Overview of new accounting standard IFRS 9 and impact on credit risk models

9th February 2015

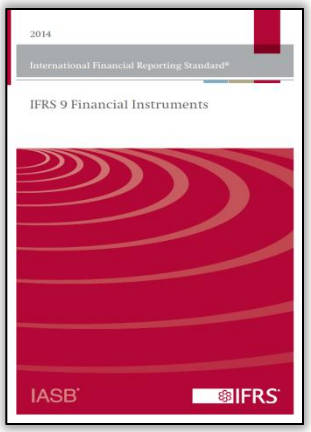
Agenda

- Introduction and effective date
- Expected credit loss model
- Impact on credit risk models

EY

Introduction and effective date

- On 24 July 2014, the International Accounting Standards Board (IASB) issued the final version of IFRS 9, bringing together all three phases of the financial instruments project:

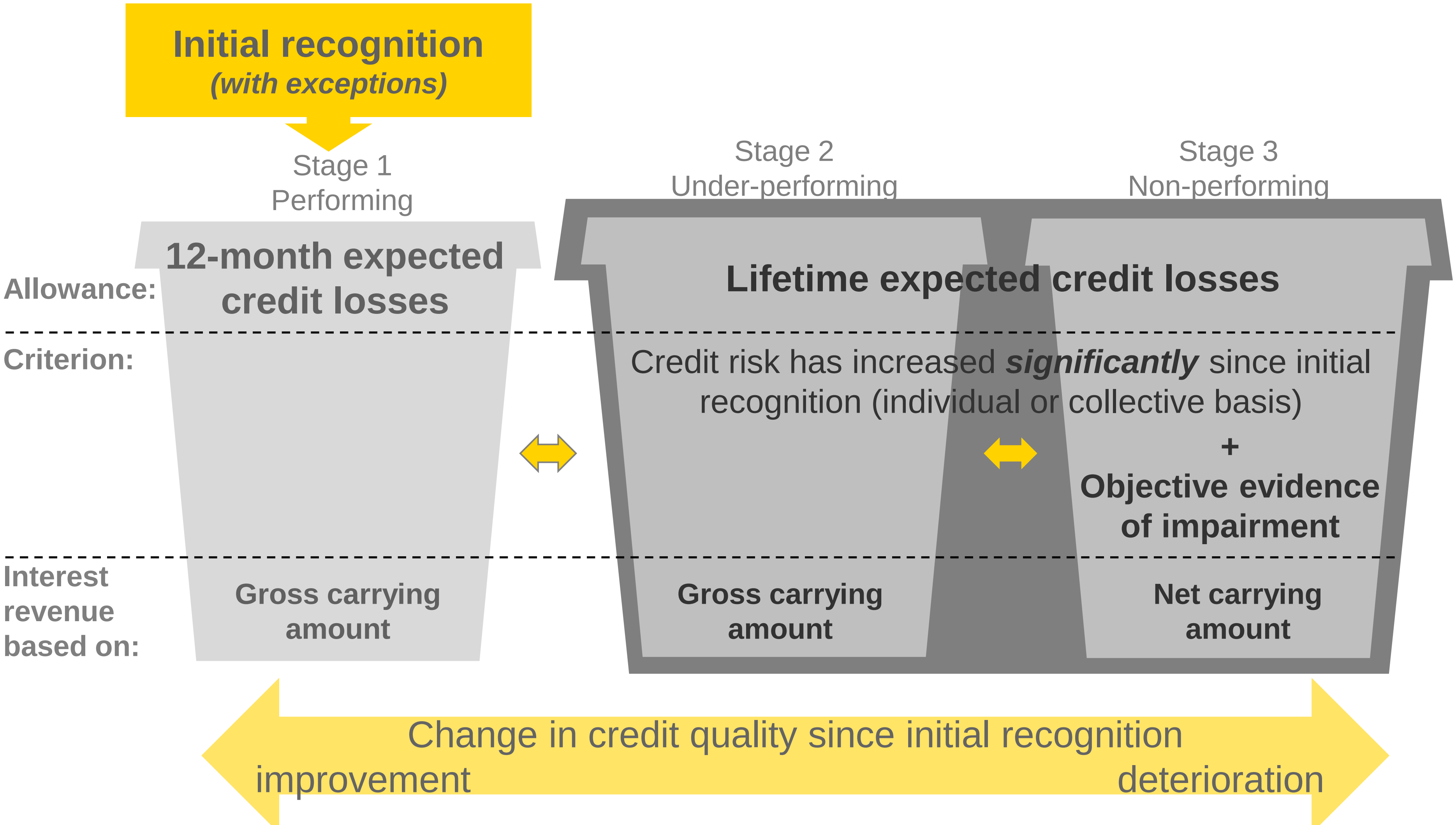


1. Classification and Measurement
2. Impairment (expected credit losses)
3. Hedge Accounting (micro)

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

EY

Expected credit loss model
General approach



Expected credit loss model
Challenge 1

Challenge 1
Significant deterioration in credit quality since initial recognition

Practical challenges

- Significant increase in credit risk since initial recognition should be monitored:
  - It should be assessed at the time of implementation: since when do you use your rating models?
  - Behavioural models are necessary
  - Change in risk over remaining life of the loan – 12M PD might not be enough: do you have bullet loans in your portfolio?
  - Different approaches for individual loans of one client
  - Use of decentralized approaches – difficulty to compare results across subsidiaries
  - Use of other than “PD-based” approaches – e.g. loss rate approach – might be challenging as collateral should not be considered in the analysis of credit risk development

EY

Definition of 12-month and lifetime expected credit losses

- **Lifetime ECL** = expected credit losses that result from **all possible default events** over the **expected life** of a financial instrument
- **12-month ECL** = a 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.

A probability-weighted outcome

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

The time value of money

EY

Expected credit loss model
Challenge 2

Challenge 2
Calculation of life-time and 12M expected credit losses for entire portfolio

Practical challenges

- 12M Expected losses:
  - PD/LGD models should be created for all portfolios (Banks, Sovereigns, etc.)
  - LIP of 1 is required
- Life-time expected losses – life-time PD and Exposure models are required
- Forward-looking models – macroeconomic conditions should be reflected (HPI, UR, FX)

Modelling considerations

General

- The definitions of 'expected credit losses' and 'risk of a default occurring' are identical to the Basel definitions of 'EL' and 'PD'
- **BUT adjustments will be required** 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(!) that is available **without undue cost or effort** at the reporting date

IRB banks

- You build on the existing Basel and provisioning models
- You have to build:
  - life-time PD models
  - models for uncovered portfolios (institutions, sovereign, etc.)
- EAD forecasting models (especially for revolving loans)

Non IRB banks

- You have to build something phenomenologically new
- Modelling considerations will be significantly different for retail and low default (corporate/SME portfolios)

EY

Highlights of the new impairment approach

- Loss allowance required for all credit exposures
- Earlier recognition of credit losses
- Likely to increase the loss allowance due to expected loss approach and earlier life-time expected losses - depending on portfolio and current practice
- Potential volatility due to changes in economic conditions and movement between 12-month and lifetime expected credit losses
- Need to consider forecasts of future economic conditions
- Impact on regulatory capital due to impact on equity
- Modification of current credit risk management and reporting systems

Thank you

EY

Building a better
working world