



**Practical insights on  
implementing IFRS 9  
and CECL**

We are pleased to present the fourth publication in a series<sup>1</sup> that highlights Deloitte Advisory's point of view about the significance of the Financial Accounting Standards Board's (FASB) ASU 2016-13 – *Measurement of Credit Losses on Financial Instruments* and related implementation considerations and IFRS 9<sup>2</sup> – *Financial Instruments*. Thought pieces that provide perspective and discuss potential implications of FASB's current expected credit loss (CECL) model will continue to be published at [www.deloitte.com/us/cecl](http://www.deloitte.com/us/cecl).

The standard setters—FASB and the International Accounting Standards Board (IASB)—have overhauled the accounting models for credit impairment. Institutions required to issue financial statements under either standard are likely to encounter significant implementation and operational challenges. As institutions with dual filing requirements under International Financial Reporting Standards (IFRS) and US Generally Accepted Accounting Principles (GAAP) begin their implementation efforts, they should formulate a broad strategic plan that factors in both the similarities and differences between the FASB's and IASB's approaches. A broad plan that effectively leverages interdependencies in credit risk management practices, operations, and reporting can:

- Lay the foundation for an integrated framework
- Facilitate a lean rollout

This point of view discusses the intersection of requirements between FASB's and IASB's credit impairment models. It also identifies potential opportunities to gain implementation efficiencies.

### Synopsis of the FASB's and IASB's expected credit impairment standards

Both the impairment model in IFRS 9 and the FASB's CECL<sup>3</sup> model are based on expected credit losses. The IASB differs from FASB in that IFRS 9 uses a three-stage approach. Under IFRS 9, debt instruments,<sup>4</sup> excluding purchased or originated credit impaired financial instruments, move through three stages as credit quality changes. Consequently, a financial institution would measure expected credit losses and recognize interest income depending upon the following stages:

**Stage 1: Assets that are performing.** If credit risk is low as of the reporting date or the credit risk has not increased significantly since initial recognition, an entity will recognize a loss allowance at an amount equal to 12-month expected credit losses. This amount of credit losses is intended to represent lifetime expected credit losses that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring. For these debt instruments, interest income recognition will be the effective interest rate (EIR) multiplied by the gross carrying amount.

**Stage 2: Assets that have significant increases in default risk.** In instances where credit risk has increased significantly since initial recognition, an entity would measure a loss allowance at an amount equal to full lifetime expected credit losses. That is, the expected credit losses that result from all possible default events over the life of the financial instrument. For these debt instruments, interest income recognition will be based on the EIR multiplied by the gross carrying amount.

**Stage 3: Credit impaired.** For debt instruments that have both a significant increase in credit risk plus observable evidence of impairment (e.g., similar concept

to IAS 39 Objective Evidence of Impairment [OEI]), stage 3 requires that, in addition to recognition of full lifetime expected credit losses, the institution should measure interest income by applying the EIR to the net carrying amount of the debt instrument. The indicators of observable evidence (e.g. default, significant financial difficulty, etc.) are consistent with how a financial institution applies IAS 39 OEI today.

For these purchased or originated assets, a financial institution recognizes only the cumulative change in lifetime expected losses since initial recognition as a loss allowance. Changes in lifetime expected losses since initial recognition are recognized in profit or loss. Thus, any favorable change in lifetime expected credit losses since initial recognition of a purchased or originated credit-impaired financial asset is recognized as an impairment recovery. Interest income recognition will be through a credit-adjusted EIR multiplied by the amortized cost.

In contrast, the FASB's CECL model requires entities to recognize lifetime expected credit losses for all assets, not just those for which there has been a significant increase in credit risk since initial recognition. Stated differently, the FASB's model follows a single credit-loss measurement approach, whereas IFRS 9 follows a dual credit-loss measurement approach in which expected credit losses are measured in stages to reflect deterioration over a period of time.<sup>5</sup> Discussed below are additional differences and similarities in the FASB's and IASB's credit impairment models.

### Significant credit deterioration

A major point of divergence between the FASB's and IASB's impairment models is the fact that credit deterioration affects the amount of loss allowance an entity would recognize under IFRS 9. Under IFRS 9, debt instruments are transferred between stages

as credit quality changes. Consequently, a critical decision point in implementing IFRS 9 is determining whether there has been a significant deterioration in credit risk since origination. Depending upon whether a financial asset is in stage 1 or stage 2/stage 3, expected credit losses will be measured as 12 months or lifetime, respectively.

Under IFRS 9, the assessment of whether there has been a significant increase in credit risk is based on an increased probability of default since initial recognition. While IFRS 9 permits the use of various approaches to assess whether credit risk has increased significantly, it also includes a rebuttable presumption that credit risk has increased significantly when contractual payments are more than 30 days past due (DPD).

Participants of Deloitte UK's Global IFRS Banking Survey – Sixth Edition,<sup>6</sup> were asked if they expect to rebut the presumption of significant increase in credit risk if they are more than 30 DPD. Responses ranged from 30 percent “never” and 62 percent “rarely” to 8 percent “often.”

The Basel Committee on Banking Supervision (BCBS) published [guidance](#)<sup>7</sup> in December 2015 on credit risk and accounting for expected credit losses.<sup>8</sup> The guidance sets out supervisory expectations for banks relating to sound credit risk practices associated with implementing an expected credit loss framework. It also highlights three IFRS 9-specific requirements<sup>9</sup> banks should consider when designing and operationalizing their implementation plan. With respect to defining and measuring significant deterioration in credit risk, the BCBS is of the view that delinquency data should

only be used in rare circumstances and lifetime expected credit losses are generally anticipated to be recognized before a missed payment occurs.

BCBS guidance provides that banks should “have processes in place that enable them to determine [significant credit risk] on a timely and holistic basis so that an individual exposure, or a group of exposures with similar credit risk characteristics, is transferred to [lifetime expected credit losses] measurement as soon as credit risk has increased significantly, in accordance with the IFRS 9 impairment accounting requirements.”<sup>10</sup> The BCBS guidance also recommends that banks establish policies and specific criteria for what constitutes a “significant” increase in credit risk for different types of lending exposures. Regulators across multiple geographies will likely expect alignment of credit risk assessment across products, business units, and jurisdictions.

As a practical expedient, IFRS 9 provides an exception for low credit risk exposures, where “entities have the option not to assess whether credit risk has increased significantly since initial recognition. [The low credit risk exemption] was included to reduce operational costs.”<sup>11</sup> However, it is the BCBS's expectation “that use of this exemption should be limited.”<sup>11</sup> In addition, the BCBS expects banks to assess significant increases in credit risk for all lending exposures in a timely manner.

As noted in Deloitte UK's Global IFRS Banking Survey – Sixth Edition, participants who expect to use the “low credit risk” exemption plan to apply it mostly for securities and corporate loans versus other type of debt instruments. Respondents with over £100 billion of gross lending, however, are less likely to use any of the practical expedients under IFRS 9.

### Data requirements and credit modeling

For all financial institutions, IFRS 9 and CECL will bring a fundamental change in how impairment of debt instruments is measured. In addition to the requirement to model lifetime expected losses, issues around data quality, availability, and collection will likely be at the forefront of implementation efforts. The following data will likely be necessary to measure expected credit losses under both IFRS 9 and CECL:

- Historical defaults, attrition, and recovery data
- Risk grades
- Delinquency data
- Internal indicators of the likelihood to pay
- Prepayments
- Collateral information
- Forward-looking economic scenarios
- Macroeconomic variables
- Origination lifetime probability of default
- Loss given default estimates
- Exposure at default estimates
- EIR
- Full repayment
- Data required for disclosures

Lifetime modeling of credit risk will be dependent upon historical risk grades and expectations of performance across these risk grades. Data relating to historical loss given default rates and recovery curves will be critical to credit modeling. Key inputs and assumptions (e.g., loss migration rates, delinquencies, and defaults) are typically used as inputs for various purposes in an organization, such as estimating expected losses under US GAAP and IFRS, capital adequacy tests, stress tests, and credit risk management. As an implementation

leading practice, institutions should consider identifying any differences in inputs and tracking the underlying rationale for why differences exist. This should lay the foundation for an integrated approach across the organization for data sourcing, key assumptions, and drivers of credit risk and modeling.

#### Unit of account

Under the CECL model, entities are required to evaluate debt instrument assets on a collective (i.e., pool) basis when similar risk characteristics are shared. If risk characteristics of a given debt instrument are not similar to the risk characteristics of any of the entity's other debt instruments, the entity would evaluate the financial asset individually. If the debt instrument is individually evaluated for expected credit losses, the entity would not be allowed to ignore available external information such as credit ratings and other credit loss statistics. Under IFRS 9, the expectation is the same—expected credit losses should be measured on a collective basis if the debt instruments share similar credit risk characteristics. This collective assessment is also applicable for determining whether significant increase in credit risk has occurred.

Expected credit losses on individual large exposures and credit-impaired loans are more likely to be estimated individually, as compared to retail exposures and other similar exposures where there is a lack of borrower-specific information (delinquency, collective historical experience of losses, and forward-looking macroeconomic). This results in credit losses typically being estimated on a collective basis.

Groupings based on similar or shared credit risk characteristics is an area where banks can align their methodology for pooling debt instruments. Consistent practices can be used to group exposures to assess credit risk (such as by product type, product terms and conditions, industry/market segment, geographical location, or vintages) for both US GAAP and IFRS. Other examples of shared characteristics include type of customer—wholesale or retail industry, date of initial recognition, term to maturity, the quality of collateral, and the loan to value (LTV) ratio. The BCBS guidance provides that “[g]roups should be sufficiently granular to allow banks to group exposures into portfolios with shared credit risk characteristics so that banks can reasonably assess changes in credit risk.”<sup>12</sup> Adopting cohesive policies and practices for grouping debt instruments for estimating expected credit losses under US GAAP and IFRS can eliminate redundancies and alleviate operational burden.

#### Measuring expected credit losses

Both IFRS 9 and the FASB's CECL model provide latitude in how expected credit losses are estimated—an entity can use a number of measurement approaches to determine the impairment allowance. Under IFRS 9 and the CECL model, information about past events, current conditions, and reasonable and supportable forecasts of future economic conditions should be considered when measuring expected credit losses. The models differ in terms of how the time value of money should be reflected in the estimate of expected credit losses. Under IFRS 9, for non-purchased or originated credit impaired debt instruments, expected losses must be discounted to the reporting date using the effective interest rate of the asset (or an approximation thereof) that was determined at initial recognition (i.e., time value of money is required to be incorporated explicitly).

Under the CECL model, estimates of expected credit losses must reflect the time value of money explicitly only when a discounted cash flow approach is used to estimate expected credit losses. Other methods (e.g., loss-rate methods, roll-rate methods, probability-of-default methods, and an aging schedule using loss factors) are acceptable, even though they do not explicitly incorporate time value of money. Because IFRS 9 does not permit time value of money to be reflected implicitly while the CECL model does, differences in measurement can arise.

In principle, measurement of expected credit losses is conceptually the same under the FASB's CECL model and stage 2/stage 3 debt instruments under IFRS 9. However, IFRS 9 requires the measurement of expected credit losses to reflect an unbiased and probability-weighted amount that is determined by evaluating the range of possible outcomes, as well as incorporating the time value of money. More specifically, IFRS 9 defines expected credit losses as the weighted average of credit losses, with the weightings being respective risks of a default occurring. Although consideration of all possible scenarios is not required, at a minimum, the risk or probability that a credit loss occurs must be considered, even if the probability of a credit loss occurring is low. In contrast, the CECL model allows for the use of a single forecast and does not require a probability-weighted measurement of expected credit losses. Entities, therefore, will need to measure expected credit losses on assets that have a low risk of loss. Thus, if an institution does not adopt a centralized approach, there may be instances where the estimate under IFRS 9 differs from the CECL expected loss estimate. To optimize implementation efforts for such debt instruments, banks should develop a unified methodology for estimating expected credit losses.

## Differences between standards

### *Contractual life for credit cards*

An additional difference between the standards is in determining the contractual life for credit cards (or other cancellable corporate facilities).

Under CECL, if an entity has the unconditional ability to cancel the unfunded portion of a loan commitment, the entity would not be required to estimate expected credit losses on that portion, even if the entity has historically never exercised its cancellation right.

However, under IFRS 9, financial institutions will be required to measure expected credit losses over the period for which they are exposed to credit risk. For example, revolving credit facilities, such as credit cards and overdraft facilities, can be contractually withdrawn by the lender with as little as one day's notice. In practice, however, lenders continue to extend credit for a longer period and may only withdraw the facility after the credit risk of the borrower increases. Companies will have to determine the behavioral life for these debt instruments under IFRS 9 and will not have the same determination under CECL.

### *Other minor differences*

Modifications of financial assets is another known difference between the standards. Under CECL a concession provided to a troubled borrower is treated to be a continuation of the original lending agreement. However, the concept of a troubled debt restructuring does not exist in IFRS 9.

In addition, IFRS 9 does not permit the application of nonaccrual practices while CECL does permit it.

- Identifying synergies between modeling techniques used for stress testing, capital, loan loss reserve, and other regulatory requirements
- Centralizing and aligning data sourcing requirements to simplify data architecture design, eliminate redundancies, reduce cost, and enhance operational efficiencies

Efforts to comply with the new credit impairment models will likely create downstream impact on an institution's current business processes, control environment, and operating model. Institutions should consider adopting a broad approach to end-to-end process redesign. The following can reduce implementation efforts and operational burden:

- Identifying multi-purpose processes and converging control points to enhance use of existing credit risk models, governance framework, validation processes, and financial and regulatory reporting processes. For example, processes and controls related to Basel III, Comprehensive Capital Analysis and Review (CCAR)/Dodd-Frank Act Stress Testing (DFAST) processes, and eventually CECL have several points of convergence.
- Dual-purpose chart of account definitions and classifications of both on- and off-balance-sheet exposures can facilitate a holistic approach for balance sheet mapping and ongoing exposure identification activities.

### **Reap the benefits of an integrated approach**

Adopting an integrated approach for end-to-end process design and implementing standardized processes and controls can significantly alleviate implementation and operational burden. Furthermore, a well-thought-out integrated approach should lend itself to a consistent framework and is more likely to be accepted by auditors and regulators.

## **Building an integrated framework**

Identifying the intersection of requirements between the FASB's and IASB's credit impairment models and adopting a unified strategy for estimating expected credit losses that effectively capitalizes on interdependencies can allow a financial institution to gain operational efficiencies and facilitate a lean implementation program.

The following can facilitate a lean IFRS 9 implementation while laying the foundation for CECL:

- Identifying how existing capabilities (i.e., provision for loss framework and parallel regulatory and reporting processes) can be leveraged in estimating expected credit losses



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## Footnotes

- <sup>1</sup> Other publications in this series can be found at [www.deloitte.com/us/all](http://www.deloitte.com/us/all).
- <sup>2</sup> IFRS 9, Financial Instruments.
- <sup>3</sup> ASU 2016-13, which amends the guidance on the impairment of financial instruments has added to US GAAP an impairment model (known as the current expected credit loss (CECL) model)
- <sup>4</sup> The term “debt instruments” used in this context applies to off-balance-sheet exposures, including guarantees.
- <sup>5</sup> Specifically for originated loans or non-credit impaired purchased assets.
- <sup>6</sup> “Sixth Global IFRS Banking Survey: No time like the present,” Deloitte LLP, May 2016. <http://www2.deloitte.com/global/en/pages/financial-services/articles/global-ifrs-banking-survey.html#>.
- <sup>7</sup> “Basel Committee on Banking Supervision, Guidance on credit risk and accounting for expected credit losses,” Bank for International Settlements, December 2015. <http://www.bis.org/bcbs/publ/d350.pdf>
- <sup>8</sup> The purpose of this document is to provide supervisory guidance on accounting for expected credit losses that does not contradict with accounting guidance.
- <sup>9</sup> While the document highlights three specific IFRS 9 concepts, “Loss allowance at an amount equal to 12-month ECL,” “Assessment of significant increase in credit risk,” and “Use of practical expedients,” the guidance should still be considered for other accounting frameworks, i.e., CECL.
- <sup>10</sup> “Basel Committee on Banking Supervision, Guidance on credit risk and accounting for expected credit losses,” Paragraph A16.
- <sup>11</sup> “Basel Committee on Banking Supervision, Guidance on credit risk and accounting for expected credit losses,” Paragraph A48.
- <sup>12</sup> “Basel Committee on Banking Supervision, Guidance on credit risk and accounting for expected credit losses,” Paragraph 46.

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