IFRS 9 and CECL:

Are banks prepared and can they find a silver lining?

A global survey

November 2017

McKinsey&Company

IACPM
INTERNATIONAL ASSOCIATION OF CREDIT PORTFOLIO MANAGERS

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About the IACPM

The IACPM is an industry association established to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. The Association represents its members before regulatory and administrative bodies in the US and internationally, holds bi-annual conferences and regional meetings, conducts research on the credit portfolio management field, and works with other organizations on issues of mutual interest relating to the measurement and management of portfolio risk.

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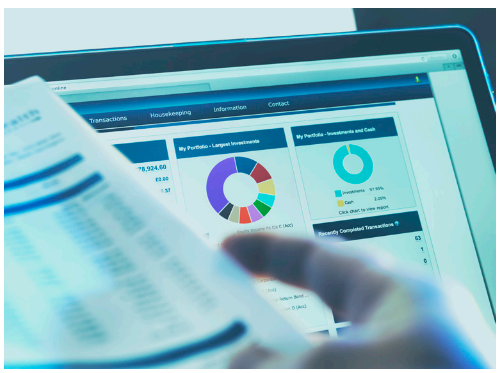
A survey of financial institutions reveals the expected impact of IFRS 9 and CECL, the new accounting standards for credit loss allowances.

Financial institutions globally are bracing themselves for new accounting standards that will drastically change how they classify and measure expected credit losses (ECL). In Asia, Canada, and Europe, International Financial Reporting Standard 9 (IFRS 9), published by the International Accounting Standards Board (IASB), is set to take effect on January 1, 2018. Last year, the US Financial Accounting Standards Board (FASB) issued final guidance on its Current Expected Credit Loss (CECL) model, which will go into effect on January 1, 2020.

US institutions are understandably not as far along in preparing for the new standards as their European counterparts, which have been working for months to adjust their operations and compliance programs. To date, IFRS 9 adopters have dedicated most of their efforts to addressing technical and methodological issues in their existing models and practices—such as determining what criteria might result in a reclassification of assets from IFRS 9 Stage 1 to Stage 2, as well as turning their 12-month loss models into lifetime loss models for both CECL and Stage 2 assets within IFRS 9. Although this work is essential, banks that focus only on the technical aspects of the new rules run the risk of overlooking the business and strategic impact.



The lack of focus on business and strategic impact is exacerbated by the fact that most banks are running their IFRS 9 and CECL adoption programs from their risk and finance departments, without the active involvement of business unit leaders. Risk and finance functions are developing, validating, and running models that produce expected loss numbers. Business leaders' involvement is very limited in this process, however, which means they have a limited understanding of why decisions are made and repercussions on business and strategy. And those repercussions could be significant, to say the least. The new standards may result in institutions tightly tying reserves to market cycles. Particularly in an economic downturn, this procyclical stance may have a profound, and as yet poorly understood, effect. And banks will need to account for this effect in their capital management strategy and risk appetite statements. Furthermore, the effects of the new reserve requirements will be unequally distributed; the most-affected asset classes could see a significant impact on pricing methodology, average maturity of loans, and willingness to lend.

For US banks just starting to develop strategies to address CECL, the experiences of European banks provide a valuable point of reference for how to prepare. While the structure and time frames of the two new accounting standards differ, the high-level implications for banks are similar and should be used to inform efforts to develop more-effective risk management strategies going forward. A new survey of 51 financial institutions around the globe sought to highlight how the industry views the strategic and business implications of the accounting changes. We also set out to learn about banks' key priorities; create a common view on critical elements for stakeholders, including regulators; and gather insights on the different approaches banks are using to implement the standards.

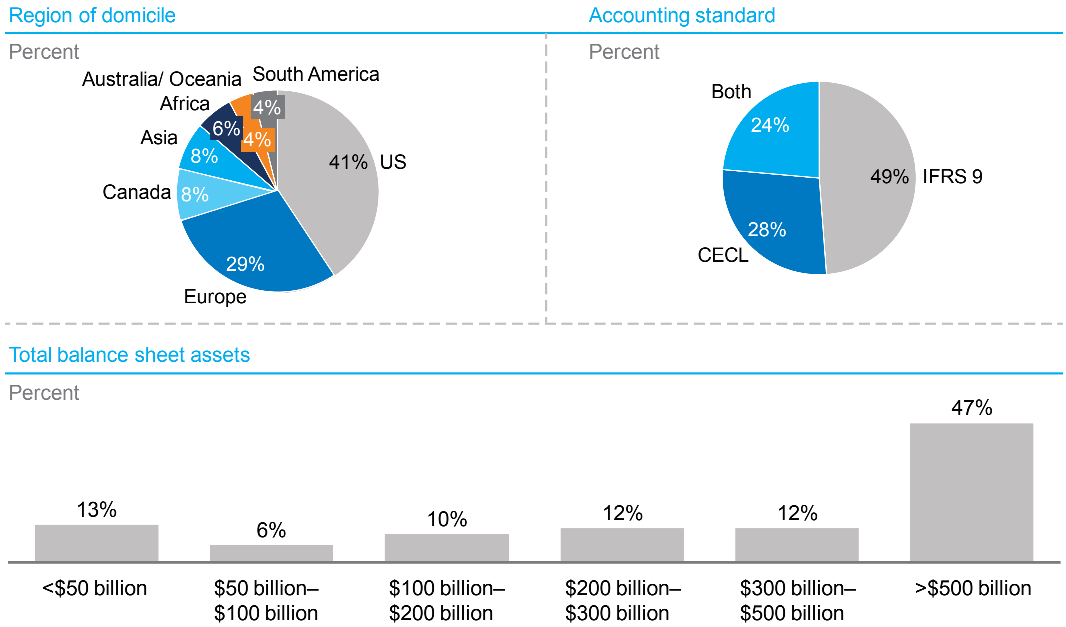
Banks that fail to grasp and act upon the ramifications of these new standards expose themselves to escalating risks while missing out on opportunities to mitigate hits on profitability and, in some cases, create a strategic advantage.

How banks are preparing for the new standards: Topline survey results

To learn more about how the sector is progressing in the design and implementation of measures to address both IFRS 9 and CECL, McKinsey and the International Association of Credit Portfolio Managers (IACPM) conducted a survey of 51 financial institutions—including 48 traditional banks, two development banks, and one institution that serves as both an export credit agency and an insurance company—between July and August 2017. About half of the respondents are headquartered in North America, and 29 percent are headquartered in Europe (Exhibit 1).

Exhibit 1

Survey participants come from a broad range of financial institutions in different geographies and with diverse asset sizes



SOURCE: McKinsey analysis

Our results show that implementation has been challenging and is generally behind schedule. Consistent with most regulatory programs that are more complex than anticipated and result in delayed timelines and a huge rush to the finish line, IFRS 9 programs are currently delayed for most of the banks we surveyed. About 60 percent of IFRS 9 adopters said that they had not yet started their testing and parallel-run phases,[1] despite that the adoption date is only a few months away. While CECL adopters have more time—two years more, to be exact—given the sweeping impact of the new rules, they, too, are likely behind where they should be.

A rush to the finish would mean banks would need to cut corners, adopt prudent assumptions, and cut back on sensitivity and impact testing. This course of action might result in adverse consequences within their models, and once these models are live, changes will be difficult to make. About 35 percent of CECL adopters said they are in very early stages of preparation and have not even conducted a gap analysis. This delay is partly due to a lack of clarity on

1 A parallel run involves changing from an existing system to a new one piece by piece, which results in both systems running simultaneously for a time.

the requirements, some of which are ambiguous, and compounded by a lack of guidance and interpretation from regulators. The fact that business lines are only partially involved in the development and management of the programs may be one impediment to the banks' ability to understand and mitigate the possible business and strategic implications of the new rules. Banks therefore need to build a collaborative effort among their finance, risk, and business units, as well as credit portfolio management, to effectively navigate these challenges.

Key strategic insights

Broadly, the survey results confirm that most respondents are still forming an understanding of the potentially significant strategic impact of the new standards.

Regulatory response. About 65 percent of IFRS 9 adopters in our sample said they expect differences between the standards will cause a significant variance in provisions levels and volatility, thus thwarting a level playing field for certain products. Indeed, about 40 percent of all banks said they anticipate needing to increase their capital requirement, while about 70 percent said they plan to embed ECL measures into stress testing.

Credit portfolio management. Nearly half of respondents said that after the new standards take effect, they expect no changes in how their lending mix evolves. This may in part be a result of deviation between risk theory and business practice: risk functions generally believe there is a need to change the mix, whereas the overall business and the market don't necessarily accept the argument. If the standards go live in a benign credit environment, then it is possible there will be little impact on market pricing. The consequence may not be fully apparent to firms until the first post-adoption credit cycle downturn, and then they will start to see the pricing effect properly baked in.

Commercial strategies. Similarly, less than half of IFRS 9 adopters report that the new standard may affect how they think about their pricing methodologies. Again, given the new capital requirements, to maintain profitability banks may have no choice but to adjust their pricing methodology for longer-term and less-collateralized products, as well as for higher-risk clients. Similar to the impact on portfolio strategies, a benign credit environment will mask the impact on commercial strategies. The real impact could be seen during the first credit cycle downturn. In addition, some of the banks said they believe pricing might not change after all due to the large amount of non-bank players in the industry.

Key business insights

Respondents to the survey verified that, to date, they have indeed been focused on the technical issues associated with the new standards. In particular, most IFRS 9 adopters have recently started to think through what the standards might mean for their business.

Process design. Banks are indeed looking at their existing infrastructure and processes to determine where changes are necessary to meet the new accounting standards. More than 60 percent of the IFRS 9 and CECL adopters said they expect implementation will be challenging due to limitations in internal data availability, quality, or timelines. Because securing the right data will be critical to detecting and predicting default, as well as to compliance efforts, banks will need to identify alternative external data sources to support their analytics efforts.

Credit risk management. Respondents were split on their opinions about credit risk management ramifications. Some take the view that the accounting standard has no effect on credit risk fundamentals, and thus they require no changes to risk management practices. Others said the increase in reserve volatility has a significant impact on profit and loss and capital, and therefore the risk needs to be actively managed and adapted in response. Many IFRS 9 adopters have invested significantly in early warning system and watchlist processes to anticipate likely challenges.

How banks are preparing for the new standards: Detailed survey results

We believe banks face a number of strategic and business challenges in adapting to the new environment under IFRS 9 and CECL. Financial institutions that start to plan for these changes now will have a considerable advantage over those that have yet to consider the full implications of IFRS 9 for their business. The survey found that to date, IFRS 9 adopters have focused primarily on model development, but they have spent less time considering the potential impact on risk and profits or how they might need to alter their business strategy. In the case of CECL and its later implementation timelines, banks are just starting to gain a deeper understanding of the requirements and develop models. Many IFRS 9 banks planned parallel runs in 2017, but their implementation timelines slipped and they were unable to follow through. Heeding the cautionary experiences of institutions planning for IFRS 9, the majority of US banks are moving full force for a parallel run in 2019.

The following sections detail how banks are currently thinking about the potential impact of impending accounting requirements in terms of credit portfolio management strategies, commercial strategies, credit risk management practices, structure and process design for regulatory compliance, and regulatory understanding.

Key finding:
Nearly 46 percent of respondents expect **no change** in the evolution of their lending mix.

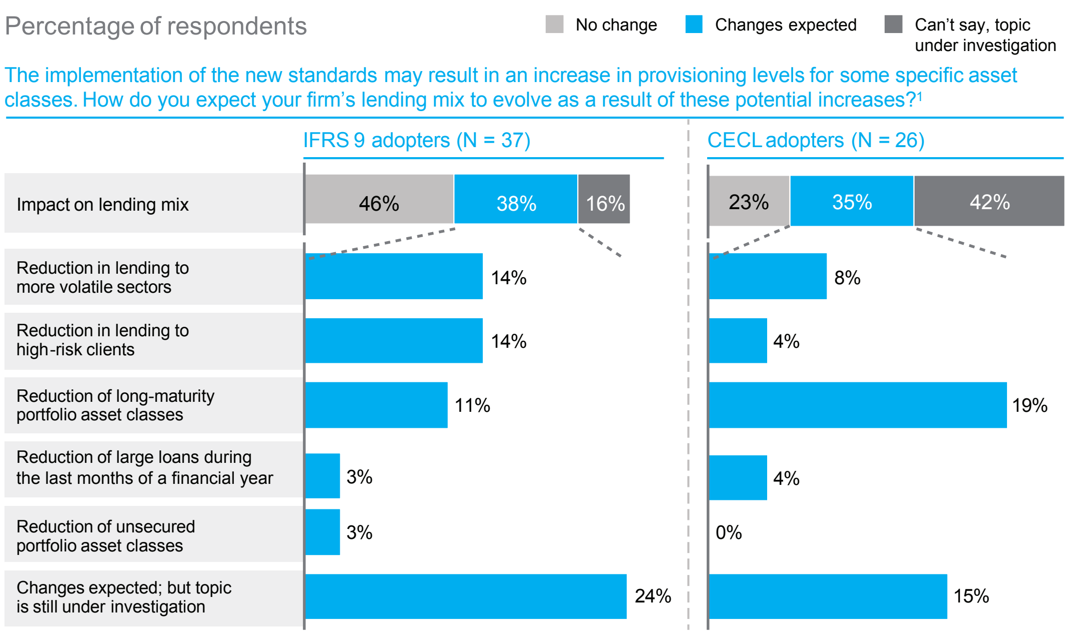
Credit Portfolio Management Strategies

Banks that have started analyzing the impact of the changes on their lending mix said they anticipate having to reduce their exposure to risky assets, whether by lowering maturities or reducing risks. Forty-six percent of all respondents facing IFRS 9 said they expect no change in the evolution of their lending mix (Exhibit 2). These findings suggest either that a significant

Exhibit 2

Less than half of respondents anticipate reducing the number of risky assets in their lending mix

Percentage of respondents



1 Multiple choice question in which respondents could choose more than one applicable option.
SOURCE: McKinsey analysis

number of these banks have not sufficiently considered how the requirements will affect them or that they assume the effect of the new standards will be muted due to their portfolio mix.

Commercial strategies

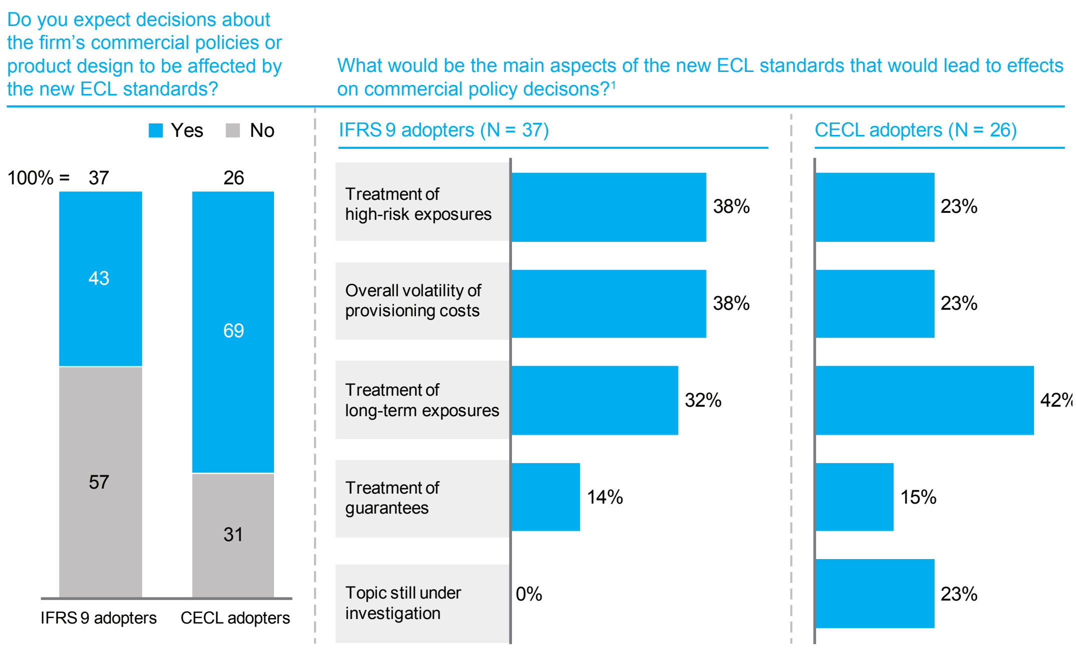
Key finding: Almost 70 percent of CECL adopters anticipate **changes in commercial policies or product design**, compared with just 40 percent of IFRS 9 adopters.

The survey revealed a gap in how banks believe IRFS 9 and CECL will affect commercial policies and product design. Indeed, 69 percent of CECL adopters said they anticipate changes in their approach to commercial policies or product design, compared with 43 percent of IFRS 9 adopters (Exhibit 3). An examination of the specific areas that would be most affected highlight these differences. While institutions facing CECL said they are most focused on the treatment of longer-term exposures—understandable since they must account for expected losses for all applicable assets—IFRS 9 adopters who are primarily worried about Stage 2 assets indicated they anticipate the treatment of high-risk exposures and the overall volatility of provisioning costs would have the greater effect.

Exhibit 3

A larger proportion of CECL than IFRS 9 adopters anticipate changes in commercial policies or product design

Percentage of respondents



1 Multiple choice question in which respondents could choose more than one applicable option.

SOURCE: McKinsey analysis

The IFRS 9 and CECL standards both have the potential to reduce profit margins for products with features that attract relatively higher estimates of ECLs. More than one-third of respondents said they expect to see differential effects across firms. After 2020, when CECL is in force, IFRS 9 banks will have the advantage over CECL banks, since the former just continue to reserve for Stage 1 assets at a lower level (that is, 12 months instead of lifetime). Fewer than one in ten respondents said they believe the standards will create clear winners and losers.

Instead, a bank's strategy and executional capabilities—such as its aggressiveness in modeling and which economic scenarios it chooses—may influence reserve levels significantly enough to differentiate between institutions.

Key finding: Only about 30 percent of IFRS 9 adopters and 40 percent of CECL adopters expect **credit risk appetite to change** as a result of the new standards.

Credit risk management practices

According to the survey results, institutions are broadly satisfied with their credit risk management processes: around half of respondents said their institution does ***not*** plan to develop proactive credit management to prevent the deterioration of a client's credit risk.

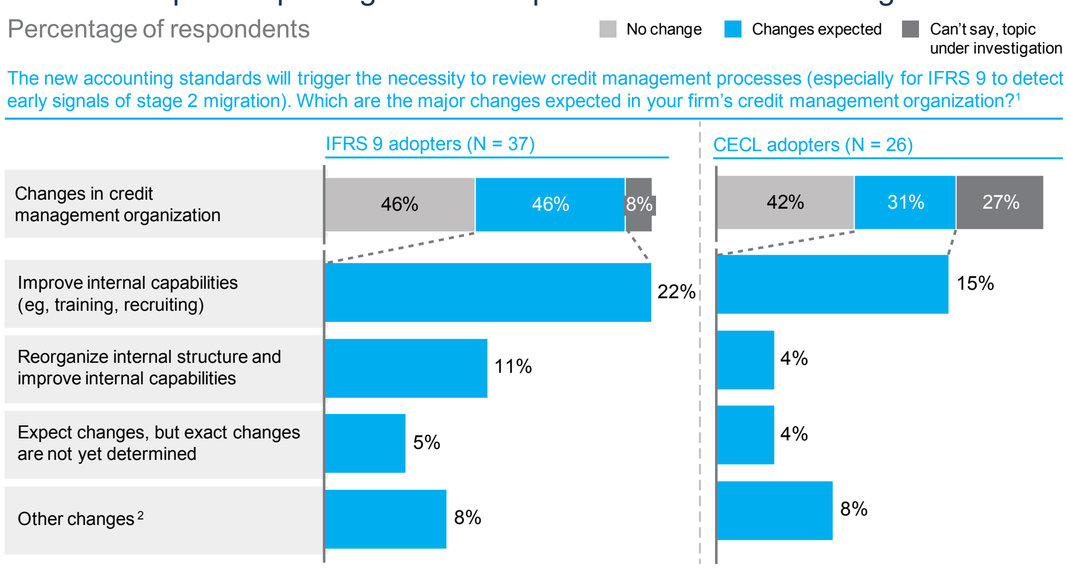
Some banks, however, indicated that they expect their firm's credit risk appetite to change as a result of the new standards. Banks must be prepared to reexamine two aspects: first, they will have to determine whether current risk metrics in the risk appetite statement are sufficient or if other indicators that tie to increased volatility in reserves need to be included in the risk appetite statement. Second, and more important, banks must set the right threshold for each of these metrics. As with other facets of the new standards, a significant number of banks are still investigating how the new rules will affect their risk management practices. And a majority of the responders who expect changes said they are still investigating the exact level of adjustment. Early trends, based on survey results, suggest that banks are likely to respond by introducing new risk metrics and changes to risk taxonomy.

Survey respondents also indicated that the new accounting standards will trigger a review of credit management processes—especially for IFRS 9 adopters—to detect early signals of slipping from Stage 1 to Stage 2. Among IFRS 9 adopters, 46 percent said they expect changes in their credit management organization, compared with 31 percent of CECL adopters, perhaps a reflection of the different deadlines and the level of scrutiny institutions have devoted to interpreting the new standards (Exhibit 4). Twenty-two percent of IFRS 9 adopters and 15

Exhibit 4

Banks anticipate improving internal capabilities in their credit organization

Percentage of respondents



1 Multiple choice question in which respondents could choose more than one applicable option.
2 Eg, new forecasting-related element, semiannual review of the forward-looking outlook, adjusting risk management practice.

SOURCE: McKinsey analysis

percent of CECL adopters said their firm would likely improve internal capabilities such as training or recruiting in response to the standards. Just as notable, more than 40 percent of respondents said they anticipate no changes to their credit management organization. This result suggests either that bank executives have carefully assessed their current credit management processes and deemed them sufficient or that they are still forming an understanding of how significantly the new standards will alter the credit risk landscape.

IFRS 9's three-stage structure for valuing ECLs will make monitoring, detection, and intervention a critical component of an effective credit risk management effort. Given the expected increase in reserves for underperforming (Stage 2) assets, 49 percent of IFRS 9 adopters indicated that they are likely to strengthen their early-warning mechanisms. The anticipated changes—including the introduction of forward-looking indicators and adjustments to thresholds for early-warning signals—are focused primarily on monitoring longer-term maturities or higher-risk assets. Twenty-seven percent of CECL adopters indicated that they plan to develop early-warning systems—a capability that will be of little significance, since under CECL banks must account for the full expected losses of products at the time of sale.

Key finding: Fully 86 percent of IFRS 9 adopters and 58 percent of CECL adopters are **relying on existing infrastructure** to meet the requirements of new standards.

Structure and process design for regulatory compliance

Over the past two decades, financial institutions have had to invest in capabilities to meet new and evolving standards, from the Basel accords to the Comprehensive Capital Analysis and Review (CCAR). Perhaps due to these ongoing investments and enhancements, a majority of IFRS 9 adopters said their bank intends to rely on current infrastructure (for example, existing models with some modification) across retail, corporate, and institutional banking (C&IB), as well as project finance. Slightly less than half of CECL adopters also said they plan to use existing infrastructure, which they developed to meet heightened standards in the wake of the global financial crisis. Eighty-six percent of IFRS 9 adopters and 58 percent of CECL adopters said they intend to use existing models and client segmentations to meet ECL requirements

A majority of respondents said they plan to use existing account-level models—rather than segment-level or portfolio-level models—after the new ECL regulations take effect. Seventy-six percent of IFRS 9 adopters said they would use account-level ECL models for the C&IB category, compared with 51 percent who said they would do so for retail. This gap was much narrower for CECL adopters, with 58 percent for retail and 54 percent for C&IB.

For IFRS 9 adopters, choosing the right metrics to detect and predict default will be an important component in effective monitoring programs. While respondents cited contractual maturity and behavioral variables as the key factors they use to determine the length of the lifetime losses, probability of default and other indicators (such as delinquency) are the most-used triggers to assess deterioration in credit quality (Exhibit 5). This reliance is particularly true for C&IB lending portfolios, as compared with retail and project finance portfolios.

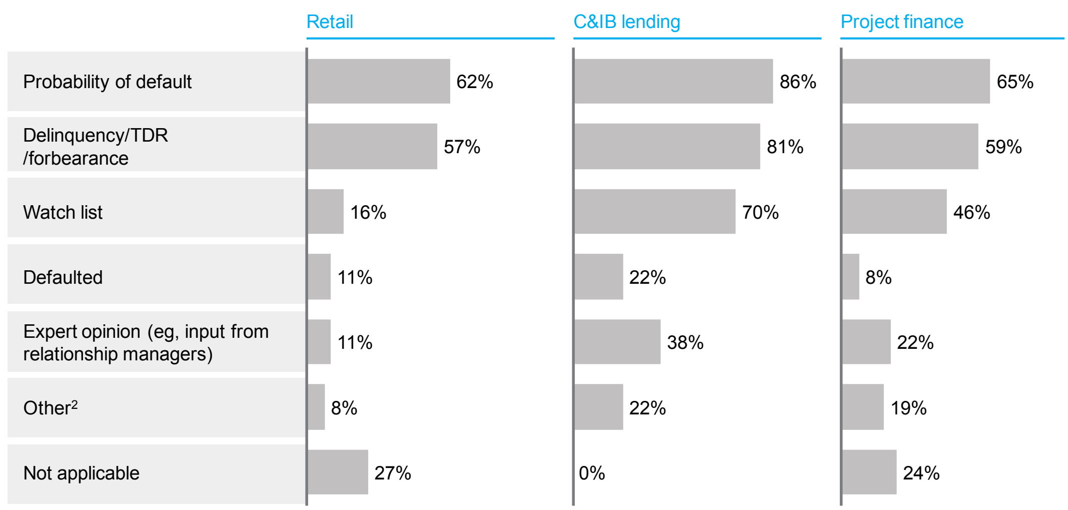
Exhibit 5

Banks primarily plan to use early default indicators as triggers to assess deterioration in credit quality

Percentage of respondents

IFRS 9 adopters (N = 37)

Under IFRS 9, what is your firm's planned trigger for assessing "significant deterioration" in credit quality, resulting in the transfer of an asset from Stage 1 to Stage 2?[1]



1 Multiple choice question in which respondents could choose more than one applicable option.
2 Eg, high-risk indicator, credit rating changes, countries, sectors.

SOURCE: McKinsey analysis

Securing the necessary data will also be an important component in compliance efforts. The survey revealed that nearly two-thirds of respondents anticipate challenges in implementing their models due to limitations in internal data. Many have already identified potential remediation. The top solution cited by IFRS 9 adopters is to enhance internal data systems and address any issues with data quality and availability. CECL adopters, meanwhile, said they are exploring ways to combine enhanced internal data with newly sourced external data—an approach that has enabled companies across industries to gain better insights from their analytics efforts.

Even though a majority of banks will use existing models to support the implementation of new accounting standards, they may find that investments in technology are necessary. One reason is that they will need to be prepared to run their existing models more frequently than they have in the past—quarterly, as opposed to annual runs, for example. However, the survey found that 54 percent of IFRS 9 adopters and 35 percent of CECL adopters are not planning to use a third-party software provider to implement or administer ECL models.

Key finding: Over three-quarters of CECL adopters **do not fully understand the new regulatory requirements**.

Regulatory understanding

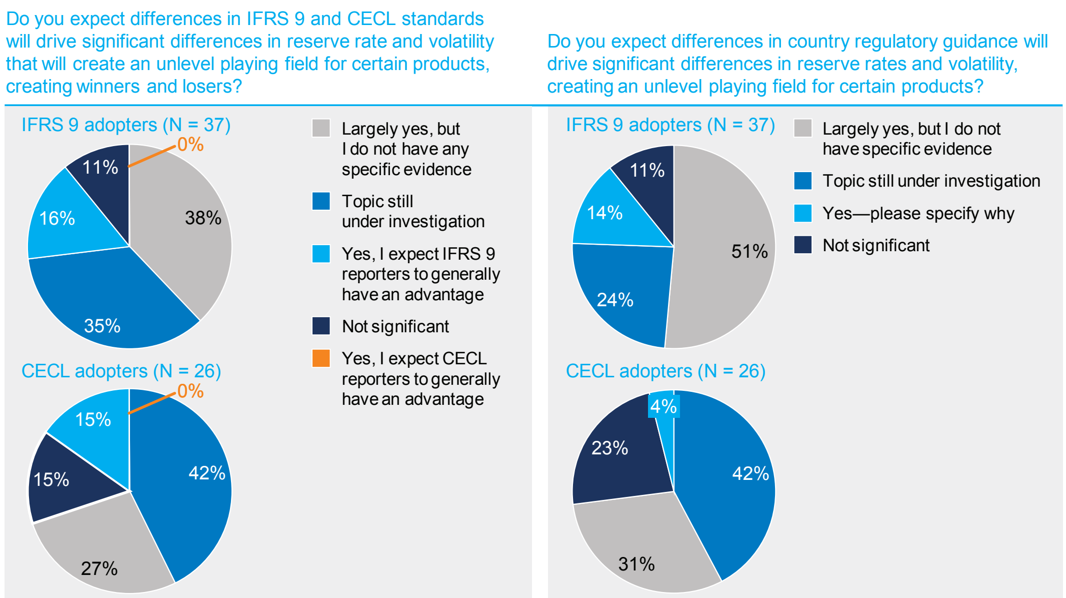
Banks are still in the process of understanding the full impact of new accounting standards: 35 percent of IFRS adopters and 42 percent of CECL adopters said they have yet to determine how these changes will affect the competitive landscape and their position in it. However, one implication seems clear to many respondents: the new standards will create strategic advantages for some and not for others. For example, 16 percent of all respondents fully expect that IFRS 9 adopters will have an advantage over CECL adopters in reserve rates and volatility;

none expect CECL adopters will have an advantage. Significant portions of each category also share that sentiment but can't point to specific evidence that supports their belief (Exhibit 6). Meanwhile, two-thirds of IFRS 9 adopters and one-third of CECL adopters expect that differences in regulatory guidance across countries will create unlevel playing fields for certain products.

Exhibit 6

Banks anticipate the new standards will create an unlevel playing field for certain products

Percentage of respondents



SOURCE: McKinsey analysis

One of the primary worries among banks is the likelihood that the new accounting standards will increase capital requirements; this concern is top of mind for about 40 percent of respondents. More than 70 percent of IFRS 9 adopters and 50 percent of CECL adopters said they have embedded or are planning to embed ECL into their stress testing. When they do, it will be important for them to distinguish between the impact they will experience upon adopting the standard for the first time and the ongoing volatility of capital. Excepting some portfolios with certain risk profiles—such as a long-maturity asset portfolio—in a benign credit environment, institutions won't feel a big impact when first moving to IFRS 9 or CECL. There is potentially a big capital volatility impact, however, in a downturn, for as losses accelerate, reserves will need to go up drastically. By using the same models for both CECL and their stress tests, US banks can develop and exploit synergies between these two important pieces of work that they will be completing on a regular basis.

As banks seek to implement the new standards, however, the survey found they struggle to obtain the clarification they need. Half of all respondents said they do not expect regulators to issue further guidance on scenario assumptions to drive consistency and comparability of results.

Advice for thriving after the expected credit loss revolution

Banks that wish to remain competitive after the new standards take effect must work to build on what they know and modify their existing policies and practices. In some cases, they will need to add new capabilities that allow them to face the formidable strategic and business challenges in adapting to the new environment. According to the survey, as of July most IFRS 9 adopters have not yet started their testing and parallel-run phases, and CECL banks have not started thinking about the business implications of changes that await them. While many of these suggestions are applicable to both IFRS 9 and CECL banks, we expect that individual CECL banks still have to go a long way to assess the applicability of these levers.

Implications for portfolio strategies

Both IFRS 9 and CECL will make some products and business lines less profitable from a structural standpoint, depending on the economic sector, the duration of a transaction, the guarantees supporting it, and the counterparty's ratings. Therefore, banks will need to review their portfolio strategy at a much more granular level than they do today. For example, banks could aim to steer their commercial focus to sectors that are more sensitive to economic cycles. In addition, banks should evaluate higher-risk clients with greater care.

Banks could also consider developing asset-light, "originate to distribute" business models for products and sectors for all CECL assets, or IFRS 9 assets that are at higher risk of Stage 2 migration—that is, slipping from Stage 1 status to Stage 2. By originating these products for distribution to third-party institutional investors, banks could reduce their need for balance-sheet capacity for risk-weighted assets and funding while avoiding the large increase in provisions they would otherwise have to make for higher expected losses. Pursuing such a strategy would involve developing an analytical platform that can calculate fair-value market pricing for each corporate loan and enable banks to instantly capture opportunities for asset distribution in the market. In addition, there may be an increased market for deteriorated loans, where credit treasuries look for exit positions with significant reserve increases.

Implications for commercial strategies

IFRS 9 will reduce profitability margins, especially for medium- and long-term exposures, because of the capital consumption induced by higher provisioning levels for Stage 2. In particular, exposures with low-rated clients and poor guarantees will require higher provisions for Stage 2 migration. For loans longer than ten years, provisions for lifetime expected credit losses may be up to 20 times higher than Stage 1 provisions, which are based on expected loss over 12 months. CECL, too, will reduce profit margins. For example, currently US banks are provisioning reserves for long-maturity mortgages for 12 to 18 months. Under CECL, however, banks will have to set aside reserves for at least five to eight years—the behavioral life of the product, or the average life span of a mortgage loan—which will inevitably lead to more volatility in reserves.

To offset this negative impact on their profitability, banks can adjust their commercial strategies by developing IFRS 9- and CECL-friendly products, specifically for high-risk clients, through which they adjust the maturity, repayment schedule, pre-amortization period, loan-to-value, and break clauses to reduce the impact of the new ECL standards on their profitability.

Compared with today, relationship managers will have to play a more active role in portfolio management, regularly monitoring portfolio composition as well as changes in a client's risk profile, to ensure that a new loan will not add to the bank's risk profile.

Implications for credit portfolio management

Under IFRS 9 and CECL, the behavior of each credit facility after origination is an important source of profit-and-loss volatility, regardless of whether the credit exposure eventually becomes nonperforming. Banks therefore need to enhance performance monitoring across their portfolio and dramatically increase the scope of active credit management to prevent credit deterioration. For IFRS 9 adopters, an early-warning system or a rating advisory service can allow banks to intercept positions at risk of migrating from Stage 1 to Stage 2. This system would extend the scope of credit monitoring and shift responsibility for it from the credit department to the commercial network. In these systems, under IFRS 9, "significant deterioration" is measured on a facility rather than a counterparty level, so virtually every facility must be monitored to spot objective signs of deterioration, such as when a payment falls to 30 days past due. By monitoring facility data and ensuring that information about guarantees is complete and up to date, banks can stave off the expensive consequences of migrations to Stage 2.

The commercial networks of both IFRS 9 and CECL adopters should be fully involved in a structured process through which risk management flags any facility with a deteriorating risk profile and identifies the likely reason: for instance, a deterioration in a debtor's short-term liquidity or a problem with data quality. An algorithm—or a credit officer—would then assign possible remediation and mitigation actions.

Finally, a relationship manager and credit portfolio managers should see the flagged position and proposed corrective actions in the system, then contact the client to discuss a remediation strategy. This strategy might include helping the client improve its credit rating through business or technical measures, such as opening a short-term facility to solve a liquidity issue or updating balance-sheet indicators to improve data quality. IFRS 9 adopters might take steps to increase the level of guarantees to reduce Stage 2 provisioning, as well as adjusting timing and cash flows in the financing mix to the assets being financed so that long-term maturities are used only when necessary.

Implications for deal origination

Both new accounting standards will prompt banks to reconsider their appetite for credit risk and their overall risk appetite framework, as well as introduce mechanisms to discourage credit origination for clients, sectors, and durations that may be too risky and expensive. For example, if banks consider global project finance to be subject to volatile cyclical behavior, they may decide to limit new business development in such deals. To react quickly and effectively to any issues that arise, they should also adjust the limits for project finance in their risk appetite framework, review their credit strategy to ensure new origination in this area is confined to subsegments that remain attractive, and create a framework for delegated authority to ensure that their credit decisions are consistent with their overall strategy for that asset class.

When IFRS 9 and CECL take effect in 2018 and 2020, respectively, they will reshape the credit landscape for some products and segments. As the survey revealed, some banks have been slow to adapt their operations and strategies accordingly. Programs that aren't timely or sufficient will certainly affect banks' profitability in the months following implementation of the new standards. But sluggishness to adapt may also hurt market share, for these new rules may tempt more nonbanks to enter the credit markets, particularly in the alternative-lending sector. These new competitors are governed by a less stringent regulatory framework and pose a growing threat to banks; in the past five years alone, credit provision in Europe by private equity firms, minibond issuers, insurance companies, and the like has grown by more than 20 percent.

For IFRS 9 adopters, there is little time left to prepare. To anticipate the repercussions of the new standards and control how they play out, these banks must move fast. CECL adopters have the luxury of learning from the experiences of their European counterparts—and they should take full advantage of the time they have.

The tidal wave of IFRS 9 and CECL will affect all banks, ready or not. The effort taken to understand the new rules and put a response in place will be well spent.

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