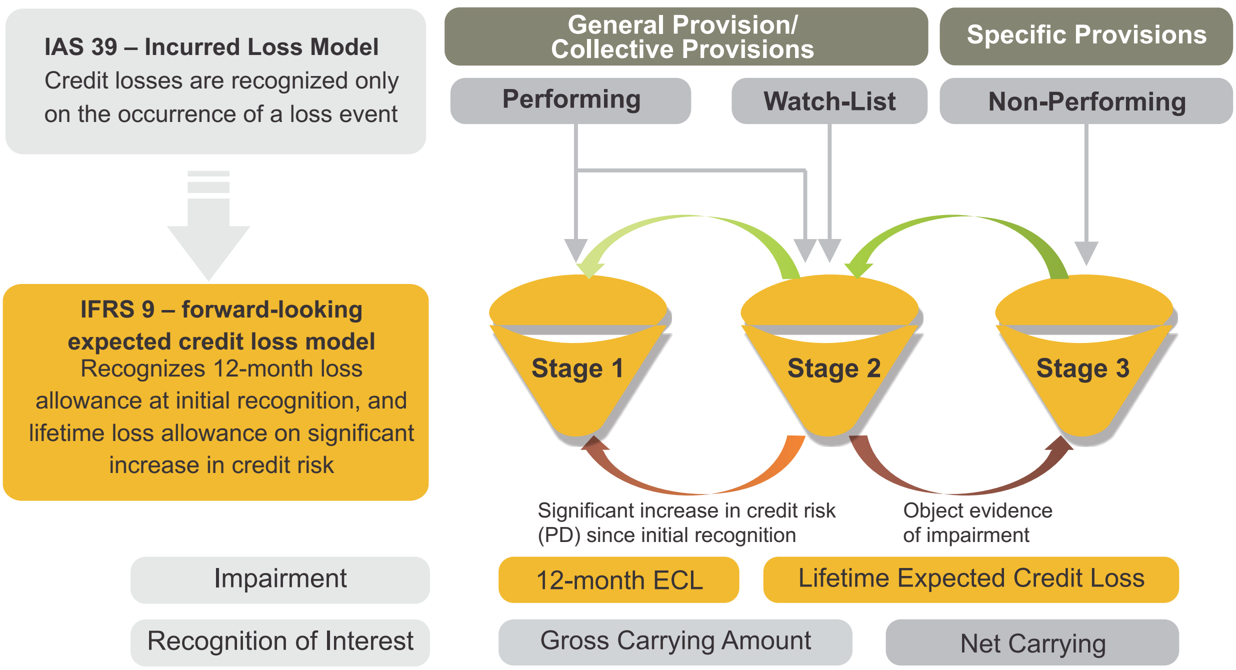
Aptivaa

Building Blocks of Impairment Modeling

As highlighted in our previous post, one of the key areas of focus pertaining to IFRS 9 principles is credit risk modeling, which is required for appropriate estimations of Expected Credit Loss (ECL). In this post we will discuss the key components of Impairment Modeling, which will call for significant attention of the Banks' management to ensure a successful implementation.

IFRS 9 uses a “three stage model” for expected credit losses based on changes in credit quality since initial recognition. Let us deliberate on the expectations pertaining to the impairment



The standard does not prescribe specific approaches used to estimate ECLs, but stresses that the approach adopted must reflect the following–

a. **Probability weighted outcome:** Rather than incorporating a best case or worst case scenario, the ECL should in entirety reflect the possibility that a credit loss occurs and the possibility that no credit loss occurs;

b. **The time value of money:** Estimates of ECL should be discounted to the reporting date;

c. **Information Set:** Reasonable and supportable forward looking information should be considered, including that with regard to macroeconomic scenario

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ECL is an estimate of present value of cash shortfalls over the life of the financial instrument, and therefore, when measuring 12-month and lifetime ECL, banks would need to consider the following requirements:

a. **Assessment of significant increase in credit risk (stage assessment)** – For financial assets which are in stage 1, 12-month ECL estimates are required, and for the assets in stage 2 and 3, lifetime ECL estimates are essential.

b. **Definition of Default** – IFRS 9 requires banks to formalise the definition of default, which is expected to be consistent with other credit risk management practices of the bank.

c. **Risk Quantification (PD/LGD approach)**

- Estimation of 12-month and lifetime Probability of Default (PD)
- PD calibration (TTC PD to PIT PD)
- Calculation of PD term structure
- Effective Maturity (expected versus contractual maturity)
- Estimation of Loss given default (LGD) and Exposure at Default (EAD)

d. **Estimation using Loss Rate approach** – Using this approach, banks would need to develop loss-rate statistics on the basis of the amount written off over the life of financial assets. Banks are also expected to adjust these historical credit loss trends for current conditions and expectations about the future.

In the coming week, we will be discussing the BCBS' expectations for high quality implementation of IFRS 9 standards.

This space aims to answer your queries pertaining to IFRS 9 principles. In case, you have any queries pertaining to IFRS 9 which you wish to discuss, do leave your comments.