Risk Solutions

CRISIL
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# Transition to IFRS 9: Overcoming the Practical Roadblocks

## Adoption of the IFRS 9 provisioning norms brings along unique set of implementation challenges towards estimation of credit losses

An analysis by CRISIL Risk Solutions (CRS) reveals the inherent challenges impeding transition to the IFRS 9 guidelines on expected credit losses, for lenders across both retail[1] and non-retail segments.

In its previous two papers in the IFRS 9 series, CRS highlighted the key implications of the new norms and their likely impact on provisions compared to current levels separately for the non-retail and retail segments. This study shall focus on the unique challenges likely to be faced by lenders in pursuit of compliance with the new guidelines.

Under IFRS 9, the provisioning would be based on the risk profile of the asset (the probability of default i.e. PD) and potential recovery after default, even for such standard (performing) assets. This principal shift in the way credit risk is measured and provisioned for shall pose a number of implementation challenges for lenders.

For borrowers exhibiting an increase in credit risk but who have not defaulted, the provisioning is required to factor in expected credit losses (ECL) over the entire remaining tenor of the asset. This necessitates a robust framework to monitor credit risk movement since initial recognition (for staging) and for provisioning based on expected credit losses. Consequently, lenders need to have a comprehensive methodology for risk rating / pooling of their borrowers, and strengthen practices around recovery data collection.

Outside the theoretical framework, movement to IFRS 9 shall also entail a number of practical challenges for lenders with respect to its on-the-ground implementation. Ensuring availability and integrity of data will be of principal importance, with technology playing a major role towards mitigation of these challenges. Leveraging technology will also help towards ensuring an institutionalized roll-out of the functional frameworks across the lending institution.

Throughout the implementation, managing multiple, possibly conflicting views from across functions such as risk, credit, finance and technology will also imply a need for active stakeholder management.

Finally, the estimation of the impact of the new norms over current provisioning levels is likely to be challenging, especially for retail segments. Furthermore, this impact is expected to vary widely from lender to lender.

[1]Defined on the basis of applicable criteria with respect to limit, turnover and concentration in overall portfolio

## Implications for lenders

The new norms underscore the need for diligent risk assessment and estimation of a corresponding probability of default. For corporate (non-retail) segments, the risk assessment is typically carried out by lenders for every individual borrower in their portfolio and quantified in terms of a credit rating or risk classification for that borrower. The same is a lot more challenging to undertake for retail borrowers, primarily because of the large number of borrowers and fewer data points available per borrower. The way lenders can conduct risk categorization in this case is by pooling their retail loans into homogenous risk pools displaying identical default behavior. Lenders usually conduct this activity separately for each retail product e.g. home loans, vehicle loans, personal loans etc.

In addition to risk classification (through rating or retail pooling) and deriving corresponding PDs, there are other significant implications for lenders which shall also need to be addressed, such as:

- **Focusing on analytics particularly with respect to recoveries:** The increased provisions and corresponding impact on capital may require lenders to focus on robust behavioral models especially on recovery analytics to ensure precise risk / recovery estimation. This may also enable institutions with a strong collection / recovery framework to reduce the level of provisions, vis-à-vis using regulatory prescribed haircuts.

- **Conducting stress testing and scenario analysis:** Lenders will have to ensure that the computed provisioning levels are robust and imbibe sufficient buffer in face of possible macro-economic fluctuations. This will require them to gauge sensitivity of computed provisions to changes in default rates, recovery levels and other similar parameters denoting a 'downturn' macro scenario.

- **Implementing functional framework and robust data management:** Ensuring systematic adaptation, maintenance of audit trails and handling high volume of data will require leveraging technology and data integrity protection mechanisms.

- **Assessing one-time impact of transition:** Given the relative difficulty in assessing the impact beforehand, lenders may have to consider a phased roll-out and comprehensive parallel run before moving on-to the IFRS 9 guidelines in entirety.

## Challenges in implementation and their mitigation

CRISIL's experience of implementing IFRS 9 frameworks and interactions with market participants across geographies highlight a number of challenges likely to be faced by the lenders in terms of its practical, on-the-ground implementation. The principal challenges are highlighted below.

- **Absence of a risk rating / pooling framework and PD estimates**
  The probability of default i.e. PD is one of the principal parameters to be used for provisioning computation under the IFRS 9 norms. PD rates themselves are a function of the inherent credit risk profile of a borrower, which can be indicated in terms of a risk rating (for non-retail borrowers) or a risk pool categorization (for retail borrowers). Thus, ensuring presence of sound frameworks for risk categorization either through rating or pooling is a primary step that lenders need to take towards IFRS 9 compliance.

  For non-retail (corporate) segments, this can be accomplished through detailed risk rating models. Models used should be specific to the borrower sub-segment e.g. large / mid-corporate, SME and MSME to reflect their inherently distinct risk drivers. Certain niche categories or borrowers such as financial institutions or holding companies may require bespoke models altogether. While lenders can use off-the-shelf risk rating models for this purpose, they can also shift to statistical rating models based on their internal data over time.

  The risk categorization challenge is more prominent for retail segments or retail-oriented lenders compared to their corporate counterparts. Many lenders do not use the IRB approach under Basel for capital computation, and hence may currently not have retail pooling frameworks for some or all of their retail products. Lenders can address this gap through conducting a pooling activity using off-the-shelf retail scorecards, and may also consider shifting to a statistical pooling approach based on internal data over time.

  Once the framework for risk categorization is established, estimation of PDs for various ratings / pools can be carried out using analysis of historical performance data. This will entail that lenders conduct a retrospective risk rating / pooling of their portfolio on the finalized framework, or hold off the analysis until sufficient number of cases are rated / reviewed using the same. In cases where both these options are not feasible, alternate approaches such as repayment performance-based risk categorization can be used to proceed with the ECL computation.

- **Absence of loss-given-default (LGD) estimates**
  For most lenders, LGD estimation is a challenge due to unavailability of structured recovery data post-delinquency. The same can be addressed by collation and analysis of historical recovery data (one-time), and by establishing a centralized, system-oriented approach towards collection of future recovery data to enable continuous update of the LGD rates. In the meantime, lenders can use heuristic scorecards for LGD estimation, or manually collate historical defaulters' data for deriving internal recovery rates.

  For non-retail segments, lenders can also use Basel / local regulator-prescribed LGD values. However, these values may not reflect a particular lender's own collection culture and recovery rates, and hence a gradual shift to internal LGD rates should be sought.

  Given the direct impact on P&L and capital requirements, it would behoove lenders to increase focus on an overall improvement in data capture, automation / audit trail maintenance and analysis of both default and recovery data.

- **Simulating cash flows for ad hoc loan structures**
  The IFRS 9 guidelines require lifetime provisioning for risky assets that have not yet been classified as delinquent. This involves determining the exposure-at-default (EAD) at various points in time until the full repayment of a term loan. While this cash flow simulation can be easily estimated for common amortizing loan structures using the loan characteristics, the same may

be a challenge for more complex structures e.g. loans with moratoriums, teaser loans, ballooning structures etc. To address this challenge, lenders must ensure that amortization schedules for all multi-year loans are documented and stored in a structured, digital manner in their internal systems.

- **Lack of reference points for new products**
  This challenge is specific to retail segments, where a new product launch is usually followed by a period of lack of default data for the first few years or until the portfolio is seasoned. This is further compounded by the absence of a standard rating scale for retail borrowers (unlike non-retail segments where rating agencies provide such a common scale). A possible option to address this challenge may be for lenders to identify a benchmark product from their portfolio and use the corresponding default and recovery rates, or use average rates across their entire retail portfolio until sufficient data history has been generated (typically one seasoning cycle for the product).

- **Need to handle high data volumes, maintain historical data**
  For the purpose of ECL computation, multiple facilities belonging to the same borrower are treated as separate contracts. This results in disproportionately high data volumes that need to be processed, especially factoring in retail segments.

Consequently, lenders will have to leverage technology and put in place an automated, system-driven approach for staging and ECL computation. Such an approach shall also ensure maintenance of an 'audit trail' and generation of reports based on historical data if required by regulators / supervisors during the transition phase.

- **Data gaps and lack of data integrity**
  Analysis of historical (and future) data requires data points to be captured in a structured, digital manner. However, a commonly observed challenge is that lenders' historical data sets are not available in such a digitized format. Also, the limited data that is available may lack integrity due to weak existing processes around data entry and validation. To address these challenges, lenders need to conduct a comprehensive data diagnostic and gap analysis at the beginning of the IFRS 9 transition movement. The output of such an analysis shall highlight the data availability and integrity gaps that need to be addressed by the lender.

Gaps in historical data are typically addressed by manual collation and cleaning, while those for on-going / future data capture can be addressed by putting in place robust data entry and validation processes, supplemented by automated solutions wherever possible. In this respect, the data diagnostic report also serves as a critical guide shaping the contours of other systems that the lender may choose to implement.

- **Stakeholder management**
  Compliance with IFRS 9 will require teams across business, risk, finance and technology to work together, with a particularly high integration required between business and risk functions. In order to ensure smooth stakeholder management, effective resolution of potentially conflicting views and fluid transmission of risk insights across departments, it is critical that the overall ownership in terms of the responsibility for the IFRS 9 movement be well-defined.

## Summing up

The move to IFRS 9 norms will result in a principal shift in the way credit risk is measured and provisioned for, compared to the current incurred loss model. For lenders, these norms pose a number of functional and implementation challenges.

In addition to developing a robust functional framework, lenders need to put in place well-defined processes to ensure data availability and integrity. This has to be supplemented by leveraging technology to enable reliability and auditability of computations, and by active stakeholder management to manage views from multiple functions.

In light of the highlighted challenges, it becomes even more important for lenders to initiate a pilot run in parallel to the existing provisioning practices, and gauge beforehand the potential impact of the new guidelines. This will also enable lenders to fine-tune nuances of their approach and set stakeholders' expectations with respect to the overall impact.

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