Regulation Asia

IFRS9

Regional Insights

2017 Asia Pacific
Market Survey

June, 2017

In association with

S&P Global
Market Intelligence

Domestic institutions in Asia have a long road ahead to meet the January 2018 deadline for reporting under IFRS 9 (the 9th International Financial Reporting Standard). The IFRS 9 Financial Instruments rule was introduced by IASB (the International Accounting Standards Board) in July 2014 to provide a model for classification and impairment of financial instruments as well as hedge accounting.

IFRS 9: An Overview

IFRS 9 adopts a principles-based approach in classifying financial assets and liabilities based on business models and cash flow. The rule also provides for a single impairment model to facilitate the recognition of expected credit loss.

This new model represents an overhaul of hedge accounting that aligns accounting treatment with risk management activities, enabling entities to better reflect these activities in their financial statements. In addition, the changes mean users of financial statements will receive better information about risk management and the effect of hedge accounting on financial statements.

The new rule replaces IAS 39, which recognises loan losses at the point of loss. IFRS 9, on the other hand, will require banks to estimate ECL (expected credit losses) on financial assets on an ongoing basis and provision as needed.

Participants expect the new rule to effect a substantial change to the way they approach impairment, specifically in calculating expected credit loss. One of the largest challenges revolves around collecting data on historical credit behaviour in various portfolios, which tends to be harder on tier 2 and tier 3 banks with a predominantly domestic focus.

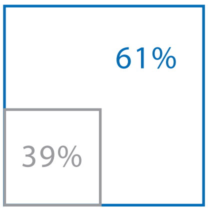
Survey

Regulation Asia in association with S&P Global Market Intelligence surveyed 189 respondents in 13 countries in Asia to gauge their readiness for IFRS 9 implementation by the January 2018 deadline, exploring implementation challenges, objectives, operational practices and costs.

30 percent of respondents were banks, financial institutions and corporates with annual revenues of more than USD50 billion . Several small and mid-sized institutions also spoke about their unique challenges with IFRS 9. Their comments are presented below. Many respondents are based in Hong Kong and Singapore with a substantial proportion in Thailand, Taiwan and South Korea.

This report presents S&P Global Market Intelligence and Regulation Asia's survey findings and outcomes from in-depth discussions with some of the respondents as well as institutions not captured by the survey.

Key Findings



61 %

Expect no deadline delay for financial reporting past January 1, 2018 deadline

1. Preparation and timeline

More than 60 percent of respondents do not expect the implementation deadline in their jurisdiction to be delayed beyond January 2018. Given the new standards are expected to converge to their local equivalent, almost all the respondents from China expect an extension in the deadline for IFRS 9 implementation.

Close to half of respondents have begun preparation for IFRS 9 and nearly a third are fully prepared. Firms that expect the timescale around the production of ECL to expand increased between December 2016 and March this year , as firms in later stages of preparation dealt with challenges around corporate lending and SME (small and medium-sized enterprise) data.

Lacking dedicated teams and with a heavy reliance on external resources, non-bank financials and insurers are the least prepared of all survey respondents, with more than three-quarters expecting to need deadline extensions.

The bulk of respondents (75 percent) say they will use a combination of internal and external resources to ramp up implementation of IFRS 9. Banks prefer to partner internal teams with external experts to bridge technical skill gaps. Corporates and insurers as well as respondents in emerging markets like China,

> *Smaller firms are caught in a 'Catch-22' where building up internal resources and expertise for IFRS 9 requires help from external resources, but bringing in external resources - specifically the Big Four consultants - requires a critical mass of internal expertise.*

Indonesia and India are most reliant on external resources. Yet these groups also indicated a preference for internally developed models (73 percent).

A senior accounting executive at a large Philippine bank told *Regulation Asia* that most banks in the Philippines are "racing against time" to meet the deadline set by regulators. The Philippines is integrating IFRS 9 into local standards, so banks in the country were able to adopt some aspects of the rule as early as 2013. However, as the final circular was released in November 2016, most banks are still in the preparation stage for installing a compliant provisioning and credit risk-modeling process.

Overall confidence in internal technical expertise dropped between December (56 percent) and March (40 percent). Smaller firms are most likely to partner for gaps in technical expertise. One interviewee at an Indian bank licensed only last year called the process of building internal expertise "daunting" and "intimidating."

He says smaller firms are caught in a 'Catch-22' where building up internal resources and expertise for IFRS 9 requires help from external resources, but bringing in external resources - specifically the Big Four consultants - requires a critical mass of internal expertise.

"We have to be lean in how we use external partners. Getting implementation help from outside consultants means we need to identify key requirements internally. This in turn requires technical knowledge that we are still developing," he says.

Several smaller banks, the executive points out, are bringing in external trainers and holding workshops for risk and accounting employees to generate a critical mass of internal knowledge. This is potentially burdensome on the existing personnel of banks, who will have to take on additional, more complex tasks in addition to their daily responsibilities.

Corporates are much better prepared - primarily due to the relative simplicity of their financial instruments. According to executives at a large Thai firm involved primarily in commodities hedging, they don't expect any addition to their workforce as a result of IFRS 9.

"We are not really bringing in any new staff for the projects. We have the technical capability and our current staff can manage this. We have between six months to a year to prepare and so from that perspective, developing models and coordinating is not such an issue," the Thai executive explains.

Thailand is implementing IFRS 9 directly in January 2019 with the finalised version of the domestic standard expected to be issued later this year.

2. Model development

Regulation from BCBS (the Basel Committee for Banking Supervision) has been directed towards encouraging banks to use internal models and analysis to develop forward-looking credit models. IFRS 9 is pushing banks in the opposite direction. Integrating Basel III models with IFRS 9 and ensuring compatibility in the selection stage is a pressing issue, as bringing together risk and finance is uncharted territory for banks in the region.

Almost half (43 percent)of the respondents are in the process of preparing for model selection.

According to a Singapore-based tax consultant, banks will need a suite of models that reduce volatility in provisioning and increase the level of integration between the risk and accounting functions.

"IFRS 9 is a good step towards a more robust and integrated risk management culture and is the logical next step in the risk-based approach championed by Basel III," he explains.

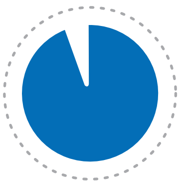
Financial assets need to be a part of risk models that provide an ongoing picture of profit and loss. Although the required investment is heavy, most banks have already done similar calculations for Basel III and put infrastructure in place.

"They should pick a model that can build and leverage on this work rather than inventing the wheel anew." the consultant says.

Banks that have already adopted the internal modeling approach to calculate credit risk under Basel II and Basel III can expect some synergies between Basel and IFRS 9. But, in emerging markets, most smaller banks have been using the standardised approach, making IFRS 9 a relatively tougher transition.

"We adopted the PD (probability of default) calculation under Basel II for risk management, so our credit modelers are confident that that is something they can build upon for ECL calculation under IFRS 9.

We are exploring similar synergies in the LGD (loss given default) framework," explains an executive at a large private bank in Thailand.



92 %

92% of respondents are still in some stage of preparation.

43% of firms have already gone past the stage of model selection;

49% are already in the process of preparing for selection; and

8% haven't started process but are confident of meeting Jan 1, 2018 deadline.

3. Data Availability

Sixteen percent of respondents cited data availability for ECL modelling as a key challenge in IFRS 9 implementation, and over half are now reviewing data availability to build impairment models. Tier 2 and 3 banks are most concerned about data. This potentially explains why the survey shows that smaller institutions are predisposed towards using practical expedients in model development, whereas larger institutions are more concerned about potential biases arising from the use of these expedients.

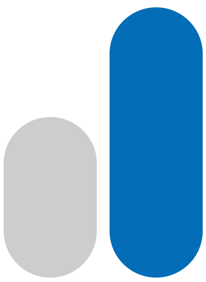
The survey also shows data availability is a big concern, predominantly in developed markets like Hong Kong, Singapore and Australia. The Philippines was the only emerging market where respondents (80 percent) did not perceive data availability to be a challenge, with the remaining 20 percent saying they have large data gaps in estimating ECL.

Many of the banks that spoke to *Regulation Asia* say they will have a more complete picture of their data availability after they are done with developing models. "Since we are still in the middle of the model development process, we are not confident if we have captured enough information. The standard doesn't specify how far back in time we need to go in terms of the starting point of the model," says the Philippine bank executive.

A senior risk management executive at a domestically-focussed bank in India explains that collecting historical data for financial assets is potentially simpler, since these form a smaller part of the business. Compared to data collection for Basel III calculations, which involve a larger amount of data culled from branches with uneven collection infrastructures, financial asset data is usually kept at the treasury and risk management levels, where data collection is much more robust.

He points out, however, that although banks in emerging jurisdictions have been transitioning to a greater level of data collection on the behaviour of their own loan portfolios under Basel III, expanding its scope to financial assets and linking this to accounting requires substantial resources for internal processes and personnel training. The Indian risk management executive tells Regulation Asia:

"We are just coming to grips with loan data analysis for PD and LGD calculations under Basel III, and this is our central business. Financial derivatives form a small part of our portfolio and the significance of operational and accounting changes required here



38 %

Shift in expectations for timescale required to accommodate the production of Expected Credit Loss (ECL) number (Dec 24%; March, 38%.)

The least prepared firms: NBFC (75%,) Insurance (83%,) Retail and Commercial banks / lenders (39%) all expected to need an extension don't match the importance of these products to our core business."

> *"Regulation from BCBS has been directed towards encouraging banks to use internal models and analysis to develop forward-looking credit models. IFRS 9 is pushing banks in the opposite direction."*

According to the survey, data is less of an issue for institutions in China, with only one respondent identifying it as one of their top three areas of focus in IFRS 9 preparation. Most respondents have reviewed the availability of historical and trend data to build a forward-looking view of impairment with only minimal to partial gaps in data. Most of these gaps seem to be coming from SME and corporate lending data, mirroring the overall results of the survey across jurisdictions.

For corporates, data availability issues have a different character. The Thai corporate cited on page 3 says that since its hedging transactions are quite simple, using mostly forwards and options, and since most of their lending is to its own subsidiaries, modeling ECL will be less of a challenge.

"We have most of the data we need. We are discussing using external providers for PD data to enhance our model," according to the Thai executive.

A large Australian infrastructure firm says it is exempt from ECL modeling, since most of its hedging is on currency. The Australian corporate executive is worried about the different calculation of currency basis under his current system versus IFRS 9. The new rule does not include currency basis in the underlying asset and is expected to result in greater P/L volatility.

"We are currently running a dual system. We do the hedge accounting with our treasury system, but the CVA portion in another system and combine the two for the result. We'd rather stick to our current approach, which is to use raw market data to get the value of the currency basis rather than under the new rule where they do one valuation with the basis and one without and then net. Both methods should ideally yield the same results, but the availability of the data for the second approach is currently not there," he says.

4. Capital

Additional capital requirements are a challenge, especially in jurisdictions in India and China where financial institutions are struggling with provisioning for their large amounts of non-performing assets, as well as capital requirements under Basel III. A Beijing-based risk management professional points out that loans under the guise of financial assets in the non-bank sector and the alternative credit sector of banks will provide the greatest capital hit to banks there.

"Although risk management professionals acknowledge that the new rules will eventually manifest positively in a better pricing mechanism, better capturing of positions and more robust capital calculations, this will be years down the line."

According to the Philippine banker cited on page 3 , the new rules will shave off roughly 100-150 basis points from their institution's capital adequacy ratio given an immediate increase in provisioning once the rules have been adopted. Other banks were in the process of refining a number, but expected a drop of between 150-200 basis points in their capital adequacy ratios.

Several banks *Regulation Asia* spoke to were further concerned about the incremental cost of implementing IFRS 9.

"This is primarily a compliance issue. So, it is very challenging to justify to our shareholders having to spend a considerable amount of money for a system, that would not have an immediate impact in terms of an increase in earning," the Philippine banker says.

Although risk management professionals acknowledge that the new rules will eventually manifest positively in a better pricing mechanism, better capturing of positions and more robust capital calculations, this will be years down the line.

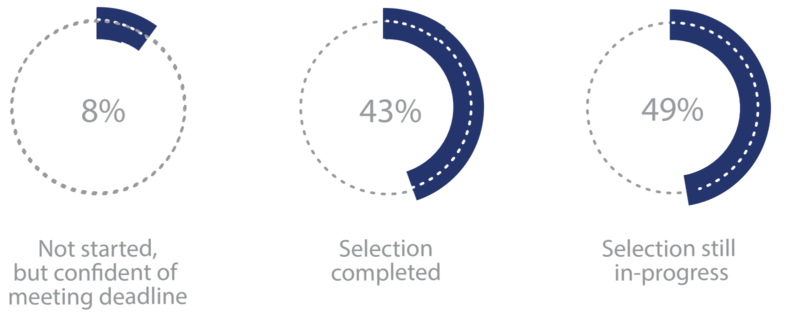
According to the Singapore-based consultant, a bank will eventually benefit from synchronising credit risk management with internal provisioning and reporting, but in the short-term this will require them to make substantial changes to their reporting processes and incur extra costs without added savings increase in revenues.

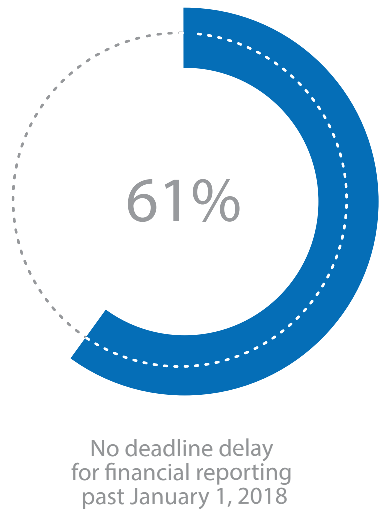
The large Thai corporate, however, focuses on transparency under the new rule and how this will eventually benefit of investors.

"The performance of the company is important. However, the transparency of the financial statements, which is what the regulator is trying to promote, is also for the benefit of the investors. We don't look at this as a burden. If we can adequately address the requirements of the rule, it will be positive for us and for our stakeholders," he concludes.

Status of model selection

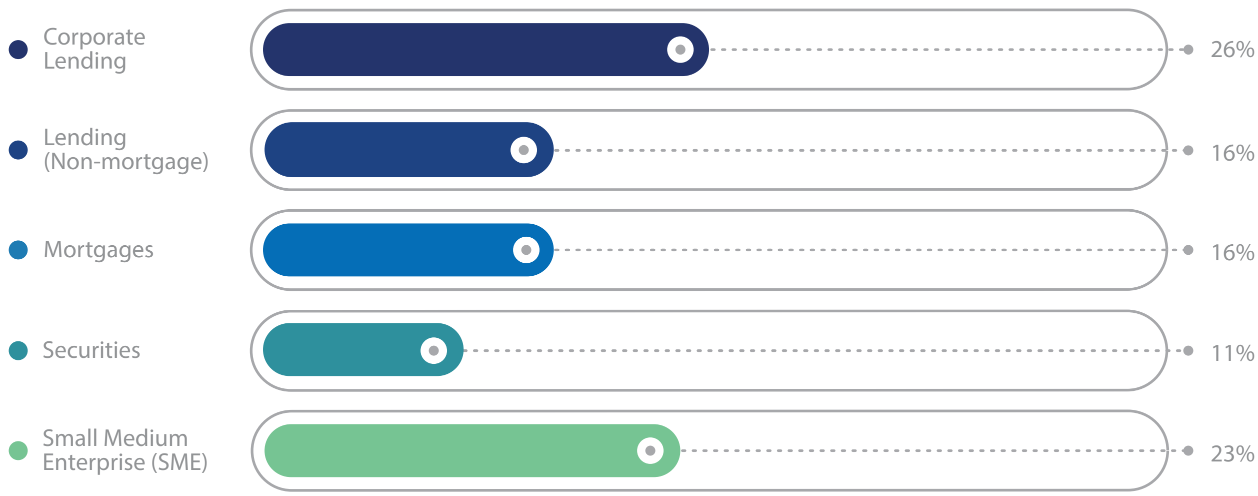
43% of firms have already gone past the stage of model selection, with the remainder already in the process of preparing for selection (49%) or not having started process but confident of achieving the Jan 1, 2018 deadline (8%).





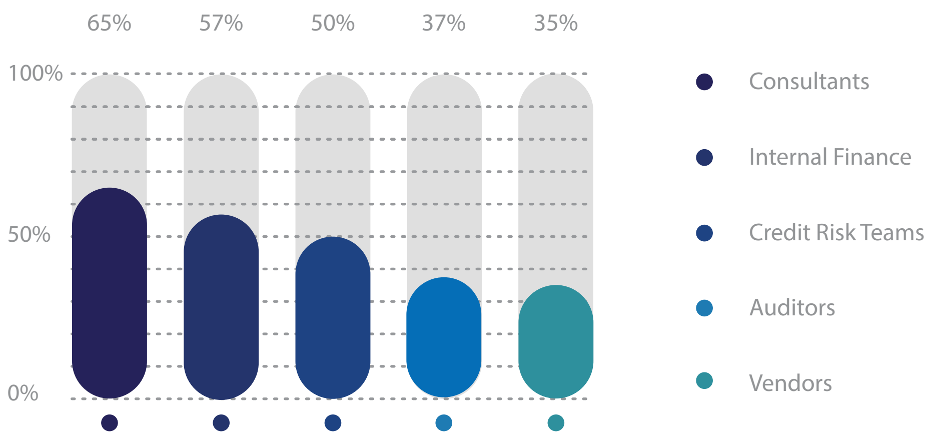
Most commonly found data challenges

Across all jurisdictions corporate lending data increasingly cited as the biggest challenge. Likewise, SME data continues to be problematic to the majority of insitutions.

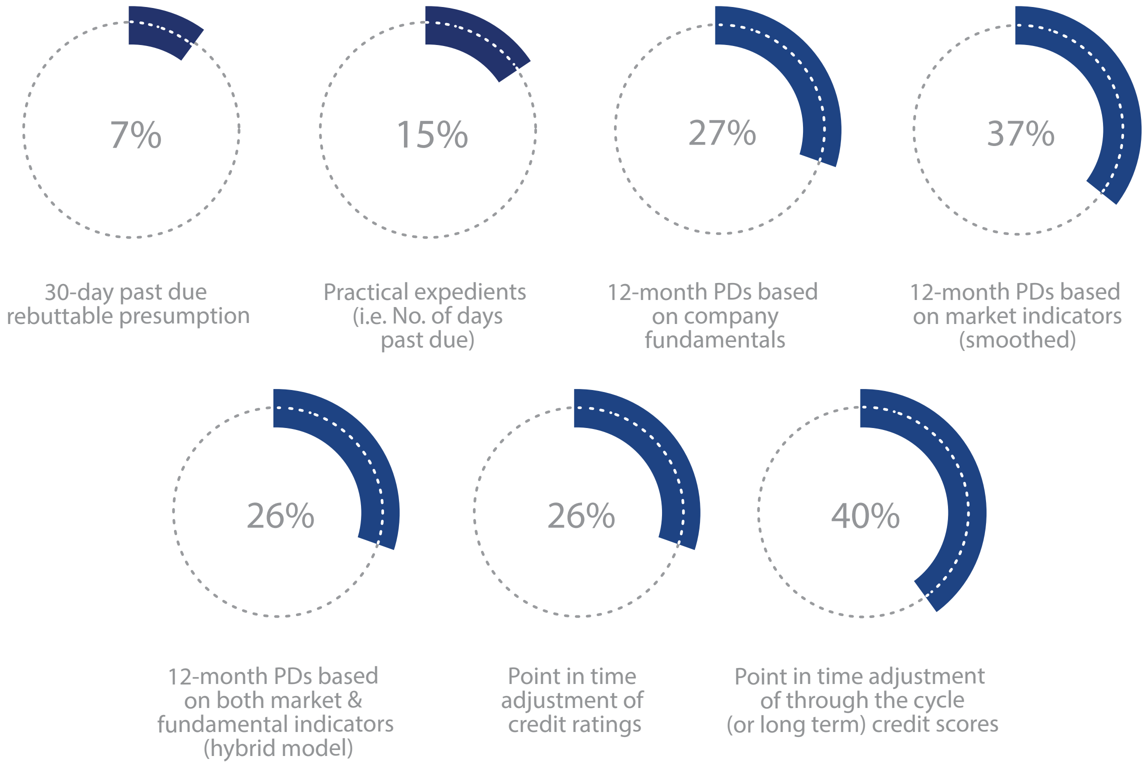


Most common tools and resources

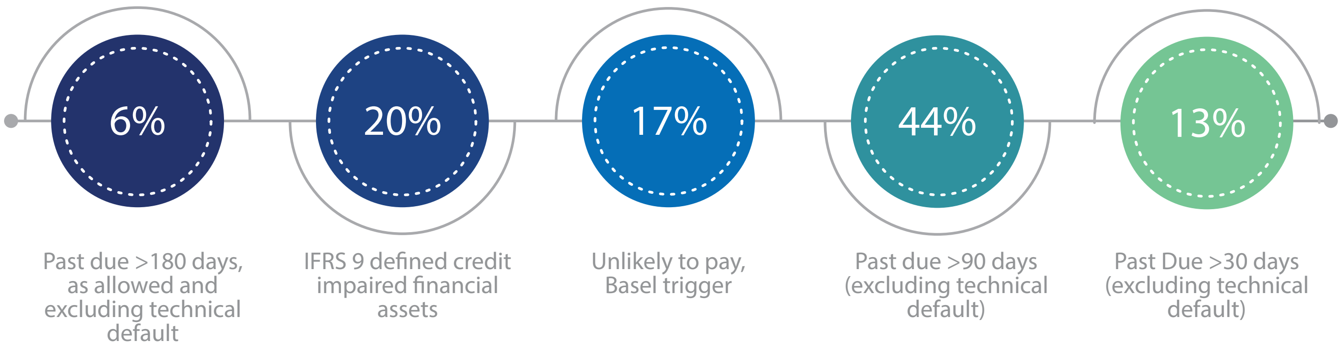
The majority of firms are reliant on a combination of internal resources and external consultants (75%.) Banks appear to prefer to partner internal teams with external experts to bridge technical skill gaps.



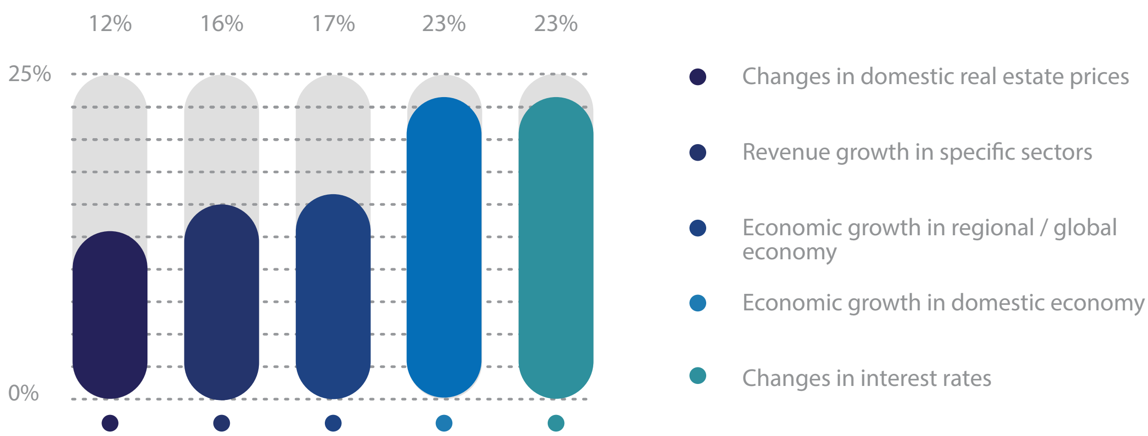
Most commonly used inputs in PD forecasting



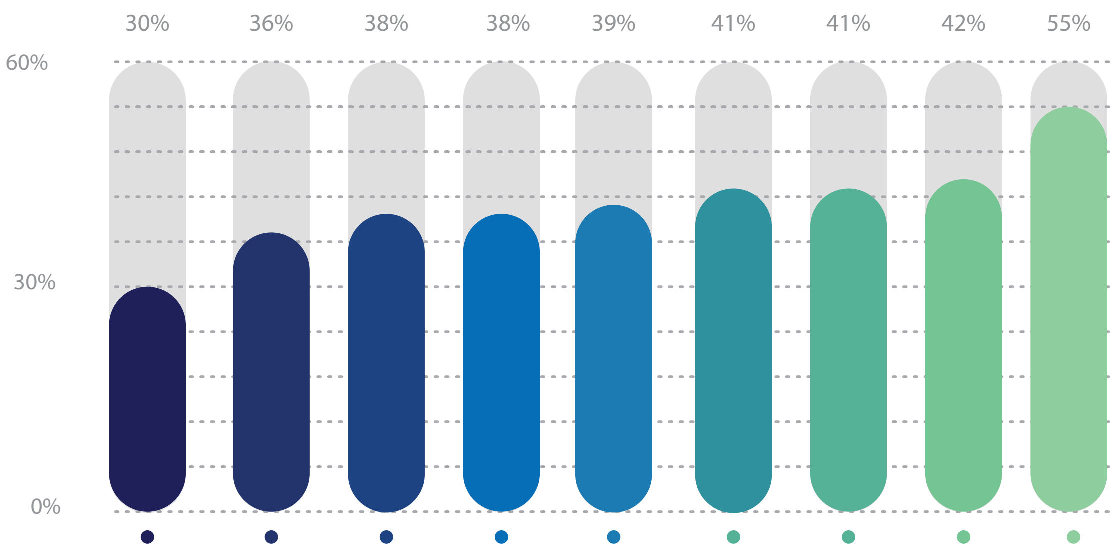
Most commonly used definitions of default



Most commonly used macroeconomic scenarios for ECL calculations

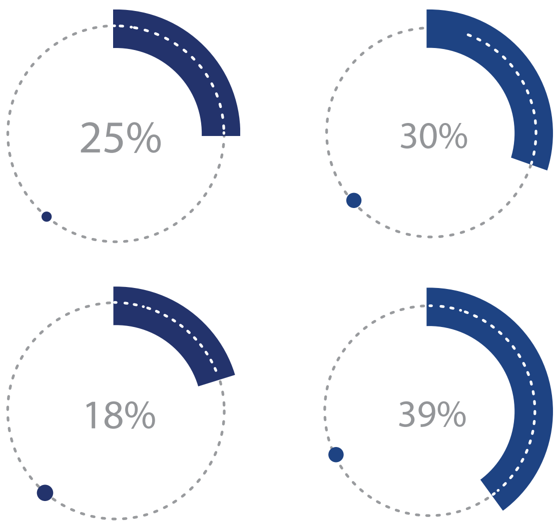


Most commonly used definition of movement between stages 1 and 2



- Significant changes in the value of the collateral or guarantees supporting the obligation
- Changes in the rates or terms of an existing financial instruments
- Significant change in the financial instrument's external credit rating
- Significant adverse change in the regulatory, economic, or technological environment of the borrower
- Significant increases in credit risk on other financial instruments of the same borrower
- Significant changes, actual or expected significant change in the quality of credit enhancement
- Significant changes in internal price indicators of credit risk
- Significant change in the operating results of the borrower
- Internal credit rating downgrade

Use of practical expedients



Yes, expect to gauge increase in credit risk using 12-month horizon as a proxy for lifetime

Yes, exemptions from lifetime ECL for instruments regarded as 'low' credit risk

Yes, use of provision matrix to estimate ECL for trade and lease receivables

No

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