Wolters Kluwer

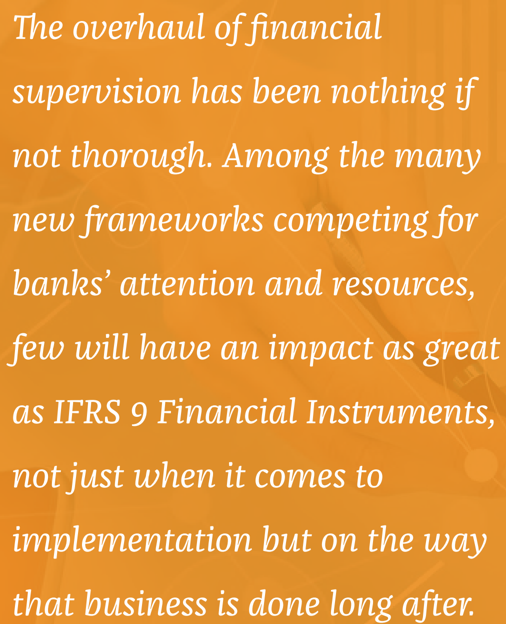
When you have to be right

The main features and capabilities that institutions should look for in identifying a solution that can support their IFRS 9-related needs, not only during the initial stages of adoption, but also well into the future.

Financial Services Solutions

Breaking Down IFRS 9 Implementation

BUYER'S GUIDE



The overhaul of financial supervision has been nothing if not thorough. Among the many new frameworks competing for banks' attention and resources, few will have an impact as great as IFRS 9 Financial Instruments, not just when it comes to implementation but on the way that business is done long after.

IFRS 9 updates International Accounting Standards Board guidelines for the treatment of balance sheet assets and is a replacement for its IAS 39 rubric. The board intends IFRS 9 to be compatible with broader Basel risk management practices, particularly with its emphasis on a principles-based approach, rather than one that compels institutions to follow a set of hard and fast rules.

Investing in inevitable change

The overarching objective of the IFRS 9 accounting standard, which went into effect at the start of 2018 and is being applied in much of the world, is to encourage banks to assess credit and risk in a more comprehensive, prospective way that takes myriad internal and external factors into account to spot trouble before it arrives. This is achieved through changes in how instruments are classified and in how credit impairments are treated.

IFRS 9 requires each instrument to be placed in one of three categories depending on the type of asset it is and the business model under which it is owned. Loans and other debt instruments that firms intend to hold to maturity and collect interest on – the stuff of traditional retail or commercial banking – are carried at amortized cost (provided these firms pass the Solely Payments of Principal and Interest test). Equity and debt instruments held as portfolio investments are carried at fair value through profit and loss, essentially a way to mark them to market periodically. Other assets, as well as conventional debt and equity owned in certain unconventional circumstances, are placed in the third category, fair value through other comprehensive income.

The other significant wrinkle in IFRS 9 is the calculation of expected credit loss (ECL). In a departure from the traditional incurred-loss impairment model that acknowledges a loss only after a default or other triggering event, banks will be required to estimate a loss from the moment an asset appears on the balance sheet and to update the estimate when facts warrant it. The estimate will cover a 12-month probability of default period for assets in reasonable shape and over their lifetime in the case of more troubled assets.

This future-is-now model has a material impact on balance sheets, and the reputation of many banks, which is apparent to boards, investors and other stakeholders. The ability to get the models right in accounting for risk is no easy task. Indeed, we see a lot of banks struggling with their IFRS 9 endeavors. Firms that succeed are likely to have a demonstrable edge over ill-prepared competitors who find themselves wandering aimlessly on the road to tomorrow, encountering obstacles along the way in the form of challenges from regulators, potential disparagement from investors and customers, as well as reduced operating efficiency and profitability.

To comply with IFRS 9 – and avoid being among firms in the second group – banks will have to reassess their internal operations. In particular they will have to dismantle barriers between departments such as Finance and Risk, as well as spruce up data management capabilities in order to make more accurate and longer-term credit assessments. These changes will come in handy not just for implementing IFRS 9 but other elements of the new architecture, too.

With so much at stake, IFRS 9 is still an urgent priority across the industry. In our experience banks have greatly underestimated the impact that IFRS 9 will have on the results, as well as the implementation challenges. Mid-tier banks in the UK, for instance, have had a 76.3% increase in ECL, on average, during the transition to IFRS 9. The range of adjustments reported by individual firms has been wide: between 16.7% and 156.9%. Banks that take an early-bird approach with IFRS 9 ECL trial runs will be better at cushioning the impact.

Wherever they may be on the road to IFRS 9 readiness, firms are sure to be working hard in the months ahead to evaluate their data systems and adopt appropriate solutions. Prepared with the input of Wolters Kluwer sector experts, this Buyer's Guide aims to assist companies in this vital process. It will touch on some of the common technical and operational issues involved in IFRS 9 projects, outlining areas of best practice and common pitfalls. It will also identify key features and capabilities that institutions should look for as they consider solutions for integrating IFRS 9 into their everyday activities.

Setting goals and finding a partner to help meet them

Whether it is viewed as a benefit or a curse, the principles-based nature of IFRS 9 and its inherent flexibility permit firms to travel many different paths to compliance. The shortest and most comfortable route between here and there will depend on a range of factors, including size and business mix.

The first step along the journey for any firm should include an assessment of its existing resources that identifies gaps in historical data, as well as deficiencies in systems that would hinder the development of the credit risk models that the standard calls for. Banks may not have to start over, even if they find that their systems are not up to scratch; they may be able to reconfigure, add to or link among them to support IFRS 9 requirements.

When it comes to implementing solutions, firms should seek a partner with the well established methodology necessary to provide support throughout the process.

There are several pitfalls that banks need to consider when starting their IFRS 9 projects. A frequent mistake is to limit the scope of the project to coming up with a number and a model for impairments, instead of focusing on cooperation, processes and governance between the risk and finance streams. It is easy to forget the impact that key functions have on one another, and the changes in ECL results that the web of relationships among functions can create. An insufficiently comprehensive project may not capture these subtleties.

When it comes to implementing solutions, firms should seek a partner with the well established methodology necessary to provide support throughout the process. The right approach is vital, particularly during the assessment stage for auditing existing resources and when mapping out key functional and technical requirements to identify where new IFRS 9 software should be integrated with existing banking systems.

These assessments must be based on an understanding of an institution's commercial and regulatory environment in order to find a solution that dovetails with it. IFRS 9 has highlighted the need for organizational and technical reforms alike. The vendor should be able, therefore, to help drive conversations with stakeholders to foster support for the project and to develop shared expectations regarding its various stages and outcomes. All of this requires a deep pool of regulatory, risk management and finance expertise, as well as industry and technical acumen.

We are all in this together

When tackling an IFRS 9 project, a firm must make clear, early on and across the organization, that responsibility for the undertaking will not be limited to any one or few departments, even though much of it will be shouldered by Finance and Risk. At many banks, the way that a credit risk assessment (CRA) is structured will have to change to allow the necessary exchange of information.

Establishing the connections among departments that will be needed to calculate ECL is one of the biggest challenges. This is why we encourage firms to form project teams that include stakeholders from Finance, Risk and other functions and assign clearly defined responsibilities to each. These teams may be set up with a limited lifespan in mind, but we have seen in practice that IFRS 9 implementation marks the start of a long-term endeavor, not the end of a discrete project. As model, management and other changes occur within a firm, it can use IFRS 9 as a strategic program that establishes how finance, risk and regulatory divisions will cooperate.

The economics department, for example, will produce scenarios and estimates that may be factored into expected loss models without having to wait for data to confirm them. Credit officers will collect a broader array of information that affects risk assessments. Product management teams will focus on the risks bundled into their offerings and the resulting impact on profits.

But good workers require good tools. An IFRS 9 solution must be able to consolidate and store financial, transactional and other data from multiple departments and systems. This creates a significant challenge from an architectural point of view. Consider contract classification under IFRS 9: while it can be done using different systems where each type of contract is generated, doing it consistently that way becomes difficult. It is also nearly impossible to create audit trails that clearly illustrate to compliance teams or regulators the logic behind classifications.

A better idea is to create a centralized classification environment where all information on a particular instrument is stored in a dedicated layer. Any related transactions or updates can be collected and reconciled in this environment, establishing a complete, coherent life story for the contract. More information can be compiled with greater simplicity, moreover, by running contract information through a rules-based engine that can be modified as needed to incorporate new systems, requirements or products. Beyond ensuring consistency in contract assessment, this engine should automatically generate a data trail that lays bare the reasoning behind any given classification.

The complexity of IFRS 9 and its entity-wide impact is amplified in the risk assessment process for contracts. Debt instruments that have been assigned to the categories of amortized cost or fair value through other comprehensive income will need to be assessed for credit risk. That means breaking them down into one of three stages that will require the calculation of 12-month or lifetime ECL, which in turn will dictate the necessary loss provisions.

Institutions have relied heavily on past-due data under IAS 39, so some have yet to develop a complete ratings-based system to support the approach to credit risk that IFRS 9 demands. The standard has been implemented in a number of countries. Once implemented in your market, assessments will have to take in not only the initial credit quality of an instrument but any subsequent deterioration.

An IFRS 9 solution, therefore, must incorporate an advanced behavioral credit scoring mechanism that monitors contracts for changes in credit quality at regular intervals aligned with reporting schedules, again drawing on and analyzing data from disparate sources.

More to calculate and more to report

There is more to IFRS 9 than crunching numbers in new and interesting ways. The numbers and the conclusions drawn from them must be reported to supervisors, also in new and interesting ways. Among other elements, firms will have to disclose and explain the formulas underlying internal risk rating grades and any developments that may affect the P&L statement. A data engine that captures information both from Finance and Risk is essential in meeting those obligations. In addition there is also the impact on the Basel regulatory requirements, which entail further interplay with the impact on capital requirements.

While existing finance and risk systems may be able to meet some of these new requirements, they are unlikely to meet them all. Some finance systems, on one hand, are based on set periods and mainly report past events, leaving them hard pressed to generate forward-looking information or absorb new financial models. Pure risk solutions, on the other hand, can generate snapshots and run through ad-hoc simulations. This latter option, however, lacks the ability to track changes over multiple accounting years or to dive into the data and decisions that underlie the modeling and simulations they perform.

As the limitations of a piecemeal approach become more evident in IFRS 9 compliance, so does the need to develop a centralized data engine. But there is nothing centralized about financial supervision. The right system will be capable of automatically generating and filing required reports, again according to pre-established rules, to regulators, shareholders and stakeholders at national, regional and global levels, in multiple formats.

Globally, multiple implementations have already been realized. However, up until today financial institutions have encountered challenges in producing the right figures and disclosures. A quick fix approach which limits IFRS 9 to modeling and spreadsheets could lead to further problems down the line rather than actually resolving the issues it intended to tackle.

The divergences among regulators extend beyond when banks must implement IFRS 9 to what exactly they should implement and when. There are timing issues which are causing some friction with regards to comparability of financial statements and disclosures. These are clear demands by stakeholders and shareholders alike, even if a regulator does not imply such a transition. Blame that on the principles-based aspect of the standard, which has left many regulators unable to provide guidance on the precise practices they are looking for. There is an ongoing need for financial institutions to react swiftly to changing regulatory updates and audit benchmarks. That almost guarantees a host of regulatory refinements and updates as the standard is rolled out, making it crucial for any data system to allow changes to be incorporated, documented and published swiftly.

Systems need an added dimension of flexibility to protect firms, their data and their models against the caprices of tomorrow. IFRS 9 and the other rules and standards to which firms must adapt are bound to continue to change as the implementation deadline passes and regulators are able to judge performance in real world scenarios.

Auditors and regulators will require institutions to be able to govern, control and mitigate any risk related to the IFRS 9 process. An IFRS 9 solution should support compliance in this effort by making it relatively painless to institute changes, for example, by automating the process as much as possible.

A service provider with the requisite expertise in reporting issues should be in a position to provide an ongoing regulatory update service, where the solution is linked to a database maintained by the provider that logs and interprets changes in key requirements. These changes can then be incorporated automatically into a client's system and reports. While oversight of regulatory developments can never be outsourced completely, a solution with this level of functionality at least can remove some of the pressures associated with day-to-day monitoring.

Managing the data flow to regulators – and back again

It may seem as though a regulator's desk is the final destination, but IFRS 9 compliance is a two-way street, and the systems used to meet reporting requirements must be designed accordingly. Data will flow from different departments into a centralized engine. There it will be massaged, tweaked and processed based on pre-established rules, assumptions and management judgement before emerging as finished reports ready to be dispatched to relevant authorities.

But traffic also will head in the opposite direction. The system must generate a clear audit trail that lets a firm and the supervisors it reports to track elements of the finished product back to the raw numbers and the departments where they originate. The underlying assumptions and decisions that play a role in determining the results, along with all the changes made along the way, must be clear.

More than that, IFRS 9 requires any changes to an impairment model – for example, what assumptions are made, how decisions are arrived at – to be recorded as a separate line item in the P&L statement. That means that whenever a change is made, a bank must run the model again and account for any differences in outcomes. This requires a specialized governance tool that tracks model changes closely. These kinds of forensic tracing solutions are the only real means to provide compliance and management teams with the hard data and tools needed to justify a position or make an adjustment if requested by regulators.

This is critical, as much of IFRS 9 compliance is based on factors that, at least to some extent, are subjective, such as risk assessments, projections for macroeconomic variables as well as management judgments on changing credit conditions. Together with the fact that audit activity is increasing across the industry globally, the scoring and reporting conducted by an IFRS 9 system must be fully traceable.

The system should provide management and compliance with the quantitative analysis needed to support and defend their positions. IFRS 9 compliance can only be achieved when there are detailed and auditable processes linked to any reports or risk modeling calculations.

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Preparing for a big impact in the real world

Producing accurate reports for regulators is a vital element of IFRS 9, but there is far more to implementing the standard than doing homework.

The changes to classification rules and impairment provisioning will have a substantial impact on institutions' P&L statements. This means regular and timely communication in the run-up to implementation is needed to ensure that numbers generated show comparability between IAS 39 and IFRS 9 figures and restatements and do not come as a shock to boards, investors and other relevant parties.

That is what the parallel run is for. For months, perhaps longer, leading up to implementation, key calculations will be made under IFRS 9 models side by side with those used under IAS 39 or any other standard a firm uses. The parallel run provides a way to gauge the impact of IFRS 9 on the balance sheet and fine-tune credit loss models before full implementation.

Even if there is no regulatory obligations for some countries yet, there is already a demand by international investors to analyze and compare financial statements in an IFRS 9 context. This means that banks should get an idea, sooner rather than later, of the impact the standard will have. In our experience, models will be updated frequently, even after the move to production, because the models need time to mature. An earlier start gives banks the needed edge to reach model and calibration maturity faster. That is far more desirable than having to explain divergences and management adjustments later, when already in production mode.

Confusion or ambiguity surrounding IFRS 9 requirements and implementation schedules across various markets must account for some delay. So must the technical complexity; setting up and running two systems at once, efficiently and transparently, is a tall order for institutions and IT departments struggling to meet existing commitments.

But the inevitable can be staved off only for so long. Investing in the right system can help move the process forward. In particular, the flexibility afforded by a detailed sub-ledger that allows a number of accounting and data views to be run simultaneously and presents quick, straightforward comparisons between them. This would be helpful to a firm looking to play catch-up.

By making use of old and new provisions and incorporating various forward-looking scenarios and models into assessments, an organization will get a vital preview of the effects of IFRS 9 on P&L statements and will be able to identify any necessary enhancements to classification and credit scoring techniques. These findings also can inform communications with internal and external stakeholders, heightening awareness of the far-reaching consequences of IFRS 9 implementation and laying the foundations for a more concerted response.

The parallel run may only last a brief time, but frequent changes in reports and disclosures as of 2018, particularly for institutions using a standardized approach under Basel, in essence means calculating and calibrating internal risk models from scratch. There are clear differences between Basel internal models and IFRS 9 point-in-time (PIT) models. IFRS 9 calls for the determination of which instruments are impaired to be made during the classification phase. It also requires credit assessments to be done in a more detailed way, contract by contract, and to incorporate macroeconomic factors.

The long-term benefits of compliance

Challenges banks may encounter when becoming IFRS 9 ready, include, but are not limited to, growing compliance requirements, a potential short-term hit to profitability, lasting changes in the way firms structure their businesses, and in some markets, ambitious implementation deadlines. So it is easy to see why some may feel hard done by. Beyond these factors, the investment required to update existing systems and install new ones that can enable all features of compliance – ones already here and the ones likely on the way – can be substantial too.

In purely financial terms, after the initial impact of changes to credit risk models (and consequent provisions) have been absorbed, a greater focus on forward-looking assessments should lead to a more accurate pricing of risk and better informed risk taking. This, in turn, will encourage a more precise segmentation of customers and products brought to market; firms are likely to focus more on their core activities than on trying to be all things to all people. The result overall will be more efficient banking, better allocation of capital – precisely what was intended by regulators – and more positive contributions to the balance sheet.

The potential dividends from a makeover of a firm's organizational architecture may be even greater. Building a centralized database and combining finance and risk processes, as IFRS 9 demands, should be viewed as a catalyst for better strategic planning. Management and the board will benefit from an accessible, enterprise-wide view of products and risk positions, and they will also experience greater visibility into the factors that influence these positions.

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IFRS 9 can act as a bridge between departments, driving them to act as one unified organism, producing and consuming information for the benefit of the entire firm, not just for each isolated silo. This enables Risk teams to be more conscious of the impact of their decisions on P&L and capital requirements and Finance staff will pay greater heed to risk when formulating forward-looking statements.

A shared understanding of the potential threats and opportunities faced by the institution will help build a common sense of purpose in safeguarding against the former and capitalizing on the latter.

Finding a traveling companion for the long road ahead

As change is often inevitable, firms should seek out a solution for implementing the standard with ongoing support rather than treat it as a discrete project with a fixed end date. The partner in an IFRS 9 solution should provide regular system updates in response to shifts in the regulatory environment, although some change inevitably will be managed internally.

The implementation of IFRS 9 is revealing itself to be a transformational event instead of merely one more item on a crowded to-do list, as it once might have been for many firms.

That makes it essential for a solution to empower users to make adjustments independently, in line with changing views on risk or the launch of new products. This is best achieved through an intuitive, functional interface where changes to assumptions, segmentations, and calculation models can be accomplished effortlessly by users themselves. One of the greatest potential benefits of regular interaction with IFRS 9 systems is the blending of finance, risk and technical skills that an increasingly regulation and technology-driven financial sector calls for and that remains in short supply.

The implementation of IFRS 9 is revealing itself to be a transformational event instead of merely one more item on a crowded to-do list, as it once might have been for many firms. With their minds concentrated by a realization of the task ahead of them, banks are coming to understand that they will require system architectures and solutions that embody the models they are striving for internally – ones that seamlessly integrate multiple functions, create areas of common ground and feature the efficiency and flexibility to embrace the many changes yet to come.

About Wolters Kluwer

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The group serves customers in over 180 countries, maintains operations in over 40 countries, and employs approximately 19,000 people worldwide. The company is headquartered in Alphen aan den Rijn, the Netherlands. Wolters Kluwer shares are listed on Euronext Amsterdam (WKL) and are included in the AEX and Euronext 100 indices. Wolters Kluwer has a sponsored Level 1 American Depositary Receipt (ADR) program. The ADRs are traded on the over-the-counter market in the U.S. (WTKWY).

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