Diverging Perspectives in Loan Loss Provisioning Between IFRS and Regulatory Requirements and Supervisory Roles

Friday, October 23, 2015
9:00 AM – 10:15 AM

Presenter: Ellen Gaston (MCM, IMF)
Different loan loss provisioning approaches and perspectives

Accounting perspective (IFRS)

Supervisory perspective (Basel regime)
Accounting side: IFRS adoption worldwide and no convergence yet

• Currently, 116 countries require and 24 permit IFRS for public companies
  ➢ EU - largest jurisdiction that adopted IFRS in 2005
  ➢ Canada, 2011, Australia, 2005, word for word
  ➢ Japan permits use of IFRS for international companies since 2010
  ➢ Argentina, Mexico and Nigeria (2012), Brazil, 2010 (early adoption permitted in 2007)
  ➢ China, substantially converged with IFRS, committed
  ➢ U.S.?  

• IASB web site: IFRS Jurisdiction Profiles for 140 jurisdictions – track progress of IFRS adoption
Accounting side: the IFRS 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
Regulatory side: no consistent international standards and practices on problem loan classification and provisioning

- no consistent international standards on classifying problem loans, and in practice, banks’ categorization systems vary greatly (e.g. IRB models)

- One of the many findings of the financial crisis is that supervisors and investors did not always trust or understand banks’ credit exposures.
  - Different and often insufficiently disclosed methodologies and assumptions for valuations, provisioning and risk-weightings, increasing opacity and reducing comparability for end users.

- The BCBS is developing common definitions and finding common ground where appropriate between supervisors:
  - “Non-performing”, “forborne/restructured”, “weakened”, “loss”, “write-off”
Regulatory side: Basel guidance and principles related to LLP

- Basel I, II, III

- BCP – Basel Core Principles of Effective Banking Supervision

- 2006 SCRAVL – Sound Credit Risk Assessment and Valuation for Loans

- ...which is to be replaced by “Guidance on Accounting for Expected Credit Losses” – consultative document to be issued soon.
Implications for Supervisors:

• Given the different perspectives and requirements, and lack of guidance from IFRS at times, what the **IMPLICATIONS** are for supervisors or what their roles should be:

**A. Balancing accounting and regulatory approaches**
- Supervisory roles under IAS 39
- How does the publication of IFRS 9 change the picture, and will supervisory roles be similar or different?

**B. Dealing with common provisioning issues in countries implementing IFRS** (under both IAS 39 and IFRS 9)
- When a Country Transitions from Local GAAP to IFRS
- Financial and Regulatory Reporting Implications
- Interest Income on Impaired Loans – to Accrue or not to Accrue
- Uncollectible Loan Write-off
- Valuation and Sale of Collateral in Possession
- Restructured Loans
Dealing with the dual provisioning approaches:

IMF Working Paper

Supervisory Roles in Loan Loss Provisioning in Countries Implementing IFRS

Prepared by Ellen Gaston, In Won Song

September 2014
The impairment loss recognition model under IAS 39

• First issued in 1999, effective in 2001, complemented by IFRS 7 and IAS 32

• Impairment loss is one of the four major components

• Incurred loss based model
  ➢ based on objective evidence
  ➢ only considers losses arising from past events and current conditions – not future credit loss events
  ➢ individual and group assessment and measurement

• Significant professional judgment required
  ➢ principle-based
  ➢ e.g. in determining objective evidence
  ➢ when applied, often focuses on lagging indicators, e.g. default – delayed recognition of loan loss
The impairment loss recognition model under IAS 39

• Issues surrounding IAS 39

➤ Criticized for recognizing impairment losses “too little and too late”

➤ Conflicts with the supervisory perspective – expected loss based

➤ Procyclical?

• However, helped to reduce earnings management
The Basel Regime

• The approach on provisioning is expected loss based
  - specific provisions based on identified losses
  - general provisions based on expected losses, unidentified losses that are expected to occur
  - use of judgment 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

• SCRAVL 2006 version

• BCP: CP 18 on Problem assets, provisions and reserves:
  "The supervisor determines that banks have adequate policies and processes for the early identification and management of problem assets, and the maintenance of adequate provisions and reserves."
Any commonalities?

**Similarities between the two are not many...**

1. both deal with how much should be set aside to mitigate credit risk,
2. both permit use of judgment

**though common data may be shared:**

historical loss rates
What about differences?

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 terms:
   impairment loss recognition vs. credit loss provisioning

4. Different results:
   regulatory provisioning > IFRS impairment loss recognition

5. Different philosophy: conservatism vs. neutrality
Implications for supervisors (A): balancing accounting and regulatory requirements

Under IAS 39

• The issue is following IAS 39 satisfies financial reporting; but banks will likely not produce sufficient 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, ability to act, as well as technical expertise.
Implications for supervisors (A): balancing accounting and regulatory requirements

Under IAS 39

• Varied practices and level of intrusiveness

• Countries where there is evidence that powers have been put in place: Australia, Austria, Canada, France, Hong Kong SAR, Italy, South Korea, and Spain.

• Germany and Belgium do not have powers to demand increase in provisioning level:

  ➢ Germany: imposing additional capital
  ➢ Belgium: deducting deficiency from banks’ own funds
The future: **IFRS 9 will replace IAS 39**

• The incurred loss model will be replaced by a forward looking credit loss recognition model

• This is at the urge of G-20 and FSB – leadership of all regulatory reform initiatives after the financial crisis

• The BCBS – set supervisory expectations of the new model
  - earlier recognition of credit losses
  - higher level provisioning
  - allows a broader range of available credit information

• The IASB undertook the Replacement Project and IFRS 9 was published in July 2014, and will be effective Jan 2018.
IFRS 9 – expected credit loss recognition model

• Expected credit loss recognition model
  - 12 month expected losses are recognized at initial recognition
  - life time expected credit losses are recognized when there is significant deterioration of credit quality
  - a wider range of information is allowed: past, present, and future

• No issues with this model?
  - more or less judgment is needed?
  - what about earnings management?
  - will it fully satisfy supervisory requirements?
IFRS 9 – slow process and implications

• IFRS 9 effective date: has been a moving target

• Implications:
  ➢ IAS 39 and the incurred loss based model will be alive for longer than expected
  ➢ supervisors should have a good understanding of the similarities and diverging perspectives between IAS 39 and Basel rules on provisioning
The future: Basel Committee’s update in light of IFRS 9 publication

- **Guidance on Accounting for Expected Credit Losses**
  
  - Update the 2006 SCRAVL which is based on incurred loss model
  - To be consistent with ECL accounting frameworks
  - Sets out supervisory expectations and promote high quality and consistent implementation of ECL accounting rules
  - 11 principles—Supervisory Requirements (8) and Supervisory Evaluation (3)
  - Annex 1 is for IFRS 9 Implementation Guidance
  - Consultative Document, comments received, publish sooner than later
Implications for supervisors (A): balancing accounting and regulatory requirements

When IFRS 9 replaces IAS 39

• Expectations:

  ✓ will better align accounting and prudential rules and result in earlier and higher provisions;

• Will supervisors roles be different?

  ✓ supervisors will help to achieve operational efficiency
  ✓ supervisors may still need to step in as under IAS 39
  ✓ new supervisory guidance would be helpful
Implications for supervisors (B): dealing with common provisioning issues in countries implementing IFRS

1. Transitioning from local GAAP to IFRS
2. Financial and regulatory reporting
3. Interest income, to accrue or not to accrue
4. Uncollectible loan write-off
5. Valuation and sale of collateral in possession
6. Restructured loans
1. Transitioning from local GAAP to IFRS (1)

• “Day one gain”
  ➢ in non-distributable reserve, or a “windfall”?

• What about a decrease of provisioning level as a result of adopting IFRS?
  ➢ supplement IFRS provisions with regulatory provisions, can be a percentage of outstanding loans
  ➢ ensure correct financial reporting
1. Transitioning from local GAAP to IFRS (2)

- The existing loan grading systems may still be used under 39.

- Measurement of impairment losses under IAS 39 using existing matrices may be questionable.

- Existing historical loss rate and PDs, updated with current and future information can continue to be used under IFRS 9.
2. Financial and regulatory reporting (1)

• How should balance sheets and income statements properly reflect impairment losses under IAS 39?
  
  ➢ impairment losses – incurred loss based – in current year income statement
  ➢ cumulative impairment losses – contra asset account (or liability account) against the gross loan amount

• How should regulatory provisioning be reported?
  
  ➢ Non-distributable reserve account in retained earnings – regulatory reserve
• What about under IFRS 9?
  ➢ credit losses –expected loss based – in current year income statement,
  ➢ with cumulative in the contra asset account on the balance sheet
  ➢ what if there is still insufficient provisioning?

• Should regulatory reporting be consistent with IFRS?
3. Interest income on NPLs – to accrue or not to accrue (1)?

- **Prudential requirement:**
  - non-accrual status on NPLs after a certain period of time
  - change to cash basis

- **IFRS requirements:**
  - apply the original effective interest rate to the difference between the carrying amount and impairment losses - IAS 39
  - Under IFRS 9: gross vs. net approach (the latter is the same as under IAS 39)
3. Interest income on NPLs – to accrue or not to accrue (2)?

• What are the issues surrounding accrual and non-accrual?
  ➢ overstating interest income?
  ➢ a good accounting practice?
  ➢ recognizing interest income on NPL as revenue
  ➢ costs vs. benefits
  ➢ what is the practice in other countries, e.g. U.S.?

• How to balance the different requirements: IFRS and regulatory?
  ➢ disclose both
4. Non-performing loan write-off (1)

• What are the benefits of timely write-off uncollectible loans?

  - more transparency in financial reporting
  - cross country comparability
  - greater accuracy in calibration of historical loss rates
  - promote a more future focused business

• What is the BCBS position on this?

  - encourages timely write-off of uncollectible loans for accurate loan loss estimates
4. Non-performing loan write-off (2)

• Do IAS 39 and IFRS 9 cover uncollectible loan write-off?
  
  ➢ IAS 39 does not address uncollectible loan write-off, though there are disclosure requirements by IFRS 7
  ➢ IFRS 9 sets overall principles without detailed guidance

• Should derecognition rules under IAS 39 be applied to uncollectible loan write-off?
  
  ➢ Derecognition rules are not applicable to uncollectible loan write-off
4. Non-performing loan write-off (3)

- Should loan write-off be preceded by exhausting all legal means and/or giving up contractual rights to cash flows?
  - no.

- What roles should supervisors and banks play to promote timely write-off?
  - have sound policies in place and help to formulate write-off criteria
  - back test loss rates
4. Non-performing loan write-off (4)

The supervisory team has access to the following information related to two different entities:

<table>
<thead>
<tr>
<th></th>
<th>Bank A</th>
<th>Bank B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non performing ratio</td>
<td>12.5%</td>
<td>18.4%</td>
</tr>
<tr>
<td>Coverage ratio</td>
<td>44%</td>
<td>60%</td>
</tr>
</tbody>
</table>

If no additional information is available, which one do you consider to have a higher credit risk, in order to prioritise the inspection resources?
4. Non-performing loan write-off (5)

In fact, in both cases the data is obtained from the same portfolio. Differences arise depending on the write-off policy followed by the entity.

<table>
<thead>
<tr>
<th>Amount</th>
<th>Impaired (Y/N)</th>
<th>Allowance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan 1</td>
<td>15.000</td>
<td>N</td>
</tr>
<tr>
<td>Loan 2</td>
<td>10.000</td>
<td>N</td>
</tr>
<tr>
<td>Loan 3</td>
<td>25.000</td>
<td>N</td>
</tr>
<tr>
<td>Loan 4</td>
<td>15.000</td>
<td>N</td>
</tr>
<tr>
<td>Loan 5</td>
<td>17.500</td>
<td>N</td>
</tr>
<tr>
<td>Loan 6</td>
<td>5.000</td>
<td>Y</td>
</tr>
<tr>
<td>Loan 7</td>
<td>7.500</td>
<td>Y</td>
</tr>
<tr>
<td>Loan 8</td>
<td>5.000</td>
<td>Y</td>
</tr>
<tr>
<td>Total</td>
<td>100.000</td>
<td>0</td>
</tr>
</tbody>
</table>

- Considering the write off of loan 8

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Performing loans</td>
<td>82.500</td>
</tr>
<tr>
<td>Non performing loans</td>
<td>12.500</td>
</tr>
<tr>
<td>Write off</td>
<td>5.000</td>
</tr>
<tr>
<td>Allowances</td>
<td>5.500</td>
</tr>
</tbody>
</table>

- Non performing ratio: 12,5%
- Coverage ratio: 44,0%

- Not considering the write off of loan 8

<table>
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</tr>
<tr>
<td>Write off</td>
<td>0</td>
</tr>
<tr>
<td>Allowances</td>
<td>10.500</td>
</tr>
</tbody>
</table>

- Non performing ratio: 18,4%
- Coverage ratio: 60,0%
5. Valuation and sale of collateral in possession (1)

• What are the different roles played by IFRS and IVS in valuation of collateral in possession?
  ➢ IAS 39: the estimate of collateral value assumes foreclosure
  ➢ IFRS 13: FV measurement principles, not methodologies
  ➢ IVS: FV methodologies, basis for appraisals

• How should supervisors help to safeguard the quality of appraised values?
  ➢ make sure appraisals follow IVS
  ➢ help banks to improve appraisal evaluation process
  ➢ establish central registry of sales prices
  ➢ proper mark down of property values
5. Valuation and sale of collateral in possession (2)

• How should supervisors help banks to divest foreclosed assets?
  ➢ IFRS 5 requires selling within one year
  ➢ ensure banks are committed to sell by
    ❖ having a plan
    ❖ actively marketing
    ❖ having reasonable listed prices

• Can banks keep foreclosed assets on their books for more than one year and still comply with IFRS 5?
  ➢ yes, in exceptional circumstances
  ➢ supervisors should ensure timely mark down
6. Restructured loans (1)

• To what extent does IFRS deal with restructured loans?
  ➢ little under IAS 39
  ➢ slightly more under IFRS 9 mostly in the context of amortized cost measurement (using original effective interest rate) and assessing significant increase of credit risk

• Supervisors to provide guidelines on:
  1. How should a restructured loan be classified?
     ➢ higher level of credit review scrutiny
     ➢ focus on the borrower’s ability to pay
     ➢ “substandard” or “doubtful”
     ➢ make sure compliance with terms and conditions of the restructured loan for a specified period of time
6. Restructured loans (2)

2. Under what conditions can it be upgraded?

- after a reasonable (minimum) period of demonstrated payment performance
- or meeting specific upgrading conditions
- practices vary across countries
Implications for supervisors: to summarize

- Supervisory role is important in enforcing capital adequacy by ensuring timely and sufficient provisioning.

- When provisioning per accounting rules are deemed insufficient for capital calculation, supervisors should step in.

- It is critical that supervisors possess the powers, willingness, and ability to act, and technical expertise to enforce prudent provisioning practices.
Implications for supervisors: to summarize

• Not withstanding the deficiencies of IAS 39 and IFRS 9, implementation of IFRS as the global accounting standard should be encouraged to achieve transparency and comparability.

• Even though IFRS 9 moves in the right direction, divergence between prudential and accounting perspectives will remain, and hence the challenges for supervisors.

• The Updated BCBS Guidance on Credit Risk and Accounting for Expected Credit losses will be a good complement to help to promote good quality and consistent implementation of IFRS 9.
Thank you