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IFRS 9 for Cooperatives

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Agenda

1. How is IFRS 9 Different?
2. IFRS 9 Implementation Checklist for Cooperatives
3. IFRS 9 Impacts on Regulatory Capital and Volatility
1. How is IFRS 9 Different?
A New Impairment Accounting Rule

5.5.17 An entity shall measure expected credit losses of a financial instrument in a way that reflects:

(a) an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes;

(b) the time value of money; and

(c) 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.

Source: International Financial Standard 9 Financial Instruments
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<thead>
<tr>
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<th>IAS 39</th>
<th>IFRS 9</th>
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<td><strong>Backward-looking</strong></td>
<td><strong>incurred loss</strong> approach.</td>
<td><strong>Forward-looking</strong></td>
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<td>Concerns of ‘too little, too late’</td>
<td><strong>expected loss</strong> approach</td>
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<td>Consider only historical experience and current conditions</td>
<td>Consider also future conditions</td>
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<td>Provision only if there is possibility of impairment</td>
<td>Provision as soon as credit is originated</td>
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<td>Provision for 12 months, unless impaired</td>
<td>Provision for 12 months or lifetime based on credit riskiness</td>
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**IAS 39** and **IFRS 9**
2. IFRS 9 Implementation Checklist
Key Implementation Steps

1. Classify loans into one of three credit impairment ‘stages’
2. Select credit loss models
#1. Classify Loans into ‘Stages’ Based on Credit Riskiness

**STAGE 1: “PERFORMING”**
- Borrower is current
- Provision for 12 month expected losses as soon as loan is originated or acquired
- Calculate interest income on gross basis.

**STAGE 2: “UNDER-PERFORMING”**
- Credit quality has deteriorated significantly since origination, though borrower could still be current.
- Provision for lifetime expected losses
- Calculate interest income on gross basis

**STAGE 3: “NON-PERFORMING”**
- Borrower is in technical default.
- Provision for lifetime expected losses
- Calculate interest income on net basis

*Special measurement requirement applies to purchased or originated credit-impaired financial assets, trade and lease receivables, and contract assets*
Q. When does a loan move from Stage 1 to Stage 2?

A. When there is ‘SICR’

Q. How is SICR defined?

A. It is NOT defined! It is highly judgmental!
Assessment of SICR typically based on …

A. Quantitative element

Estimate relative increase in default risk since initial origination
  i. Compare change in lifetime PDs, considering residual life
  ii. Use external ratings

B. Qualitative elements

C. Backstop indicator

Choose a reasonable threshold of change.
Too narrow window → volatility in allowances
Too broad window → late recognition of losses
#2. Select Credit Impairment Models

Probability of Default \( \times \) Loss Given Default \( \times \) Exposure at Default \( \times \) Discount Factor = Expected Credit Loss

- **PD Models**
  - Macro-conditioned point-in-time PD
  - Lifetime PD/PD Term Structure

- **LGD Models**
  - Macro-conditioned point-in-time LGD
  - Lifetime LGD/LGD Term Structure

- **EAD Models**
  - Lifetime EAD/EAD Term Structure
  - Prepayment
#3. Select Economic Scenarios & Prob. Wts

**Scenario Examples**

- **BL** Baseline Forecast (50\(^{th}\) pctile)
- **S0** Strong Upside (4\(^{th}\) pctile)
- **S1** Stronger Near-Term Growth (10\(^{th}\) pctile)
- **S2** Slower Near-Term Growth (75\(^{th}\) pctile)
- **S3** Moderate Recession (90\(^{th}\) pctile)
- **S4** Protracted Slump (96\(^{th}\) pctile)

Use minimum 3 scenarios – a **baseline, an upside and a downside**

Calculate the ECL (over 12m or lifetime) **for each scenario**. Take the probability weighted average of these ECLs.
3. IFRS 9 Impact on Loss Provisions, Regulatory Capital & Volatility
Impact on Impaired Loans

Impaired loans / Gross loans, YE 2018 vs YE 2017

Impact of IFRS 9 clouded by changes in managerial decisions and operating environment

- Italian banks cleaned up bad loans
- Asset quality deteriorated in Russia and Turkey

Sources: Moody’s Analytics analysis using BankFocus data, June 2019
Impact on Loan Loss Reserves

Loan loss reserves / Gross loans, YE 2018 vs YE 2017

Impact of IFRS 9 clouded by changes in managerial decisions and operating environment

Sources: Moody’s Analytics analysis using BankFocus data, June 2019
Impact on Regulatory Capital

CET 1 ratio, YE 2018 vs YE 2017

Increase in profitability checked the drop in EM regulatory capital

Sources: Moody’s Analytics analysis using BankFocus data, June 2019
1. Basel Committee’s Transitional Capital Add-back Standard for IFRS 9 allows the impact on regulatory capital to be phased in over 5 years.

2. IFRS 9 standard’s ‘practical expedient’ allows institutions to omit the discounting of expected future cashflows.
Beyond Day 1: Volatility in Provisions, Earnings and P&L

Sources of quarter-over-quarter volatility

1. Changes in macroeconomic outlook
2. Transition between credit risk stages

Challenge is to understand and communicate this to members
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