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Prudential Policy Considerations of Non Performing Loans and Expected Loss Provisioning

Katia D'Hulster

Role of prudential supervisors in the proper implementation of IFRS 9 and NPE definitions

Build and retain IFRS expertise

- IFRS, general accounting and audit expertise is essential for prudential supervisors.
- It is needed for:
  - follow IASB policy debate
  - set policy in line with international standards;
  - support frontline supervisors on technical matters;
  - review of the annual financial statements; and
  - communicate with the external auditors.
- Rare skillset to source and retain

Detail supervisory expectations for the application of IFRS 9

- Supervisory guidance on sound credit risk practices
- Build on Basel Committee “Guidance on credit risk and accounting for ECLs (December 2015)
- Build on EBA “Guidelines on credit institutions credit risk management practices and accounting for ECL” (May 2017)
- IFRS specific: 12 month ECL allowance
- IFRS specific: Assessment of significant increases in credit risk
- IFRS specific: Use of practical expedients

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Keep in mind the differences between regulatory capital models and ECL models

		IFRS 9	Capital calculations
PD	Measurement period	12 months (stage 1) Lifetime (stage 2 and 3)	12 months
	Cycle sensitivity	Point in time, considering forward looking information, including macro economic factors	Economic cycle
LGD/EAD	Measurement	Neutral estimate, considering forward looking information, including macro economic factors	Downturn estimate

Source BCBS (2016)

Require those charged with bank governance to achieve a good understanding and actively discuss, monitor, review and challenge

- Data quality and availability
- Methodologies, modeling and assumptions
- Expert credit judgement
- Systems processes and internal controls
- Clear reporting lines and accountability

Consider relying on the regulatory probation periods for forborne exposures

- IFRS 9 allows upgrades of forborne loans across the stages if repayment capacity has been demonstrated based on revised terms over a period of time.
- Substantial scope for variation across banks and jurisdictions
- Supervisory expectations when assessing forborne exposures are now clarified
- Entry and exit criteria can be useful references for supervisors
- Reasons for significant divergence between IFRS and prudential definitions should be understood.

Mandate clear rules for write offs in banks internal policies

- Fully provided loans impact NPE ratios
- IFRS 9 requires banks to write off loans if there is no reasonable expectation of recovery.
- IFRS 7 requires disclosure of write off criteria
- A write off is not debt forgiveness, yet in some countries judges continue to interpret it that way
- Internal policies should have clear guidance on timeliness of write offs

Use supervisory powers to ensure provisioning policies, practices and levels meet prudential expectations

- Binding standards, guidance or good practice
- Calibration, design and scope of binding provisioning standards require careful consideration
- Backstops can be used temporarily for banks that do not (yet) have the capacity to develop, implement and maintain ECL methodologies that meet supervisory expectations
- Option 1: Require provisions to be increased
- Option 2: Adjust the capital ratio to reflect higher provisions
- Option 3: Hold additional capital adjustment

Consider cross border issues and set clear expectations

- Group methodologies – “Black box”
- Local data
- Local assumptions
- Local expertise
- Involvement of consultants
- Supervisory cooperation and information exchange is essential

Revise credit quality, asset classification and provisioning standards

- To align with IFRS 9 and NPE definitions
- To ensure alignment with good international practice (Basel, EU,..)
- Areas that most often require review:

- Forbearance definitions too restrictive
- Unlikely to pay criterion missing
- Waiting periods not clearly defined
- Exit criteria
- No validation or benchmarking of mandatory regulatory provisioning requirements
- …

Consider the impact of ECL and NPE definitions on the prudential toolkit.

- Regulatory provisioning matrices
- Prudential reporting forms
- Off site analysis reports
- Stress tests
- AQR
- Supervisory guidance and expectations

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Thank you!