IFRS 9 leaves much open to interpretation

by Richard Crump

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IMPLEMENTATION EFFORTS for IFRS 9 can finally begin in earnest, but the failure of US and global rule makers to agree a fully converged standard could create a conundrum for investors when comparing US and non-US banks.

Under the new model, which will take effect in 2018, banks will have to provision for debts that go bad much earlier, which is expected to increase loan loss provisions on banks' balance sheets by about 50%, potentially forcing banks to set aside more capital to cover possible future losses.

In June, the IASB completed its long-awaited financial instruments accounting standard. Launched in response to the financial crisis, the new standard replaces the incurred-loss model in favour of a forward-looking approach and includes enhanced guidance for classification and measurement of financial assets and supplements new general hedge-accounting requirements.

Accountants have largely welcomed the standard as an improvement on the previous, discredited model, known as IAS 39, which allowed banks to overstate their profits and make inadequate provisions for loans that could go bad and so contributed to the financial crisis.

"It is an improvement in three levels," says Andrew Spooner, lead IFRS financial instruments partner at Deloitte. "The hedge-accounting requirements are more aligned with risk management activities and there is a more consistent approach to criteria for classifying a financial asset."

Nailing down an expected-loss model has proved extremely difficult, however, and the IASB has had to compromise by creating a standard that, while not conceptually pure, is something that is economically viable. The final solution is far from perfect but represents an approach that is more operational.

The new model introduces a three-stage process to loan-loss provisioning, based on a continuous assessment of the level credit risk. Specifically, it requires banks to recognise 12-month expected credit losses from when financial instruments are first recognised and to recognise full lifetime expected losses in instances where the loan's credit quality significantly deteriorates.

This approach has not been to everybody's taste and the IASB's so-called three-buckets approach has failed to placate critics of its previous incurred-loss model.

"The standard has absolutely no conceptual basis. The 12-month forward view of IFRS 9 is arbitrary and insufficient. The model is still an incurred-loss model where the loss event horizon has been pushed out 12 months," says Tim Bush, head of governance at shareholder pressure group Pirc and an outspoken critic of IAS 39.

"The standard may well be practically unworkable as the key measure of 12-month expected losses has no rational economic basis and is unlikely to inform any lending decisions, which should be appraised on lifetime losses."

Others are less critical and accept that the IASB has had to compromise between creating a conceptual standard or one that is operationally and economically viable.

"It is a better compromise between something that is conceptually pure and not booking massive day one loss impairments," says Chris Spall, KPMG's global IFRS financial instruments leader.

Judgement day

Hans Hoogervorst, chairman of the IASB, says IFRS 9 has introduced "much-needed improvements" to the reporting of financial instruments and is consistent with requests from the G20 for a forward-looking approach to loan-loss provisioning.

"The new standard will enhance investor confidence in banks' balance sheets and the financial system as a whole," Hoogervorst says.

Nevertheless, the new model will create challenges for preparers of account, particularly because of the increased need for judgement. "Estimating impairment is an art, rather than a science. It involves difficult judgements about whether loans will be paid as due – and, if not, how much will be recovered and when. The new model widens the scope of these judgements," explains Spall.

"Preparers will have to make new judgements, auditors will have to review them, and users of financial statements, including prudential and securities regulators, will have to understand them. A major issue for banks and investors in banks will be how adoption of the new standard will affect regulatory capital ratios. Banks will need to factor this into their capital planning and we expect users will be looking for information on the expected capital impacts.

"Credit risk is at the heart of a bank's business and applying the new standard will depend heavily on a bank's credit systems and processes."

The IASB has set up an implementation group to support stakeholders in the transition to the new impairment requirements. According to Bush, this is "unheard of" and is an attempt by the IASB "to try to control what is likely to be a chaotic and embarrassing implementation process".

Again, others are more generous. Spooner at Deloitte says it "makes a lot of sense" because of the "seismic changes" taking place, while Steven Cooper, IASB board member, says the group is being set up because of the element of judgement in the forward-looking model.

"It is important people interpret the standard consistently," he says.

Hitting the buffers

Efforts between the IASB and US counterpart FASB to create a converged standard failed. The project hit the buffers in 2012 after the boards expressed different views about how to account for the impairment of financial instruments. FASB's standard, which is still being deliberated, is likely to recognised losses up-front and distanced instead of IASB's so-called three-bucket approach.

Commentators have said it is "regrettable" the IASB and FASB were unable to come to an agreed solution. The two different models will likely prove a bugbear for investors.

"Having different rules under US GAAP and IFRS will mean a lack of comparability for investors between the results of banks reporting under the different frameworks, and increased costs for those banks that have to prepare figures under both accounting frameworks," says Spall.

It is also unlikely that banks will bridge the gap between the two models by disclosing the expected lifetime losses that the FASB may require. According to Deloitte's fourth global IFRS banking survey, 80% of banks doubted that the benefits of disclosing lifetime expected losses would justify the additional effort.

"Banks see little value in calculating and disclosing this information ahead of such deterioration [in credit risk]," the report said.

In terms of transitioning to the new standard, it has a mandatory effective date of 1 January 2018 but can be adopted early. Spall expects banks will need the whole period to prepare for adoption of the expected credit loss requirements.

"The long lead time to mandatory adoption and the different possibilities for IFRS 9 adoption could mean a protracted but temporary period of diversity. In many jurisdictions, including the European Union, companies will not be able to adopt the new standard until it is legally endorsed or permitted by regulators. Given the significance of the standard to the financial services sector, the road to endorsement may be longer and more winding than usual," he concludes.