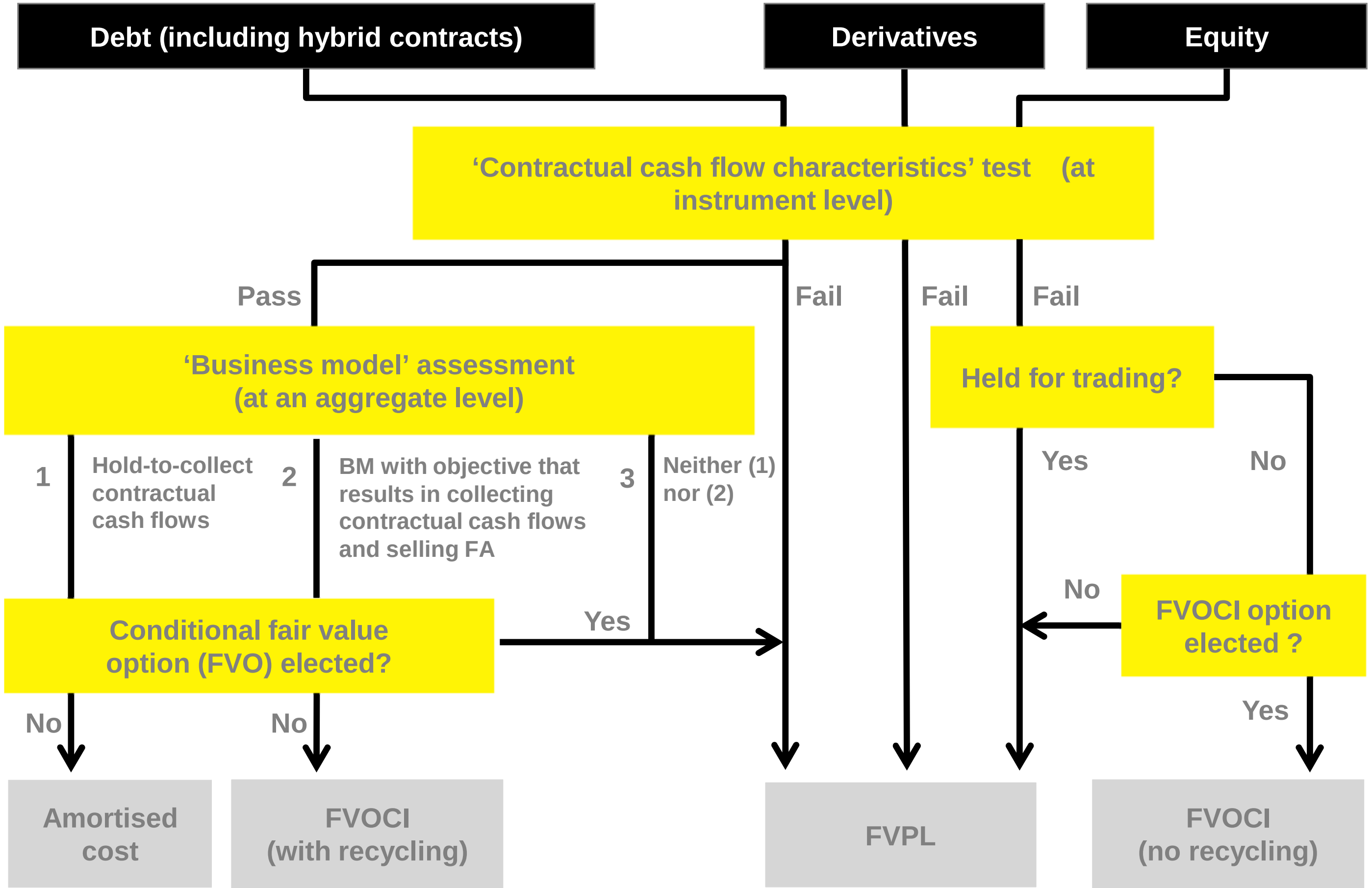
### Data/Technology

- Early involvement of Technology specialists critical for successful implementation
- Future proof implementation and testing (e.g. for loan volume increases)
- Data issues impact robustness of IFRS adoption
  - Data quality/availability is critical
  - Need for management overlays?
- Assess/test quality of data
  - Data validation controls and governance

# Financial Asset Classification



# Classification Process & Challenges




**Key Challenges**

- Contractual Cashflow Characteristic Test ;
  - Deminimis Criteria
  - Non-Genuine Criteria
- Business model assessment
- Fair Value measurement for all equity instruments
- If The Bank Group or any of its in-scope entities makes FVO election, obtain documented evidence of FVO election made by management:

  a. For debt instruments that The Bank Group or its in-scope entities decides to select the FVTPL measurement basis despite having the business model 1 or 2; and

  b. For equity instruments that The Bank Group or its in-scope entities decides to select the fair value through other comprehensive income ("FVOCI") without recycling as its measurement basis.

# Questions?