

IMPLEMENTATION CHALLENGES OF IFRS 9 IMPAIRMENT REQUIREMENT IN POST-SOVIET COUNTRIES' BANKS

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Summary: The purpose of this article is to examine the changes of impairment requirement in accordance with IFRS 9 and to provide the main challenges in implementation of new impairment model. This new accounting standard will have significant impacts on accounting practices and performance results. Although the goal of these changes is to simplify the existing rules and strengthen investor confidence in the financial statements of banks and the financial system, however, financial institutions, especially in most post-soviet countries, face a lot of obstacles during its implementation and only by solving these problems the goal of new standard will be achieved.

Keywords: International financial reporting standards (IFRS), IFRS 9, impairment, expected credit losses, stages, credit risk, probability of default

JEL Classification: M41 Accounting, G21 Banks; Other Depository Institutions; Micro Finance Institutions; Mortgages

Introduction

IFRS 9 *Financial Instruments*, which replaced the accounting standard IAS 39 *Financial Instruments: Recognition and Measurement*, was published by the International Accounting Standards Board (IASB) in July 2014 and was effective for periods beginning on or after 1 January 2018.

One of the key differences between the mentioned two standards, with large implications, is the clarification and methodology for recognizing impairment. The IFRS 9 requirements reduce the complexity of impairment testing by requiring the same model for all financial instruments subject to impairment testing. Previously, under IAS 39, there were different impairment models for financial assets measured at amortised cost and available-for-sale financial assets. Under IFRS 9, there is a single impairment model for all debt instruments measured at amortised cost and at fair value through other comprehensive income. Furthermore, loan commitments and financial guarantee contracts that were previously in the scope of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* are now in the scope of the IFRS 9 impairment requirements. The new methodology for recognizing impairment aims to address concerns raised during the financial crisis relating to the IAS 39 incurred loss impairment model which delayed the recognition of impairment until there was an objective evidence of impairment, i.e., it is no longer necessary for a credit event to have occurred before credit losses are recognised. Instead, an entity always accounts for expected credit losses (ECLs), and updates the loss allowance for changes in these ECLs at each reporting date to reflect changes in credit risk since initial recognition. Consequently, the holder of the financial asset needs to take into account more timely, reasonable and supportable forward-looking information. Although IFRS 9 establishes this objective, it generally does not prescribe particular detailed methods or techniques for achieving it. Therefore, additional complexity comes with this change, both in interpreting the technical requirements and in applying them. This new impairment standard applies to all firms reporting under IFRS 9. In particular, requirements affect firms holding financial instruments, therefore, new model will impact banks most, due to their large financial instrument holding. Below we will present in detail the impairment requirements of IFRS 9 and the main challenges arising during implementation.

An overview of the impairment requirements of IFRS 9

IFRS 9 provides three approaches for recognizing impairment loss of financial assets:

- A general approach for regular financial instruments,
- A simplified approach for lease receivables, trade receivables, and contract assets without a significant financing component,
- A special, "credit-adjusted Effective Interest Rate (EIR)" method for purchased or originated credit-impaired financial instruments².

As the main challenges are arising from general approach, here we will focus only on requirements of the general approach. The general approach has been commonly referred to as the three-stage approach, although IFRS 9 does not use this term. The three stages in the new impairment model reflect the general pattern of the deterioration in credit risk of a financial instrument that ultimately defaults. At each reporting period, an entity assesses which stage a financial instrument that is subject to impairment falls into, and the stage determines the relevant impairment requirements.

Stage 1 includes financially healthy financial assets that are expected to perform in line with their contractual terms and which have not had a significant increase in credit risk since initial recognition or that have low credit risk at the reporting date. For these assets, 12-month ECLs are recognised and interest revenue is calculated on the gross carrying amount of the asset (that is, without deduction for credit allowance). 12-month ECLs are the expected credit losses that result from default events that are possible within 12 months after the reporting date. It is not the expected cash shortfalls over the 12-month period but the entire credit loss on an asset weighted by the probability that the loss will occur in the next 12 months.

Stage 2 includes financial instruments that have had a significant increase in credit risk since initial recognition (unless they have low credit risk at the reporting date) but that do not have objective evidence of impairment. For these assets, lifetime ECLs are recognised, but interest revenue is still calculated on the gross carrying amount of the asset. Lifetime ECLs are the expected credit losses that result from all possible default events over the expected life of the financial instrument.

Stage 3 includes financial assets that have objective evidence of impairment at the reporting date. For these assets, lifetime ECLs are recognised and interest revenue is calculated on the net carrying amount (that is, net of credit allowance)⁸.

Standard define ECL as the weighted average of credit losses with the respective risk of default accruing as the weights. ECLs are generally measured based on the risk of default over one of two different time horizons, depending on whether the credit risk of the borrower has increased significantly since the exposure was first recognized by comparing the difference between the cash flows that are due to an entity in accordance with the contract and the cash flows that the entity expects to receive discounted at the original effective interest rate. In line with IFRS 9 expected cash shortfalls for collateralized financial instruments should include the cash flows from the realization of the collateral and other credit enhancements that are part of the contractual terms and not recognized separately by the firm.

Often it may not be practical to determine, for every individual financial instrument, whether there has been a significant increase in credit risk, because they may be small and many in number and/or because there may not be the evidence available to do so, consequently, it may be necessary to measure ECLs on a collective basis. For both, to assess the staging of exposures and to measure a loss allowance on a collective basis, IFRS 9 allows the bank to group its exposures into segments on the basis of shared credit risk characteristics⁵.

As noted above, IFRS 9 requires entities to evaluate whether the credit risk of the borrower has increased significantly since initial recognition or not. To help enable an entity's assessment of significant increases in credit risk, IFRS 9 provides the following operational simplifications:

- A low credit risk threshold equivalent to investment grade, below which no assessment of significant increases in credit risk is required.
- The ability to rely on past due information if reasonable and supportable forward looking information is not available without undue cost or effort. This is subject to the rebuttable

presumption that there has been a significant increase in credit risk if the loan is 30 days past due.

- Use of a change in the 12-month risk of a default as an approximation for change in lifetime risk².

IFRS 9 does not define the term "default" but instead requires each entity to do so. The definition used should be consistent with the definition used for internal credit risk management purposes and consider qualitative indicators when appropriate. There is a rebuttable presumption that default takes place no later than 90 days past due. However, IFRS 9 contains no further guidance on how to define default⁵.

In accordance with IFRS 9, historical information is an important base to measure expected credit losses. However, an entity shall adjust historical data, such as credit loss experience, on the basis of current observable data to reflect the effects of the current conditions and its forecasts of future conditions that did not affect the period on which the historical data is based, and to remove the effects of the conditions in the historical period that are not relevant to the future contractual cash flows.

Summarizing the impairment requirements of IFRS 9, it is worthy to mention, that IFRS 9 does not give specific methodology requirements for measuring ECL, instead it provides general guidance stating that the measurement of ECL should reflect:

- An unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes,
- The time value of money,
- 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.

IFRS 9 also requires banks regularly review their methodology and assumptions to reduce any differences between the estimates and actual credit loss experience⁵.

Main challenges of implementing IFRS 9 impairment requirements

As stated above, one of the main improvements in IFRS 9 relates to the application of one impairment model for all financial instruments and another to the issue of "too little, too late" loan loss reserve arising from the incurred loss model. Banks will need to adopt sound ECL methodologies commensurate with the size, complexity, structure, economic significance and risk profile of their exposures. The approach to implementing impairment requirement of IFRS 9 will vary depending on the circumstances. Reasonable and supportable information will not generally present itself to management as such – rather management will need to determine what is relevant in the context of the impairment requirements and to actively gather and analyse data and use it to make estimates. For a bank, impairment is an area of high estimation uncertainty that is typically material to the bank's financial statements. Judgements made in applying accounting policies for impairment are typically complex and have a significant effect on amounts recognised in the financial statements³.

For many big banks in developed countries, the impairment elements of IFRS 9 are easier to implement, because they had to employ similar models and data to meet Basel or other regulatory requirements, as well as they have developed risk evaluation departments. Whereas in most post-soviet countries, where there are typical small banks and credit organizations, which haven't had to think about these kind of requirements before, are struggling with IFRS 9. Challenges for these banks, related to the new impairment requirements, start by grouping their exposures into segments on the basis of shared credit risk characteristics, by determining default and significant increase in credit risk, then continue by choosing appropriate ECL calculation model, by including macro-economic forecasts and forward-looking information and end by disclosing all necessary information in financial reports in accordance with IFRS 7 Financial Instruments: Disclosures. Below we will refer separately to each of the above listed challenges.

- **Portfolio segmentation:** Calculating expected credit losses usually begins by finding the appropriate segmentation scheme that groups exposures into different portfolios. Banks

usually segment portfolios along business lines, product types, and risk characteristics for impairment calculation, but IFRS 9 requires developing a more granular and dynamic approach for portfolio segmentation. Now banks must group financial assets based on shared credit characteristics that typically react in a similar way to the current environment and macroeconomic factors so that banks can reasonably assess changes in credit risk and, thus the impact on the estimate of ECL. These characteristics may include instrument type, credit risk ratings, industry, geographical location, date of initial recognition, remaining term to maturity, underlying collateral, etc⁷. Moreover, banks should re-evaluate and re-segment groupings, whenever there is new and relevant information (e.g., change in economic conditions) or credit risk expectations change. The segmentation scheme implemented upon initial recognition may not necessarily be appropriate subsequently, since the responsiveness to those credit risk characteristics may change over time. Most importantly, exposures should not be grouped in such a way that the performance of the segment as a whole masks an increase in a particular exposure's credit risk. When credit risk changes after initial recognition and it affects only some exposures within a group, those exposures should be segmented out into appropriate subgroups⁵. Hereby, a bank's methodology for grouping exposures to assess credit risk should be documented and subject to appropriate review and internal approval.

For the small banks implementation and documentation of the methodology for grouping exposures as well as performance of the procedures to ensure that the groups of exposures continue to share credit characteristics, and re-segmentation of the portfolio when necessary are additional burdens.

- **Determining default:** The definition of default is one of the most important keys for impairment calculation, and the banks must do it themselves as the standard itself does not define it. Although the Basel Committee has recommended that the definition of default adopted for IFRS 9 accounting purposes is guided by the definition used for regulatory purposes by providing examples in addition to the 90 days past due backstop which are known as unlikelihood to pay indicators ("UTP")³, there are still likely to be differences in the definition of default for regulatory purposes and per the IFRS resulting in some assets that may be considered by the regulator to be in default but not in default by as per the IFRS 9 and vice versa. For small banks, in this context, more disputes with tax authorities are expected since the regulators definition of default does not factor expected default but only considers default when it has occurred. Thus, the determination of the default continues to be challenging for small banks, which, on the one hand, are prone to use the definition of regulators to make easier their task, on the other hand should investigate the differences and assess their impact on the staging of its assets and ECL calculations, because using the IFRS 9 definition of credit-impaired indicators as the definition of default or using the definition of default from regulator's rules – affects the calculation of PDs, LGDs and EADs, and as a result different definitions can lead to different ECL.

- **Significant increase in credit risk:** The concept of significant increase in credit risk is critical to the implementation of IFRS 9 impairment requirement because the transition from 12-month ECLs to lifetime ECLs (i.e. from Stage 1 to Stage 2), which results in higher provisioning levels, is based on the notion of significant increase in credit risk over the remaining life of the financial instrument. Although IFRS 9 in paragraphs B5.5.17 (a)–(p) provides a list of factors that can indicate increase in credit risk, the banks need to develop clear policies to identify the transitioning between Stage 1 and Stage 2 in a timely manner. Banks will also need to implement systems that are capable of handling and systematically assessing the large amounts of information that will be required to judge whether or not particular lending exposures or groups of lending exposures exhibit a significant increase in credit risk since initial recognition and to measure lifetime expected losses where that is the case¹. For small banks one of the challenges in calculating credit risk changes is the back-filling of credit risk assessment at origination. For this purpose, it is necessary to consider the

credit risk characteristics at initial recognition, for which historical information is needed, such as internal ratings, external ratings, financial statements, and/or economic conditions statistics. To overcome this challenge, the standard advocates for the bank to determine the loan classification at the origination of the loan and then review its loan classification at the reporting period. The movement noted would then determine whether there has been a significant increase in credit risk. The most significant limitation expected for small banks is that they may not have developed an internal risk rating model which is applied to the loan portfolio. It may, therefore, not be possible to determine what the original risk rating was for a loan or the risk rating at the reporting date. For many smallbanks, the classification being used is the Central Bank ratings of "Normal", "Watch", "Substandard", "Doubtful" and "Loss". This classification is, however, largely based on "days past due", which is the number of days a loan repayment has been due for payment and the migration between buckets is largely determined by the days past due. While this is an acceptable approach for the standard, it is also very punitive, because by taking into account only days past due information we will come back again to the incurred loss model.

- ***ECL calculation model:*** The biggest problem in practical implementation of the new impairment model is the fact that IFRS 9 does not prescribe a specific measurement method for calculating ECL model. Quite the opposite, entities are expected to develop their internal models using reasonable and supportable information from the past and from the future. Accountants are well aware that such freedom looks nice only from the outside, but when it comes to real life, a thousand questions appear, and you have no one to ask. Actually, you can ask for help, but it is not free of charge, far from it⁴. Thus for most small banks of post-soviet countries the biggest challenge remains the choosing an appropriate and cheaper in implementation model for ECL calculation.

Consistent with regulatory and industry best practices, ECL calculations are based on four components:

- Probability of Default ("PD") – This is an estimate of the likelihood of default over a given time horizon.
- Exposure at Default ("EAD") – This is an estimate of the exposure at a future default date, taking into account expected changes in the exposure after the reporting date, including repayments of principal and interest, and expected drawdowns on committed facilities.
- Loss Given Default ("LGD") – This is an estimate of the loss arising on default. It is based on the difference between the contractual cash flows due and those that the lender would expect to receive, including from any collateral. It is usually expressed as a percentage of the EAD.
- Discount Rate – This is used to discount an expected loss to a present value at the reporting date using the effective interest rate (EIR) at initial recognition³.

Small banks are faced different challenges during the calculation of each aforementioned component.

These challenges are starting with calculation of PD. There are two main ways to determine PD. The easiest way is to look it up in transition matrices for time horizon of one year, published by external rating agencies. Basic assumption is that your counterparty/issuer is a big company that is included in the external rating process. Small banks can implement this approach only for issuers of debt securities quotes on big stock exchanges around the world, if they have any. The second way, the hard way, which usually refers to small banks, is the situation, when your counterparty is not rated by external rating agencies, so it has no rating, and no externally available value of PD and bank should set up an internal model for determining the PD value⁴. In this case, if a bank uses IRB (internal ratings-based approach) models for regulatory purposes, the bank may use the outputs from its IRB models as a starting point for calculating IFRS 9 PDs. However, the PDs from these IRB models may be determined using a through the cycle (TTC) rating philosophy (or hybrid point-in-time approach) or may include certain conservative adjustments (such as floors). Thus, these PDs should be appropriately adjusted if they are to be used for IFRS 9 purposes, which can become an additional burden for small banks³. Nevertheless, the most difficult case is when bank does not have neither

externally available value of PD nor IRB models and should develop totally new model to produce PDs for IFRS 9 purposes. As all key risk drivers are identified and calibrated based on historical data over a suitable time period, the bank should analyse a significant amount of data in order to estimate the PD. But the internal systems of small banks very often do not contain the necessary historical data and, moreover, they do not have appropriate employees who will be able to carry out that analysis and develop the relevant model. Although, where relevant, IFRS 9 allows the bank to use external benchmarking to a similar risk portfolio, in case there is insufficient default history for a particular portfolio³, this benchmarking information is also very limited in many countries. For example, there is no such an official information in Armenia.

The difficulties of PD calculation continue with measurement of lifetime PD. To determine lifetime PD, the bank either builds from the 12-month PD model or develops a lifetime PD model separately. For small banks it will be easier to build from the 12-month PD model. In this case bank should develop lifetime PD curves or term structures to reflect expected movements in default risk over the lifetime of the exposure by sourcing historical default data for the portfolio, performing vintage analysis to understand how default rates change over time, extrapolating trends to longer periods, where default data are not available for the maximum period of exposure and performing analysis at an appropriately segmented level, such that groups of loans with historically different lifetime default profiles are modelled using different lifetime default curves³. The implementation of all the required provisions requires great efforts from the small banks.

The next component of ECL calculation model is EAD. Although for defaulted accounts, EAD is usually just the amount outstanding at the point of default, however, for performing accounts small banks face the challenges of determining the period of exposure for revolving facilities, as this is based on the behavioral life that could be longer than the contractual term. Another and the main challenge for small banks on EAD is again limitation on historical data to estimate assumptions e.g. on prepayments and refinancing as well as expected drawdowns on committed facilities.

As regards to LGD, comparatively speaking, bank risk managers may find it somewhat less difficult to estimate, especially if collateral values are routinely updated and historical recovery rates for comparable assets are readily available in the internal accounting systems. However, in this case, small banks also face challenges, because their internal accounting systems usually do not have updated collateral values; moreover, they have to make a forward-looking estimate of how the collateral price will change and how long they will need to sell collateral in case of default. When exposures had no collateral, bank should estimate LGD by calculating historical recovery rates, therefore small banks again face the limitation of historical data.

Even if all the three components in the expected loss approach are readily available, additional issues will arise when determining the ECL. Rules require discounting the expected cash shortfalls in order to obtain the current value at the reporting date. Current regulatory calculations do not discount at all or discount only to the date of the expected default point. Firms will need to modify existing systems to better capture the expected timing of credit losses and to discount future amounts to the reporting date. IFRS 9 requires the use of the effective interest rate at initial recognition when discounting the cash flows. Small banks must also complete the effective interest rate for financial instruments if this information is missing in the current accounting system.

Summarizing the challenges arising in implementation of new ECL calculation model, it is worthy to mention that the internal accounting system of almost all banks corresponds to the requirements of the regulator, therefore, each deviation from it, requires new software solutions, which can become a big expense burden for small banks.

- **Macro-economic forecasts and forward-looking information:** One more challenging requirement is that consideration of forward-looking information, including macroeconomic factors, is a distinctive feature of ECL accounting frameworks and is critical to the timely recognition of ECL. Banks will have to employ sound judgment consistent with generally accepted methods for economic analysis and forecasting. The assignment of credit risk, in general, depends on the borrower's capacity to satisfy its contractual cash flow obligations on the date and the adverse changes on economic conditions. This last idea is a relevant new

approach of the newest standard, which recognizes that macroeconomical factors are the key driving force behind impairments of financial assets, by contemplating prospective estimations under different possible macroeconomic scenarios. Banks are required to evaluate the impact of forward-looking economic changes on their expected credit losses under a range of unbiased possible economic outcomes. Many small banks have difficulty in developing credible economic scenarios to measure expected credit losses that reflect an unbiased, probability-weighted outcome. There is an additional issue with availability and relevance of forward looking (macro-economic) data in most post-soviet countries. In many cases, the state official sources of macro-economic factors forecasts, such as the data of Central Bank or National Statistical Service are different from World Bank's forecasts and banks should choose the appropriate source. Moreover, banks need to find the accurate forward looking factors which have influence on their ECL. Although financial institutions may rely on historical information to identify correlations between different (macro-economic) factors and eventual credit losses and then map these factors and monitor going forward, in this case again small banks face the limitation of historical data and ability of creating appropriate correlation models.

- **Disclosures:** Due to new impairment requirements and in accordance with IFRS 7, banks should disclose in their financial reports information about their credit risk management practices and how they relate to the recognition and measurement of ECL – including the methods, assumptions and information used to measure ECL, additional quantitative and qualitative information to evaluate the amounts in the financial statements arising from ECL – including changes and the reasons for those changes and information about a bank's credit risk exposure – including significant credit risk concentrations. All the aforementioned new requirement of disclosures become additional challenge for small ones, but it is worthy to pay attention to the explanation of changes in ECL, for which banks should provide by class of financial instrument, a reconciliation from the opening balance to the closing balance of the loss allowance, in a table, showing separately the changes during the period for: (a) the loss allowance measured at an amount equal to 12-month expected credit losses; (b) the loss allowance measured at an amount equal to lifetime expected credit losses by separating those which are not credit-impaired and which are credit-impaired⁶. As we have already mentioned, internal accounting systems of banks are adopted for the regulatory requirement, hence they will not have the necessary information about changes in ECL in their accounting system. To overcome this issue, banks should parallel have another accounting system which will be adopted in line with IFRS requirements, but it generates a new challenge, as it is due to high costs.

Conclusions

Summarizing the article, we can conclude that IFRS 9 requires banks to make judgments on certain complex areas of accounting and other judgments related to credit risk management, which could materially affect the provision levels. Moreover, the expected losses will possibly result in higher volatility in the ECL amounts charged to profit or loss, especially for small financial institutions. The level of loss allowances will increase or decrease depending on bank's estimation of this or that component of the ECL calculation model, or depending on economic conditions forecasts.

While enforcement of the new standard is up to each country, and some are granting deferrals, banks that fail to implement IFRS 9 could face severe consequences ranging from adverse audit opinions to de-listing from exchanges. Therefore, to avoid such consequences small banks should overcome all challenges listed above and the role of each post-soviet country's Central Banks may be decisive in this process. In our opinion small banks need an official guidance which will help them to overcome their challenges in implementation of IFRS 9 impairment requirements and which can make this process cheaper for them.

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