

In depth

A look at current financial reporting issues

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IFRS 9: Expected credit loss disclosures for banking

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At a glance

IFRS 9 introduces significant additional disclosure requirements relating to credit risk and expected credit loss allowances. Understanding the data and systems needed to meet these new requirements will be critical to ensuring the completeness of IFRS 9 project scopes, thereby avoiding revisions later in the project that could be costly and jeopardise project timings.

Simply replicating the illustrative disclosures included in IFRS 9 risks missing key information requirements. Considering these disclosure requirements as part of the broader consideration of internal management reporting and investor communications will also likely deliver significant benefits.

This 'In depth' sets out key considerations and what they will mean in practice.

Background

IFRS 9 includes consequential amendments to other accounting standards. The lengthiest amendments are to IFRS 7, 'Financial Instruments: Disclosures', with the introduction of significant additional disclosures relating to credit risk and expected credit loss allowances. Identifying the information and data required for these disclosures will often need detailed analysis and is unlikely to be simple:

- Banks should not plan to simply replicate the illustrative disclosures in IFRS 9, or else they risk being too simplistic and missing portfolio complexities.
- More detailed analysis than the published disclosures will typically be needed, in order to identify what should be separately disclosed.

There is also likely to be significant overlap between the data required for the new IFRS 7 disclosures and the data needed to address other broader stakeholder reporting needs for IFRS 9. Examples of this broader reporting might include:

Management reporting – what caused movements seen in IFRS 9 loss allowances and which factors contributed most?

Business planning and forecasting – how might loss allowances change in the future and what are the key sensitivities?

Investor & analyst questions – what effect did the change in macro-economic assumptions and other factors have on loss allowances?

Regulator requests – Enhanced Disclosure Task Force (EDTF) and other additional 'best practice' disclosures in annual reports or non-public reporting?

Understanding the required data and systems for all these needs will therefore be critical to ensuring the completeness of IFRS 9 project scopes and avoiding revisions later in the project that could be costly and jeopardise project timings.



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Practical issues

'Roll forward' reconciliations

To illustrate the potential complexities and considerations highlighted above, a good example is the requirement of paragraph 35H of IFRS 7 to present a reconciliation from the opening balance to the closing balance of the loss allowance (sometimes referred to as a 'roll forward' reconciliation).

This reconciliation is required by class of financial instrument and, for each class, by each of stages 1, 2 and 3 and purchased / originated credit-impaired assets. An illustrative example in IFRS 9 of how such a disclosure might look for mortgages, including supporting narrative disclosure, is reproduced below:

Mortgage loans-loss allowance	12-month expected credit losses	Lifetime expected credit losses (collectively assessed)	Lifetime expected credit losses (individually assessed)	Credit-impaired financial assets (lifetime expected credit losses)
CU'000				
Loss allowance as at 1 January	X	X	X	X
Changes due to financial instruments recognised as at 1 January:	X	-	(X)	-
- Transfer to lifetime expected credit losses	(X)	X	X	-
- Transfer to credit-impaired financial assets	(X)	-	(X)	X
- Transfer to 12-month expected credit losses	X	(X)	(X)	-
- Financial assets that have been derecognised during the period	(X)	(X)	(X)	(X)
New financial assets originated or purchased	X	-	-	-
Write-offs	-	-	(X)	(X)
Changes in models/risk parameters	X	X	X	X
Foreign exchange and other movements	X	X	X	X
Loss allowance as at 31 December	X	X	X	X

Significant changes in the gross carrying amount of mortgage loans that contributed to changes in the loss allowance were:

- The acquisition of the ABC prime mortgage portfolio increased the residential mortgage book by x per cent, with a corresponding increase in the loss allowance measured on a 12-month basis.
- The write off of the CUXX DEF portfolio following the collapse of the local market reduced the loss allowance for financial assets with objective evidence of impairment by CUX.
- The expected increase in unemployment in Region X caused a net increase in financial assets whose loss allowance is equal to lifetime expected credit losses and caused a net increase of CUX in the lifetime expected credit losses allowance.

Source: IFRS 9 para IG20B

Whilst this illustrative disclosure provides a helpful starting point, it is only intended as an illustration. As a result, it does not include a number of items which might be needed for mortgages or other types of loans, either as a separate row in the reconciliation or as supporting narrative disclosure. For example:

- Models/risk parameters: the impact of changes in models and risk parameters are combined in a single row in the illustrative disclosure. In practice, this might combine the effects of a range of factors, such as changes in credit ratings, changes to model assumptions or changes in forward-looking information. Some of these factors might be individually significant and require separate disclosure, particularly if economic expectations worsen and loss allowances increase significantly, as illustrated in the narrative disclosure opposite. In addition, when developing IFRS 9 models, granular data showing the impact of individual factors will typically be required for model development and model validation procedures, in order to give management comfort over the behaviour of their new models, particularly in stressed scenarios.
- Passage of time: loss allowances are likely to be impacted by the passage of time in a number of ways. As time passes, the effect of discounting expected credit losses will unwind. This is an item already commonly included by banks in existing disclosure of impairment allowance movements. Where assets have a remaining life of less than one year at the period end, part of the reduction in loss allowance will have arisen from the passage of time reducing the probability of default (PD), with the PD often calculated as 12-month PD x number of days to maturity / 365. This will particularly be the case for shorter-maturity loan books such as unsecured personal loans, where a stable overall loss allowance might result from a combination of increased loss allowances from new business and decreased loss allowances from loans nearing maturity or that have matured.

Transfers to lifetime expected losses: the illustrative disclosure includes a row showing the transfer of 12-month expected credit losses when an asset moves from stage 1 to stage 2 or 3. However, in many cases the loss allowance required will increase, potentially significantly, when an asset moves from stage 1 to stage 2 or 3, given that lifetime credit losses have to be recognised. This increase is not shown separately in the illustrative disclosure but is likely to be of interest to users of the accounts and be a material component of the period-on-period movement for many banks.

- Derecognised assets: as well as loans that have been fully derecognised during the period, the row 'Financial assets that have been derecognised during the period' will also need to include the effect on loss allowances of partial derecognition events. An example would be the receipt of a monthly capital and interest repayment on a mortgage. The effect of partial derecognition events might prove challenging to calculate if robust interfaces do not currently exist between cash management, accounting and/or risk systems.
- Loan modifications: under IFRS 9, modifications of loans that reduce the present value of contractual cash flows will typically result in a modification loss and a consequent reduction in the loss allowance will be required. Examples include interest payment holidays or maturity extensions, often referred to as 'forbearance'. Movements in loss allowances due to such modifications are not separately shown in the illustrative reconciliation or the related narrative. Given the other disclosures required by IFRS 9 for modified assets (see also 'Modifications' below), it might be desirable for some banks to show the impact of loan modifications on loss allowances separately in the reconciliation, in order to be internally consistent and to allow cross-referencing.

- Changes in gross carrying amount vs changes in credit quality: the effects of loan modifications will also need to be considered when addressing the related requirement of paragraph 35I of IFRS 7 to explain how significant changes in the gross carrying amount of financial instruments contributed to changes in the loss allowance. This requirement is illustrated in paragraph IG20B of IFRS 9 with a similar 'roll forward' reconciliation.

Some items in the loss allowance 'roll forward' reconciliation, such as newly originated loans or transfers from stage 1 to stage 2, will clearly result from either a change in the gross carrying amount or a change in credit quality. However, some items such as 'Foreign exchange and other movements' could result from both. So it might be beneficial to choose row descriptions that make clear the cause of the change. This could also support the grouping within the loss allowance 'roll forward' reconciliation of items that were caused by a change in gross carrying amount or by a change in credit risk.

- Acquisitions or originations of credit-impaired assets: the impacts on loss allowances of these items are specifically noted as excluded from the illustrative disclosure in paragraph IG20B of IFRS 9 and require reconciliation under paragraph 35H(c) of IFRS 7. Practically, this could be addressed by including an additional column in the reconciliation table.

As can be seen from these points, designing the format of the disclosure and scoping the related data requirements might be far more complex than first seems the case. Performing a detailed planning analysis of the various new disclosure requirements should therefore be a key part of IFRS 9 projects.

Sensitivities

Paragraph 35G of IFRS 7 contains a specific requirement to explain the inputs, assumptions and estimation techniques used in measuring loss allowances. It does not contain any specific requirement to also disclose the sensitivity of the loss allowance to those inputs, assumptions or estimation techniques. Nevertheless, sensitivities are an area that should be considered at the planning stage for a number of reasons.

Paragraph 125 of IAS 1 requires disclosure of major sources of estimation uncertainty at the end of the reporting period that have a significant risk of resulting in a material adjustment to the carrying amounts of assets and liabilities within the next financial year. For most banks, loss allowances will give rise to such a risk. Paragraph 129(b) of IAS 1 goes on to note that an example of such a disclosure might include the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including the reasons for the sensitivity.

Key sensitivities are also likely to be of interest to management, investors and analysts in explaining business performance and possible future movements in loss allowances. Where two banks use different macro-economic assumptions, understanding the sensitivity of loss allowances to those assumptions could also help investors and analysts to understand the possible impact of those differences.

Granularity of disclosure

Paragraph 35D of IFRS 7 states that an entity should consider how much detail to disclose in order to meet the overall objectives of the new credit risk disclosure requirements. The level of detail provided could have a significant impact on the resulting data requirements, and so should be a key planning consideration. In determining the appropriate level of detail, future possible economic scenarios should also be considered, as it is unlikely that current economic conditions and the resulting composition of loss allowances / movements will remain the same.

For banks operating in multiple geographies and asset classes, determining the level of detail to be provided is likely to be especially important.

A further challenge in designing these disclosures will be the inherent complexity of IFRS 9 loss allowance calculations. As an example, multiple macro-economic scenarios could be used to calculate expected losses in a particular geography, but different sets of scenarios might be relevant for different geographies. Time invested upfront will therefore be key to producing disclosures that are at an appropriate level of detail and integrated with any 'front half' credit risk disclosures in the annual report.

Modifications

Paragraph 35J of IFRS 7 requires disclosure explaining the nature and effect of modifications to financial assets with loss allowances measured at lifetime expected losses (that is, stage 2 or 3) that have not resulted in derecognition. These disclosures include the net modification gain/loss. Despite being included within the section on Credit Risk, there is a view that the disclosure covers *all* modifications and not just those made for credit reasons (in other words, forbearance). Given the risk of incompleteness, in practice it might be simplest for banks to initially capture data for all modified loans and not just those thought to be in stage 2 or 3. Where there are significant modifications for reasons other than forbearance, banks might also want to disclose these modifications separately, to avoid users of the accounts assuming that these modifications also relate to credit deterioration. Capturing robust, real-time data on the reasons for modifications will be key to doing this.

Other

In addition to the disclosures discussed above, which are likely to be the most challenging to implement, the new requirements include a range of other new disclosures. Those which are likely to be of particular interest to users of the accounts, given their insight into the measurement of loss allowances and explanation of the impact of IFRS 9 adoption, include:

- How an entity determined whether the credit risk of financial instruments has increased significantly since initial recognition, including, if and how:
 - (i) financial instruments are considered to have low credit risk in accordance with paragraph 5.5.10 of IFRS 9 (and so can be assumed to have had no significant increase in credit risk since initial recognition), including the classes of financial instruments to which it applies; and
 - (ii) the presumption in paragraph 5.5.11 of IFRS 9, that there have been significant increases in credit risk since initial recognition when financial assets are more than 30 days past due, has been rebutted. [IFRS 7 para 35F(a)]
- An entity's definitions of default, including the reasons for selecting those definitions. [IFRS 7 para 35F(b)]
- How the instruments were grouped, if expected credit losses were measured on a collective basis. [IFRS 7 para 35F(c)]
- On the date of initial application of section 5.5 of IFRS 9, information that would permit the reconciliation of the ending impairment allowances in accordance with IAS 39 and the provisions in accordance with IAS 37 to the opening loss allowances determined in accordance with IFRS 9. For financial assets, this disclosure should be provided by the related financial assets' measurement categories in accordance with IAS 39 and IFRS 9, and should show separately the effect of the changes in the measurement category on the loss allowance at that date. [IFRS 7 para 42P]