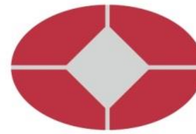

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BANK FOR INTERNATIONAL SETTLEMENTS

Panel 3: Implementation issues – model complexity and supervisory capacity

Banco de España – CEMFI – FSI High-Level Conference

The new bank provisioning standards: Implementation challenges and financial stability implications

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*Views expressed here may not necessarily reflect those of the FSI, BCBS or BIS

Agenda

- Context
- Snapshot of provisioning frameworks used worldwide
- Specific prudential issues to consider under IFRS 9
- Key takeaways

Context

- Provisioning gets at the heart of supervision – impacts asset values, earnings and regulatory capital
- Shift from incurred to ECL provisioning –the most consequential accounting change in the history of financial reporting of banks
- Welcome development..but raises implementation challenges that have prudential implications
- FSI insights #5 published in Oct. 2017 – ' Prudential policy considerations under expected loss provisioning – lessons from Asia'
  - highlights key IFRS 9 implementation challenges
  - outlines range of prudential considerations for SA and IRB banks
- To access paper: https://www.bis.org/fsi/publ/insights5.pdf

IFRS 9 – much needed, but poses formidable implementation challenges

- One accounting standard – no 'standardised' or 'advanced approaches'
- Complex standard – accentuates role of experienced credit judgement
- Credit judgment required under IFRS 9 ***exceeds***:
  - IAS 39 requirements
  - discretion permitted under A-IRB

…and so what?

- BCBS study on variability of cRWA (2014)
  - Banks with broadly similar credit portfolios arrived at different capital levels when using IRB models
  - Raises concern about 'gaming' models to deliver outcomes that results in less capital
  - Same models used to calculate IFRS 9 provisions
- Prudential response: curtail the use of models for certain credit portfolios (Final Basel III package - Dec. 2017)

Examples where IFRS 9 ECL judgement *required* > discretion *permitted* under IRB approaches

Portfolio / modeling parameters	Basel III IRB – cRWA	IFRS 9 – EL provisions
Exposures to banks/FIs	A-IRB not allowed (LGD and EAD parameters cannot be modeled)	Full discretion *required* (ie, estimate PD, LGD and EAD) to calculate accounting EL – all banks
Large and mid-sized corporates (consolidated revenues > EUR 500 million)	A- IRB not allowed	
Equities	IRB approaches not allowed (PD, LGD and EAD cannot be modeled)	
PD time horizon for non- impaired portfolios	12 month PD	12 month PD – stage 1 Lifetime PD – stage 2
PD input floors	• Corporate 5bp • Retail classes 5-10bp	Full discretion provided to estimate LGD to all banks
LGD input floors: A-IRB banks	• Corporate – unsecured 25%; secured 0-15% based on collateral type; • Retail: unsecured 30%-50% based on collateral type; secured 0-15% based on collateral type proposal)	
Overall supervisory floor	72.5% of standardised RWA	• SA banks: No floor • IRB banks: IRB is the floor to IFRS 9!

Implications for migration to IFRS 9 ECL provisioning

- Raises possibility of unwarranted divergence in provisioning outcomes – implications for earnings and regulatory capital
  - IRB banks: constrained IRB models under Basel III vs. unconstrained IFRS 9 provisioning
  - SA banks: simple calculation for credit risk capital vs. unconstrained IFRS 9 provisioning – how to bridge the gap?
- What (if any) should be the role of prudential regulation under IFRS 9?

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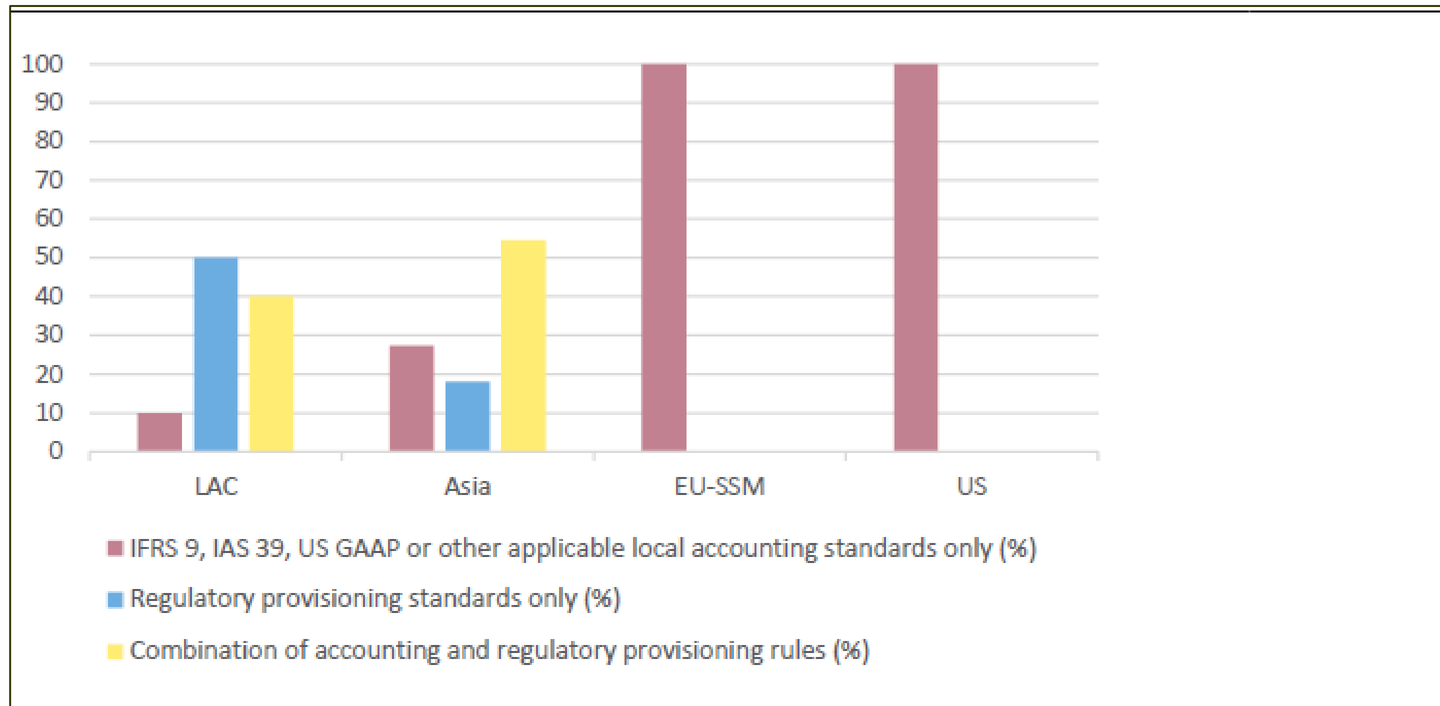
Provisioning frameworks vary globally

What approach is used to estimate and recognise provisions in the P&L (chart in % terms)?*



* See FSI Insights #7 (Baudino et al.): https://www.bis.org/fsi/publ/insights7.pdf
Based on FSI survey of EU-SSM, US, 10 Latin American & 11 Asian jurisdictions

..and can lead to different provisioning outcomes

- Accounting provisions ≠ regulatory provisions
- Regulatory provisioning frameworks widely used in Asia, & Latin America & Caribbean (LAC) and Eastern Europe (World Bank 2014) under IAS 39 – but design varies
- When both accounting and regulatory provisioning used – interaction between the two varies
- Implications are consequential & can cause variations in earnings and regulatory capital figures

Question for Policy

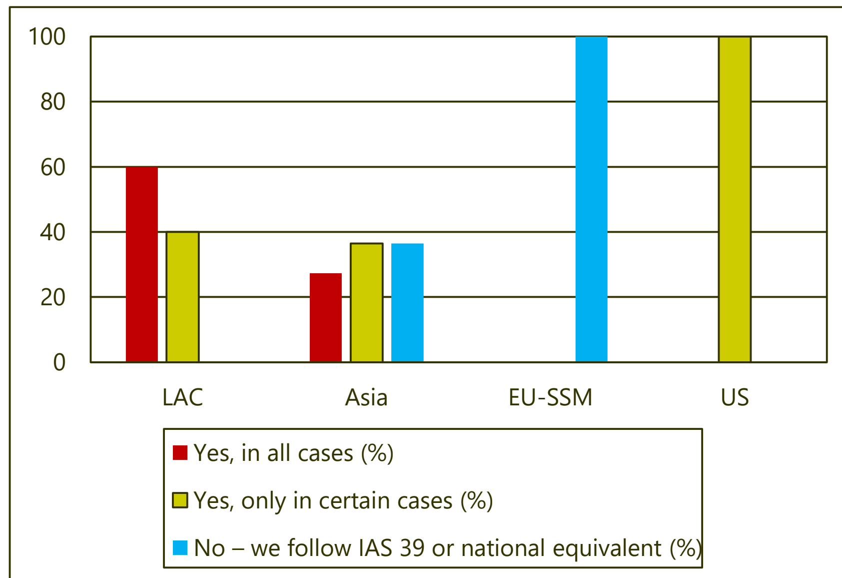
- Is there a role for regulatory provisioning backstops under IFRS 9?
  - Conceptual purists: 'IFRS 9 provisions should flow from the P&L into regulatory capital – backstops now redundant since accounting has moved to ECL provisioning'.
  - Pragmatists: 'Implementation challenges significant – cautious regulatory stance warranted particularly during initial stages of adoption'.

Specific prudential issues to consider under IFRS 9

- Specify supervisory expectations for treatment of restructured debt to facilitate supervisory risk assessments
- Explore possible regulatory or supervisory measures in relation to accruing interest income on NPAs
- Specify supervisory expectations in relation to loan write-offs
- Outline policy issues relevant for SA and IRB banks
- Gain powers to deduct EL provisioning shortfalls from CET 1 – if accounting EL provisions are inadequate from supervisory perspective

Treatment of accrued interest on NPAs – not harmonised globally

Do you require banks to place NPAs on nonaccrual status or to neutralise its impact through provisioning requirements in the P&L*?

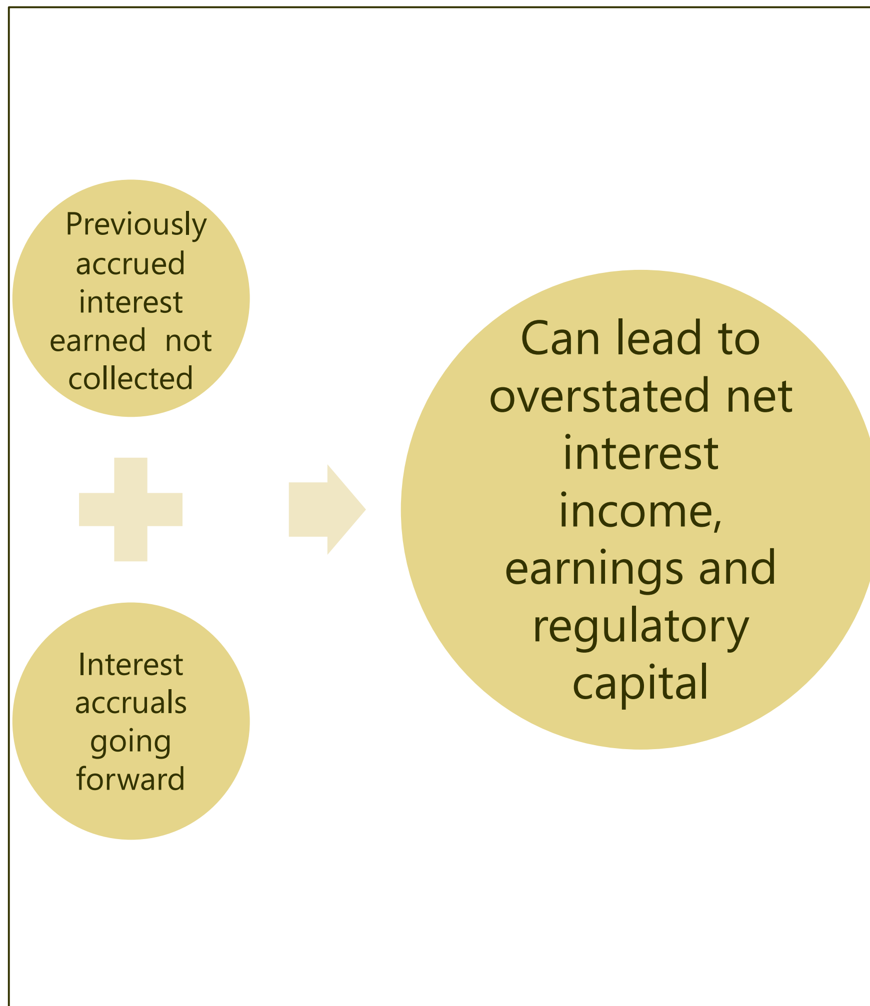


IFRS 9 requirement

- For stage 1 and stage 2 loans, interest income is accrued on a gross basis (before provisions)
- For stage 3 loans – interest income is accrued on a net basis (net of provisions).

* See FSI Insights #7: Based on survey of EU-SSM, US & 10 Latin American & 11 Asian jurisdictions

Treatment of interest accruals on NPAs – policy issues



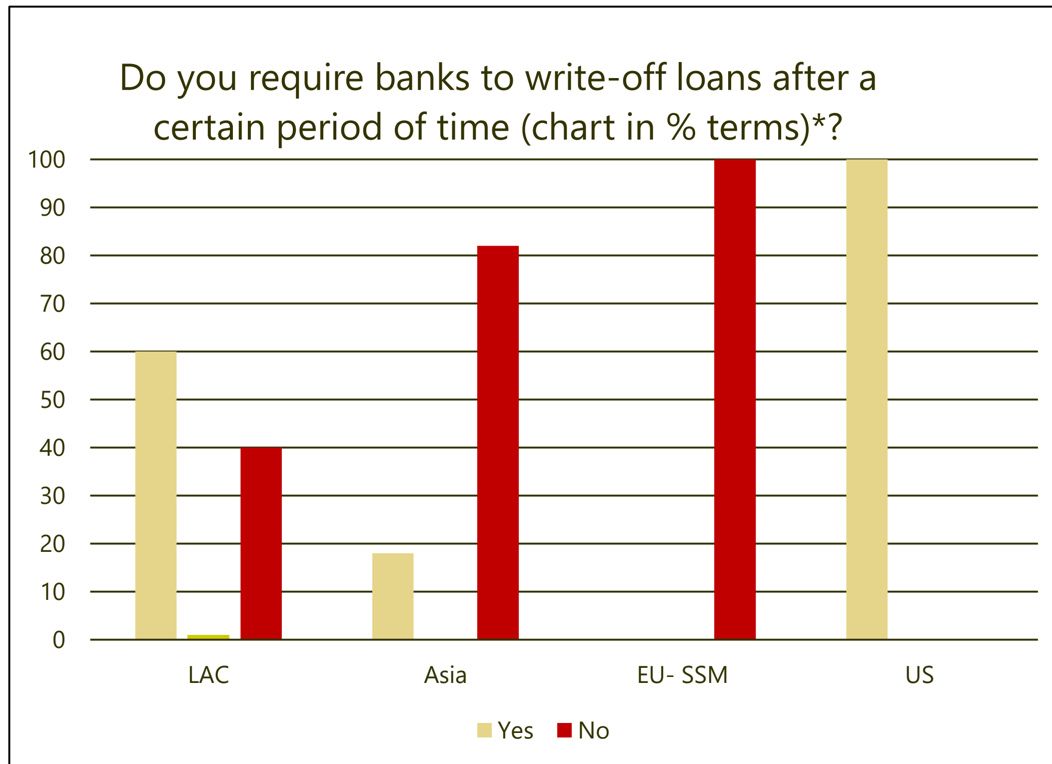
IFRS 9 view

- All sorted through discounting of collateral – nothing conceptually wrong with accruing int. income on net basis

Prudential view

- Too assumption dependent: various policy levers used to address concerns
  - place loans on non-accrual status
  - require commensurate provisions for accrued interest
  - require banks to report amount of accrued int. on NPAs – and consider prudential measures via capital if warranted

Loan write-off requirements vary and can also impact provisioning outcomes



IFRS 9 requirements

- Writeoffs encouraged if no prospects of recovery
- Ex: if collateral dependent and recovery expected to be 30%, with no prospect of recovery of remaining amount – the 70% should be written off

* See FSI Insights #7: Based on survey of EU-SSM, US & 10 Latin American & 11 Asian jurisdictions

..because 'excess' collateral support on legacy NPLs can lead to zero or minimal provisions – time value estimate key driver

Commercial real estate loan past due over 120 days and internally classified Loss. Repayment now expected solely from liquidation of physical collateral (assume commercial building).

IFRS 9 Provisioning (stage 3 loan)

	Assume 3 yrs. to sell collateral	Assume 8 yrs. to sell collateral
Loan book value	100	100
Physical collateral	125	125
Assume foreclosure costs and costs to sell at 5% of collateral value	6	6
Estimated Value of physical collateral less foreclosure costs and costs to sell	119	119
PV of estimated recovery: (assume 3yrs., discounted at 6%)	100	75
Estimated Impairment loss	**0**	**25**

..and even fully provisioned NPAs – in the absence of write-offs - can distort key analytical ratios

Balance sheet items/ratios	Bank A (before writeoff)	Bank A (after writeoff)
Gross loans	1,000	1,000 -50=950
Gross NPLs	100	100 -50=50
Fully provisioned NPLs (included in gross NPLs)	50	Written off
Accumulated Provisions	130	130-50=80
Gross NPLs/Gross Loans	100/1000=10%	50/950=5.3%
Accum. Provisions/NPLs	130/100=130%	80/50=160%

Specific policy issues relevant for SA banks

- Evaluate merits of establishing (or maintaining) regulatory provisioning backstops under IFRS 9
- Map IFRS 9 provisions to regulatory concepts of general (GP) and specific provisions (SP)
  - Key issue: what portion of IFRS 9 provisions are GP vs SP?
  - Two schools of thought
    - Conceptual purists: 'All IFRS 9 provisions are SP' (they are 'expected losses')
    - Pragmatists: 'A subset of IFRS 9 provisions are GP – issue is treatment of stage 2 loans'

Specific policy issues relevant for IRB Banks

- IRB and IFRS 9 modeling inputs differ – can lead to different provisioning outcomes

Modeling inputs	Basel III IRB EL	IFRS 9 ECL
PD time dimension	TTC	PIT
PD time horizon non-impaired loans	12 months – all loans	12 month – stage 1 Lifetime – stage 2
PD and LGD	Various input floors for corporate and retail exposures	No floors
Discount rate	WACC	EIR

  - IFRS 9 EL provisions>IRB EL – excess added to T2 (up to .6% of cRWA)
  - Potential for more Tier 2 add-backs under IFRS 9 vs. IAS 39 – is this an issue?
- Still a need for the IRB to backstop accounting provisions?
  - Conceptual purists: 'no – this is redundant'
  - Pragmatists: ' let's not remove without understanding implications'
    - Comfortable that IRB is **THE** backstop?

Key takeaways

Implementation challenges – IFRS 9

- complex standard – significantly expands role of judgment
- no 'SA', 'IRB' or 'A-IRB' – one choice & more freedom than A-IRB
- Banks, audit standard-setters, auditors play key role

Prudential Implications

- Excess variability in provisioning outcomes possible – implications for P&L and regulatory capital
- Capital measures under Basel III not comparable across countries

Prudential policy considerations

- BCBS provisioning guidance (GRAECL) useful in designing policy strategy
- Policy options must be fit for purpose – some universal, others relevant for SA & IRB banks
- Provisioning backstops in determining regulatory capital – reasonable approach & respects domain of accounting standard-setters and regulators

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Thank you!