EXPLORING THE PRACTICAL CHALLENGES OF IMPLEMENTING IFRS 9 FOR FINANCIAL INSTITUTIONS

ICAEW

IFRS 9

DFSA
Dubai Financial Services Authority

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Foreword

This paper has been produced based on comments from the breakfast briefing jointly organised by The Institute of Chartered Accountants in England and Wales (ICAEW) and the Dubai Financial Services Authority (DFSA), on 20 February 2017 at DFSA.

The briefing was introduced by Ian Johnston, Chief Executive, DFSA, and concluded by Michael Armstrong, Regional Director MEASA, ICAEW. The panel discussion was moderated by Bryan Stirewalt, Managing Director Supervision, DFSA. Bryan joined DFSA in 2008 and has served as Managing Director of the Supervision Division since 2010. The Supervision Division includes prudential and conduct-oriented oversight of a variety of financial service providers. Inter alia, the Supervision Division oversees DFSA's role with auditors and credit rating agencies.

THE FOLLOWING PANELLISTS PARTICIPATED IN THE DISCUSSION:

Neslihan Alankus Erkazanci, Chief Financial Officer, MENA, HSBC Bank Middle East Limited

Neslihan has 21 years of experience in financial services, having joined HSBC Turkey as Deputy Director of Financial Planning in 2001, after previously working at Arthur Andersen in Turkey and in Luxembourg in audit and consultancy practices. After joining HSBC, she took an integral part in acquisitions and integrations of the Turkey business. In 2008 she was appointed CFO for HSBC Turkey, a role she held for seven years.

Zulfiqar Unar, Director Capital Markets and Accounting Advisory Services, PwC

Zulfiqar is a Director in the Capital Markets and Accounting Advisory Services team in the Middle East and leads the Complex Financial Instruments Accounting Advisory team including advising on accounting and financial reporting aspects in treasury functions. Zulfiqar leads PwC's regional Middle East IFRS 9 advisory services working closely with banks and banking regulators within the region to achieve a smooth, managed and consistent approach to IFRS 9 implementation.

Asim Rasheed, Group Financial Controller, Emirates NBD

Asim has over 20 years professional experience working with and advising banking and capital market institutions in the UK and Middle East. Asim is associated with Emirates NBD. In his role as Group Financial Controller Asim looks after external reporting (including the implementation of new standards), financial controls and taxation. Asim is currently leading the IFRS 9 project at Emirates NBD.

Trevor Skinner, Banking Supervision Expert

After a successful international banking career Trevor moved to a senior position in supervision and regulatory development at a major Middle East central bank where he remains today. He played a significant role in that central bank's response to the global financial crisis and acts as a focal point between the regulator and its regulated entities. He continues in that latter function and is part of that central bank's senior management team.

Where comments are attributed to an individual the views expressed are their own and are not necessarily views shared by ICAEW or DFSA.

Introduction

The IASB released the final version of IFRS 9 Financial Instruments (IFRS 9) in July 2014. IFRS 9 replaces IAS 39 Financial Instruments: Recognition and Measurement, which was generally found to be difficult to apply. The financial crisis brought the vagaries of IAS 39 into focus and highlighted the need for change. IFRS 9 is mandatory for annual periods beginning on or after 1 January 2018, with early application permitted.

IFRS 9 adopts a principles-based single classification and measurement approach for financial assets, based on their contractual cash flow characteristics and the business model in which they are held.

IFRS 9 also introduces a single approach to the impairment of financial assets. IAS 39's 'incurred loss' model is replaced with a more 'forward-looking' expected loss model. Under IFRS 9, it is no longer necessary for a loss event to have occurred before credit losses are recognised. Instead, the standard requires an entity to recognise a loss allowance for all financial assets based on expected credit losses. This addresses the need for more timely recognition of loan losses.

The classification and measurement requirements for financial liabilities are largely unchanged. The new standard does, however, introduce new requirements for accounting for changes in the fair value of an entity's own debt instruments when the fair value option has been applied. These changes were made to address the so-called 'own credit' issue and prevent entities from, somewhat counter intuitively, recognising gains in profit or loss when their own credit quality declines.

IFRS 9 also introduces a new hedging model that more closely aligns hedge accounting with an entity's risk management activities.

The focus of this briefing paper is the practical challenges arising as a result of an institution's transition from an incurred to expected loss model.

Impairment

Following the global financial crisis, the delayed recognition of credit losses on loans and other financial assets, as permitted by IAS 39, was deemed problematic. This led to the prescription of a forward-looking approach to impairment by the standard-setters.

IFRS 9 introduces an 'expected loss' approach to accounting for credit losses, which uses more forward-looking information than the IAS 39 approach and will result in earlier recognition of credit losses. Under IFRS 9 it is no longer necessary for a loss event to have occurred before credit losses are recognised. Instead, the standard requires an entity to recognise a loss allowance for all financial assets based on expected credit losses. The standard requires an entity to base its estimates of expected credit losses on reasonable and supportable information that is available without undue cost or effort, including historical, current and forecast information.

Under IFRS 9's general model, impairments are recognised in three stages to reflect the potential variation in credit quality of financial assets:

STAGE 1

Items that have not deteriorated significantly in credit quality since initial recognition. For these items, a loss allowance equal to 12-month expected credit losses is recognised and interest income is calculated on the gross carrying amount of the asset (ie, without reduction for the loss allowance).

STAGE 2

Items that have deteriorated significantly in credit quality since initial recognition but that do not have objective evidence of a credit loss event. For these items, a loss allowance equal to lifetime expected credit losses is recognised but interest income is still calculated on the gross carrying amount of the asset.

STAGE 3

Items that have objective evidence of impairment at the reporting date. For these items, a loss allowance equal to lifetime expected credit losses is recognised and interest income is calculated on the net carrying amount (ie, reduced for the loss allowance).

An item will move from stage 1 to stage 2 when there is a 'significant' increase in credit risk since initial recognition. If an asset is low credit risk at the reporting date, it can be assumed that its credit risk has not increased significantly.

An item will move from stage 2 to stage 3 when there is 'objective evidence' of impairment, such as a default or delinquency in interest or principal payments. It is only at this point that any loss allowance would have been recognised under IAS 39.

The amount of expected credit losses is updated at each reporting date to reflect changes in credit quality. Consequently, more timely information will be provided about expected credit losses.

Moderator guided discussion

WHAT ARE THE CHALLENGES OF IFRS 9 IMPLEMENTATION?

Zulfiqar Unar commented that 'the three and a half year implementation window for IFRS 9 reflected a recognition of the challenges involved, not just in the accounting, but also in collecting data; identifying and implementing the right IT solutions; and engaging and collaborating with internal and external stakeholders, including regulators.'

It was recognised that in emerging markets, such as the Middle East, these challenges are often far greater than in other markets with more established systems in place.

One of the most significant challenges identified by panelists was the availability and quality of data. Institutions need a large amount of historical, current and forward-looking data to build a model upon which judgements can be based about expected losses. Making such judgements will inevitably involve making difficult judgements about possible default events and whether payments will be received as due and, if not, how much will be recovered. Likewise, judgement will be needed to determine the point at which there is a significant increase in credit risk.

In this region, reliable macroeconomic data is less readily available than elsewhere. Where this information is generated by financial institutions themselves, extra care has to be taken to ensure its rigour.

The lack of a common definition of default presents a further challenge. Trevor Skinner commented that 'one of the challenges for regulators is to reconcile what we determine a default compared to what the bank determines a default; if we were to rely on institutions themselves to determine what is a default then they might present a more optimistic view. Banks generally want to take the lowest provision but regulators want to protect depositors.'

HOW WILL ENTITIES ENSURE THEY HAVE COVERED EVERYTHING?

Neslihan Alankus Erkazanci highlighted that 'IFRS 9 is a major change in the way we report financial assets. IFRS 9 implementation is not just a financial project but also a risk project. As such both the Chief Risk Officer and Chief Financial Officer are jointly responsible for the project's delivery.' Trevor added that 'big banks with relatively sophisticated risk management processes have this aspect well covered but data is the big issue. For small banks the risk management processes are typically lacking, so they have this to deal with in addition to data collection issues.'

Despite most entities starting their IFRS 9 journey some time ago, it is only now that most entities are starting parallel runs with dry runs planned for this year end. The large scale of the project means that a significant amount of work is being undertaken behind the scenes.

Asim Rasheed commented that 'the real challenge is whether we have done enough to cover all aspects of IFRS 9 to ensure we are not leaving unwarranted risks that may impact after the implementation. Implementation is very complex. There are a number of matters which require judgements/interpretation hence it is useful to involve your external auditors and independent consultants on an upfront basis. This should help to ensure coverage of all significant aspects of IFRS 9 and to conclude judgements/interpretation matters thereby avoiding any unwarranted risks in future. If I look back to 2015, most of the banks planned parallel runs in early 2017; however, due to the complexity of the matters this has been delayed to the second half of 2017. Delays have been attributable to challenges around availability of data, interpretation and treatment of various aspects of IFRS 9, and incorporating macroeconomic factors.'

One of the most significant challenges identified by panellists was the availability and quality of data

IFRS 9 implementation is not just a financial project but also a risk project

HOW DO ENTITIES INCORPORATE MACROECONOMIC FACTORS INTO THEIR ASSESSMENTS?

It was recognised that macroeconomic factors are a key driving force behind impairments of financial assets. Additional guidance on incorporating macroeconomic factors might encourage greater consistency between entities and allow users of financial statements to make better comparisons.

With HSBC's global presence, Neslihan acknowledged that 'incorporating macroeconomic factors across a global business is difficult but our regional footprints allow us to factor in local input. We have challenge sessions in the different regions.'

Asim explained that for Emirates NBD their main focus is the UAE macroeconomic landscape but that they will also include 'some specific overlays for the main territories in which they operate (eg, Egypt and Saudi Arabia). However, the challenge is identifying the macroeconomic scenarios that are relevant to your portfolios and need to be incorporated; and sourcing the information required. For global banks the application of macroeconomic factors is far more complex with both global and local considerations.'

Questions from the audience

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DO YOU HAVE A VIEW ON WHETHER REGULATORS SHOULD BE PUSHING FOR MORE CONSISTENCY ON MACRO-ECONOMIC IMPACTS AND INDICATORS OF DETERIORATING CREDIT QUALITY?

Neslihan said that 'it could be useful if the regulator could provide some guidance on how to adjust for the impact of macroeconomic factors, to enable standardisation across banks, otherwise we are going to end up with different interpretations and potentially more uncertainty for the reader. However, at the same time bank management should be able to use their judgement to interpret guidance.'

Asim said that 'the challenge is to ensure consistency in implementation by banks and consistency in approach followed by auditors. Regarding macroeconomic factors, it would be useful to have some guidance from the regulator about the source of information and number of scenarios.'

Trevor identified that 'the challenge would be about where to draw the line in providing guidance and how many macroeconomic factors should be considered. Also, macroeconomic factors should be reasonable and supportable, but it would be hard to prove that a forecast will be unbiased.' There is also the possibility that providing further guidance could increase risk. 'Regulators are not prescriptive. Prescribing models could increase systemic risk.'

Bryan Stirewalt added 'banks will complain, saying that regulators didn't tell us what to do. The regulators respond, telling the banks what to do. The banks will then say that the regulator's proposal is not reasonable. Only then will discussions start. In this spectrum, we're at the first stage.'

Q

WHAT NUMBERS ARE WE TALKING ABOUT? HAVE THERE BEEN IMPACT STUDIES AND WHAT ARE THEY SHOWING?

There is understandable concern that significant increases will be required to loan loss provisions, although those in the region more closely involved with the implementation of IFRS 9 have not seen this so far. Trevor explained 'local regulation has been fairly conservative on provisions for some years. For banking systems in this region the impact of IFRS 9 is not expected to be significant but will vary from institution to institution. Inconsistency between institutions is the biggest problem. Having worked with a number of banks, not many are saying that their IFRS 9 provisions will be greater than their current provisions. It's not about the numbers, it's an accounting change, regulatory change, risk management change and IT change.'

Prescribing models could increase systemic risk

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WHAT IS THE COST?

There is no 'one size fits all' answer to this. Estimating the cost of IFRS 9 implementation would vary from bank to bank. The starting point for implementation, challenges faced and the approach adopted to address those would be unique to each bank. Banks would need to ensure sufficient time and resources are made available to address the main challenges that are common to any IFRS 9 implementation project.

Zulfiqar observed that 'given the nature and scale of change and the expertise required (both internal and external), we have seen costs for IFRS 9 implementation run into the multiple millions of dollars. In addition to the first time implementation costs, banks need to factor into their annual budgets costs to maintain the credit risk models, related data and IT architecture and provide good governance over the ongoing operations under IFRS 9 reporting.'

Not many are saying that their IFRS 9 provisions will be greater than their current provisions

Conclusion

Many financial institutions are a long way into their projects in preparation for the implementation of IFRS 9. However, the challenges of a successful implementation cannot be underestimated. The wide-ranging scope of IFRS 9 across the finance, risk and IT areas of the business, as well as the additional complexities of data collection and interpretation mean that implementation projects are complex and time consuming.

Complexities of data collection and interpretation mean that implementation projects are complex and time consuming

Financial institutions cannot wait for regulators to issue further guidance. They must be proactive in their interpretation and implementation of IFRS 9. The challenges of reporting on an IFRS 9 compliant basis will continue to evolve. Financial institutions must ensure that their solutions are sufficiently dynamic to be able to respond to changes in the environment on an ongoing basis.

CONSIDERATIONS FOR AUDITORS

Emilio Pera, Head of Financial Services, KPMG Lower Gulf, provided insight into the proposed updates to the International Standard on Auditing (ISA 540) dealing with judgements (Auditing Accounting Estimates, including Fair Value Accounting Estimates, and Related Disclosures).

Emilio is part of the ISA 540 task group established in 2015 whose focus has been to review the auditing standard to ensure it also considers appropriately the requirements of IFRS 9.

A number of complexities have been identified by the ongoing review of the standard, including:

- geographies where quality data is not readily available as opposed to some more developed markets;
- suitable skill-sets and availability (particularly in relation to model design, development and validation); and
- the impact on other auditing standards (eg, use of experts) and whether any required changes to those standards would be affected in ISA 540.

Over recent months the focus has shifted towards requirements relating to the auditor's response to risk of material misstatement. To provide clarity, the standard is being restructured to consider requirements addressing specialist skills, work effort (complexity, judgement, estimation and uncertainty) and other items such as disclosure.

The proposed exposure draft is in its final stages of drafting and the expected timing for release of the final standard is the first quarter of 2018.

SOURCES AND FURTHER READING

IASB Publication: IFRS 9 Financial Instruments. July 2014 Project Summary.

ICAEW Financial Reporting Faculty publication: Introducing IFRS 9 Financial Instruments, IFRS Factsheet.

ICAEW Financial Reporting Faculty publications are available to members of the faculty. To join go to: icaew.com/joinFRF

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ICAEW MIDDLE EAST
Currency House
Unit 404 Level 4
Dubai International Financial Centre
PO Box 506836
United Arab Emirates

T +971 4 4080000
E measa@icaew.com
icaew.com

Chartered Accountants Worldwide
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