

Preparing for the expected: implementing IFRS 9**Date: 15 September 2015****Speaker: Hans Hoogervorst, Chairman, IASB****Venue: ICAEW-IFRS Foundation conference, London, UK****Introduction**

Ladies and gentlemen, it is a pleasure to open this conference and welcome you. This is the third annual event organised jointly by the IFRS Foundation and ICAEW, focussing on financial reporting for financial services institutions. I would like to thank ICAEW for again hosting the event in this historic building.

Response to financial crisis

A lot has happened since we held the first joint conference in December 2013. The biggest event, obviously, being the finalisation of the financial instruments Standard (IFRS 9) in July last year. In doing so, we have worked closely with other international organisations, such as the Basel Committee for Banking Supervision and the Financial Stability Board (FSB).

The more forward-looking expected loss model in IFRS 9 should help investors get a better picture of the risks banks face with regard to potential losses on loans extended to customers.

As you know, our new impairment model requires banks to recognise, at a minimum, 12-month expected losses on all loans and full lifetime losses on loans that have experienced a significant increase in credit risk. First indications are that this model will lead to a very substantial increase in the level of provisioning, in the order of around 35 per cent.

Still, some think that IFRS 9 is not tough enough and that banks should be required to recognise full expected lifetime losses on all loans as soon as the loan has been made. Now, I am all in favour of imposing tough prudential requirements on banks, because the crisis has demonstrated that the costs of lax rules are staggering. I believe robust capital requirements are the best way to make the banking system safe and transparent accounting can be of great help too.

Imposing high, artificial losses on banks as they issue new loans, however, is not a good way to make banks safer. It would seriously distort the actual performance of a bank and would probably have highly undesirable side-effects. Let me explain this further.

Accounting should reflect the economics

First of all, forcing banks to recognise expected lifetime losses on the day they make the loans clearly does not reflect the economics. Booking a loan on market terms does not cause the bank to suffer a loss immediately. Day-one losses based on lifetime expected losses could be quite substantial, especially for long-term loans such as 30-year mortgages. Booking a loss on Day one would cause loans to be on the books at amounts substantially below their true value, thus creating a distorted picture.

Because such Day-one losses do not reflect the economics, imposing full lifetime losses at inception would have perverse consequences. A bank that is increasing its long-term lending business could show depressed earnings, even when its lending practices are perfectly healthy. That is clearly not a reflection of economic reality.

Suppose a newcomer in the lending industry wants to build up a portfolio of long-term mortgages. This new bank would be forced to swallow hefty losses even before any of its newly issued mortgages has in fact become a problem loan. Clearly this is not a good way to introduce more—and much-needed—competition into the banking industry. The already hefty entry barriers in banking would be increased by artificial accounting.

It is also easy to predict what would happen if a bank's earnings were to come under pressure. The easiest way for a bank to prop up earnings would be to simply stop making long-term loans and run down its loan book. This would be a very easy way to avoid the related lifetime loss recognition on Day one and book gains instead! In a recession, this would undoubtedly have a severe pro-cyclical effect and cut off liquidity to the market. Just when long-term lending is needed most, artificial accounting would choke off credit to viable customers.

Finally, estimating expected lifetime losses on a long-term loan is extremely difficult and the level of estimation uncertainty is greatest for new loans. The toughest estimates to make are those on long-term performing loans—and small differences in assumptions can make huge differences to earnings, because of the large volume of such loans. Earnings management would become very tempting. Artificial Day-one losses might be used to mask real future losses.

In IFRS 9, lifetime losses need to be recognised on loans that have experienced an increase in credit risk. While the trigger for such losses is much lower than in current practice, these losses will be

estimated on a subset of loans about which much more credit information is available. Clearly, this is a much less subjective exercise than calculating lifetime losses on all loans at Day one.

In sum, while imposing Day-one expected lifetime losses may look tough, it remains to be seen whether it will in fact turn out to be conservative in practice. It will most certainly lead to negative consequences for long-term lending, especially in times when we need it most. The expected loss model in IFRS 9 will lead to much more timely recognition of inevitable losses, but it avoids the pitfalls of recognising highly uncertain lifetime losses prematurely.

Implementation

The effective date of the Standard, 1 January 2018, is now less than two and a half years away. That may sound like a long time, but we all know that when it comes to making big accounting changes, it is not. The impairment element of IFRS 9 will result in fundamental change to current practice. That is why this conference, which aims to focus on the practicalities of implementation, is so important.

That is also why we established the Impairment Transition Resource Group (ITG) last year. This group consists of experienced preparers and auditors from around the world, with the Basel Committee and IOSCO attending the meetings as observers. It has so far met twice and the third meeting takes place tomorrow. It is a public meeting; you are all free to attend or watch it via our website. There is a further meeting pencilled in for December. If you still have implementation issues after today's discussions, you can submit them for consideration as topics to be discussed by the ITG.

There are many parties who need to do work when a change of this magnitude comes into force and that requires international collaboration. For example, the Basel Committee will deliver guidance on implementation and is also looking at how the new Standard will affect capital requirements. The Enhanced Disclosures Task Force (EDTF) is expected to discuss later this year potential updates to their recommended disclosures by banks in relation to the expected credit loss impairment models. The IASB is closely involved with these initiatives.

Interaction with insurance contracts Standard

IFRS 9 as a Standard will obviously not only have an impact on banks. Though the focus of today's event—impairment—is most relevant for banks, IFRS 9 will also have an impact on the insurance industry.

As you are aware, the IASB is getting close to finalising a new Standard for insurance contracts. Because it is clear that the new insurance contracts Standard will have a later effective date than the

effective date of IFRS 9, insurers have raised concerns. They are worried about potential accounting mismatches and temporary volatility if they are unable to implement both Standards at the same time.

The IASB is working hard to find a pragmatic solution to those concerns, while limiting the impact on the wider financial services community, investors and regulators. We want to get all the benefits from the new financial instruments Standard—improved classification and measurement, improved accounting and disclosure of expected credit losses, improved hedge accounting and disclosures about risk management—as soon as possible.

We made some initial decisions on this in July and will continue discussions on this topic later this month, when we will also discuss the potential deferral of IFRS 9 for certain companies. We realise the importance of coming to a conclusion on this matter and are committed to completing this work stream as quickly as possible.

Close

With that, I would like to introduce today's keynote speaker; Richard Thorpe. Richard is the Financial Stability Board (FSB) Adviser on Accounting and Auditing. He has a keen interest in financial reporting and has many years of experience grappling with financial institution regulation both in the UK and at an international level. Richard was also part of the IFRS Advisory Council, which advises the IFRS Foundation Trustees and the IASB on its strategic direction and technical work plan. Richard has wide experience and intimate knowledge of accounting, so I am very much looking forward to his presentation today. Richard, over to you!