IFRS 9: Closing the Gap between Risk and Finance

Written by Jeroen Van Doorselaere
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The global financial crisis has changed the landscape of the financial industry significantly. This paper examines the ongoing convergence in the measures used by risk and finance functions and the potential for developing a ‘single version of the truth’ for both.

The two separate worlds of risk and finance, and their frameworks, have much in common; despite being written to achieve different objectives, they often work in a complementary manner. This is well demonstrated in the recent International Financial Reporting Standards (IFRS) 9 issued by the International Accounting Standards Board (IASB), in which it indicates that some risk management information should be disclosed, and also notes that risk management may form the elementary input for accounting in some areas. There are two clear examples of the latter.

Firstly, in the Exposure Draft titled ‘Financial Instruments: Expected Credit Losses’ released by the IASB on 7 March 2013, the way that the risk management function builds its internal rating classes can have an effect on the way that expected losses are calculated. Secondly, it can be observed that financial institutions have tied some technical definitions to the structure and identification of exposures as they relate to the value defined in the underlying accounting standard. For example the definition of ‘fair value’ exposures relates back to the fair value definitions as disclosed on the balance sheet giving an indirect pointer to the IFRS 13 standard around fair value measurements.

How close is convergence? Despite some interconnectedness, there remain major differences. Both frameworks have separate definitions of fair value, expected losses and offsetting amongst others. Consequently, an entity should be able to understand and reconcile these differences.

The financial crisis has acted as a catalyst for convergence between different accounting standards. The idea of convergence between different standards originated in the 1950s and the process of convergence has been supported along the way since then by numerous statements from the G20, which have repeatedly pushed for a more uniform way of reporting and disclosures.

After the global financial crisis a number of convergence projects were set out between US standards body, the Financial Accounting Standards Body (FASB), which is responsible for US Generally Accepted Accounting Principles GAAP, and the IASB. However many projects were delayed and after the last IASB Exposure Draft the two sets of rules had not found complete alignment.

Using an expected loss model was the obvious way forward, as it had already been agreed by the IASB and FASB. This opened a potential bridge with risk management measurements. Would these expected losses be the same if we compared the different publications of the Bank of International Settlements (BIS), FASB and IASB? How could the integration between the finance and risk worlds be integrated for expected losses? These questions will be addressed within this paper.
The IFRS 9 Expected Credit Loss General Model

The general model is divided into 3 stages:

- **Stage 1:** The underlying asset did not show a significant deterioration in credit risk compared to initial recognition or it has a low credit risk grade (also known as investor grade for rated financial assets).

- **Stage 2:** A financial asset is transferred to the second stage when there is a significant deterioration and it is considered not ‘low’ risk anymore. In both stages interest revenue will be calculated based on the ‘gross amount’, the amount without subtracting the impairment allowances.

- **Stage 3:** The transfer to the third stage will happen when there is a loss event and there is sufficient evidence that the individual financial asset will default. In Stage 3 interest revenue is calculated based on the ‘net amount’ (the financial assets value less the impairment allowance taken into account).
Understanding the IASB exposure draft

Scope and classification
The main objective of the exposure draft was to make calculation of impairment more independent from classification of the financial asset. The new exposure draft applies to all financial assets that are not measured at fair value through profit and loss, and equity investments, with the exception of purchased impaired assets (see p.8 ‘Purchase impaired assets’).

By comparison, IAS 39 used different methods of impairment calculation, depending on the financial asset category which a given instrument had been assigned to. In that way a bond which was classified ‘available for sale’ could have a different impairment amount calculated than the bond classified as ‘held to maturity’.

In IFRS 9 all these elements will use the same general method which also includes some provisioning for off-balance sheet items, like loan commitments and guarantees, which used to be treated under IAS 37. In addition to this scope it must be noted that in the first phase of IFRS 9 the classification requirements were altered too, as can be observed in the following diagram.

The principles
Compared to IAS 39, it will mainly be the classification of financial assets – and consequently the measurement basis attached to the classification – that will be modified by applying the IFRS 9 Phase I Classification & Measurement. In terms of financial liabilities, the main difference relates to the recognition of the impact that non-performance risk has on those liabilities for which the ‘fair value option’ has been selected. Under IFRS 9 these changes are recognized in Other Comprehensive Income (OCI) instead of under P&L as they were under IAS 39.

Although the aim of this paper is not to explain in detail the underlying principles driving the classification and consequently the measurement basis, it is worth highlighting the main ideas. The classification of financial assets is based on two criteria: first the characteristics of contractual cash flows and secondly the applicable business model for managing the financial asset. The order in which the tests are executed does not matter.
When assessing the characteristics of the contractual cash flows (CCFs), verify whether payments are solely related to the reimbursement of the principal or interest on the outstanding amount (so called P+I Test). Interest must take consideration of time value as well as for the associated credit risk. In order to perform this test, an entity needs to obtain the contractual cash flows. Next to that, an entity also needs to determine the credit risk incurred when it became party to the contract, to judge whether the interest rate is correctly balanced against that risk.

Special attention should be paid to the following types of financial assets. Firstly one should consider financial assets acquired in the light of project finance. It often occurs that remuneration of project finance is linked with cash inflows of the underlying investment. In such a case, we may conclude that the contract does not respect the contractual cash flow test. Secondly, when performing the CCF test for contractually linked financial assets such as residential mortgage-backed securities (RMBS) or asset-backed securities (ABS), an entity should use the following methodology:

1. Assess whether the contractual terms of the financial asset respect the CCF test
2. Perform a look-through. An entity has first to identify the underlying pool of instruments generating the cash flows. To check if a portfolio of assets contains instruments passing through cash flows, an entity needs to apply a look-through. IFRS 9 foresees that the underlying pool may consist of financial instruments reducing the cash flow variability—for instance interest rate cap/floor derivatives or credit derivatives—or aligning cash flows of the financial asset with the cash flows of the underlying pool in regard of interest, currency and timing.
3. Confirm that credit risk in the financial asset is equal to or lower than the credit risk exposure of the underlying pool of assets.

The assessment should be performed based on the situation at initial recognition and taking into account any change in the underlying pool after initial recognition. If an entity is not able to make the assessment, the financial instrument is measured at fair value through profit and loss. Consequently, if an entity would like to avoid volatility in its income statement, it needs to invest in gathering and analyzing the data.
During the implementation of the IFRS 9 accounting principles, it is important to set the business model at the right level, which normally requires striking a balance between the instrument and the entity level. A higher level of granularity will probably allow an entity to obtain the most desirable measurement basis but will also require much more documentation effort. If the scope of the IASB recent exposure draft is compared with the latest exposure draft of the FASB it can be observed – along with other differences indicated later within this paper – that because of the different classifications, the scope of the US draft is not entirely the same in terms of the financial assets that fall within the scope for the IASB. For example, financial guarantees are not in scope within the proposal for US GAAP while they are included within the IASB scope. This will lead to differences in reconciliation and interpretation between preparers of the local GAAP versus IFRS GAAP.

The second principle driving the classification of financial assets relates to the business model or the way that an entity manages the asset. The business model is not assessed on an instrument-by-instrument basis, but takes a broader view and is mainly based on how key management personnel each manage and evaluate the company’s performance. Consequently, an entity can have different business models. IFRS 9 categorizes three types of business models:

1. Holding the asset in order to collect the contractual cash flows
2. Collecting both the contractual cash flows and realizing a profit by sale
3. All other models

If the business model is to buy the financial asset and to hold it to collect contractual cash flows, in combination with contractual cash flows representing solely repayments of principal or interest (time value and credit risk), then the asset is measured at amortized cost. An example would be an issued retail loan, in which the bank has to realize interest margin as a reward for the credit risk.

In the second situation, where the business model is to solely collect principal and interest, then to realize a profit by sale, the item should be measured at fair value through OCI. Long-term bonds that are used in some risk management strategies will be handled within this category. For example, to counter short-term liquidity risk measures on a long-term basis, the bonds are acquired, providing interest-based revenue. They will be sold if necessary as part of a long-term liquidity strategy. Also this category was created to cater for some insurance products to have a better match with their corresponding products on the liability side.

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An additional issue arises for preparers filing both US GAAP and IFRS compliant financial statements. Although both accounting frameworks use similar concepts as ‘contractual cash flows’, ‘business model’ and ‘fair value option’, their classification and measurement bases can differ. This is partly because the application guidance differs but also because the use of the fair value option is much more restricted under US GAAP compared to IFRS. Consequently, financial assets could potentially be measured at amortized cost under IFRS, while under US GAAP, the fair value measurement is applicable, or the way around. As a result, similar data such as contractual cash flows should be treated differently. In addition, the entity will be required to reconcile between both reporting standards.

If the scope of expected losses under IFRS 9 is compared with the scope in the Basel II/III text of the Basel Committee, in which the calculation of the expected losses is limited to the banking book, it is clear that the two will not necessarily correspond in scope. Some banking book exposures will be measured at fair value through profit and loss as they would be classified under a ‘fair value’ option within the context of IFRS 9. Vice versa, some of the trading book debt instruments could have been classified in ‘available for sale’ which would be part of the expected loss model under IFRS 9 but not under Basel II/III. The European Banking Authority (EBA) has published a framework for financial reporting (FINREP) based on IFRS and capital adequacy reporting (COREP) based on Basel reports, between reconciliation is required. But what to do with the gap?
The default definition

The classifications of the different assets can consequently relate to what has been decided within a Basel II context, as expected by the IASB.

Although risk management practices and classification can be partially used, they will have to be disclosed as part of the accounting policy and disclosure requirements following IFRS. An additional part of the credit risk assessment is that financial institutions will need to classify and calculate using forward-looking information rather than ‘past due’ buckets within their expected credit loss models. It should be added however, that historical data will still form the basis of this analysis, so past due can still be used for the detection of loss events.

The exposure draft released in March clearly states that financial institutions should report life-time expected losses. For low credit risk portfolios or financial assets with no significant credit deterioration (based on the classifications made within credit risk assessment) institutions should calculate the 12-month expected losses, with some exceptions for the simplified model and the credit impaired asset.

The definition of the 12-month expected losses seems to be aligned with Basel calculation for probability of default with an outlook of 12 months; however this is far from the truth. It is observed that rather than a 12-month probability of default, the 12-month expected credit losses are the life time losses for those contracts with an expected loss event within the next 12 months. By proposing Stage 1 at initial recognition and with no credit deterioration, the exposure draft has not only created differences with the prudential reporting like Basel, but created another reconciliation difference with US GAAP in which the first stage has not been adopted. Financial institutions will have to recognize life-time expected losses from the initial recognition.

One point on which the FASB and IASB agree is how the losses are calculated. A model needs to be developed which can be very simple as long as it captures all available information to which the financial institution has access; it should hold at least two scenarios, one in which the underlying will default and one in which it does not.

Expected losses
Relatively new within IFRS is the stress on forward-looking credit risk assessment in a finance context. To deliver this, IFRS 9 directs finance to the risk management function to determine the different investment or credit grades of the different financial assets.
Probability of default and the way expected losses are calculated

Under IFRS 9, generation of expected losses is based on a probability-weighted outcome rather than on best estimate. For IAS 39, the general practice to calculate losses for individual assessment is based on a best estimate for expected recoveries.

Within the exposure draft it is clear that the preparers should now not only take into account the most likely outcome, but different possibilities given all the available information. Regarding the different possibilities, they do not have to take into account every possibility, but at least two scenarios, of which one is the default even if the most likely outcome is a non-default state. By comparison, the requirement of the Basel Committee is that the best estimate is enough to be compliant.

Within the Basel text, the probability of default is calculated as the probability to default within a year and within a credit class to which the financial instrument was assigned. Under IFRS 9, the probability of default is calculated based on the probability-weighted outcome, taking into account as many macro-economic factors. The difference between these two, aside from the definition of default and the acceptance by Basel but not by IFRS of best estimate (see above), is that the time horizon is different, as well as the fact that the migrations can be counted for in IFRS but not under Basel.

The horizon, as well as the context, will influence the way models are built both in an IFRS as well as within a Basel context. However it cannot be disregarded that the credit classes defined within the risk framework for Basel can be reused in both the models proposed by the FASB and IASB as they are in line with both definitions and formerly stating the credit classes should be determined by the risk department based on risk framework techniques. Despite the differences, the base for the default rate calculation within a risk and accounting standard are the same.

Unit of account
In the proposal it is stated that the calculation of the expected losses can be assessed on an individual or a group level. Theoretically, the IASB exposure draft states that the financial assets should be assessed on an individual level. An entity can assess the financial assets as a group when they share the same credit characteristics. As such there is no formal difference between the FASB and IASB accounting standards.

Discount rate
The discount rate is important, related to time value that is calculated in order to discount all cash flow shortfalls over the remaining lifetime of a financial asset. In the exposure draft of the IASB, it is written that the discount rate can be a rate between the risk-free rate and the effective interest rate, for assets following the general model within Stage 1 and Stage 2. This is challenging and reduces the comparability between the same financial assets across financial institutions. In IAS 39, this discount rate has been set to the effective interest rate of the financial assets. The discount rate within the proposal form the FASB is not set as such, as the time value of money can be determined explicitly by using the effective interest rate or another discount factor, or implicit via the expected loss model. It is linked to the effective interest rate only and not to a range of possible discount factors. The discount rate within loss-given default (LGD) calculations under Basel is not specified besides the fact that it should be used within estimates when they have a material effect on the LGD calculation.

Interest revenue
The calculation of interest revenue as such remains more or less unchanged with the practice under IAS 39, regarding assets under the general model. In a Stage 3 classified financial asset the interest revenue is calculated using the net amount – the gross amount minus the impairment losses. This is similar to the accrued interest after impairment (IAS 39) as this is also calculated on the present value of the expected recoveries of a financial asset. For Stages 1 and 2 the requirement of accounting for an effective interest rate, based on the gross amount with no deduction of any allowances or provisions, is in line with the IAS 39 requirement before a loss event has occurred.

The statements of the FASB, compared to the proposals from the IASB, are somehow different. The FASB requires entities to account for contractual interest, compared to effective interest under the IASB proposal, and to stop accruing when the entity deems it will no longer collect substantially all principal and interest payments.
Purchased credit impaired assets

For a purchased impaired asset there is a special treatment, in theory both with the IASB and the FASB. For the Exposure Draft, the IASB requires entities to have an adjusted effective interest rate for the future expected credit losses. The adjusted effective interest rate is the effective interest rate based on the future expected cash flows, taking into account the initial expected credit losses within those cash flows. This differs from the general model, in which the corrections for expected credit losses were decoupled from the effective interest rate. This proposal is in line the first exposure draft of IFRS 9 phase II published in 2009.

The model of purchased impaired assets within an FASB context is that the effective interest rate calculated will still be equal to the effective interest rate in the general model, as the initial credit losses are considered to be a different component from the purchased price, which is not used as a base to calculate a credit-adjusted effective interest rate as in the IASB proposal.

Data collection in risk and finance
The challenge for many preparers, in both risk and finance functions, is the collection of qualitative data. With the arrival of IFRS 9 on the one hand and the Basel III text on the other, even higher stress has been imposed on data collection and forecasting capabilities. Despite the differences between the risk and finance frameworks, from a historical perspective the amount and type of data which is required for both standards looks the same. IFRS 9 looks to risk assessment with its use of various credit scoring techniques. Basel III bases its capital composition on IFRS data and the definition of exposures relates back to fair value as defined within accounting standards. The output and the requirements of the models may be different but the input in both models is the same.

The demands for reconciliation between risk and finance, from both regulators and academics, are acting as a catalyst for firms to deliver a more unified approach. Re-use of data will be the key, or maybe a more revolutionary train of thought could lead to a ‘single version of the truth’ data management. This could address the risk and finance requirements creating a ‘reconciliation by definition’ state which can reduce time that preparers need for creating the reports with more time focused on analyzing it. Financial institutions can then concentrate, focus more on business despite the greater demands of disclosures by both regulators and investors.

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The recent financial crisis has led to reform in finance and risk disclosure for investors as well as for authorities. This paper specifically looked at differences in the approach to the expected loss question. At the beginning of this paper it was asked if expected losses under FASB, BIS and IASB were the same and could be reused for the different standard setters. The conclusion to this is 'no'.

Despite expected losses between the FASB and IASB being closely related, there are still some major differences. Between the IASB and Basel frameworks there are larger differences. However, the data requirements for all these standards can be unified and stamped as being similar. IFRS 9 will replace IAS 39 within the next coming years and financial institutions will be challenged by the requirements.

A strategic decision to simplify the collection of data could reduce operational complexity by accelerating the pace of reporting for both risk and finance. Expected losses may be different, however, it will bring financial institutions one step close to integrating finance and risk.
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