When you have to be right

As deadlines loom for new accounting and regulatory frameworks, firms must ensure they have the right management structures and systems in place

Financial Services Solutions

IFRS 9, CECL, BCBS 311: Preparing for Financial Standards around the World

WHITE PAPER

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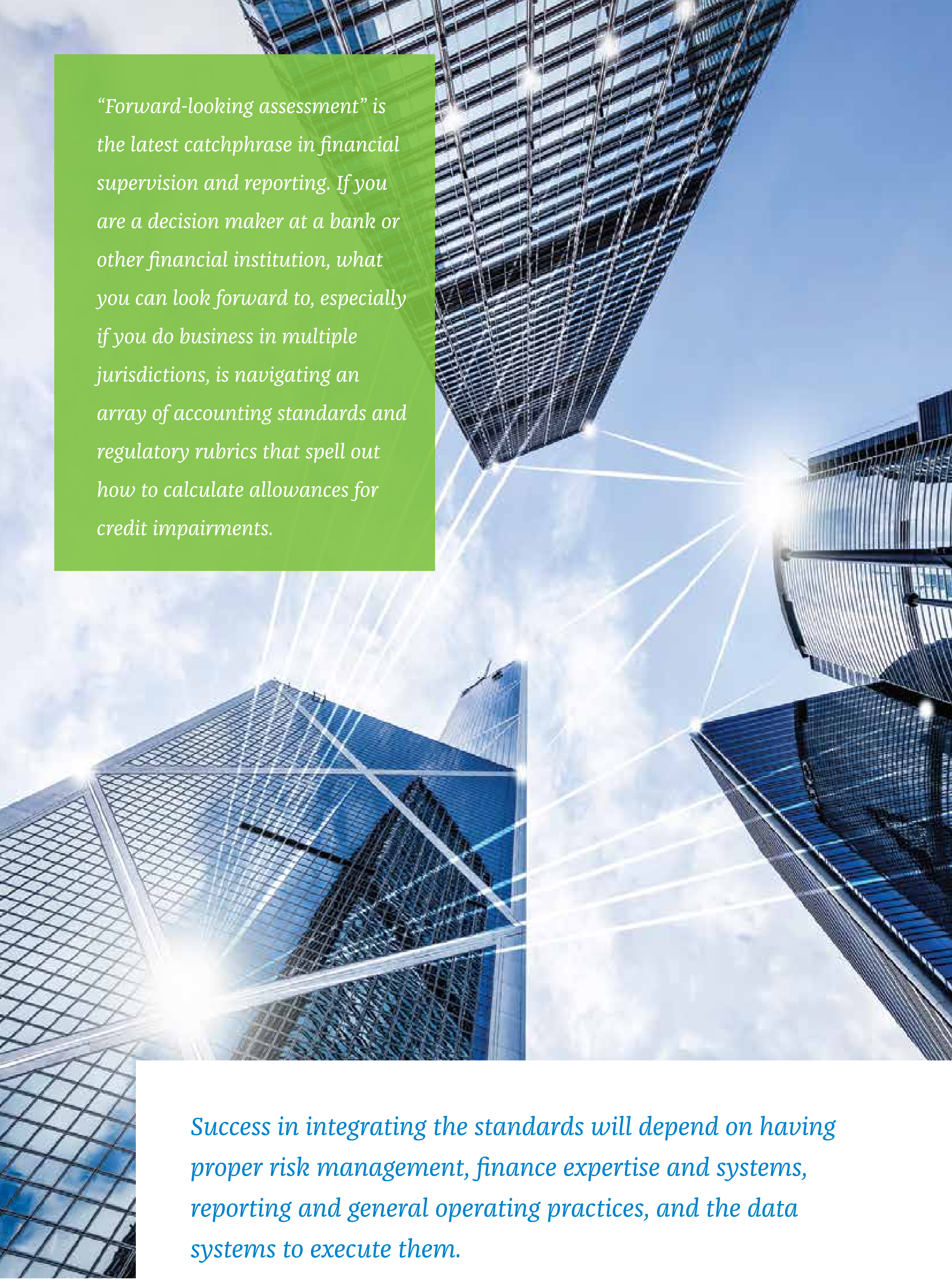

“Forward-looking assessment” is the latest catchphrase in financial supervision and reporting. If you are a decision maker at a bank or other financial institution, what you can look forward to, especially if you do business in multiple jurisdictions, is navigating an array of accounting standards and regulatory rubrics that spell out how to calculate allowances for credit impairments.

Success in integrating the standards will depend on having proper risk management, finance expertise and systems, reporting and general operating practices, and the data systems to execute them.

Several routes into the future

Overhauls of standards by the two main arbiters of accounting practices, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB)[1], have produced the Current Expected Credit Loss (CECL) and IFRS 9 Financial Instruments protocols, respectively.

Beyond those, firms must contend with guidelines issued by national authorities that instruct them in how to interpret and apply the standards, and with requirements set forth by the Basel Committee on Banking Supervision. The committee expressed its thoughts in consultative document 311, issued in February 2015. It updated them in a discussion paper last October[2], acknowledging the difficulties that firms might have in implementing the accounting standards and hinting at a willingness to be flexible in how they apply the committee's principles.

With its emphasis on predicting credit losses, IFRS 9 is seen as an improvement on the traditional incurred-loss model, which only recognized losses after a default or other triggering event. CECL is intended to make the same upgrade to the American method of accounting for credit risk, although it permits historical factors to retain a greater role in the process. Other ways in which the standards diverge relate to how the results of expected-loss calculations are used throughout an organization and in reports to regulators and shareholders.

Standard setters and regulators insist that they're all part of one big, happy family of overseers striving to reach a common goal – set out on several occasions, most notably at a June 2011 G20 conclave – of ensuring that firms operate in an efficient and prudent manner. No doubt, that's true, but as they come to grips with the new supervisory order, firms are realizing that even slight discrepancies in how that goal is envisioned, and the mechanisms instituted to try to achieve it, are likely to create added confusion, work and expense.

Preparing for and implementing IFRS 9, CECL and other procedures will compel firms to think about credit risk in new ways and to develop new models to account for it, with matters being especially thorny and complex for institutions that operate across borders. Such a formidable undertaking will also require talking, not just thinking; effective communication among functions – risk, finance, compliance, reporting, tech. – is essential.

Global financial institutions almost certainly will have to comply with several standards and reconcile the results with one another. At least they will have to make sure that each department is consistent in its use of the numbers produced from a given set of calculations, analyses, forecasts and reports so that they can be interpreted effectively and used by senior management to draw proper conclusions about the operating environment and make appropriate decisions.

That will be all the more difficult to accomplish given that new regulatory and accounting frameworks call for bankers to adhere to principles – which are open to interpretation and therefore to misinterpretation – rather than fixed rules. Flexibility, it turns out, is a double-edged sword. Success in integrating the standards into their organizations will depend on proper risk management, finance expertise and systems, reporting and general operating practices and the data systems to execute them.

1. The FASB is responsible for the United States and other places where the use of U.S. generally accepted accounting principles (U.S. GAAP) is the norm; the IASB is responsible for much of the rest of the world.

2. http://www.bis.org/bcbs/publ/d385.htm

Too much hindsight, not enough foresight

IFRS 9 and other standards and guidelines that form the continually evolving global supervisory architecture started to be developed around the same time and for the same reasons. One conclusion that could be drawn from the 2007-2009 financial crisis was that watchdogs, not to mention institutions themselves, clearly did not see it coming, in part because the rules in place encouraged an unhealthy reverence for the past.

The old order relied almost exclusively on historical precedent to gauge the strengths and weaknesses of firms and the risk of loss during bouts of instability. This proved to be a significant shortcoming: much as Tolstoy observed about happy and unhappy families, normal operating environments have a uniformity to them, while each period of acute stress is stressful in its own way.

That's why the industry was blindsided when the black swans descended. Responses turned out to be too little, too late, because firms had too much to contend with that was too new. Because existing procedures compelled financial institutions to emphasize historical events when evaluating their status and estimating risks – even during such a rare set of circumstances – once the grimness of their situation became apparent, they could do little more than flail away as they tried to determine where they stood – if they stood at all – from one day to the next, overestimating or, more likely, underestimating their exposure to various risks.

When it came to assessing and accounting for credit losses, the pre-crisis philosophy that led banks to gaze into the rearview mirror as they headed straight for the cliff was evident in IAS 39, the predecessor to IFRS 9. The old standard required a loss to be recognized only after the triggering event and the acknowledgement of it in the profit-and-loss statement – in other words, after it was too late to prepare for the impact that it would have on key metrics of financial wellbeing.

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Under IFRS 9 and CECL, credit positions are quite literally born to lose. As soon as one goes on the balance sheet, it is accompanied by an expected credit loss (ECL) that must be monitored continually and recalculated when a material change in payment prospects occurs. The new procedures will force bankers to keep their eyes on the road ahead, although the differences between the standards, and among the related supervisory rubrics, mean that they stand a good chance of being pulled in several directions. Even if they are able to put themselves on the right path or paths, they will only be able to see for a limited distance, although effective risk data tools and systems will help sharpen their vision.

Tomorrow's credit losses today

IFRS 9 attempts to work around the primary drawback of IAS 39 – a tendency for formal recognition of credit losses to be made too late – by making running estimates of expected cash flows from loans and other assets on the books to determine loss projections. These are based on continual updates of internal and external factors influencing them, filtered through management judgment of their likely impact, with each asset discounted by its effective interest rate to calculate the present value of the expected flows and the requisite provisions.

IFRS 9 requires firms to calculate an impairment allowance for any asset on the balance sheet and to report it in the firm's profit-and-loss statement, against the book value. The allowance for an instrument with stable risk characteristics will be the present value of lifetime credit losses from defaults anticipated over the next 12 months; in other words the 12-month probability of default (PD) occurring during the next 12 months.

For a credit that deteriorates to a certain point, compared to its status when it was first acquired – which is up to each firm to determine based on the rules of its impairment model – the allowance typically will be the present value of the loss expected from defaults over the instrument's lifetime. In general, if risk for the impaired asset then subsides, crossing the threshold back to stable, the horizon for the allowance will be adjusted to 12 months again after a period of monitoring. If risk keeps going the wrong way, the credit enters a third stage: the ECL calculation is still based on lifetime losses, but accrued interest from the asset is treated on the net amount instead of the gross amount.

These procedures must be followed for all exposures (in the correct asset classes), which can be treated individually or, more likely, segmented into pools of instruments with similar credit characteristics. How a firm does it depends on its size and business mix, among other factors, and is ultimately the responsibility of senior management to determine.

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The grand tour

If accounting standards like IFRS 9 and CECL can be thought of as different languages expressing the same thoughts, then the guidelines set by national authorities for how firms within their jurisdictions should interpret and comply with the standards amount to dialects, inflections and accents. Some call for the most stringent adherence to the overarching standard that applies in a given country, typically IFRS 9, while others encourage a more relaxed attitude. Here are some examples:

- The Office of the Superintendent of Financial Institutions (OSFI) in **Canada** is one of the first kind. It has said that it intends to enforce rigorous implementation of the IFRS 9 impairment principles. Its broad treatment of credit provisioning amounts to a by-the-book interpretation of Basel guidelines.
- The **Qatar** Central Bank lines up at the opposite end of the spectrum. It is encouraging banks to take a simpler approach to IFRS 9 that focuses on a limited set of rules and model choices.
- In **Britain**, the Prudential Regulation Authority (PRA) is positioning itself somewhere in the middle. The agency has said it expects large, sophisticated financial institutions to take a more stringent approach to implementing IFRS 9, while it will allow smaller institutions more leeway. They will be able, for instance, to make a more liberal use of practical expedients: incorporating shortcuts, essentially educated guesses based on experience in similar operating backdrops, into impairment models. Practical expedients produce results that are less precise than would be obtained through more in-depth analysis but that are close enough to the truth to be deemed reliable. The PRA outlines a proportionality principle to determine what a firm needs to do. It will depend on the discretion of the auditor how much the models will fall under the undue cost and effort or materiality principle.
- Somewhere in the middle is a useful way of thinking about financial matters in Britain in general these days. The country voted in a referendum to leave the European Union, an act known as **Brexit**, but – at the time of

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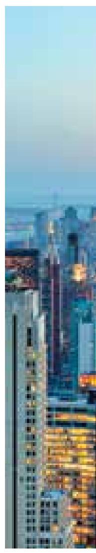

writing – the government has not yet invoked Article 50, the mechanism under E.U. law by which a departure from the bloc is effected. Until negotiations with the rest of Europe are concluded, a process that can take two years, it's unclear how the PRA's guidelines concerning IFRS 9 might be altered, in particular the extent to which they might conform with those of the European Banking Authority.

- The EBA, which governs institutions across the **euro zone**, issued a draft of financial reporting standards, or Finrep, in 2015 that tracks the impairment treatment called for under IFRS 9 quite closely.

- The same goes for three jurisdictions in the Asia-Pacific region – **Singapore**, **Hong Kong** and **Australia** – that tend to follow European, and specifically British, legal and regulatory traditions. Supervisors there have had little to say otherwise on the subject of IFRS 9.

- One indication of the indirect influence that IFRS 9 is having on global financial supervision can be found in the **Philippines.** Authorities there have not explicitly called on firms to implement the standard, but they have urged them to establish practices in modeling credit risk that are much like those mandated by the IASB.

The American way

The requirement under IFRS 9 to make provisions for lifetime losses from default events expected only over 12 months on stable credits seems like a well balanced compromise, compared to the procedure called for by the FASB, where estimated losses must be recorded in a New York minute. Allowances for stable and riskier assets alike, from the moment they appear on the balance sheet, must reflect lifetime losses estimated to occur on defaults anticipated for as long as the assets are expected to be held on the books. There are other key differences:

- CECL covers all loan commitments, with no nuance. IFRS 9 takes into account potential changes in the contractual status of loan commitments, based on longstanding practices within a firm; if a commitment is nominally irrevocable but can be called back after 30 days, say, in the event of a material deterioration in credit quality, then that is how the firm should treat it in its ECL calculations.

- Allowances under CECL are to be calculated solely based on cash flows not expected to be collected, while IFRS 9 asks firms to incorporate factors beyond the anticipated cash flow shortfall.

- IFRS 9 relies more on projections of operating conditions based on macroeconomic forecasts. CECL allows a greater dependence on historical precedent, with adjustments made based on prospective assessments. Moreover, the period to which firms must look ahead is typically shorter under CECL.

How loss estimates are calculated in the FASB standard is otherwise similar to the way it's done under IFRS 9 and under the FASB protocols being phased out. Firms should devise their own assumptions and analytical methodologies "based on historical experience, current conditions, and reasonable and supportable forecasts," the FASB said in its announcement of final CECL procedures in June.

"Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates," it went on to say. "Many of the loss estimation techniques applied today will still be permitted… Organizations will continue to use judgment to determine which loss estimation method is appropriate for their circumstances."

There are more similarities than differences between the IASB and FASB treatments of impairments, but such are the inherent intricacies that even the similarities can have distinct differences. Under both frameworks, implementation will be staggered, but based on different criteria.

Implementation of CECL will be based largely on the ownership structure of the financial entity. Companies with publicly held equity, so-called Securities and Exchange Commission filers, must be compliant with CECL procedures in the fiscal year that begins after December 15, 2019. The standard will be in force a year later for firms with publicly owned debt and a year after that for all others.

Under the IASB rules, by contrast, a key distinguishing feature is the type of financial vehicle for which impairments must be calculated. When it comes to financial instruments, the province of IFRS 9, there is a hard start date of January 1, 2018, but it's a different story with vehicles such as insurance contracts within pure insurers (conglomerates tend to fall below the threshold and will need to comply by 2018).

The relevant standard for these is IFRS 4 because the measurement of impairments depends on determining insurance risk – the likelihood that an institution will have to pay up because an insured event occurs – rather than financial risk – the likelihood that an institution will be on the hook because a debtor has not paid up. IFRS 4 has probably a January 1, 2021 implementation deadline, so firms governed by IASB standards have much more leeway in addressing these items on their books.

For firms that are ahead of the game, IFRS 9 can be implemented immediately. CECL implementation will not be permitted until January 1, 2019.

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Back to the present

In the CECL announcement, the FASB's chairman, Russell G. Golden, made a pitch to win the hearts and minds of bankers: "The new guidance aligns the accounting with the economics of lending by requiring banks and other lending institutions to immediately record the full amount of credit losses that are expected in their loan portfolios, providing investors with better information about those losses on a more timely basis."

More timely indeed

One of the main aims of standards like IFRS 9 and CECL is to encourage a more forward-looking outlook, but rather than transport firms into the future, the practices of anticipating risks and making allowances for the losses that might emerge from them bring the future right here to the present. It's not the brighter parts of the future, either, where institutions can earn more from capitalizing on stronger growth and productivity, as bankers take jet packs to work without wrinkling their suits. Only the potential losses are accounted for today.

That's fair enough, as risk control is the point of the impairment estimates. But the impact on today's profit-and-loss statement, capital requirements and so forth is likely to be substantial when the new standards are implemented for those with a big debt instruments book. Just how substantial will be determined by which standard is in effect and the degree to which frontloading of credit losses occurs.

Different inputs, different outputs

The discrepant procedures for calculating ECL mean that each standard has benefits and drawbacks compared to the other. Without the need for stage assessments, and the ensuing variation in provisioning, CECL should be simpler to apply. The ability to rely more on historical and current data in crafting estimates helps to make impairment models more user-friendly, too. But while the stage assessments under IFRS 9 require an additional complicated step, they also allow firms to book losses more gradually.

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Every little bit helps. While it's probably too early to gauge the effects of the CECL framework on key metrics, forecasts of the damage that IFRS 9 will cause in the implementation phase, due to the need to account for future losses while current losses are still affecting performance, will make uncomfortable reading for senior bankers, especially in Western Europe.

A study by the research firm S&P Capital IQ predicted that banks in the region will see their core Tier 1 capital ratio decline by 0.53 percent for every 10 percent increase in impairment allowances. The impact will be more subdued elsewhere, particularly in Canada, the study found.

The capital erosion is expected to have worrisome knock-on effects. An analysis of S&P Capital IQ research and IASB estimates indicated that each 10 percent increase in allowances will reduce shareholders' equity by 2.4 percent.

The good news is that the harm from frontloading allowances will come and go fairly quickly. Once the early hit is taken, allowances for subsequent years should settle in at levels that firms are used to, all else being equal. More than that, by anticipating negative events, assuming it's done right, the jolt to banks' balance sheets during recessions should be milder.

Planning for the worst, to try to prevent it

The aim of accounting standard setters is to devise a mechanism for banks to estimate the risk of loss. For regulators, the goal is to avert, or at least mitigate through diligent preparation, damage to the financial system and the banks that make it function. For regulators, accounting standards are a means to that end. Although the Basel committee wholeheartedly endorsed IFRS 9 and CECL in BCBS 311, these related but distinct objectives account for key differences between Basel guidelines and the two standards.

If the accounting standards ask firms to dwell on the negative aspects of an imagined future, BCBS 311 compels them to imagine the bleakest possible future. In line with its emphasis on stress scenarios incorporating grim economic backdrops, the committee asks firms to include the assumptions from only those scenarios in their ECL models and calculations, not just a compilation of likely and unlikely positive and negative ones.

Another key difference under Basel is a requirement to calculate the present value of expected losses by using the cost of capital as the discount rate. For CECL and IFRS 9 calculations, the effective interest rate (EIR) on each credit is used. One counterpoint to the emphasis on negative scenarios under Basel can be found in the way probability of default is measured. The accounting standards call for a point-in-time (PIT) assessment; Basel allows PD to be calculated through the cycle (TTC), minimizing the impact of acute bouts of stress and reducing swings in the loss estimates generated.

Many bankers – and regulators, too – fear that the ECL calculations mandated in IFRS 9 will have a bigger effect on their capital positions than the Basel requirements. Their concerns include the broad impact of bringing losses forward in the way the standard demands, as well as the prospect of added volatility in provisioning during periods of stress as deteriorating conditions force banks to factor in greater future losses.

There is concern that the impact will be especially severe for institutions in Asia. In a survey of risk officers at the FICO APAC CRO Forum in Singapore this year, 88 percent said that up to 30 percent of their retained earnings might have to be set aside for loan loss provisions.

Perhaps in response to such misgivings, or else just conceding the magnitude of the differences among the accounting standards and the rigor required to implement and live with them, the guardians of capital adequacy in Basel have been making some forward-looking assessments of their own lately. In document 385, the October discussion paper, the committee backed away somewhat from the stringent practices it advocated in BCBS 311:

"The new accounting provisioning models introduce fundamental changes to banks' provisioning practices in qualitative and quantitative ways, as higher provisions are possible with the lifetime loss concept and the inclusion of forward-looking information in the assessment and measurement of ECL. In addition, ECL provisioning might cause more volatility in regulatory capital."

Highlighting the discrepant modeling and calculation procedures under IFRS 9, CECL and local standards, it added:

"This variability in practice may contribute to level playing field concerns. Therefore, the Basel Committee is considering whether prudential capital regulation should be based on a more harmonized regulatory treatment of accounting provisions across banks and jurisdictions."

In other words, the next set of guidelines from Basel may compensate somewhat for the differences among the standards. The document asked institutions to offer suggestions on how best to smooth out the rough edges.

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Different standards, different models, one system

Now that firms and regulators recognize the magnitude of the task of introducing the various and varied accounting standards and incorporating prospective decision making and related practices into the basic fabric of financial organizations, how should firms go about executing it?

Producing forward-looking assessments means making forecasts, which means creating models. Firms that operate in multiple jurisdictions that use different standards or the same standard applied differently may have to devise a model for each of them. If one of those jurisdictions is the United States, the models and calculations will be meaningfully discrepant in the procedures applied from the initial analysis through to the reports sent to supervisors.

One set of books will need to be submitted to each banking regulator. A different set altogether, perhaps reconciling the results of the ones sent to the regulators, may be sought by stock market authorities. Meeting those needs will require a sound data management system that executes the steps that will let a firm produce all necessary reports in all formats, under all regulatory and accounting frameworks, in all jurisdictions. These include collection of finance and risk data, performing the necessary calculations, stage assessment and application of management judgment (under IFRS 9), external and internal disclosures, creating an audit trail and ensuring good governance practices overall.

Firms will not just need good systems to handle their Basel and accounting requirements; they will need them in the run-up to implementation, an event that they acknowledge they are not ready for. In surveys conducted recently by Wolters Kluwer and other organizations, financial institutions showed that they have considerable catching-up to do if they are going to implement IFRS 9 in time for a deadline that, for most of them, is barely a year away.

The general lack of preparedness should make an evaluation and overhaul of data systems a priority. But it would be shortsighted to do it merely as an exercise in connecting the dots to ensure compliance with accounting standards and Basel guidelines, although that could be a useful catalyst for stakeholders who need to be convinced of the merits of such a daunting endeavor.

The emphasis on forward-looking analysis and principles-based, as opposed to rules-based, regulation is a cornerstone of the post-crisis supervisory architecture. It is so pervasive that entire management frameworks like Finance, Risk and Regulatory Reporting (FRR), not just accounting standards and the like, have achieved purchase across the financial services sector to accommodate the new reality. Firms that employ these management frameworks recognize that being able to gauge the impact of potential events on key metrics like P&L and capital requirements is vital for preparing forecasts and guidance for senior management, not just reports for regulators.

To do this effectively requires analytical solutions that comprehensively address the particular methodologies and calculations outlined in the new IASB and FASB rubrics. Systems must encompass all facets of each of myriad processes, from project consultation to classification and measurement, impairment and hedge accounting, through to internal and regulatory reporting. The design must be modular and flexible to allow a solution to be tailored to each situation.

Because IFRS 9 and CECL touch on the three principal functions at an organization – finance, risk and regulatory reporting – it is essential that the enterprise providing the systems can offer the technology, as well as the brainpower of its human experts, to support all three. Expertise in one or even two is not good enough. Once the right systems are in place, the dovetailing of management and regulatory objectives permits firms to leverage the systems to accommodate the need for greater cooperation and communication among functions, particularly risk and finance, and at all levels of management in all places. That means a single system with the flexibility to behave like many smaller ones, allowing data to be shared and manipulated – for analysis, forecasting, budgeting and planning – in ways that conform to the needs of each part of an organization.

Such a capability also serves the ultimate goal of creating a safer, more efficient institution, which is the whole point of the new regulatory and accounting frameworks, of course. And it may not be as difficult to put it in place as it might seem at first. One benefit of having so many intersecting challenges and objectives is that firms that have begun to configure their systems to conform to FRR practices have also begun, whether they realize it or not, to prepare for IFRS 9 and CECL.

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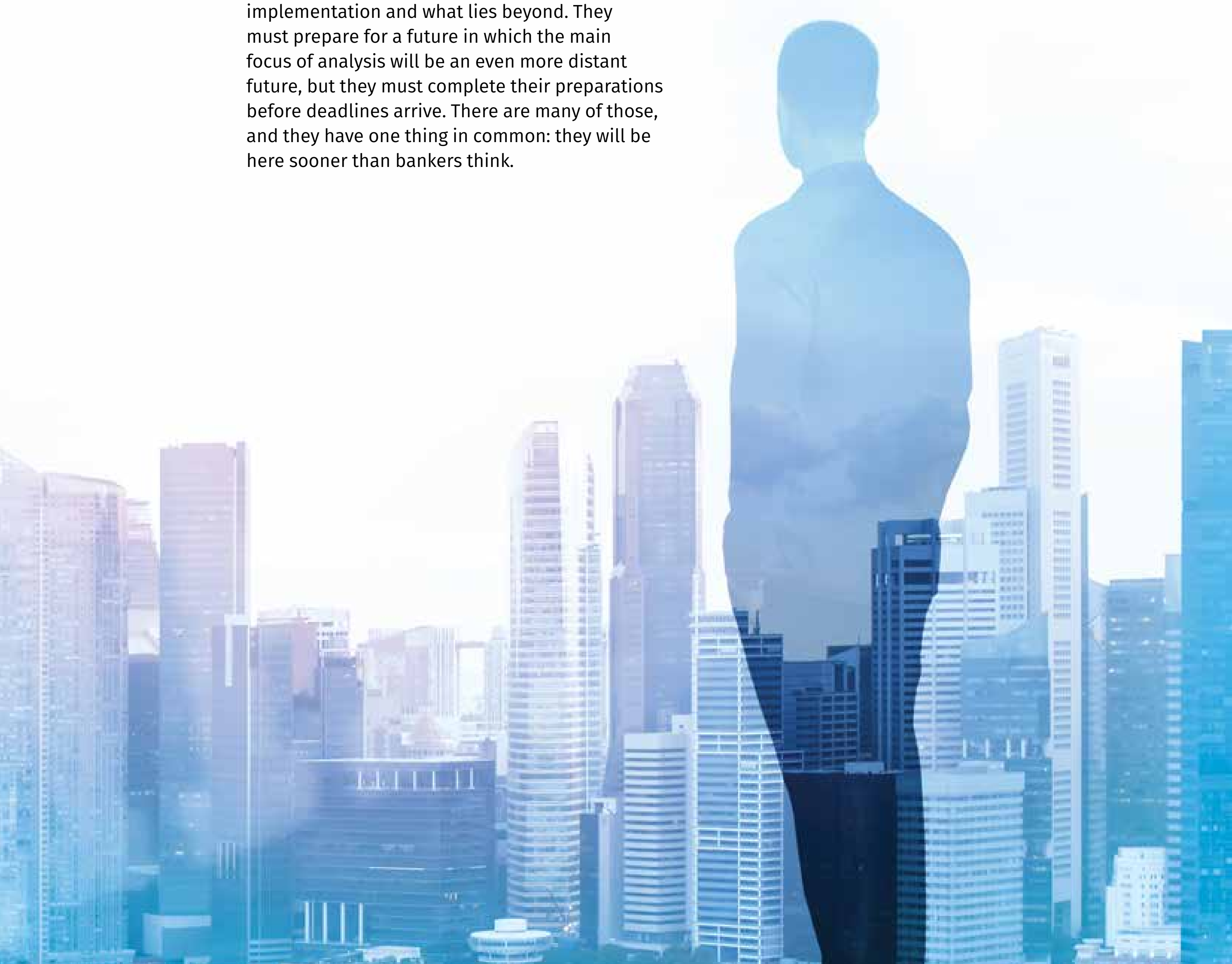
The future isn't now, but it's close

The introduction of new standards and the discrepancies between them present fresh dilemmas for senior bankers, especially because the standards call on them to make better guesses about something inherently unknowable and unquantifiable: the future.

There are still many unknowns concerning the impact that IFRS 9, CECL, Basel and other guidelines will have, especially because their final forms may not yet be written.

What is certain, is that, unless they are being unduly modest, firms are not ready for implementation and what lies beyond. They must prepare for a future in which the main focus of analysis will be an even more distant future, but they must complete their preparations before deadlines arrive. There are many of those, and they have one thing in common: they will be here sooner than bankers think.



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