The accounting standard and its emphasis on forward thinking are stirring anxiety, but a GFRC management model can help carry firms into the future.

**IFRS 9: Unexpected Gains from Expected Losses**

**WHITE PAPER**

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IFRS 9 calls for firms to replace the traditional incurred-loss model for gauging credit exposure with one that uses a variety of internal and external criteria, plus a liberal amount of management judgment, to calculate expected credit losses (ECL).
Unexpected Gains from Expected Losses

It probably wasn’t part of their job description when they were hired, but one of the chief duties of senior bankers these days is time travel. A common theme in the new architecture of financial supervision is the encouragement of institutions and their key executives to take a leap into the future by emphasizing forward-looking analysis to try to anticipate adverse events instead of just react to them.

IFRS 9 Financial Instruments is a prime example. The new accounting standard calls for firms to replace the traditional incurred-loss model for gauging credit exposure with one that uses a variety of internal and external criteria, plus a liberal amount of management judgment, to calculate expected credit losses (ECL).

Under the old method, banks wrote down values on loans and other assets in their profit-and-loss statements only after a default or other incurred triggering event. Such a retrospective process may be effective in a normal operating environment, but as the global financial crisis revealed, the environment can quickly change from normal to catastrophic during periods of acute stress. An ECL approach aims to help banks prepare for negative outcomes by continually reassessing their credit exposure.

IFRS 9, one of the International Financial Reporting Standards devised by the International Accounting Standards Board (IASB), sets out methodologies for assessing the credit quality of an asset or a portfolio of related assets. There is a classification system with three stages that represent different levels of impairment and use different methods to determine expected/incurred losses.

To follow the protocols, firms will be required to exercise judgment throughout the organization, evaluating internal developments and the wider economic and financial backdrop. The unique skills, perspective and outlook that each department, most notably Finance and Risk, brings to the task makes it one that’s best accomplished between them, working together, not just within them.

Creating the ECL model is a critical step, but it’s merely the first one. The model will have to be integrated into operations as diverse as data collection and analysis; capital management; compliance and reporting, with results ultimately being felt in P&L statements, capital ratios and shareholders’ equity.

This is when the collaborative thinking incorporated into IFRS 9, which banks are free to implement now and which will become mandatory in 2018, will reveal its value most clearly. To prepare for the standard, organizations must understand the changes being introduced, their impact on vital functions and on the ways that those functions interact with one another, as well as the knock-on effects on key elements of financial performance and risk management. Relying on the divergent vantage points from which a firm’s operations are viewed – the focus on P&L by Finance, for instance, and capital requirements by Risk – will create a fuller and timelier picture of evolving developments. That will permit a more accurate assessment of credit impairment and its impact ... with one caveat: An institution can comply successfully with, and benefit from, IFRS 9 if all centers of leadership act in concert; the standard can be a time machine that lets them leap into the future, but only if they make the journey together.

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GFRC: tomorrow’s management model today

The emphasis on forward-looking analysis is not the only aspect of IFRS 9 that should encourage bankers to think and act more cooperatively. Like many new initiatives, the standard is principles based, not rules based. Rather than comply with a set of instructions – in Situation A, follow Procedure X – they will have to evaluate facts on the ground to determine, first of all, where they stand – whether they indeed are facing Situation A. Then they must select a course of action by using logic, experience and common sense to a greater extent than under earlier supervisory regimes.

They will have to do this, incidentally, across all of a firm’s activities and at all levels, not just in estimating credit impairments, although that is what IFRS 9 is chiefly concerned with. This undoubtedly will be a difficult adjustment for bankers used to following a concrete set of rules based on hard data and historical precedent, with no freeform riffing allowed.

But as financial supervision makes progress, so does financial management. The industry has come to embrace Governance, Finance, Risk and Compliance (GFRC), an overarching management framework ideally suited to the prospective, principles-based elements of IFRS 9. GFRC stresses the links among centers of leadership within a firm, rather than the activities of each one alone, the modus operandi of traditional accounting standards and the silo organizational structure entrenched in many institutions.

GFRC promotes the pursuit of common goals consistently and ubiquitously across an organization. It helps managers engage in deeper, more comprehensive analysis to make more creative, strategically focused decisions and anticipate critical events. Once GFRC principles are in place and information and ideas flow through the breadth and depth of a firm, an ECL model becomes easier to craft and implement. The results that it generates are likely to be more accurate and meaningful, moreover, and lead to more efficient use of capital and stronger financial performance.
Governance: the buck stops up there

When authorities call on bankers to make decisions based on their best judgment, they're not talking about Dave in the mailroom. The IASB and other supervisory bodies, such as the Basel Committee on Banking Supervision (BCBS) and the Federal Reserve Board, stress that senior management – relying on internal controls, not external strictures – is directly responsible for ensuring the correctness and completeness of all information accumulated and reported, as well as the analysis, decisions and financial results that arise from it...

High-level judgment must be applied in all of a company’s business lines and in all geographic jurisdictions. Beyond the need to measure and understand facts and figures, a goal that effective data management technology can help meet, attention is required on matters affecting a firm’s reputation. That may be underestimated because of the fuzzy, amorphous nature of such a behavioral construct, but it must be remembered that reputation influences a bank’s standing in the marketplace and with investors. In fact, it ultimately contributes to stability in the financial system.

When it comes to implementing IFRS 9, it will not take long for management judgment to come into play. The standard features a three-stage system for calculating expected credit losses. As soon as an asset is recognized on the books, it’s placed in Stage 1, with ECL defined as the probability of default over the next 12 months (taking into account all cash shortfalls over time).

An asset that has suffered a deterioration of credit quality is placed in Stage 2, for which the impairment allowance is measured as the present value of the probability of default over the expected lifetime. In Stage 3, objective evidence for default has been found and the loss event has occurred.

Before any asset is examined, it will be necessary to formulate procedures to determine stage classifications; definitions of the relevant characteristics used in making the determinations and also the triggers that will confirm material changes in credit quality and justify stage reassessments. Once models and definitions are established, further judgment will be needed to assure the validity and reliability of methods used to measure credit risk and other inputs into the model.

Related activities for which senior executives will be responsible include the selection of methods for aggregating data – who compiles what, where – and policies and procedures to track how calculations and decisions are made – which departments and at what levels. In a nutshell, a well governed firm that implements IFRS 9 will have leaders who measure the right things in the right way. They will also be able to show their work and explain and justify all key decisions and actions to their colleagues and to external supervisors.
Support from top to bottom and back again

It’s difficult using a GRC model in isolation to accommodate such a shift in focus – from understanding what happened in minute detail to making useful forecasts of what is going to happen – because of the model’s inherently static nature. The system is put in place, and actions conform to established procedures. No improvisation. Anticipating or even responding to unusual or unforeseen developments becomes a tall order.

Good judgment doesn’t spring like magic from bosses’ heads. Senior managers must receive support in spreading sound governance principles throughout an organization. Firms must strive, for example, toward robust accounting policies that are compatible with the work of different departments. Accounting policies, furthermore, should dovetail with risk policies, and they should feature strong tracking and documentation procedures. They also should be easily adaptable to new lines of business.

Flexibility of all sorts should be a hallmark of governance systems established with IFRS 9 in mind. Any significant change in conditions, within a firm or that affect it from outside, needs to be factored as gracefully as possible into credit assessment models and tracking, documentation and reporting methods. All practices must be sufficiently pliable to satisfy demands of auditors and regulators in multinational, national and other jurisdictions.

Another useful governance tool amounts to a kill switch, a mechanism that permits senior management to recognize developments that significantly alter the operating landscape, even if they’re difficult to discern through typical quantitative methods, and to override established procedures. Such a mechanism, for example, might allow the model for assessing credit impairment to be adjusted for certain groups of assets.

Although the people in charge are ultimately responsible for everything that happens at a bank, other officials have important duties to fulfill to implement IFRS 9 successfully. It’s vital to include them in designs for ECL models and in decision making and planning in general. Among them are:

- **The chief economist.** Responsible for analyzing and estimating values for macroeconomic variables that influence a firm’s performance and serve as input data for ECL models, probability scenarios and senior management’s interpretation of them.

- **Treasury officers.** They will have to assess how changes in the classification rules for financial instruments make some better or worse as potential funding sources.
• **Product managers.** Important because product viability and profitability depend to a greater extent today on the capital charge on the risk associated with a product, a key element of the expected-loss calculation. The new standard could make certain products desirable when they otherwise would not be, or vice versa, due to the way their risk profiles cause them to be accounted for under IFRS 9.

• **Branch credit officers.** In the spirit of IFRS 9 and its emphasis on forward-looking analysis, these sentinels serve as the eyes and ears of the corporate generals and can warn of changes in the outlook for various types of loans and for the credit environment as a whole before they become widely known.

The need to transmit information up and down across an institution heightens the importance to good governance of strong data management. That includes a system that permits collection and storage on different levels, with efficient segmentation and customization by product, entity and department – with the needs of Finance and Risk of particular importance – overlaid with a history-management capability. It’s clear that an intimate understanding of connections among departments is a critical prerequisite for accomplishing governance tasks – exercising judgment soundly and consistently and with a view to expected outcomes, not established precedent – that go hand in hand with implementing IFRS 9. This is why a GFRC approach is so valuable, and the emphasis on senior management judgment shows why “G” is the first item listed.

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Finance: Jack of all trades, master of each one

If there is a natural home for an accounting standard like IFRS 9 or Current Expected Credit Loss (CECL), its American cousin from the Financial Accounting Standards Board (FASB), it’s Finance. Banks certainly see it that way, based on their inclination to entrust projects for implementing the standards to Finance officers.

The judgment of senior management is paramount, as the standard setters and regulators stress continually. Finance is responsible, however, for providing much of the crucial information used to make ECL and other calculations related to IFRS 9 and for furnishing senior management with the facts, figures and analysis on which their judgment is founded and on which those who preside over other key functions within an organization rely.

Finance has much to do to meet the demands imposed by accounting standards, most notably in areas like the P&L statement and all factors that go into it. But this central department also must concern itself with elements of a firm’s operations that verge into the spheres of Risk and Compliance, such as capital requirements and disclosures, respectively. Even if Finance outsources these to other departments, they still affect the way Finance does its job.

Perhaps more than with any other critical function, Finance will bear the burden of making the leap into the future that IFRS 9 calls for. The shift to an ECL impairment model from one measuring incurred losses may have a dramatic impact on P&L and therefore on all major aspects of performance that affect stakeholders from employees to investors to supervisory authorities.
The shift to an ECL impairment model from one measuring incurred losses may have a dramatic impact on P&L and therefore on all major aspects of performance that affect stakeholders from employees to investors to supervisory authorities. The new impairment calculations will influence the bottom line due to:

- The need to account for an expected loss for an asset the moment it’s recognized on the books. This is not a result of any deterioration of the asset, and there should be no long-term difference in the impact on P&L between IFRS 9 and the old IAS 39 standard, but the allowance is frontloaded under IFRS 9.

- A further requirement to account for a downgrade from Stage 1 to Stage 2 if and when an asset suffers a sufficient erosion of credit quality. This will force an allowance to be taken that represents expected lifetime losses instead of default events anticipated over the next 12 months – again without any default or other trigger having occurred.

- The restating of allowances for assets in existing portfolios on the books, not just for each new contract made after IFRS 9 is implemented. Many in the financial services industry describe the revised treatment for instruments moving to Stages 1 and 2 as once off P&L effects, but they are mere bumps in the road compared to the impact that the new ECL rules will have on existing portfolios.

The good news is that a further downgrade to Stage 3 – the event that the other ECL moves were preparing for by bringing allowances forward – will have a less deleterious effect on P&L than under IAS 39 (the cliff effect is less under IFRS 9 than under IAS 39). That will come in handy during hard times. IASB research shows that when a recession kicks in, the cliff effect under IFRS 9 is expected to be less steep and be absorbed by the earlier recognition of lifetime expected losses.

**P&L expense under IFRS 9 more responsive to changes in expectations**

![Chart showing P&L expense under IFRS 9 more responsive to changes in expectations.](chart.png)

Source: IASB
Following the rules and making them too

Before an asset is classified, Finance will play a key role in applying tests to decide how instruments will be treated based on their cash-flow characteristics – whether they will be held at amortized cost or at fair value through other comprehensive income (FVOCI). That has several important potential knock-on effects: It can add to P&L volatility and be a make-or-break feature in determining whether a product line is worth pursuing, and it can influence a firm’s capital position and funding requirements.

It also will be up to Finance, in large part, to determine how broadly simple or complex the ECL model will be; which elements, including triggering events for stage changes, will figure into the model; whether, in what circumstances and how practical expedients will be used in measuring ECL and when and how tradeoffs can be made between qualitative and quantitative indicators in the calculations.

Other tasks include setting the conditions for stress-testing scenarios and supervising the parallel run through which impairments and other important metrics are compared with their values under other standards and rules. The parallel run is particularly important because it provides a way to test the reliability of assumptions and procedures used in ECL models and work the kinks out before full implementation. It serves as a preview of changes in key indicators that can be expected when a bank goes live with IFRS 9.

It also will fall to Finance to verify that different functions across a firm measure phenomena in consistent ways. That will ensure the creation of a single version of the truth to report to all departments and senior management within a firm and key figures outside, such as regulators and investors.

These interrelated requirements and objectives again highlight the need for cooperation among centers of leadership – Finance and Risk foremost – as well as transparency throughout a firm, underpinned by sound tracking, documentation and data management procedures. Over the long haul, there is unlikely to be an appreciable difference in impairment levels between IFRS 9 and IAS 39. But in banking, as in comedy and trapeze acts, timing is everything.

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Risk: safeguarding capital when it’s needed most

The emphasis on forward-looking analysis in IFRS 9 leaves Finance focusing above all on the P&L statement. The Risk department, meanwhile, will fix its gaze on a firm’s capital position and how it’s likely to be altered, and potentially placed under stress, by the shift to an expected-loss framework and the impact on P&L and shareholders’ equity from frontloading allowances.

Issues related to capital are not the only concern for Risk. It will play a vital part, in concert with the Finance department, in developing and calibrating credit risk models that guide ECL calculations. This includes evaluating and selecting macroeconomic variables and establishing procedures for determining rating grades and dividing credit exposures into appropriate segments. As with other aspects of IFRS 9, it will be necessary for Risk to document and be able to explain and justify all actions taken.

Risk also will be counted on to report key metrics derived from IFRS 9, other accounting standards like CECL, when relevant, and regulatory frameworks such as Basel’s and to develop practices to reconcile them with one another and with different versions of the IFRS 9 ECL model if it has undergone material changes.

The impact of allowances on P&L and equity is no small matter. An IASB study found that provisions for loan losses reduce profits by 20 percent a year under normal conditions and caused an annualized 50 percent decline during the financial crisis. Any increase in allowances in 2018 is bound to be scrutinized carefully by regulators and investors.

The study also found that allowances have a substantial impact on shareholders’ equity. A 10 percent increase in allowances, for instance, translated into a 2 percent decrease in equity, and a 100 percent increase in allowances corresponded to a 24 percent equity decline.

Research by Standard & Poor’s found similarly that higher allowances depressed regulatory capital, especially for banks in Western Europe. A doubling of allowances led to a 5.3 percent decline in the common equity ratio for institutions there, while Canadian banks suffered least under that scenario, with just a 0.1 percent reduction. It’s worth pointing out, too, that allowances will be more of an issue for some firms than others, say those with heavy mortgage businesses as opposed to wealth managers.

When it comes to capital requirements, Risk will feel pressure on two fronts as 2018 approaches. The mandated adoption of IFRS 9 and the anticipated higher initial allowances for impairments coincide with the introduction of requirements under Basel III to maintain Tier 1 capital of at least 4.5 percent of gross exposures and a 3 percent leverage ratio. That means that measured capital is expected to decrease just when more of it will be needed.
After the initial pain, some gains

For all the challenges that Risk must confront in implementing IFRS 9, there will be benefits for organizations that use the daunting task as a catalyst to strengthen links between departments. Risk officers tend to focus on worst-case scenarios, for instance, and may favor point-in-time assessment in credit models. A through-the-cycle approach may be more sensible for a given firm, something that would become evident when other centers of leadership entered into the discussion.

Dividends also will accrue down the road as additional regulations that require more data sharing and cooperation in general take hold. Among the affected areas are Fundamental Review of the Trading Book (FRTB), Intraday Liquidity Requirements, and Risk Data Aggregation (aka BCBS 239).

Living with IFRS 9 itself is expected to become easier over time thanks to various mitigating factors that make its adoption and impact less onerous from a Risk standpoint:

• The requirements of different sets of regulations and standards governing credit losses are likely to converge after they’re put into practice in the real world and log enough miles on the clock. At the same time, standardization in weights used to calculate probability-weighted outcomes under certain scenarios should occur across regulations, indicating a modest shift back to rules-based analysis. Also, the number of macroeconomic variables accepted in ECL calculations and in stress scenarios, for instance, probably will expand as they’re put to the test.

• It’s customary in much of the world to incorporate floors into impairment estimates. This is most common in Southern Europe, the Middle East, Africa and the Asia-Pacific region. That should cushion the blow from the more stringent ECL methodology called for under IFRS 9. An unintended consequence of the use of floors is that incurred losses seldom rise above floor levels for many firms. That has left them out of practice when it comes to establishing procedures for measuring impairments, but some firms have acknowledged this and are being conspicuously diligent in their preparations for IFRS 9.

• Moving to an ECL model at first could create an unrealistically bleak forecast of impairment levels for some firms, to the point that they may consider departing certain business lines that suddenly seem too risky when evaluated strictly by the numbers. Common sense, supported by back-testing, would be relied on in these instances to confirm or rebut the reliability of the forecasts and reassess assumptions in the model.

• Just as there can be floors under losses, there can be ceilings above them. In nearly every case, expected lifetime losses cannot exceed the life of a loan contract.
Compliance: talking to the outside and inside worlds

Regulatory compliance is the last critical function involving IFRS 9, but certainly not the least. It’s through the Compliance department that a firm creates its public face to demonstrate to authorities – and to investors and others whose good opinion counts – that procedures are being followed and, just as important, how they’re being followed.

At its most basic, Compliance is responsible for making mandatory disclosures. Disclosures required under IFRS 9 are broad but for the moment at least in the EU should be in line with the Financial Reporting (FinRep) requirements set out by the European Banking Authority (EBA), although FinRep calls for some additional breakdowns. Local regulators may demand further information to accompany IFRS 9 data, and banks with activities outside Europe are likely to face other disclosures.

The best approach for firms in multiple jurisdictions is to prepare a set of add-ons for different authorities to go with a general IFRS 9 disclosure and be aware that a process of consolidation and reconciliation may be needed to explain discrepancies between disclosures under different supervisory rubrics, not just to regulators but to investors and relevant departments within the firm, too.

During the development of IFRS 9, the IASB expressed concern that institutions would disclose too much, not too little, and encouraged firms and authorities to emphasize quality above quantity. A conundrum that firms face is that different stakeholders place a priority on different information.

Investors, for instance, focus on financial performance, fulfillment of capital requirements and details of changes undertaken to enhance performance. Regulators are interested in long-term sustainability and meeting requirements related to solvency, liquidity and credit risk. Employees are interested in long-term growth prospects, and the board concentrates on risk-adjusted performance and the commercial outlook under various conditions.

To try to keep everyone happy, institutions are including management summaries with their disclosures and highlighting the parallel run to provide performance comparisons under different scenarios. Compliance also needs to ensure that it possesses varied skill sets compatible with those of the Risk and Finance departments – credit risk modeling and auditability, respectively.

Dividends also will accrue down the road as additional regulations that require more data sharing and cooperation in general take hold. Among the affected areas are Fundamental Review of the Trading Book (FRTB), Intraday Liquidity Requirements, and Risk Data Aggregation (aka BCBS 239).
Explaining the numbers, not just reporting them

In a principles-based framework, there is more to be disclosed than facts and figures. As in other facets of life, the journey is as important as the destination. Compliance must explain and document the processes, assumptions and triggers used to reach each result, along with the reasons for choosing them over others.

For example, the amounts of assets transferred from Stage 1 to Stage 2 must be disclosed, as well as the allowances taken and the criteria that went into the decision to move individual assets or groups of them. The need to document and justify each decision, in turn, helps management evaluate its own performance and can serve as a catalyst for adjustments to credit models, types of products emphasized and so forth. Two-way traffic is essential in compliance functions with IFRS 9 in mind.

Once a model has been implemented and compliance procedures are up and running, it’s important to avoid complacency. The IASB and regulatory agencies continually publish updates on requirements and procedures. Firms should maintain centers of excellence and strategic partnerships with external solution providers with regulatory update services that notify compliance officers of pending changes so that they can be promptly documented and disseminated company-wide.

Reporting and explaining data require systems that can compile, manipulate and analyze it with power and finesse alike. Employing the right data management systems gives Compliance the time and freedom to examine discrepancies in key indicators flagged in the reconciliation process. It also facilitates responses to questions about disclosures generated internally and externally and the incorporation of updates into reporting procedures. Effective data management furnishes the means to evaluate parts in detail in order to create a comprehensive conceptual whole.

Strategic planning across the enterprise

In his peculiar wisdom, Yogi Berra, a baseball player renowned for his colorful and tenuous grasp of logic, said, “It’s tough to make predictions, especially about the future.” After being caught out during the global crisis, the financial services industry and supervisory authorities know how true that is. IFRS 9 is an attempt to encourage banks to develop models and mechanisms that will function as the time machine that allows them to forecast tomorrow’s credit conditions today and avoid the next crisis.

Operating such a device takes a well-trained crew working together. One pilot can’t do it alone, although some firms insist on testing that notion. They see the call for prospective analysis from either a Finance perspective, primarily emphasizing factors such as budgeting and the use of ECL models that rely on qualitative criteria, or they adopt the vantage point of Risk and focus on capital planning and creating models that stress macroeconomic variables or repurpose Basel scoring techniques.

What they need instead is a holistic approach for which the objective is strategic planning across the enterprise, encompassing Finance and Risk functions and backstopped by Compliance, all within a sound Governance architecture. Before the journey begins, these time travelers need to recognize that the future is a big place. With the right command structure and a sturdy-yet-flexible data management system to aid in navigation, they can embrace IFRS 9 as an opportunity, not an unavoidable obstacle, and steer toward the future with confidence.
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