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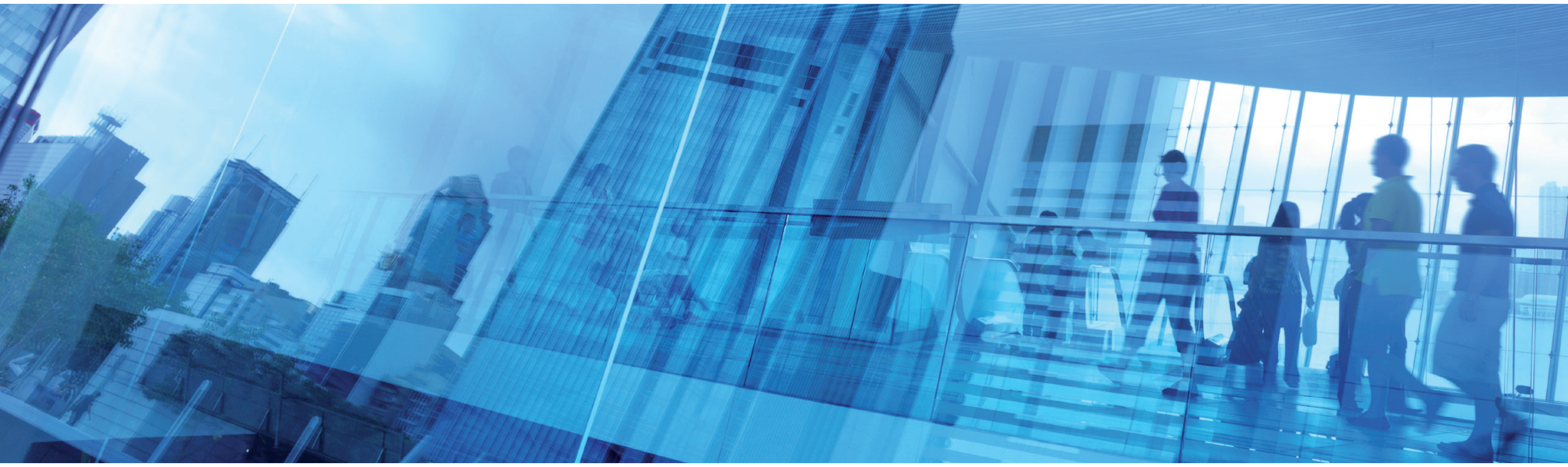

RISK

IFRS 9: A silent revolution in banks' business models

Banks have addressed the technical requirements of the new rules, but what about their significant strategic implications? Here's how to prepare.

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Over the past few years, European banks have been preparing for the implementation of International Financial Reporting Standard 9, a new accounting principle for financial instruments that becomes effective in January 2018. IFRS 9 will change the way banks classify and measure financial liabilities, introduce a two-stage model for impairments, and reform hedge accounting (see sidebar, "What is IFRS 9?"). In preparing for the new principle, banks have dedicated most of their efforts to technical and methodological issues—in particular, how to incorporate forward-looking macroeconomic scenarios into their existing models and processes.

Essential though this work is, banks run the risk of overlooking the strategic repercussions of the new standard. These repercussions will be so significant—requiring banks to rethink their risk appetite, portfolio strategy, and commercial policies, among other things—that we believe nothing less than a silent revolution is under way. If banks fail to grasp the importance of IFRS 9 before it comes into force, they will have to manage its impact reactively after the event, and could lose considerable value in doing so.

Why a revolution? What IFRS 9 could mean for your business

We believe banks face a number of strategic and business challenges in adapting to the new environment under IFRS 9. Addressing these challenges will require fundamental changes to their business model and affect areas as diverse as treasury, IT, wholesale, retail, global markets, accounting, and risk management. Banks that

What is IFRS 9?

IFRS 9 is an international financial reporting standard published by the International Accounting Standards Board (IASB) in July 2014. It will replace the existing standard, IAS 39, in 2018 and will introduce important changes to accounting rules for financial instruments in three main areas:

Classification and measurement. The basic accounting model for financial liabilities under IAS 39 remains intact, with its categories of "fair value" and "amortized cost." However, under IFRS 9, a financial instrument must meet two conditions to be classified as amortized cost: the business model must be "held to collect" contractual cash flows until maturity, and those cash flows must meet the "SPPI criterion": solely payment of principal and interest. Financial instruments that fail to meet the SPPI criterion—such as derivatives that generate a trading profit—will be classified at fair value, with gains and losses treated as other comprehensive income (FVOCI) or through profit or loss (FVTPL). A major consequence of this change will be an increase in P&L volatility as the value of financial instruments is constantly adjusted to the current market value.

Impairment. The "current incurred loss" impairment model of IAS 39 is being replaced by an "expected loss" model that recognizes two types of performing credit exposure: stage 1 exposures that have experienced no significant change in credit quality since origination, and stage 2 exposures that have experienced significant deterioration. Stage 1 impairments will be based on a one-year expected credit loss (ECL) rather than on an incurred loss, while stage 2 impairments will be based on lifetime ECL—that is, the probability of defaulting during the whole life of the exposure, taking into account current and future macroeconomic conditions. This will require banks to make higher loan-loss provisions on performing exposures, and the sharp rise in risk costs for stage 2 liabilities could mean that some clients or parts of the business are no longer profitable. Banks will also need to monitor fully performing exposures more closely to prevent them from migrating to stage 2.

Hedge accounting. IFRS 9 introduces reforms in hedge accounting to better align banks' accounting practices with their risk-management activities. It increases the range of exposures that can be hedged to include derivatives embedded in financial liabilities or nonfinancial contracts, and nonderivative foreign-exchange financial instruments measured at fair value. It also recognizes changes in currency base spread in other comprehensive income (OCI). One major consequence of this change is that noncore elements of derivatives (such as the time value of options) can be excluded from hedge accounting, and fair-value changes in them will no longer affect P&L as a trading instrument but will be recognized in other comprehensive income instead. IFRS 9 also allows banks to hedge nonfinancial items, such as the crude-oil component of jet fuel.

These changes, especially the new impairment framework with its stage 2 classification, will have a substantial impact on banks. We expect to see a 20 percent increase in provisions in first-time adoption and a 30 to 40 percent P&L impairment volatility caused by the allocation and release of provisions on loans entering and exiting from stage 2 on a recurring base. This volatility will be mainly generated by commercial clients, which typically have a higher probability of default and a lower collateralization. The range of these estimates is in line with impact assessments conducted by the European Banking Authority in 2016.[1]

[1] See *Report on Results from the EBA Impact Assessment of IFRS 9*, European Banking Authority, November 2016, p. 33, eba.europa.eu.

start to plan for these changes now will have a considerable advantage over those that have yet to consider the full implications of IFRS 9 for their business. To help banks get ahead, we have identified strategic actions in five areas: portfolio strategy, commercial policies, credit management, deal origination, and people management.

1. Adjusting portfolio strategy to prevent an increase in P&L volatility

IFRS 9 will make some products and business lines structurally less profitable, depending on the economic sector, the duration of a transaction, the guarantees supporting it, and the ratings of the counterparty. These changes mean that banks will need to review their portfolio strategy at a much more granular level than they do today.

- *Economic sector.* The forward-looking nature of credit provision under IFRS 9 means that banks will need to reconsider their allocation of lending to economic sectors with greater sensitivity to the economic cycle.
- *Transaction duration.* The more distant the redemption, the higher the probability that the counterparty will default. Under IFRS 9, stage 2 impairments are based on lifetime ECL—the expected credit losses resulting from all possible default events over the expected life of the financial instrument—and will therefore require higher loan-loss provisions.
- *Collateral.* Unsecured exposures will be hit harder under the new standard. Collateral guarantees will help mitigate the increase in provisions for loss given default under IFRS 9, particularly for exposures migrating to stage 2.
- *Counterparty ratings.* IFRS 9 imposes heavier average provision "penalties" on exposure to higher-risk clients, so counterparty ratings will have a direct impact on profitability. Industry observers expect provisioning for higher-risk performing clients to rise sharply once the new framework is in place.

This shift in structural profitability suggests that banks should, where possible, steer their commercial focus to sectors that are more resilient through the economic cycle. This will reduce the likelihood of stage 1 exposures migrating to stage 2 and thereby increasing P&L volatility. Higher-risk clients should be evaluated with greater care, and banks could introduce a plafond (credit limit) or other measures to restrict the origination of products most likely to be vulnerable to stage 2 migration, such as longer-duration retail mortgages and longer-term uncollateralized facilities, including structured-finance and project-finance deals.

Banks could also consider developing asset-light "originate to distribute" business models for products and sectors at higher risk of stage 2 migration. By originating these products for distribution to third-party institutional investors, banks could reduce their need for balance-sheet capacity for risk-weighted assets and funding, and avoid the large increase in provisions they would otherwise have to make for stage 2 migration. Pursuing such a strategy would involve developing an analytical platform that can calculate fair-value market pricing for each corporate loan and enable banks instantly to capture opportunities for asset distribution in the market.

2. Revising commercial policies as product economics and profitability change

IFRS 9 will reduce profitability margins, especially for medium- and long-term exposures, because of the capital consumption induced by higher provisioning levels for stage 2. In particular, exposures with low-rated clients and poor guarantees will require higher provisions for stage 2 migration. For loans longer than ten years, provisions for lifetime expected credit losses may be up to 15 to 20 times higher than stage 1 provisions, which are based on expected loss over 12 months. To offset this negative impact on their profitability, banks can adjust their commercial strategies by making changes in pricing or product characteristics:

- *Pricing.* When possible, banks should contractually reach agreement with clients on a pricing grid that includes covenants based on indicators that forecast the probability of migration to stage 2, such as the client's balance-sheet ratio and liquidity index. If a covenant is breached, the rate would increase—for example, by 10 to 20 basis points to compensate for the extra cost of stage 2 for exposures between five and ten years, and by 25 to 35 basis points for exposures longer than ten years. If flexible pricing is not possible, the expected additional cost of a stage 2 migration should be accounted for up front in pricing. This cost should be weighted by the expected time spent in stage 2: for example, 3 to 5 basis points on average for exposures with a maturity of five to ten years, and 5 to 10 basis points for those longer than ten years.

- *Product characteristics.* Banks could adjust maturity, repayment schedule, pre-amortization period, loan-to-value, and break clauses to reduce the impact of IFRS 9 on their profitability. In particular, they should aim to reduce their maturity and amortization profile by providing incentives to relationship managers and clients to shift to shorter-term products, and by introducing new products or options that allow early redemption or rescheduling.

3. Reforming credit-management practices to prevent exposures from deteriorating

Under IFRS 9, the behavior of each credit facility after origination is an important source of P&L volatility regardless of whether the exposure eventually becomes nonperforming. Banks therefore need to enhance performance monitoring across their portfolio and dramatically increase the scope of active credit management to prevent credit deterioration and reduce stage 2 inflows. Different approaches can be used to do that, including an *early-warning system* or a *rating advisory service.*

Forward-looking early-warning systems allow banks to intercept positions at risk of migrating to stage 2. This system would extend the scope of credit monitoring and shift responsibility for it from the credit department to the commercial network. "Significant deterioration" will be measured on a facility rather than a counterparty level under IFRS 9, so virtually every facility will need to be monitored to preempt the emergence of objective signs of deterioration, such as 30 days past due. Monitoring facility data and ensuring that information about guarantees is complete and up to date will be vital in preventing the expensive consequences of migrations to stage 2.

The commercial network should be fully involved in a structured process through which risk management flags any facility approaching migration and identifies the likely reason: for instance, a deterioration in a debtor's short-term liquidity or a problem with data quality. An algorithm—or a credit officer—then assigns possible remediation and mitigation actions, such as opening a short-term facility to solve a liquidity issue or updating balance-sheet indicators to improve data quality. Finally, the relationship manager sees the flagged position and proposed remedial actions on the system and contacts the client to discuss a set of strategies. These might include helping the client improve its credit rating through business or technical measures like those just mentioned, taking steps to increase the level of guarantees to reduce stage 2 provisioning, and adjusting timing and cash flows in the financing mix to the assets being financed so that long-term maturities are used only when necessary.

By a *rating advisory service*, banks could advise clients on ways to maintain good credit quality, provide solutions to help them obtain better terms on new facilities, and reduce their liability to migrate to stage 2. Banks could offer a fee-based service using a rating simulation tool that enables credit officers and relationship managers to propose how clients could improve their rating or prevent it from worsening. The tool would need to include a macroeconomic outlook and scenarios to forecast how different economic sectors might evolve; a list of actions for improving or maintaining the client's rating in situations such as a drop in revenues, declining profitability, or liquidity issues; and a simulation engine to assess how ratings may evolve and what the impact of various actions could be.

Over time, the bank could build up a library of proven strategies applicable to a range of client situations.

4. Rethinking deal origination to reflect changes in risk appetite

IFRS 9 will prompt banks to reconsider their appetite for credit risk and their overall risk appetite framework (RAF), and to introduce mechanisms to discourage credit origination for clients, sectors, and durations that appear too risky and expensive in light of the new standard.

For example, if banks consider global project finance to be subject to volatile cyclical behavior, they may decide to limit new business development

The new US standard: CECL

Banks active on both sides of the Atlantic face the additional operational challenge of managing two different standards at once when the CECL model is introduced in the United States.

The current expected credit losses (CECL) model is part of an update to the United States' generally accepted accounting principles (GAAP) standard on credit losses, introduced by the American Financial Accounting Standards Board (FASB). Like International Financial Reporting Standard 9 (IFRS 9), it marks a move from an incurred-loss to an expected-credit-loss model. Both standards share the same objective: correcting the weakness in previous accounting requirements that led to too few credit losses being recognized at too late a stage during the financial crisis. But there are also important differences between the two standards:

Phasing in. IFRS 9 applies from 2018, CECL from 2020.

Measurement of expected credit losses. CECL foresees a single model for calculating lifetime losses; IFRS 9 sets out two models for calculating losses, with a 12-month horizon for stage 1 exposures and a lifetime duration for stage 2.

Operational and capital implications. The dual measurement model introduced by IFRS 9 requires additional operational effort from banks to scrutinize every asset at every reporting period to determine whether it might transfer from stage 1 to stage 2 or vice versa. This activity is not required under CECL, because all credit losses are measured over the lifetime of the instrument. This approach could, however, require higher provisioning than under IFRS 9.

in such deals. To react quickly and effectively to any issues that arise, they should also adjust the limits for project finance in their RAF, review their credit strategy to ensure that new origination in this area is confined to subsegments that remain attractive, and create a framework for delegated authority to ensure that their credit decisions are consistent with their overall strategy for this asset class.

5. Providing new training and incentives to personnel to strengthen the commercial network

As banks are forced to provide for fully performing loans that migrate to stage 2, their commercial network will need to take on new responsibilities.

In particular, relationship managers will assume a pivotal role, becoming responsible for monitoring loans at risk of deterioration and proposing mitigation actions to prevent stage 2 migration, as noted above. However, most relationship managers have sales and marketing backgrounds, and though they typically originate loans, they do not actively manage them thereafter. As a result, they will need to be trained in new skills such as financial restructuring, workout, and capital management to help them deal with troubled assets effectively.

In addition to introducing training programs to build these capabilities, banks should review their incentive systems to ensure that relationship managers (RMs) are held accountable for any deterioration in credit facilities in their portfolio. The RMs should be evaluated and compensated on an appropriate risk-adjusted profitability metric, such as return on risk-weighted assets, return on risk-adjusted capital, or economic value added, with clear accountability for how well stage 2 costs are managed.

The strategic and business implications of IFRS 9: A CEO checklist

Most banks have been busy addressing the methodological and technical aspects of IFRS 9—but only a few have got as far as considering and acting on business implications.[1] To anticipate the far-reaching strategic impact, CEOs, CROs, and heads of business will need to challenge existing IFRS 9 programs with sets of important questions in each of the five areas we have been discussing.

1. Implications for portfolio strategies. Should we revise our credit portfolio allocation and lending policies?

- Should we reduce lending to volatile sectors with a poorer outlook? How do we reflect this in our lending policies?
- Should we weigh the financial duration of portfolios more heavily in our lending decisions and reduce lending on long-term transactions?
- Should we focus on collateralized lending portfolios to mitigate loss given default and reduce lending to unsecured exposures?
- Should we treat higher-risk clients differently in our lending decisions? Should we scrutinize lending to performing high-risk clients more thoroughly? How should we reflect this in our risk appetite?

2. Impact on commercial policies. Should we rethink our product offering? Should we adjust our pricing to sustain profitability?

- Should we adjust maturity and amortization to shorten product lifetimes? How can we encourage relationship managers and clients to shift to products with shorter terms or early-redemption options?
- Should we raise prices for longer-term and less collateralized products and for higher-risk clients? Would that damage our competitive position?

3. Changes to credit risk management. Should we strengthen our monitoring of counterparty and data quality to prevent increases in ECL?

- Should we improve our early-warning mechanisms to detect any deterioration in a client's lifetime credit risk?
- Should we increase our monitoring of collateral data?
- How should we flag warning signs to our relationship managers to trigger remedial actions?

4. Evolution of deal origination. Should we adjust our credit strategy and policies to change the course of new business development?

- Should we introduce new risk limits for the clients, sectors, or products most affected by IFRS 9?
- Should we change our origination process—for example, by adopting a delegated-authority system or improving the link between our risk-appetite framework and our underwriters?

5. Impact on people management. Should we revise our incentive and compensation schemes for relationship managers? Should we change their accountability?

- Should we change our performance metrics to reflect IFRS 9–adjusted profitability?
- Should we provide training for our relationship managers on the consequences of IFRS 9 and appropriate remedial actions?

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The introduction of IFRS 9 is likely to change banks' behavior and reshape the credit landscape for some products and segments—but it may also tempt nonbanks into the market. In particular, banks should keep a watchful eye on the alternative lending sector. Credit provision by private equity, mini-bond issuers, insurance companies, and the like has grown by more than 20 percent in Europe in the past five years alone. These new competitors are governed by a less stringent regulatory framework and could pose a growing threat to banks, especially if they are slow to react to the new challenges and costs of IFRS 9.

There is little time left to prepare. To anticipate the repercussions of the new standard and control how they play out, banks must move fast. The silent revolution of IFRS 9 will affect all banks, ready or not. The effort taken to understand the new rules and put a response in place will be well spent. ■

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[1] US banks have begun addressing similar issues under US regulatory changes. See sidebar "The new US standard: CECL."

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