Evolution of loans impairment requirements and the alignment with risk management approach

Summer Banking Academy, June 2015

Risk management and Financial reporting

- Banks measure/ quantify/ estimates the credit risk for making business decisions (e.g. origination, pricing, capital allocation)
  - a simple rating scale with no PD attached (which only orders the exposures by risk) to
  - more sophisticated quantitative approaches that measures risk in bp
- Overtime, the banks' approaches to quantify the risk for business purposes developed/ evolved in "best practices" and even in regulatory requirements or **financial reporting requirements**
- Impairment allowance/ Provisioning requirements is just a form of reflecting the credit risk based on a given set of principles/ rules (i.e. financial reporting standards). An **estimate** impacting both:
  - financial position (BS)
  - financial performance (IS/P&L)

Objective of “general purpose financial reporting”

To provide financial information that

- is useful to a range of users (existing and potential investors, lenders and other creditors, etc)
- in making decisions about providing resources to the entity.

Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit.

- Many existing and potential investors, lenders and other creditors cannot require reporting entities to provide information directly to them and must rely on general purpose financial reports for much of the financial information they need. Consequently, they are the primary users to whom general purpose financial reports are directed.
- Regulators and members of the public may also find general purpose financial reports useful. However, those reports are not primarily directed to these other groups.
- **Financial reports involves estimates, judgments and models**

IAS 39 Impairment

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IAS 39 requirements for loans and receivables

- An entity shall **assess**, at the end of each reporting period, **whether there is any objective evidence** that a financial asset or group of financial assets is **impaired**.

- Impairment losses are required to be recognised in profit or loss **if there is objective evidence that a 'loss event' has occurred/ as a result of past events** and that loss event has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated **(INCURRED LOSS, new concept).**
  - Losses expected as a result of future events, no matter how likely, are not recognized (e.g. loss event soon after reporting date).

IAS 39 requirements for loans and receivables

- Examples of loss events:
  - significant financial difficulty of issuer
  - a breach of contract such as failure to make interest/principal payments
  - high probability of bankruptcy or other financial reorganization
  - for economic or legal reasons relating to borrower's financial difficulty, lender grants concessions that the lender would not otherwise consider
  - historical pattern/ observable data indicating a measurable decrease in estimated CF from a group of FA since initial recognition, although decrease cannot be identified with individual assets (e.g. adverse change in payment status, worsening economic conditions that correlate with default)

IAS 39 requirements for loans and receivables

- **Loss=** Carrying amount less present value of expected cash flows discounted at original effective interest rate.

  Assessment is done individually for significant assets and individually or collectively for the rest
- **Specific impairment**
  - Individually significant items
  - Group of assets sharing similar risk characteristics
- **Collective assessment** recognition of losses believed to exist in a portfolio but not yet identifiable with an individual asset – often referred to as ‘incurred but not reported’ (IBNR) losses
- Historical data and expectations on near future provide the basis for estimating impairment in a group of financial assets;

  e.g. IBNR= LCP*PD (3-12m)*LGD*BV or similar

  e.g. Loss for group of assets = Haircut/LGD type parameter)

IAS 39 requirements for loans and receivables

Summary

- IAS 39 requires objective evidence of impairment, losses not recognized before triggering event

Loss model (incurred loss) criticized for

- Difficult to understand and apply ("incurred loss" was new)
- Delaying the recognition of losses by triggering event=>
  - Has cyclical effect
- Interest revenue is understated before triggering event
- Too complex-multiple approaches

IFRS 9 Impairment

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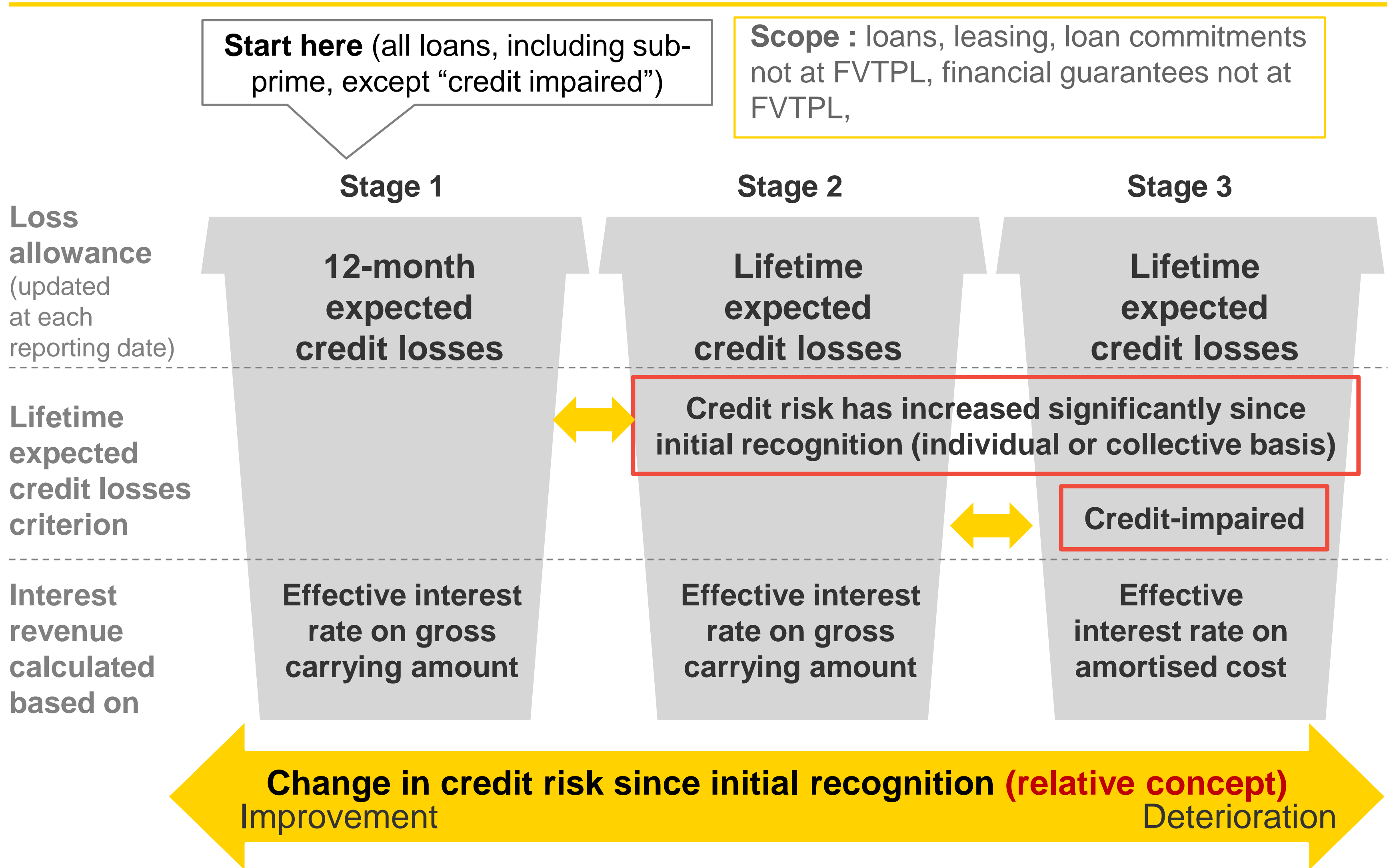
Overview of the new impairment model

- Given the criticism of incurred loss model, IFRS 9 introduces an expected loss model (not quite the same as the Basel one)
  - No objective evidence of impairment needed
  - All financial assets shall have a loss allowance
  - Attempt to recognize EL over the life of the FA
- Key features
  - Assigns assets to 3 categories/ stages based on the credit quality at reporting date respectively, evolution of credit quality subsequent to initial recognition (e.g. origination)
  - Depending on the category EL calculated over 12 month period or life of the FA
  - Interest calculated on gross BV until asset becomes credit impaired (3rd stage)

IFRS 9 Impairment model
General approach



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Definition of 12-month and lifetime expected credit losses

Lifetime expected credit losses

Expected credit losses that result from ***all possible default events*** *over the expected life of a financial instrument.*

= [Exposure at Default x Probability of Default x Loss Given Default]

12-month expected credit losses

The ***portion*** *of lifetime expected credit losses that result from* ***default events*** *on a financial instrument that are* ***possible within the 12 months*** *after the reporting date.*

'Default'

Default must be ***consistent with risk management***

It shall take into account qualitative indicators (for example, financial covenants)

There is a ***90 days past due rebuttable presumption****.*

In practice

- The definitions of 'expected credit losses' and 'risk of a default occurring' are identical to the Basel definitions of 'EL' and 'PD'
- **BUT the computation of ECL under IFRS 9 will require adjustments** to remove the effects of Basel rules, including:
  - Remove through-the-cycle assumptions of default and conservatism bias (for instance regarding LGD)
  - Have a forward-looking estimate of PD and LGD

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Definition of 12-month and lifetime expected credit losses

- Measurement of ECL must reflect
  - **reasonable and supportable** information,
  - that is available **without undue cost or effort** at the reporting date,
  - about **past events, current conditions and forecasts of future economic conditions**
  - It must be directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status etc.).
  - It should consider observable market information about the credit risk of the financial instrument (or similar instruments)
- Historical information should be used as a starting point, from which adjustments are made to reflect current and forward-looking information
  - Consider economic data used for budgeting and capital planning (except longer term plans may, deliberately, be 'aspirational')
  - Leverage calculation, stress testing and information used for Basel II

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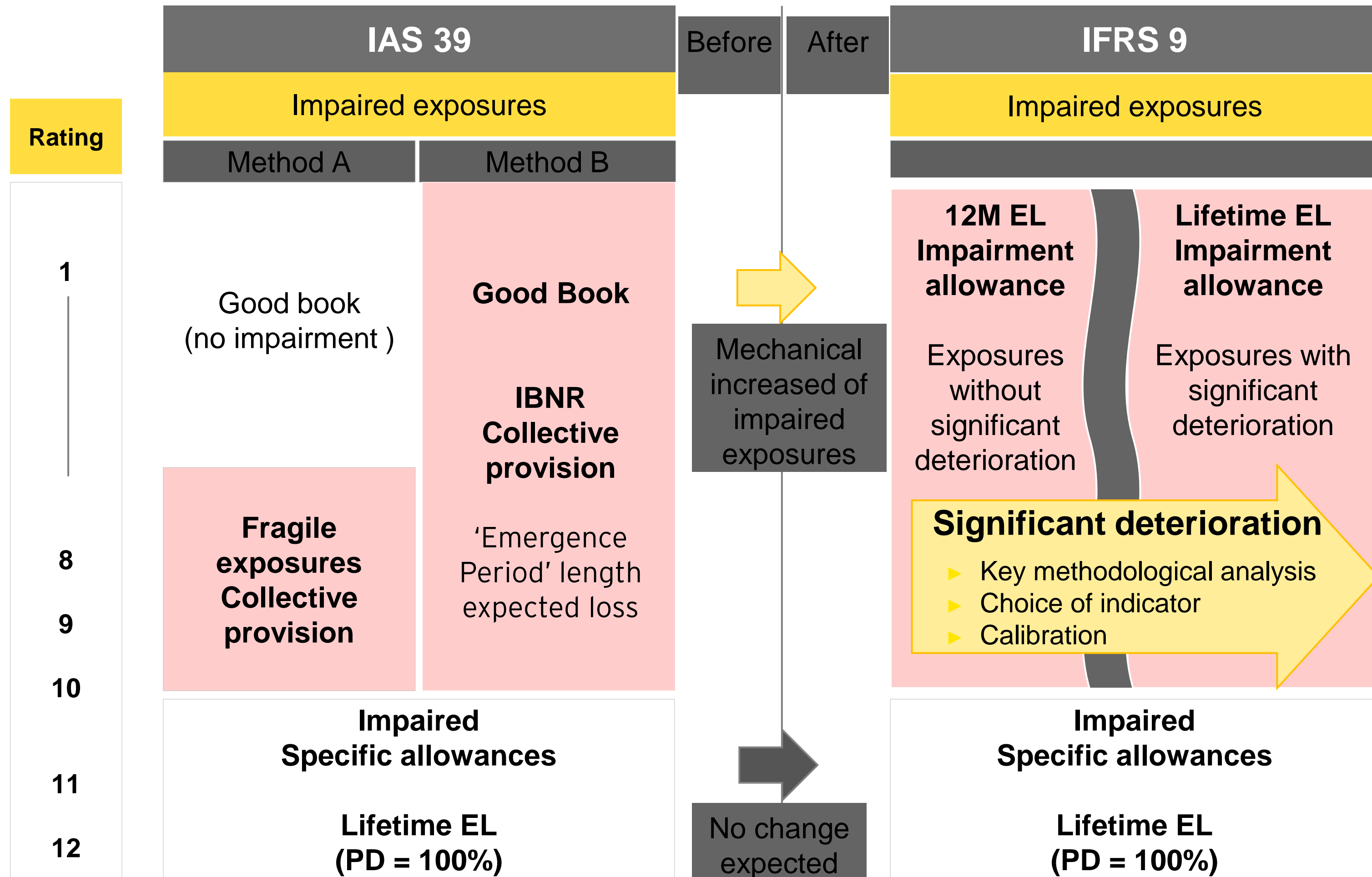
From IAS 39 to IFRS 9

Example :



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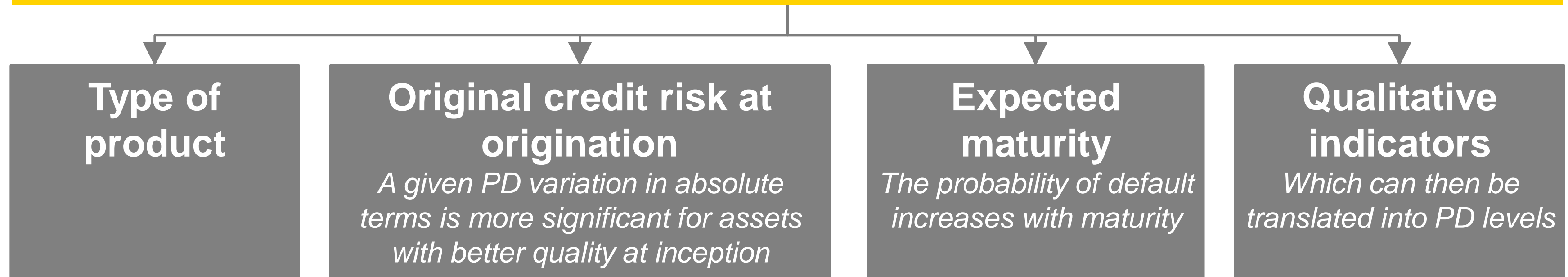
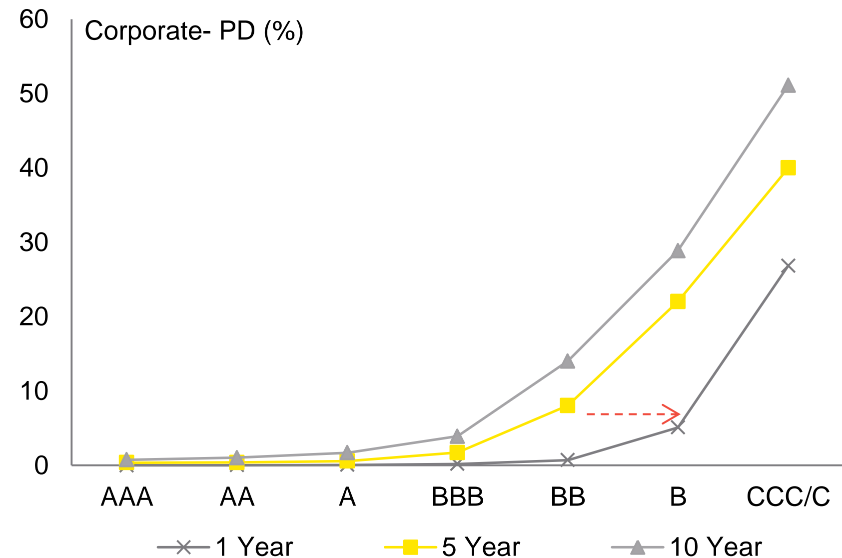
Significant deterioration

- Key concept that triggers the switch from 12M EL to lifetime EL
- Must be based on the **change in the risk of a default occurring (~ PD)**
  - Not change in expected credit losses (collateral is not taken into account)
- Must be identified **before default occurs** or the financial asset becomes credit-impaired
- **No specific or mechanistic approach** is imposed by the standard
  - The appropriate approach will vary depending on the level of sophistication of entities, the financial instruments and the availability of data
- Involves a **multifactor and holistic analysis**
  - Based on all **reasonable and supportable information** that is available without undue cost or effort, and
  - that is relevant for an individual financial instrument, a portfolio, portions of a portfolio and groups of portfolios.
  - An entity need not undertake an exhaustive search for information
- **Significant disclosure area**
  - Parameters, approaches, judgment, triggers

What does ‘significant’ mean ?



S&P rating	PD - Corporates		
	1 Y	5 Y	10 Y
AAA	0.00	0.36	0.76
AA	0.02	0.39	1.03
A	0.07	0.59	1.71
BBB	0.20	1.73	3.93
BB	0.71	8.05	14.04
B	5.10	22.04	28.87
CCC/C	26.85	46.74	51.13



Note: Standard and Poor’s Global Corporate Average Cumulative Default Rates by Rating Modifier (1981 – 2012)

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Significant deterioration
Use of delinquency & 30 Days Past Due presumption

- If reasonable and supportable FL information is available without undue cost or effort, **an entity cannot rely solely on past due information**
  - Days past dues are lagging indicators
  - **More leading/ forward looking indicators must be used** (behavioural scores, forbearance, credit bureau data, loan to values)

- There is a rebuttable presumption that the credit risk has increased significantly since initial recognition when contractual payments are **more than 30 days past due**
  - It is presumed to be the latest point at which lifetime expected credit losses should be recognized even when using forward-looking information (including macroeconomic factors on a portfolio level).
  - An entity can rebut this presumption if the entity has reasonable and supportable information that demonstrates that there is no causal link between 30 DPD and a significant increase in PD

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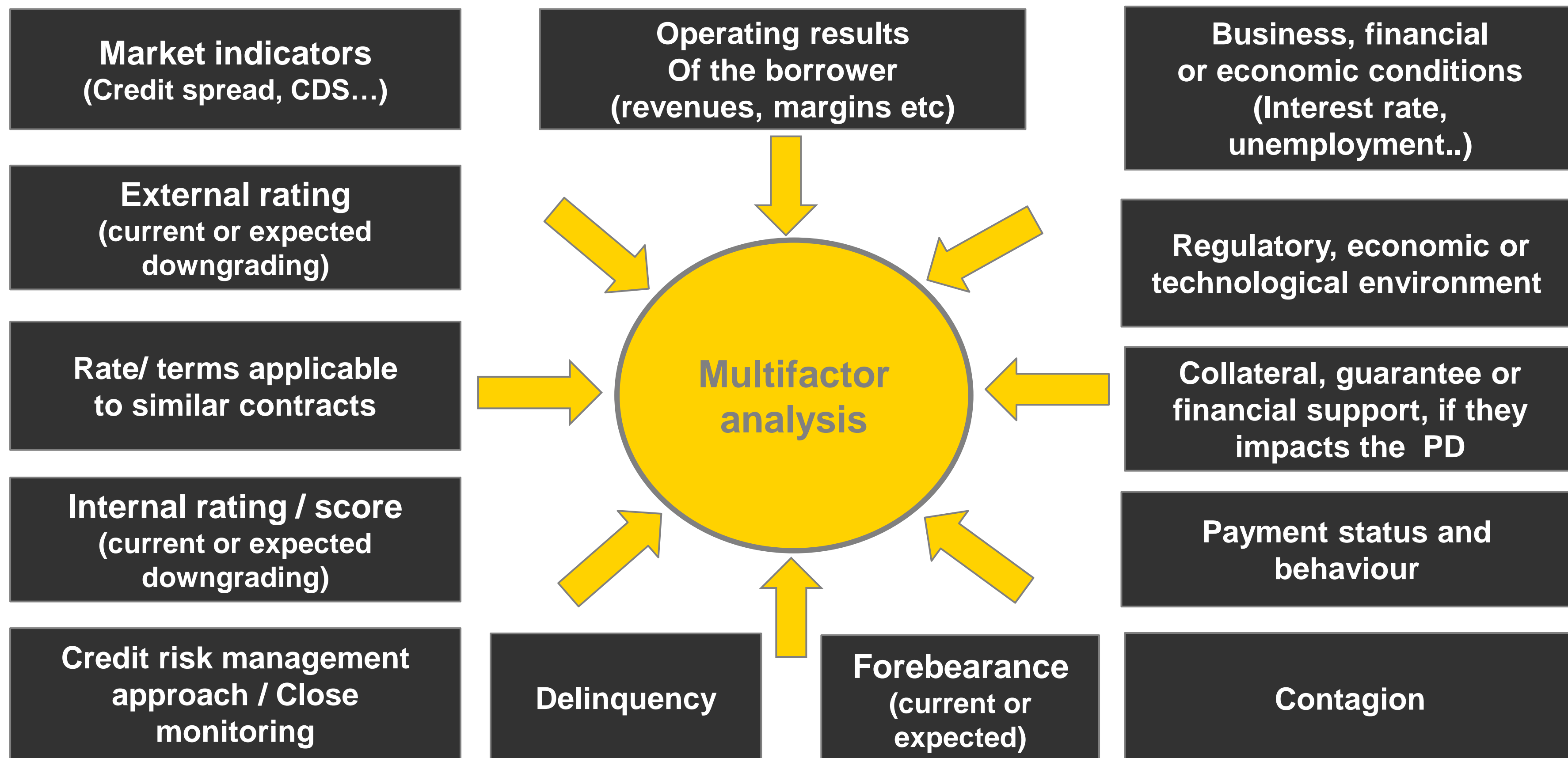
Significant deterioration

- Non-exhaustive list of factors or indicators to consider
  - Deterioration that have already occured or are **only expected**



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Significant deterioration
Collective approach

- It may be necessary to perform the assessment on a collective basis **when the information is insufficient at individual level**
  - Example : Retail loans for which there is little or no updated credit risk information that is routinely obtained and monitored on an individual instrument until a customer breaches the contractual terms
  - The objective is to approximate the result of recognising lifetime EL on an individual instrument level
  - By considering information that is indicative of significant increases in credit risk on, for example, a group or sub-group of financial instruments.
- **Example** illustrates 3 situations :
  - **Scenario 1**: The information available at instrument level is very comprehensive and frequently updated → a collective approach is not necessary
  - **Scenario 2 and 3**: The information available at individual level is not sufficient and must therefore be supplemented by a collective analysis (bottom-up or top-down)

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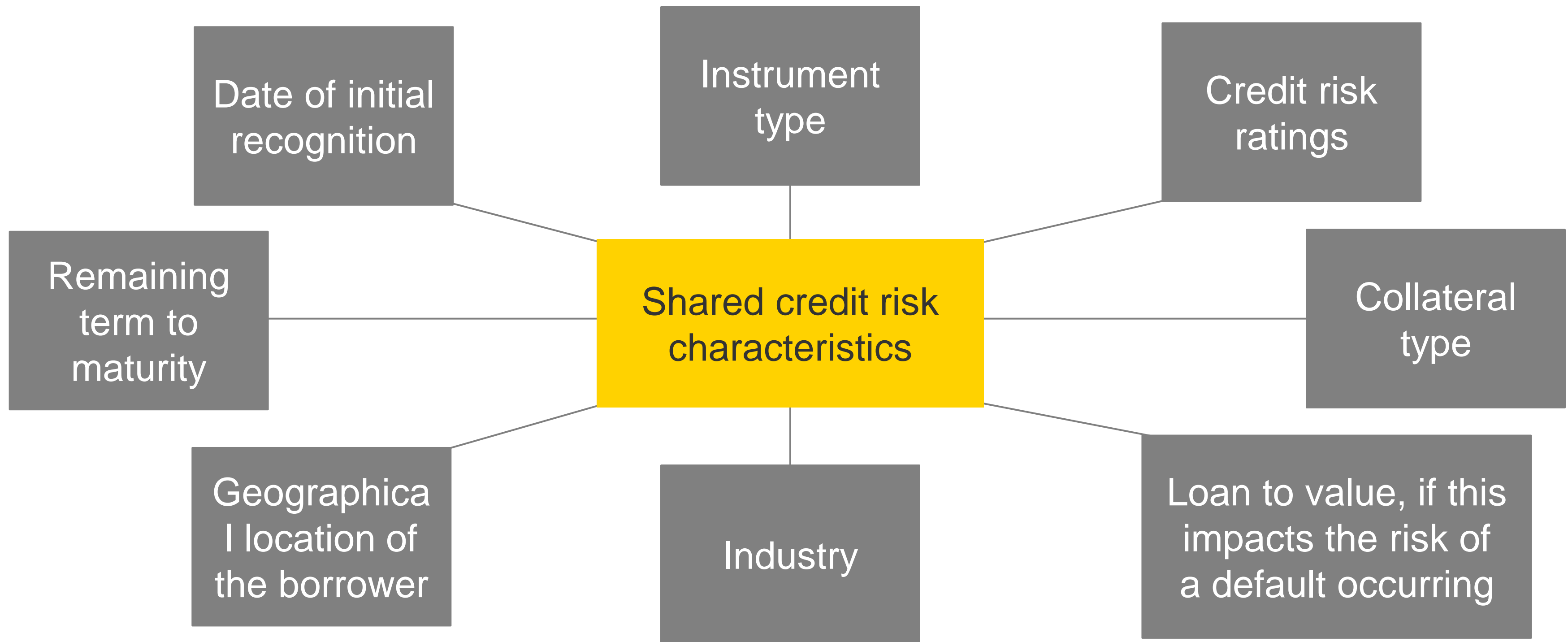
Collective approach
Shared credit risk characteristics

Examples in the Standard include:



In practice

As groupings are required to be amended over time, banks need to put in place processes to reassess whether loans continue to share similar credit risk characteristics.

Significant deterioration
Option: « low credit risk » exception

Trigger	Investment grade				Non-investment grade							
											No origination	
S&P	AA+	A	BBB+	BBB-	BB+	BB	BB-	B+	B	B-	CCC/C	D
12M PD (1)	0	0.07	0.14	0.32	0.43	0.68	1,13	2.31	4,73	7,92	26.87	100
Allowance	**12 M EL**				**12 M EL or lifetime EL ?**						**Lifetime EL**	

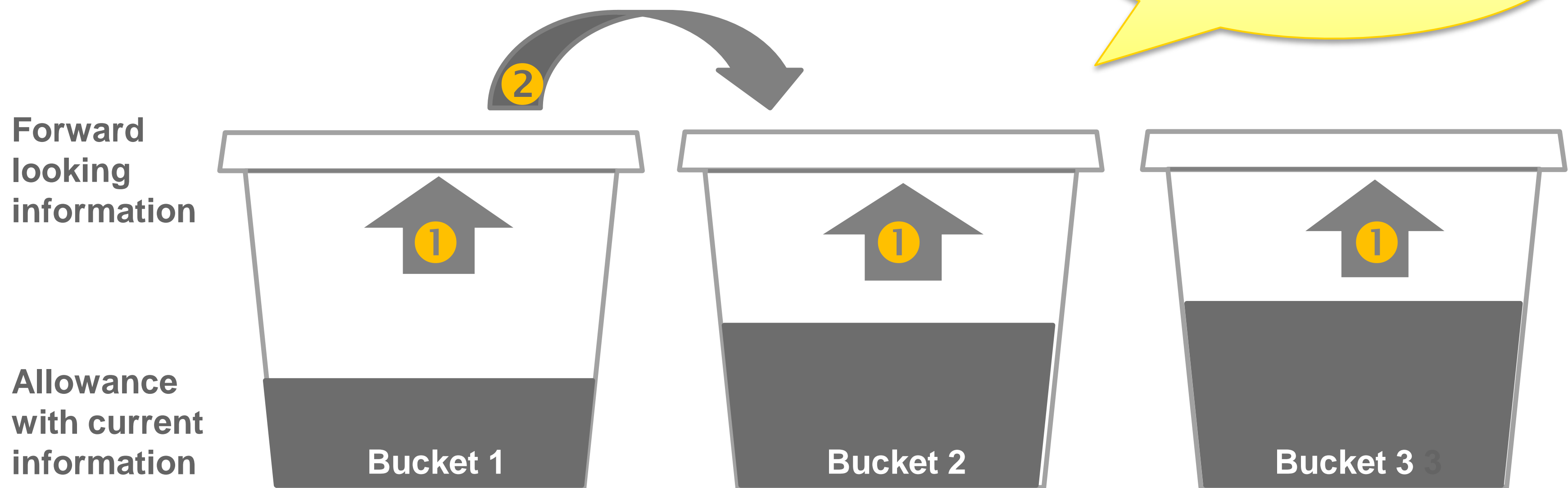
- **Low credit risk:** an entity may assume no significant increases and recognise 12M EL
- **If not:** an entity has to assess whether there has been a significant increase in credit risk (low credit risk is not a bright-line trigger to recognise lifetime EL)
- An external rating of 'investment grade' is an example but an external rating is not required
  - An entity may use its internal credit risk ratings or other methodologies that are consistent with a globally understood definition of low credit risk
  - Low credit risk should reflect a market participant perspective

(1) S&P "Global Corporate Average Cumulative Default Rates By Rating Modifier" (1981-2013)

How to include forward looking information in the impairment methodology ?

- Forward-looking estimates should affect both:
  - ➊ Measurement of **ECL** (12M and lifetime), and
  - ➋ **Allocation** of exposures between buckets

Ensure consistency between measures and transfers



Examples of forward looking information	
▸ Macroeconomic indicators ▸ Unemployment rates ▸ GDP ▸ Housing prices	▸ Economic sector information ▸ Geographical specificities ▸ Correlated defaults ▸ …

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Transition and effective date

- IFRS 9 is effective for annual periods beginning on or after 1 January 2018, with early application permitted
- Retrospective application with transition reliefs

Initial credit risk	► Seek to **approximate** initial credit-risk based on reasonable and supportable information available without undue cost or effort ► An exhaustive search for information is not required ► Consider internal and external information, including portfolio information ► May apply low credit risk or more than 30 days past due ► If undeterminable, recognise lifetime expected credit losses until derecognition or 'low credit risk' status
Comparatives	► Restatement of prior periods not required (may only restate without use of hindsight) ► Cumulative impairment loss allowance is recognised in the opening retained earnings of the first reporting period where IFRS 9 is applied (1st January, 2018)

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