Professional indemnity claims in emerging economies: Accounting for IFRS 9

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In its July 2009 report to the International Accounting Standards Board (IASB) and its US equivalent, the FASB, the Financial Crisis Advisory Group (FACG) noted that the incurred loss model for loan loss provisioning and, more specifically, difficulties in applying that model when it came to identifying appropriate trigger points for loss recognition, had in many instances delayed the recognition of losses on loan portfolios, resulting in losses embedded in the financial system being generally understated. The FACG advocated that the IASB and FASB explore alternatives to the incurred loss model for loan loss provisioning, using more forward-looking information.

Five years later, the IASB introduced, as a subchapter of International Financial Reporting Standard (IFRS) 9, impairment requirements governing accounting for an entity's expected credit losses on both its financial assets and its commitments to extend credit. Under these requirements, which take effect for annual reporting periods beginning on or after 1 January 2018, it is no longer necessary for a credit event to have occurred before credit losses must be recognised. Instead, an entity is required to account for expected credit losses and changes in those expected credit losses. For example, regardless of the way in which an entity assesses significant increases in credit risk, IFRS 9 applies a rebuttable presumption that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. The amount of expected credit losses has to be updated at each reporting date to reflect changes in credit risk since initial recognition.

IFRS 9 applies to many entities, including lenders. In short, it will require them to recognise credit losses much earlier than ever before - exactly the opposite of a global trend that caught on in the immediate aftermath of the global financial crisis, to "extend and pretend", indulging borrowers with non-performing loans by extending their repayment terms, effectively kicking the can down the road in the hope that their loans could eventually be restructured. In a note issued in September 2015, Fitch has said that IFRS 9 could result in a surge in impairment charges on long-term secured lending, such as retail mortgage books. This will likely dent lenders' capital ratios significantly, as IFRS 9 forces them to provision for recognised credit losses.

IFRS 9 is, as its name suggests, an international standard. Its implementation is mandatory for those countries which have adopted IFRS. A review of the interactive map on the IASPlus website shows the extent of IFRS adoption, particularly by emerging economies. In its October 2015 Global Financial Stability Report, the International Monetary Fund noted that financial stability risks continue to rotate from advanced economies (where lenders have spent the past few years deleveraging and repairing balance sheets, raising capital and strengthening funding arrangements) towards emerging economies. In particular, at this point in the credit cycle, lenders in emerging economies, which already have thinner capital cushions relate to their counterparts in the advanced economies, face an increasing incidence of non-performing loans as corporate earnings and asset quality deteriorate.

Deteriorating corporate health in the emerging economies signals a looming economic slowdown, or even a recession. Against this background, IFRS 9 is likely to severely curtail the ability of lenders in emerging economies to extend and pretend. Credit losses will have to be recognised. Past experience in advanced economies shows us that when lenders are forced to recognise credit losses they become voracious litigators, principally against big pocket insured defendants in the form of the providers of professional services – lawyers, valuers, surveyors, accountants and financial advisers. There is no reason to think that, faced with sharply elevated credit losses they have been forced by IFRS 9 to recognise in their financial statements, lenders in emerging economies will respond any differently. If the current economic slowdown persists in the emerging economies over the next few years, or there is a recession, the introduction of IFRS 9 will very likely herald a dramatic increase in the volume and severity of lender professional indemnity claims.

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