IFRS 9 provisioning: lessons learned and challenges to come

As many may know, IFRS 9 Financial Instruments (IFRS 9) has a mandatory effective date of 1st of January 2021 for insurance companies. Linked to a potential delay in IFRS 17 Insurance Contracts, this date may be pushed back. Nonetheless, for other financial institutions this standard is already effective since 1 January 2018 and some insurers have started their implementation activities some time ago already. Thus, lessons can be learned from the work done by banks and insurers up to now.

This article focuses on the IFRS 9 provisioning (i.e. impairment) experiences to date and on the current discussion around interest rate only (IO) mortgages from an IFRS 9 perspective. This topic is a hot topic within credit risk from both a provisioning as capital perspective and is of that much interest to society that the Dutch banking association and the Dutch association of insurers have initiated an awareness campaign because of the potential risks for consumers. As the impairment model landscape becomes more complex and choices within IFRS 9 and IFRS17 impact each other, creating awareness of the choices made in the provisioning on both sides of the balance sheet should be part of the actuary's agenda.

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CREDIT RISK PROVISIONING – WHAT'S NEW IN IFRS 9?

The most important change from the current IAS 39 provision to the IFRS 9 provision is that the IAS 39 provision only covers the best estimate credit losses of exposures already in default (i.e. the incurred losses), where IFRS 9 also covers expected losses for credit exposures that are not in default. The IFRS 9 provision thus covers a larger asset scope and typically (should) also result in a higher provision. Comparing this to P&C reserving, the IAS 39 thus only covers the claims reserve.

For all individual assets in scope of the impairment provision, the following 3 steps are most important:

– *Determine the stage of the asset* – For every individual asset (so not on an obligor level), determine in which stage the asset is. Defaulted loans are stage 3, and non-defaulted loans are either stage 1 or stage 2, depending whether it has experienced any significant increase in credit risk;

– *Select reasonable macro-economic scenario's and the likelihood they will materialize* – IFRS 9 provisions are a probability weighted average of the best estimate expected credit losses under multiple economic scenarios, meaning macro-economic forecasts are a key element of the calculation input. If forecasts are used elsewhere in the organization, a consistency check should be performed;

– *Determine best estimate future cash flows of the expected losses* – the provision equals the present value of future expected credit losses for respectively the first 12 months (stage 1) or the remaining lifetime of the contract (stage 2 and 3) following the calculation date.

All cash flows should be determined on a best estimate basis. IFRS 9 therefore requires complex modelling and model validation to explicitly ensure that no bias (also no prudency) is included in the models. To accomplish this, institutions need to derive appropriate estimates to model the impact of developments in macro-economic drivers on their expected credit losses. IFRS 9 ensures outcomes that allow for better comparison between institutions for similar portfolios.

OBSERVATIONS FROM OTHER FINANCIAL INSTITUTIONS

Given the 1 January 2018 IFRS 9 effective date for other financial institutions, insurance companies can compare their preliminary calculation results and disclosure approach with the externally audited results and disclosures in annual accounts, to the extent that the level of detail provided allows for this. Some observations relating to the other institutions' approaches and outcomes are:

– *Institutions apply a wide variety in IFRS 9 approaches both in their modelling as in the level of details provided in their disclosures* – Although a conversion in approach and outcomes are expected, the current market shows large differences at this moment. IFRS 9 provisions for a stage 1 unsecured corporate loan with a duration of 5 years shows value translating to a factor >50

between minimum and maximum estimate. For a similar stage 2 loan it even shows a difference of a factor >100 between provisions of the same loan in the extreme observations[1]. Also, the different approaches result in large difference in the sensitivity with respect to macro-economic scenarios, a benchmark study shows[2].

Provision estimate for a single large corporate
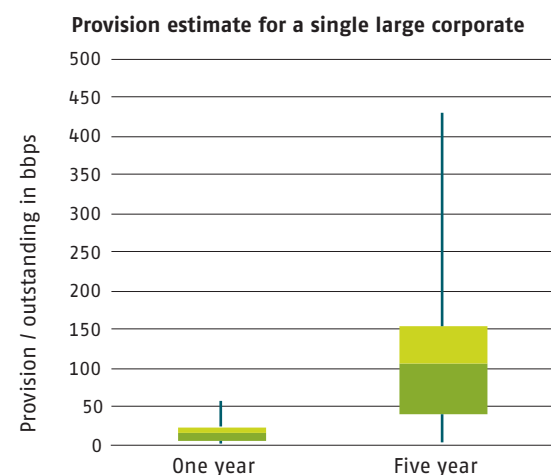
Provisions between the 1st and 3rd quartile differ a factor 4 for the same loan.

Variability under macro-economic scenarios for a single large corporate
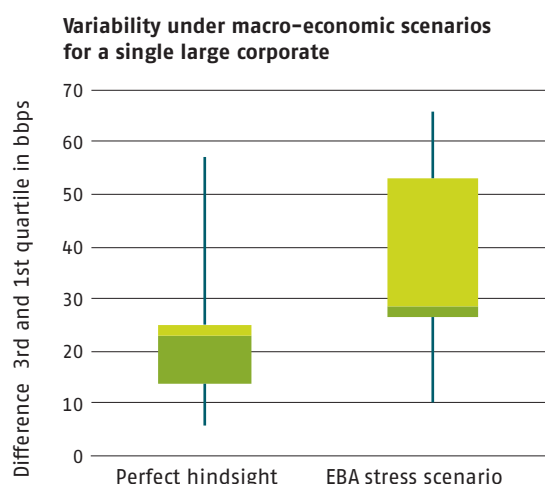
Results between organisation are larger under economic stress scenarios, and less under benign conditions

– *The IFRS 9 provision is higher than the IAS 39 provision* – On average, the IFRS 9 provision is c. 20% higher than the IAS 39 provision. As expected, the differences are higher for portfolios with higher expected default rates and low collateralization levels and lower for highly collateralized, high-quality wholesale exposures (i.e. investment graded corporates/sovereigns). Note however that impairment provisions are small compared to IFRS4 provisions. Therefore, insurers might make different choices than banks for similar portfolios due to the size of the provisions and the complexity of their portfolio in scope of IFRS 9 provisioning.

– *The IFRS 9 provision is higher compared to expected losses under a single best estimate macro-economic scenario due to non-symmetrical effects* – When using multiple economic scenarios instead of a single baseline scenario the provision typically increases with 2.5-15% dependent on the asset portfolio. Main driver for this is the non-linearity of credit losses: the increase in expected losses is higher in a downturn scenario than the decrease observed in an upside scenario.

UPCOMING CHALLENGES

Although Banks and Insurers are in different phases in their IFRS 9 implementation, similar challenges exist when looking at mortgages and non-retail (e.g. Corporate or Sovereign) loans:

– *Data scarcity on the wholesale (non-consumer credit) portfolio* – High quality corporate and sovereign portfolios are typically low default portfolios and therefore only have a limited set of historical defaults to create statistically robust IFRS 9 models. This pushes institutions to use either external data or vendor models. For these it is more difficult to prove that the resulting model yields unbiased outcomes for their specific portfolio(s).

– *Interest rate only mortgage valuation* – Approximately 51% of the Dutch households have interest only mortgages, a study shows[3]. When calculating the IFRS 9 provision for a portfolio of interest-rate only mortgage portfolio, one should take into account a higher margin default risk close to expiry date compared to regular (amortizing) mortgages. This is due to the nature of the contract, in which consumers are expected to repay or reFinance their debt upon contract expiry. When the size of the loan exceeds the value of the property or when the future expected income at expiry date is not sufficient to reFinance, clients are more likely to struggle with either option. This is estimated to be true for approximately 265.000 clients, a study of the NVB[4] shows. In the assessment of whether clients have experienced a significant increase in credit risk in the staging phase, this is to be considered.

A large proportion of these mortgages is due to expire in 2035 – 2040. Some institutions are considering to increase the marginal probability of default closer to expiry date based on their best estimate. This will then result in potentially large increases of the provisions for these mortgages in future years.

– *Times are changing - applicability of historical data to model future behavior?* Changing trends in borrowing or lending behavior because of the changed economic environment might trigger a borrowing or lending behavior that limits the models' ability to create accurate forecasts for the years to come based on historical data. Three examples:

1. Client payment behavior:
• *Consumers are now made aware of potential risks* that are associated with interest only mortgages which could lead to a change of client behavior in their mortgage plans.

• *low interest rates on saving accounts pushes pre-payment levels to historically rarely observed heights*, which is to be accounted for in IFRS 9 calculations.

• *a potential "correction" on housing prices* makes it difficult to estimate recoveries on collaterals under different IFRS 9 economic scenarios, especially as in 2019 DNB imposed banks to hold increased buffer levels for the capital calculations due to this possible future event.

2. Client borrowing behavior:
• *the low interest rate environment* might lead to increased levels of credit at firms and consumers as monthly payments are relatively low. This potentially triggers an unhealthy appetite for loans according to the AFM and DNB. In addition to the typically lower margins and higher value of liabilities due to low interest rates, also new kinds of procyclicality might therefore be introduced in credit portfolios.

3. Financial Institution lending behavior:
• *the low margins in the wholesale credit market* could lead to an unhealthy lender risk appetite, which may result in a change in clients characteristics and risk levels, causing a mismatch between future portfolio composition and historical data.

– *Embedding IFRS 9 in the organization*, for example in the asset scoping, the classification and measurement in combination with IFRS 17 implementation choices impacting P&L and OCI levels and variability. Although IFRS 9 compared to IFRS 17 provisions might be small, the insights obtained from these new credit risk models might help in future underwriting decisions in for example the mortgage portfolio. Furthermore, new insights in the excepted credit losses are relevant information for both (1) the illiquidity premium as part of the IFRS 17 discount curve (e.g. in defining the credit risk adjustment in your IFRS 17 discount curve), and (2) the refinement of the Net Capital Generation or Analysis of Movement analysis, as there needs to be consistency regarding expected (credit) losses used in IFRS 9.

It is up to the institutions to ensure that the modelling landscape matches the scale and complexity of the business. As with any new accounting standard, non-compliance on a non-material element of an accounting standard is not likely to result in major discussions with external auditors if the institution is able to quantify the impact. However, this new standard does provide with its forward-looking approach and the incorporation of various potential macro-economic developments (and their impact) opportunities for both insurers as banks to incorporate more insights in their underwriting and investment risk management.

CONCLUSION

The upcoming introduction of IFRS 9 along with IFRS 17 requires insurance companies to re-assess their credit risk exposures. Like for IFRS 17, the IFRS 9 provision is designed to provide a better representation of the financial situation of an institution than the current (IFRS4 and IAS 39) standard. For the IFRS 9 provisioning, specific challenges exist that are further discussed in this article. Insurers can benefit from the fact that the standard is already in place for several years in other financial institutions, providing opportunities to learn from those who already have experience in setting up IFRS 9 provisioning. At the same time, benchmark studies show that within the banking industry there is a wide variety in approaches and results for very similar exposures, indicating that future changes might be expected.

As the IFRS 9 implementation date is approaching, insurance companies should find an effective approach to meet the requirements as set out in the standard. As presented in this article, setting up IFRS 9 provisioning is not just a one-time exercise, but requires ongoing model maintenance and is sensitive to macro-economic developments and their relations with credit risk exposures. Specific IFRS 9 market-wide challenges exists for the mortgage and non-retail portfolios, which are most relevant for insurance companies as well. Given the specific macro-economic situation we are in, this is challenging for all financial institutions already reporting IFRS 9 provisions and might be even more so for insurance companies that still have to start their IFRS 9 impairment modelling process. ∎

1 – GCD benchmark across 18 banks

2 – GCD benchmark across 7 banks

3 – Rapport Trendzicht 2020, AFM, Oktober 2019

4 – 2018 study of the NVB