Next steps for you

The data and systems required to support an IFRS9 provision estimate are now of critical importance. Entities must capture internal default and loss experience, as well as develop a forecasting capability to predict defaults and recoveries. The data and techniques used to assess the IFRS9 provision will likely align with a banks internal risk grading approaches and methodologies.

However, it is critical that banks and entities subject to IFRS9 commence their assessments on preparedness for moving to an EL provision model. Gaps in data, systems and forecasting capabilities will have a significant lag time to address.

We recommend you perform the following:

1- Understand the requirements of IFRS9 and impacts on your organisation.
2- Complete a detailed assessment of existing risk and finance infrastructure to determine gaps with IFRS9 requirements.
3- Develop plans and design solutions to address any gaps in your data, systems and forecasting capabilities.
4- Complete your IFRS9 transition work, developing accounting policies and forecasting solutions.
5- Consider how to implement IFRS9 solutions into risk and portfolio management reporting and strategies to devise approaches to optimise portfolio metrics.

How can PwC help you?

PwC have a team of credit specialists, with regional and global experience.

We have been supporting banks and regulators understand the proposed changes, as well as the design and development of credit modelling and financial reporting solutions.

We have the expertise to support you in addressing the IFRS9 challenge, for both conventional and Islamic finance portfolios.

Capital Markets and Accounting Advisory Services team

The PwC Capital Markets and Accounting Advisory Services team comprises specialists who advise clients on the interpretation and implementation of IFRS accounting standards.

The team comprises individuals who have supported banks locally, as well as globally, in the development of impairment methodologies.

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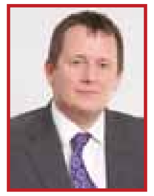

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Supporting our clients understand and implement solutions for financial instrument accounting and risk analytics

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Credit Impairment

Preparing for the new expected loss provision model

pwc

Introduction

The existing rules governing how entities measure impairment for credit losses are being subjected to major revision.

The International Accounting Standards Board ("IASB") is nearing completion of the new accounting standard for measurement of credit losses, IFRS9 Phase 2.

The approach being proposed will change the shape of the financial statements of entities using IAS39, which will now be required to use the new IFRS9 methodology.

In addition IFRS9 will place a significant implementation effort on entities, where they will need to build forward looking risk forecasts of credit defaults. This will need to be completed in time for the mandatory adoption date, currently 1 Jan 2015. In addition, prior year comparatives for 1 Jan 2014 will need to be produced.

The existing IAS39 rules

The principles of the existing provisioning requirements for credit losses under IAS39 can be summarised as follows.

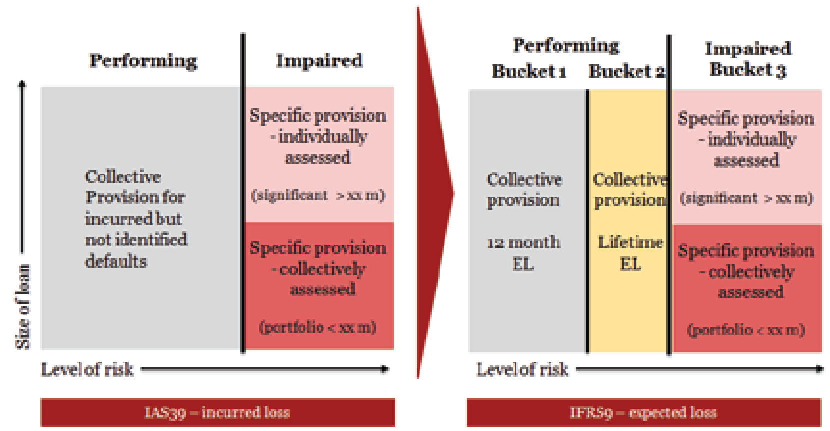
Incurred loss model	IAS39 is a strict incurred loss model and does not allow the recognition of any future expected losses. Provision is assessed for impaired assets at the balance sheet reporting date only.
Measurement	Losses under IAS39 are measured at amortised cost, where the net present value of future cash-flows is determined. Cash-flows are discounted using the effective interest rate ("EIR").
Types of provision	As a minimum, individually significant impaired assets must be measured on an individual basis. Where no provision is required these individually assessed assets must then be collectively assessed. All remaining assets can be collectively assessed.
Qualitative Adjustments	Once an underlying model based provision estimate has been determined, an appropriate review must be carried out to validate the model estimate and adjustments applied where appropriate.

The new IFRS 9 proposals

Under the proposals the new model will be an expected loss ("EL") model. This will mean provisions need to be recorded for future losses. The approach is illustrated below.

Performing Assets Bucket 1	Performing Assets Bucket 2	Impaired Assets Bucket 3
Assets where there is no identified credit deterioration since initial recognition.	Assets where there is more than insignificant deterioration in credit quality since initial recognition.	Assets which are identified as impaired.
12 month EL	Lifetime EL	Lifetime EL

This will likely result in a significant uplift in the base provision due to the need to recognise future losses, a fundamental change from the existing methodology. This is illustrated below.



Bucket 1 includes performing loans with no credit deterioration and requires provision for loss events that are expected to occur over the next 12 months.

Bucket 2 includes performing loans with credit deterioration and requires a lifetime provision.

Bucket 3 represents identified impaired loans, similar to that under IAS39, requiring a lifetime provision assessment.

The calculation challenge

The proposal is now a risk based forecast, which must be based off and calibrated to a banks risk profile. Risk management will play a key role in producing forecasts with finance.

The basic principles which must exist in the rating system include:

1 Definition of impairment	An impairment definition is required which will be the boundary between Bucket 1 and Bucket 2.
2 Segmentation approach	The portfolio will need to be segmented into groups of assets/loans with similar risk characteristics. This will likely align with the portfolio risk segmentation, Basel segmentation and operational segmentation.
3 Probability of Default ("PD")	Forward looking PD ratings will be required for each of the segments/pools. This is required to assess credit deterioration and then to calculate provisions. Forecasts are required on a 12-month and lifetime outcome.
4 Loss Given Default ("LGD")	LGD forecasts will be required for all segments / pools. This must reflect a discounted loss rate and be based on the portfolio loss experience of the bank. This must be based on the portfolio loss experience of the bank.

The stages above will provide the components for the base provision estimate. An additional key stage required is the management review and qualitative adjustment framework.

5 Management review / input	Model based estimates must reflect future management expectations and how this will impact the portfolio and associated provision estimate.