INDUSTRY GUIDANCE ON THE IMPLEMENTATION OF IFRS 9

Introduction

International Financial Reporting Standard (IFRS) 9 introduces significant changes in the accounting for financial instruments, particularly for financial institutions. It is anticipated that significant changes for the accounting for impairment of loans and other financial assets will be required. The standard requires recognition of either 12-month or lifetime Expected Credit Losses (ECL), generally on the day a financial asset is first recognised. As a result, valuation allowances are likely to increase, with a corresponding decrease in retained earnings.

The Bank of Sierra Leone (BSL) expects a disciplined, high-quality approach to the assessment and measurement of ECL under the IFRS 9 accounting framework. The guidance herein should be read holistically with the understanding that a checklist approach to applying this guidance is not intended. For example, the guidance does not set out principles and expectations targeted at specific categories of loans such as corporate, retail and project finance. The BSL understands that credit risk management practices and information available to banks will vary to a certain extent depending on the type of lending exposure. In this regard, certain aspects of the guidance may be more applicable to the individual credit assessment of a large corporate borrower while other aspects may be more relevant to collective assessments of a particular group of retail customers. The principles and the expectations within the guidance should be read in such a context.

Banks should also give due consideration to the application of the principle of materiality. However, this should not result in individual exposures or portfolios being considered immaterial if, cumulatively, these represent a material exposure to the bank. In addition, materiality should not be assessed only on the basis of the potential impact on the profit or loss statement at the reporting date. For instance, large portfolio(s) of lending exposures such as real estate mortgages would generally be considered material even if they are highly collateralised.

In considering how to take proportionality or materiality into account in the design of an ECL methodology or in its implementation, it is important to ensure that bias is not being introduced. In cases where banks believe that their approach to implementation is likely to have introduced bias, they should correct their assessment for identified bias and thus ensure that the objective of the IFRS 9 is met (see in particular IFRS 9, paragraphs B5.5.1–B5.5.6).

Content

Glossary

BSL	Bank of Sierra Leone
ECL	Expected Credit Losses
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standard
LGD	Loss Given Default
PV	Present Value
PD	Probability of Default
FVTPL	Fair Value Through Profit & Loss
FVOCI	Fair Value Through Other Comprehensive Income
HTM	Hold to Maturity
AFS	Available for Sale
L & R	Loans & Receivables

1. Sound ECL Methodologies

Banks should adopt, document and adhere to policies which include sound methodologies, procedures and controls for assessing and measuring credit risk on all lending exposures. The measurement of allowances should build upon those methodologies and result in the appropriate and timely recognition of ECL in accordance with IFRS 9.

The credit risk assessment and measurement process should provide the relevant information for senior management to make its experienced judgements about the credit risk of lending exposures, and the related estimation of ECL.

The BSL expects that banks should leverage and integrate common processes, systems, tools and data that are used within the bank to determine if, when, and on what terms, credit should be granted; monitor credit risk; and measure allowances for both accounting and capital adequacy purposes.

The bank's allowance methodologies should clearly document the definitions of key terms related to the assessment of credit risk and ECL measurement (such as loss and migration rates, loss events and default). Where different terms, information or assumptions are used across functional areas (such as accounting, capital adequacy and credit risk management), the underlying rationale for these differences should be documented and approved by senior management. Information and assumptions used for ECL estimates should be reviewed and updated as required by IFRS 9. Moreover, the rationale for changes in assumptions that affect the measurement of ECL should be well documented.

The BSL expects that banks should have in place adequate processes and systems to appropriately identify, measure, evaluate, monitor, report and mitigate the level of credit risk. During the transition to the ECL accounting model, existing processes and systems should be evaluated and, if necessary, modified to collect and analyse relevant information affecting the assessment of credit risk and ECL measurement.

Banks should adopt and adhere to written policies and procedures detailing the credit risk systems and controls used in their credit risk methodologies, and the separate roles and responsibilities of the bank's management body and senior management.

2. Documentation

Banks should adequately document, and periodically update as necessary, the following:

- The ECL assessment and measurement methods (such as a loss rate method, probability of default (PD)/loss-given-default (LGD) method, or another method) to be applied to each exposure or portfolio;

- Reasons why the selected method is appropriate, especially if different ECL measurement methods are applied to different portfolios and types of individual exposures. Banks should be able to explain the rationale for any changes in measurement approach (for example, a move from a loss rate method to a PD/LGD method) and the quantitative impacts of such changes;

- Inputs, data and assumptions used in the allowance estimation process, such as historical loss rates, PD/LGD estimates and economic forecasts;

- How the life of an exposure or portfolio is determined (including how expected prepayments and defaults have been considered);

- The time period over which historical loss experience is evaluated;

- Any adjustments necessary for the estimation of ECL in accordance with IFRS 9. For example, if current and forecasted economic conditions are different from those that existed during the historical estimation period being used, adjustments that are directionally consistent with those differences should be made. In addition, a bank may have experienced little to no actual losses in the historical period analysed; however, current or forward-looking conditions can differ from conditions during the historical period, and the impact of these changes on ECL should be assessed and measured;

- The process for evaluating the appropriateness of significant inputs and assumptions in the ECL measurement method chosen. The basis for inputs and assumptions used in the process of the estimation of allowances should generally be consistent from period to period. Where the inputs and assumptions or the basis for these change, the rationale should be documented;

- Identification of the situations that would generally lead to changes in ECL measurement methods, inputs or assumptions from period to period (for example, a bank may state that a loan that had been previously evaluated on a collective basis using a PD/LGD method may be removed and evaluated individually using the discounted cash flow method upon receipt of new, borrower-specific information such as the loss of employment);

- Consideration of the relevant internal and external factors that may affect ECL estimates, such as the underwriting standards applied to a lending exposure at origination and changes in industry, geographical, economic and political factors;

- How ECL estimates are determined (for example historical loss rates or migration analysis as a starting point, adjusted for information on current and expected conditions). A bank should have an unbiased view of the uncertainty and risks in its lending activities when estimating ECL;

- Factors considered when establishing appropriate historical time periods over which to evaluate historical loss experience. A bank should maintain sufficient historical loss data to provide a meaningful analysis of its credit loss experience for use as a starting point when estimating the level of allowances on a collective or individual basis;

- The extent to which the value of collateral and other credit risk mitigants affects ECL;

- The bank's policies and procedures on write-offs and recoveries;

- Policies for the analyses, estimates, reviews and other tasks/processes that are inputs to or outputs from the credit risk assessment and measurement process, performed by competent and well-trained staff and validated by staff who are independent of the bank's lending activities;

- Methods used to validate models for ECL measurement (for example back-tests).

3. Loss Allowance Measured at 12-Month ECL (Stage 1 Assets)

Upon initial recognition of a financial asset, IFRS 9 generally requires the establishment of 12-month ECL. In addition, "if, at the reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12-month expected credit losses". The BSL expects that a bank will always measure ECL for all lending exposures, and that a nil allowance will be rare because ECL estimates are a probability-weighted amount that should always reflect the possibility that a credit loss will occur.

The BSL expects banks to adopt an active approach to assessing and measuring 12-month ECL that enables changes in credit risk to be identified in a timely manner. Estimates of the amount and timing of 12-month ECL should reflect management's experienced credit judgment and represent an unbiased probability weighted estimate of expected credit losses by considering a range of possible outcomes. The methodology used to estimate 12-month ECL should be robust at all times and should allow for the timely recognition of ECL.

IFRS 9 defines an amount equal to 12-month ECL as the "portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date". The BSL emphasises that an amount equal to the 12-month ECL is not only the losses expected in the next 12 months; rather, it is the expected cash shortfalls over the life of the lending exposure or group of lending exposures, due to loss events that could occur in the next 12 months.

In formulating the estimate of the amount equal to 12-month ECL, it is important to consider reasonable and supportable information that affects credit risk, especially forward-looking information, including macroeconomic factors. A bank should exercise its experienced credit judgment to consider both qualitative and quantitative information that may affect the bank's assessment of credit risk. IFRS 9 provides that an entity need not undertake an exhaustive search for information when measuring an amount equal to 12-month ECL; nevertheless, banks should actively incorporate information that may affect the estimate of ECL and should not exclude or ignore relevant information that is reasonably available. For the measurement of an amount equal to 12-month ECL to be sufficiently sensitive to relevant drivers of credit risk, the BSL expects banks to consider all reasonable and supportable information that is reasonably available, without bias, and known to affect the assessment and measurement of credit risk. This will permit the timely recognition of ECL in response to changes in credit risk and better reflect the inherent credit risk associated with lending.

4. Low Credit Risk Exemption

IFRS 9 introduces an exception to the general model in that, for "low credit risk" exposures, banks have the option not to assess whether credit risk has increased significantly since initial recognition. It was included to reduce operational costs for recognising lifetime ECL on financial instruments with low credit risk at the reporting date. Although use of the low-credit-risk exemption is provided as an option in IFRS 9, the BSL expects that use of this exemption should be limited. In particular, it expects banks to conduct timely assessment of significant increases in credit risk for all lending exposures. In BSL's judgment, use of this exemption by banks for the purpose of omitting the timely assessment and tracking of credit risk would reflect a low-quality implementation of the ECL model and IFRS 9.

In that context, the BSL expects that banks should always recognise changes in 12-month ECL through the allowance where there is not a significant increase in credit risk and a move to lifetime measurement if there is a significant increase in credit risk. In the BSL's view, in order to achieve a high-quality implementation of IFRS 9, any use of the low-credit-risk exemption must be accompanied by clear evidence that credit risk as of the reporting date is sufficiently low that a significant increase in credit risk since initial recognition could not have occurred.

According to IFRS 9, paragraph B5.5.22, the credit risk on a financial instrument is considered low if:

1. the financial instrument has a low risk of default;
2. the borrower has a strong capacity to meet its contractual cash flow obligations in the near term; and
3. adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations.

To illustrate the meaning of low credit risk, IFRS 9, paragraph B.5.5.23, cites as an example an instrument with an external "investment grade" rating. The BSL is of the view that this is only an example and that all lending exposures that have an "investment grade" rating from a credit rating agency cannot automatically be considered low credit risk. The BSL expects banks to rely primarily on their own credit risk assessments in order to evaluate the credit risk of a lending exposure, and not to rely solely or mechanistically on ratings provided by credit rating agencies (where the latter are available). Nevertheless, optimistic internal credit ratings, as compared with external ratings, would require additional analysis and justification by management.

5. 30 Days Past-due Rebuttable Presumption

IFRS 9 contains a rebuttable presumption that a significant increase in credit risk occurs no later than 30 days past due.

The BSL agrees with the view expressed in IFRS 9 that delinquency is a lagging indicator of significant increases in credit risk. Banks should have credit risk assessment and management processes in place to ensure that credit risk increases are detected well ahead of exposures becoming past due or delinquent. The BSL expects that a bank would not use the more-than-30-days-past-due rebuttable presumption as a primary indicator of transfer to lifetime ECL, while recognising that appropriate use of this rebuttable presumption as a backstop measure would not be precluded in accordance with IFRS 9 alongside other, earlier indicators for assessing significant increase in credit risk.

The BSL expects that any assertion that the more-than-30-days-past-due presumption is rebutted on the basis that there has not been a significant increase in credit risk will be accompanied by a thorough analysis clearly evidencing that 30 days past due is not correlated with a significant increase in credit risk. Such analysis should consider both current and reasonable and supportable forward-looking information that may cause future cash shortfalls to differ from historical experience.

In this regard, the BSL expects a bank to use relevant forward-looking information that is reasonable and supportable, to analyse whether there is any substantive relationship between such information and credit risk drivers. The BSL expects that a bank will not use the 30-days-past-due rebuttable presumption unless it has demonstrated that the forward-looking information had no substantive relationship with the credit risk driver or such information is not available without undue cost or effort.

In the limited instances where past-due information is the best criterion available to a bank to determine when exposures should move to the lifetime ECL category, banks should pay particular attention to their measurement of 12-month ECL allowance to ensure that ECL are appropriately captured in accordance with the measurement objective of IFRS 9. Moreover, banks should recognise that significant reliance on backward-looking information will introduce bias into the implementation of an ECL model and that the BSL expects banks to pay particular attention to ensuring that the objectives of the IFRS 9 impairment requirements (i.e. to reflect ECL that meet the stated measurement objectives and to capture all significant increases in credit risk) are met.

6. Loss Allowance Measured at Lifetime ECL (Stage 2 Assets)

IFRS 9 requires assets to be moved to “Stage 2”, with recognition of Lifetime ECL, if it is determined at the reporting date that there has been a significant increase in credit risk since initial recognition of the asset. In assessing a significant increase in credit risk, banks should consider quantitative, current and forward-looking qualitative, and “back-stops” (e.g., the 30-day past due rebuttable presumption in IFRS 9) indicators.

In using quantitative indicators, banks should consider the change in lifetime Probability of Default (PD) at the reporting date with the lifetime PD at initial recognition. The criteria for relative quantitative increases in PD indicative of a significant increase in credit risk should be defined and documented by banks. The assessment by banks should, among other factors, consider changes in credit risk at the counterparty and individual credit level.

The BSL strongly endorses the IASB’s view that “lifetime expected credit losses are generally expected to be recognised before a financial instrument becomes past due” and that “typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example a modification or restructuring) are observed”. (See IFRS 9, paragraph B5.5.2). Therefore, it is important that a bank’s analyses take into account the fact that the determinants of credit losses very often begin to deteriorate a considerable time (months or, in some cases, years) before any objective evidence of delinquency appears in the lending exposures affected. Delinquency data are generally backward-looking, and the BSL believes that they will seldom on their own be appropriate in the implementation of an ECL approach by banks, consistent with IFRS 9.

Banks should have a clear policy, including well developed criteria on what constitutes a “significant” increase in credit risk for different types of lending exposures. Such criteria and the reasons why these approaches and definitions are considered appropriate should be disclosed in accordance with IFRS 7, paragraph 35F. IFRS 9, paragraph 5.5.9, requires that, when making the assessment of significant increases in credit risk, “an entity shall use the change in the risk of default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses”. In other words, this assessment is made in terms of the risk of a default occurring and not expected credit loss (i.e., before consideration of the effects of credit risk mitigants such as collateral or guarantees).

In addition to the criteria provided in IFRS 9, paragraph B5.5.17, banks are advised to consider the following qualitative factors in assessing significant increase in credit risk:

- Classification of the exposure by internal or external credit ratings;
- Deterioration of relevant credit risk drivers for an individual obligor (or pool of obligors);
- Expectation of forbearance or restructuring due to financial difficulties;
- Evidence that full repayment of principal and interest without realisation of collateral is unlikely, regardless of the number of days past due; and
- Deterioration in credit worthiness due to factors other than those listed above.

To assess whether a financial instrument should move to a lifetime ECL measure, the change in the risk of a default occurring over the expected life of the financial instrument must be considered. In some circumstances, IFRS 9 allows changes in the risk of a default occurring over the next 12 months to be used to make this assessment; however, this may not always be appropriate. Particular attention is drawn to the examples set out in IFRS 9, paragraph B5.5.14.

7. Collective (Group) Assessments

ECL measurement may be determined on an individual or collective basis. Where a bank sets its transfer threshold for groups of financial assets, it is important that all financial assets within that group have similar risk characteristics at initial recognition.

IFRS 9, paragraph B5.5.5 provides the following guidance: “For the purpose of determining significant increases in credit risk and recognising a loss allowance on a collective basis, an entity can group financial instruments on the basis of shared credit risk characteristics with the objective of facilitating an analysis that is designed to enable significant increases in credit risk to be identified on a timely basis. The entity should not obscure this information by grouping financial instruments with different risk characteristics. Examples of shared credit risk characteristics may include, but are not limited to, the:

(a) instrument type;

(b) credit risk ratings;
(c) collateral type;
(d) date of initial recognition;
(e) remaining term to maturity;
(f) industry;
(g) geographical location of the borrower; and
(h) the value of collateral relative to the financial asset if it has an impact on the probability of a default occurring (for example, non-recourse loans in some jurisdictions or loan-to-value ratios)."

The list above is not exhaustive, and the BSL expects banks to review the appropriateness of collective assessments, on an on-going basis. In some cases, it may be appropriate to combine two or more "common risk characteristics" within a group of collectively assessed assets, in order to further segment the assets within the group. In addition, where information becomes available to management indicating that further or different segmentation within a group of lending exposures is required, the group should be split into subgroups and the measurement of the amount equal to 12-month ECL should be updated separately for each subgroup or, in the case of transient circumstances, a temporary adjustment should be applied.

The BSL expects that, in instances where it is apparent that some exposures in a group have experienced a significant increase in credit risk, that a subset or a proportion of the group will transfer to lifetime measurement of ECL even though it is not possible to identify this on an individual exposure basis.

8. Loss Allowance Measured at Lifetime ECL (Stage 3 Assets)

Stage 3 loans include those for which a credit event (default) has occurred. Such loans should carry a lifetime ECL. The BSL expects banks to adopt a realistic and supportable definition of "default" in applying IFRS 9.

9. Collateral

For the purposes of measuring ECL, the estimate of expected cash shortfalls should reflect the cash flows expected from collateral and other credit enhancements that are part of the contractual terms and are not recognised separately by the bank. The estimate of expected cash shortfalls on a collateralised loan reflects the amount and timing of cash flows that are expected from foreclosure on the collateral less the costs of obtaining and selling the collateral, irrespective of whether foreclosure is probable. Therefore, the estimate of expected cash flows considers the probability of a foreclosure and the cash flows that would result from it.

The BSL expects banks to use realistic, supportable and well-documented estimates of the value of collateral and the present value (PV) of any cash flows that may be derived from the ultimate realisation of such collateral. The discount rate used to determine the PV is the effective interest rate for the loan, as determined at the time the loan is first recognised.

10. Modified or Restructured Loans

When determining whether there is a significant increase in credit risk for a modified lending exposure, the BSL expects a bank to demonstrate whether such modifications or renegotiations have improved or restored the ability of the bank to collect interest and principal payments compared with the situation upon initial recognition. In developing ECL estimates, a bank should also take into account whether the modification or renegotiation has improved or restored the ability of the bank to collect interest and principal payments as compared with the situation prior to modification. Consideration should also be given to the substance of modified contractual cash flows as well as the implications of the modifications for the future credit risk of the exposure (taking into consideration the obligor's credit risk). Factors to consider include, but are not limited to, the following;

(a) whether the modification or renegotiation of the contractual terms and resulting cash flows is economically beneficial to the obligor, compared with the original, unmodified contractual terms, and how the modification economically affects the obligor's ability to repay the debt;
(b) whether factors can be identified that support a bank's assessment of the obligor's ability to repay the debt, including circumstances leading up to the modification, and future prospects of the obligor as a result of the modifications, considering current conditions, macroeconomic forecasts, and prospects for the sector/industry within which the obligor operates, the obligor's business model, and the obligor's business (management) plan that outlines the obligor's expectations of its future performance, financial resilience and cash flows; and
(c) whether the obligor's business plan is feasible, realisable and consistent with the repayment schedule of interest and principal under the modified contractual terms of the lending exposure.

Exposures transferred to lifetime ECL that are subsequently renegotiated or modified, and not de-recognised, should not move back to 12-month ECL measurement unless there is sufficient evidence that the credit risk over the life of the exposure has not increased significantly compared with that upon initial recognition. For example, where a bank grants various concessions such as interest rate reductions or postponements of principal repayments to obligors in financial difficulty, the loan may exhibit characteristics of a lower credit risk even though in reality the obligor may continue to experience financial difficulty with no realistic prospects of making scheduled repayments over the remaining term of the exposure. IFRS 9 notes that evidence that the criteria for the recognition of lifetime ECL are no longer met could include a history of up-to-date and timely payment performance against the modified contractual terms. Typically, a customer would need to demonstrate consistently good payment behaviour over a period of time before the credit risk is considered to have decreased. For example, a history of missed or incomplete payments would not typically be erased by simply making one payment on time following a modification of the contractual terms.

11. Commitments and Guarantees

In addition to on-balance sheet financial assets, the IFRS 9 model also applies to loan commitments and financial guarantees. The date that the bank becomes a party to the irrevocable commitment should be considered to be the date of initial recognition for the purpose of applying the IFRS 9 ECL requirements.

The application guidance for IFRS 9 contains the following guidance:

"B5.5.8 For loan commitments, an entity considers changes in the risk of a default occurring on the loan to which a loan commitment relates. For financial guarantee contracts, an entity considers the changes in the risk that the specified debtor will default on the contract.

B5.5.30 For undrawn loan commitments, a credit loss is the present value of the difference between:

(a) the contractual cash flows that are due to the entity if the holder of the loan commitment draws down the loan; and
(b) the cash flows that the entity expects to receive if the loan is drawn down."

12. Appendix

The BSL requests banks to submit the following information not later than 31 August, 2018. (Dates refer to the deadlines set in the preliminary planning period for first time adoption)

In addition, banks should submit any subsequent changes to this information with 30 days of the changes. If the change relates to a change in accounting policy, banks should explain how the criteria in IAS 8 for changes in policy have been met (i.e., new policy is reliable and more relevant).

1. Expected Credit Loss Model

Detailed information on existing and/or proposed model(s) for ECL calculation, including information on:

a. Number of years loss data available to the bank;
b. Supporting analyses, inputs, assumptions and rationales for the ECL model;
c. Macroeconomic data (types and sources) for forecasting;
d. The extent, and any exceptions, to the two "rebuttable presumptions" included in IFRS 9; and
e. Policy for classifying financial assets into Stages 1, 2, and 3, using the format below:

Stage	Description	Criteria	Criteria	Other Criteria

		(quantitative)	**(qualitative)**	
Stage 1	12-month ECL			
Stage 2	Lifetime ECL due to significant increase in credit risk			
Stage 3	Lifetime ECL - default			

f. Policy for upgrading/downgrading financial assets in the various stages;
g. Detailed information for the valuation of equity investments, inclusive of details of valuation models; and
h. Policies for modification and renegotiation of financial assets.

2. Categories of Financial Assets and Liabilities

In addition, banks are requested to provide information on the classification (or designation) of their financial assets/liabilities as at 31 December 2017 to IFRS 9 categories, including amounts, in line with the template below: (Dates refer to the deadlines set in the preliminary planning period for first time adoption)

Financial Assets – Debt Instruments:

IAS 39 Categories				IFRS 9 Categories		
FVTPL	AFS	HTM	L&R	FVTPL	FVOCI	Amortized Cost
##				##	##	##
	##			##	##	##
		##		##	##	##
			##	##	##	##

Financial Assets – Equity Instruments:

IAS 39 Categories		IFRS 9 Categories	
FVTPL	AFS	FVTPL	FVOCI ("OCI Option")
##		##	##
	##	##	##

Financial Liabilities

IAS 39 Categories		IFRS 9 Categories	
FVTPL	Amortised Cost	FVTPL ("FV Option" or Trading)	Amortised Cost
##		##	##
	##	##	##

3. Definitions and Accounting Policies

Banks are also requested to submit definitions and accounting policies under IFRS 9, for the following:

a. Definition of "default"
b. Policy for derecognition of financial assets, including loans that have been modified/restructured
c. Policy for recognition of ECLs for loan commitments and financial guarantees
d. Intended use of the IFRS 9 rebuttable presumptions (including circumstances under which there may be deviations from these), regarding
    1) Significant increase in credit risk no later than 30 days past due
    2) Default occurring no later than 90 days past due
e. Policy for write-off of loans and other assets, under IFRS 9