Forward-Looking Credit Loss Recognition-IFRS 9 & Related Developments and Supervisory Roles

Ellen Gaston

Monetary and Capital Markets Department
International Monetary Fund
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Outline

1. The current diverging approaches between accounting and regulation on LLP and implications for supervisors
2. IFRS 9 expected loss based credit loss recognition model and issues surrounding it
3. Will supervisory roles be different or similar under IFRS 9
4. Other relevant international developments after publication of IFRS 9
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The current diverging accounting and supervisory approaches

Accounting perspective
(IFRS/IAS 39)

Supervisory perspective
(Basel regime)
IFRS/IAS related to credit loss recognition

- **IAS 39**, Financial Instruments, current guiding standard
- **IFRS 7**, Disclosures - financial instruments
- **IFRS 5**, Non-Current Assets Held for Sale and Discontinued Operations
- **IFRS 13**, Fair Value Measurement
- **IFRS 9**, Financial Instruments - the future
Current approach: impairment loss recognition under IAS 39

- First issued in 1999, effective in 2001
- Incurred loss based model
  - based on objective evidence
  - only considers losses arising from past events and current conditions – not future credit loss events
  - principle-based
  - individual and group assessment and measurement

- Significant professional judgment required
  - e.g. in determining objective evidence
  - estimating future cash flows
Current approach: Issues with IAS 39

- Criticized for recognizing impairment losses “too little and too late”
- Conflicts with the supervisory perspective – expected loss based
- Pro-cyclical
- When applied, often focuses on lagging indicators, e.g. default – delayed recognition of loan loss
- Inconsistent implementation
- However, helped to reduce earnings management
Current approach: the regulatory side

- Approach per Basel II, III, and BCP.

- The approach on provisioning is expected loss based
  - specific provisions – for identified losses
  - general provisions – for expected losses, unidentified losses that are expected to occur
  - use of judgment as an enhancement

- Provisioning is consistent with capital adequacy assessment framework, which is forward looking
  - the measurement of provisions is directly linked to capital ratio calculation
  - expected loss concept explicit in Basel II IRB approach – PD x LGD
The current diverging approaches – how are they different

1. Different approaches and perspectives:
   Incurred loss based vs. expected loss based

2. Different purposes: fair statement of financial statements vs. capital adequacy assessment

3. Different results:
   regulatory provisions ≠ IFRS impairment loss recognition

4. Different philosophy: conservatism vs. neutrality
Implications for supervisors under IAS 39

- The issue is following IAS 39 satisfies financial reporting; but banks will likely not recognize sufficient and timely provisions from a supervisor’s view point.
- What is expected of supervisors is that they should step in to impose additional provisions, practices vary among countries.
- This is consistent with the BCBS view.
- Prerequisite: this calls for supervisory powers, willingness, and ability to act, as well as technical expertise.

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IFRS 9 forward-looking credit loss recognition

- Published in July 2014, effective January 1, 2018

- Expected credit loss recognition model
  - Stage 1: 12 month expected losses are recognized at initial recognition
  - Stage 2 (& 3): life time expected credit losses are recognized when there are significant increases of credit risk
  - Interest accrual: gross for stages 1&2 and net for stage 3
  - A wider range of information is allowed: past, present, and future
  - Reasonable and supportable information without undue cost and effort
  - Judgement needed
IFRS 9 forward-looking credit loss recognition

• **Credit Loss**: difference between all contractual cash flows due to entity in accordance with the contract and all the cash flows that the entity expects to receive (i.e. all cash shortfalls) discounted at the original effective interest rate

• **Expected credit loss (ECL)**: credit losses estimated to flow from a credit event, e.g. default; calculated as the weighted average of credit losses, weighted by the **probabilities of default**

• **12-month ECL**: the portion of lifetime expected credit losses that represents the expected credit losses that result from **default events** on the financial instrument that are possible within the 12 months after the reporting date

• **Life-time ECL**: the expected credit losses that result from all possible **default events** over the expected life of the financial instrument
### IFRS 9 forward-looking credit loss recognition

#### Default
- not defined by IFRS 9, entities may use their regulatory definitions
- IFRS 9 90-day rebuttable presumption: default does not occur later than 90 days past due

#### Significant increase of credit risk
- not defined by IFRS 9, to be defined by reporting entities
- “when making the assessment, an entity shall use the change in the risk of a default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses”
- IFRS 9 30-day rebuttable presumption: life-time expected loss recognition if payments are more than 30 days past due
A brave new world?

• The world of LLP will likely look like this:
  ➢ Expected loss based credit loss recognition approach will be universal in the accounting world
  ➢ More aligned with the regulatory approach
  ➢ Earlier recognition of credit losses
  ➢ More support from the banking supervisors (e.g. the new BCBS Guidance)

• What about the provisioning level (higher, lower than regulatory)? Will it fully meet supervisory expectations?
Is this a perfect model? Issues with IFRS 9

• More or less judgment is needed than IAS 39?
  ➢ Implication for consistent implementation

• Any room for gaming in implementing it?
  ➢ In judging moving from 12-month to life-time, anticipating an economic up-turn

• Will IFRS 9 be more or less pro-cyclical than IAS 39?

• Without “objective evidence”, does this create space for earnings management? What is the solution?
  ➢ IASB response

• Finally, not so philosophical a question
  ➢ Should there be one LLP approach for both accounting and regulatory sides or one for each?
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Will supervisory roles be different or similar under IFRS 9?

• Risks
  - unpredictable as to the level of provisions before it’s implemented and for a while
  - smooth transitioning to IFRS 9 and consistent implementation

• Similar as under IAS 39
  - in the event provisioning level does not meet supervisory requirement for capital calculation, supervisors still need to step in
  - in dealing with the following commonly seen provisioning related issues such as
    - uncollectible loan write-off
    - Interest accrual
    - collateral valuation
    - restructured loans
Will supervisory roles be different or similar under IFRS 9?

On these commonly seen provisioning related issues, one of the challenges is there are often

- Little IFRS guidance
- No IFRS guidance
- Conflicting guidance between IFRS and supervision
Will supervisory roles be different or similar under IFRS 9?

- **What’s more**, more responsibilities and challenges for supervisors

1. heightened overall supervisory oversight will be an important safeguard
   - be abreast of all related accounting and regulation rules
2. supervisors will play an important role in helping banks to transition to IFRS 9 and consistent implementation
Will supervisory roles be different or similar under IFRS 9?

…continued, supervisory role in IFRS 9 implementation

- ensure proper and timely planning
- good governance structure--IFRS 9 Committee with top management buy-in and responsibility
- collaboration and communication between key parties, i.e. supervisors, banks’ internal/external auditors, accountants, risk management, regulatory reporting, and IT – IFRS 9 requires more integration between banks’ finance and IT
- ensure data quality, system/model configuration
- leverage the existing regulatory parameters with modifications (regulatory driven prudence vs. accounting neutrality)
Supervisory roles in IFRS 9 implementation

- Data availability & quality
- Coordination between finance, IT, risk management
- Knowledge and proper interpretation
- Model building

Governance
Supervisory roles in IFRS 9 implementation

- Data requirements
  - historical loss rates, attrition and recovery data
  - risk grades
  - delinquency data
  - loss migration rates
  - internal indicators of the likelihood to pay
  - collateral information
  - forward-looking economic scenarios
  - macroeconomic variables
  - PD, LGD, EAD

Source: Deloitte
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Other relevant international developments post IFRS 9

Published:
- FSB Enhanced Disclosure Task Force (EDTF)— “Impact of Expected Credit Loss Approaches on Bank’s Risk Disclosures”, November, 2015
- BCBS— “Guidance on Credit Risk and Accounting for Expected Credit Losses”, December 2015

Published for consultation:
- EBA—”Guidelines on Credit Institutions’ Credit Risk Management Practices and Accounting for Expected Credit Losses”, July 2016
- EBA— “Guidance to Banks on Non-Performing Loans”, September 2016
Other relevant international developments post IFRS 9

Just published for consultation:


• BCBS- “Regulatory Treatment of Accounting Provisions”, October 2016, Discussion paper (longer term solution)
EDTF IFRS 9 disclosure recommendations

• Existing recommendations issued in 2012—still applicable
• Additional guidance issued in December 2015 in the context of ECL framework (aimed at both IFRS and U.S. GAAP)

• Objectives:
  - Promote high quality, transparency and comparability in risk disclosures
  - Help the market to understand the upcoming changes as a result of using ECL

• A gradual and phased approach
  - Temporary (before or upon transition) and permanent considerations
  - Increasing granularity of disclosures as the ECL models phase in—from qualitative to quantitative
EDTF IFRS 9 disclosure recommendations

Highlights of key recommendations

• Key concepts to be defined

  ➢ Difference between accounting and regulatory:
    ✤ PD, LGD, EAD, discount rate
    ✤ point in time vs through the cycle

  ➢ Within accounting ECL framework, for example
    ✤ Default
    ✤ Significant increase of credit risk
    ✤ Modification
EDTF IFRS 9 disclosure recommendations

Highlights of key recommendations

• Credit loss modeling techniques developed to implement the ECL approach
  
  ➢ techniques for determining PD, LGD, EAD
  
  ➢ types of forwarding looking information used
  
  ➢ judgement applied
  
  ➢ if Basel models are used as a starting point, explain how they adapt it to fit into accounting requirement, e.g. how lifetime PD is developed from Basel 12 month through the cycle

• Impact on capital adequacy requirement
BCBS guidance on accounting for ECL

- Set **supervisory expectations** on implementing “expected credit loss” (ECL) accounting models

  - Replaces the 2006 version of the BCBS Guidance

  - Presents the BCBS views of how ECL accounting standards should be applied, how they interact with banks’ credit risk practices and regulatory framework

  - Ensures high-quality and consistent implementation of ECL models

  - Consistent with and complementary to accounting standards established by, for example, IASB – Annex on IFRS 9

  - Poor implementation of the ECL model is likely if supervisory guidance is not provided to banks early enough
BCBS guidance on accounting for ECL

- Internationally active banks

  - are expected to have the highest quality implementation of an ECL accounting standard
  - should rarely use IFRS Simplifications/Practical Expedients that IFRS establish to facilitate implementation.

- Use of proportionality and materiality should not undermine high quality implementation of ECL accounting framework

- Incorporate reasonable and supportable forward-looking information in both individual and collective assessments
A. Supervisory guidance (8 Principles)

1. A bank’s board and senior management are responsible for credit risk practices.
2. A bank should adopt sound methodologies for assessing and measuring the level of credit risk.
3. A bank should have a process in place to appropriately group lending exposures.
4. A bank’s allowances, regardless of whether determined on a collective or an individual basis, should be adequate as defined by the Basel Core Principles.
5. A bank should appropriately validate its internal credit risk assessment models.
6. A bank’s use of experienced credit judgment, especially forward-looking information and macroeconomic factors, is essential for ECL.
7. A bank should have credit risk assessment and measurement processes that provide for common systems to assess and price credit risk, and account for ECL.
8. A bank’s public reporting should promote transparency and comparability.
BCBS guidance on accounting for ECL

B. Supervisory evaluation (3 principles)

9. Banking supervisors should periodically evaluate bank’s credit risk practices.

10. Banking supervisors should be satisfied that the methods employed by a bank to determine allowances produce an appropriate measurement of ECL in accordance with accounting rules.

11. Banking supervisors should consider a bank’s credit risk practices when assessing capital adequacy.

C. Appendix: Supervisory requirements specific to jurisdictions applying IFRS 9
Prudential treatment of problem assets - definitions of non-performing exposures and forbearance

- Based on survey of supervisory practices of 28 supervisors; questionnaire on industry practices of 39 banks from 28 jurisdictions

Performing  Under-performing  Non-Performing

Forbearance

Are we ready for greater international consistency?
Prudential treatment of problem assets - definitions of non-performing exposures and forbearance

• Possible drivers for differences in NPE definitions
  ➢ the scope of application
  ➢ the use of gross exposures or net exposures
  ➢ extension of the same categorization to other exposures
  ➢ use of a quantitative approach or a qualitative approach for categorization
  ➢ how collateral is treated
  ➢ frequency of assessment for updates
Prudential treatment of problem assets - definitions of non-performing exposures and forbearance

- **Purpose**
  - harmonize quantitative and qualitative criteria for credit categorization
  - promote consistency in the supervisory reporting and disclosures by banks

- **Specifically, the definitions will be used for:**
  - supervisory asset quality monitoring
  - banks‘ internal credit categorization systems for credit risk management purposes
  - pillar 3 disclosure on asset quality
  - dissemination of data for asset quality indicators
  - reference point for other relevant BCBS work
Prudential treatment of problem assets - definitions of non-performing exposures and forbearance

- **Definition** of non-performing exposures
  - It includes the accounting “impairment” and regulatory “defaulted”
  - Harmonized recognition criteria: 1) **90 days past due**, 2) **qualitative** assessment of ability to pay
  - Collateral plays no role in NPL categorization

- **Reclassification criteria**:
  - no delinquency more than 90 days;
  - repayments made when due over a period specified by the supervisor;
  - financial situation has improved: and the exposure is not “defaulted” according to the Basel II standard or “impaired” according to the accounting framework.
Prudential treatment of problem assets - definitions of non-performing exposures and forbearance

- Forbearance- no international harmonization on
  - definition of forborne exposures
  - the practices of recognizing forborne exposures as impaired or defaulted
  - policies to categorize forborne exposures
  - exit criteria

- Main Issues related to forbearance
  - “good forbearance” is a tool for sound credit risk management and reduction of credit risk
  - “bad forbearance” can mask borrowers’ underlying difficulties and deterioration of banks’ portfolio quality
  - important to not use forbearance to avoid classifying loans as non-performing, delay provisioning, and weaken confidence in a bank’s adequate capital levels
Prudential treatment of problem assets - definitions of non-performing exposures and forbearance

- **Definition**: forbearance occurs when
  - a counterparty is experiencing financial difficulty, and
  - a bank grants a concession that it would not otherwise

- The definition covers exposures of performing and non-performing status before the granting of forbearance measures

- **Exit criteria**:  
  - repayments as per the revised terms have been made in a timely manner (principal and interest) over a period of **not less than one year**;
  - the counterparty has solved its financial difficulties.
Prudential treatment of problem assets - definitions of non-performing exposures and forbearance

- **Interactions** between forbearance and NPE and performing exposures

  - Forborne exposures should be classified as non-performing if
    - they have been categorized as such prior to forbearance
    - or if they meet the criteria to be categorized as non-performing
  
  - When a performing exposure is forborne and derecognized, the newly created forborne exposure should be categorized as non-performing

  - Performing forborne exposures should be categorized separately from other performing exposures

  - Attention should be payed to classification of exposures that have been forborne more than once
Thank you