SUPERVISORY GUIDANCE ON ACCOUNTING FOR EXPECTED LOSSES UNDER IFRS 9

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Introductory

This presentation has been prepared in the personal capacity of the presenter and is not a document of the Central Bank of Cyprus.

The presentation is based on the "Guidance on credit risk and accounting for expected credit losses" issued by the Basle Committee on Banking Supervision in December 2015 and the consultation paper titled "Draft Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses" issued by the European Banking Authority in July 2016.

These papers include eight principles covering the supervisory guidance to credit institutions.

Principle 1 – Management body and senior management responsibilities

The board of directors and senior management have the responsibility to ensure that appropriate credit risk management practices, including an effective internal control system, to consistently determine adequate provisions in accordance with the stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

All policies, procedures and processes for credit risk assessment and measurement including an effective credit rating system and a model validation process, an independent internal audit function and clear and formal communication and coordination within the relevant units of the institution are setup by senior management upon instructions of the board of directors.

Principle 2 – Sound Expected Loss (ECL) methodologies

Credit institutions should adopt, document and adhere to policies including sound methodologies, procedures and controls for assessing and measuring credit risk on all lending exposures. Aim: the appropriate and timely recognition of expected credit losses.

Key issues:

1. Know the level, nature and drivers of credit risk upon initial recognition and identify and quantify changes in credit risk
2. High demand for data and information
3. Relevant criteria to consider the impact of forward-looking information, including macroeconomic factors
4. Adequate grouping of exposures with common credit characteristics
5. Appropriate historical time periods for evaluation of historical loss experience
6. Sound methods for estimating probability of default (PD) and loss given default (LGD)
7. Everything needs to be documented and justified as to its relevance and appropriateness

Principle 2 – Sound Expected Loss (ECL) methodologies

Factors that affect borrower's ability, willingness and incentives for repayment should be identified. These could include:

1. Borrower's sources of recurring income available to cover the repayment schedule
2. Borrower's ability to generate sufficient cash flow over the term of the lending exposure
3. Borrower's overall leverage level and expectations of changes to leverage
4. Incentives or willingness of borrowers to meet the repayment schedule
5. Unencumbered assets of the borrower that could used to raise funds and expectations of changes to their value.
6. One-off events and recurring behaviour that may affect borrower's ability to repay
7. Timely evaluations of collateral value and the factors that may impact the future value of collateral (collateral values are an input into the LGD calculation)

Principle 2 – Sound Expected Loss (ECL) methodologies

The process for the estimation of ECL should include different potential scenarios and should not rely on subjective, biased or overly optimistic considerations. Therefore, credit institutions should:

1. Show how ECL estimates would change with variations in scenarios
2. Document the process for determining the time horizon of the scenarios and how they estimate ECL for exposures that mature beyond the period of the scenarios.
3. Have a variety of experts (risk experts, economists, business managers and senior management) assisting in the selection of scenarios that are internally developed.
4. Perform back-testing to check the relevance of the economic factors to collectability and credit risk.

Principle 2 – Sound Expected Loss (ECL) methodologies

Inherent risks within a lending portfolio should be considered so as to avoid the inadequate estimates of ECL. For example:

1. Credit granted to borrowers with fragile income streams or with limited verification of borrower's income sources
2. High debt service requirements relative to the borrower's net available expected cash flows
3. Flexible repayment schedules such as payment vacations and interest-only payments.
4. For real estate and other asset based financing, loan to value ratios above 100% or with inadequate security margin.
5. Undue increases in restructurings due to financial difficulties of the borrowers
6. Circumvention of the classification and rating requirements including restructuring
7. Increasing volume and severity of past-due, low-quality and impaired exposures

Principle 2 – Sound Expected Loss (ECL) methodologies

Extra care is needed for credit exposures that have been renegotiated/modified and the provisioning methodology should address these to ensure that the provisions estimated reflect the collectability of the exposure.

Renegotiations/modifications should not automatically lead to the conclusion that there has been an immediate decrease in the credit risk of the exposure but such decrease should be supported by strong evidence. This would entail consistent satisfactory performance over a reasonable period of time. The European Commission Implementing Regulation 2015/227 on the definition of forbearance and the observance period for forborne exposures should be considered.

For exposures where the renegotiation/modification provides for the payment of interest only, credit institutions should carefully consider whether the collection of loan principal is reasonably assured.

Principle 2 – Sound Expected Loss (ECL) methodologies

Loss allowance at an amount equal to 12-month ECL

An amount equal to the 12-month ECL is not only the losses expected in the next 12 months, it is the expected cash shortfall over the life of the lending exposure or group of lending exposures due to loss events (i.e. default) that could occur in the next 12 months. A nil allowance for stage 1 credit exposures should be rare as ECL estimates are a probability weighted amount that reflects the probability that a credit loss will occur.

Lending exposures should not be grouped in such a way as to obscure the identification of significant increases in credit risk on a timely basis.

IFRS 9 does not define default and credit institutions should be guided by the definition used for regulatory purposes (i.e. unlikeness to pay or 90 days-past-due). The 180 days-past-due that may be allowed by supervisors for certain exposures is not applicable when defining default for accounting for ECL.

Principle 2 – Sound Expected Loss (ECL) methodologies

Assessment of significant increase in credit risk

Credit institutions should have in place systems that are capable of handling and systematically assessing the large amounts of information required to judge whether or not particular lending exposures or groups of exposures exhibit a significant increase in credit risk.

Key issues:

1. Data and forward projections for the key drivers of credit risk
2. Quantification of credit risk based on current and forecasted conditions using experienced credit judgement
3. Delinquency data is generally backward-looking
4. Increase in credit risk should be assessed in terms of the increase in the risk of default occurring and not the expected credit loss (i.e. before credit risk mitigants such as collateral).

Principle 2 – Sound Expected Loss (ECL) methodologies

Assessment of significant increase in credit risk – Examples of indicators to be used (non-exhaustive list):

1. The element of the price of lending exposures that reflects credit risk would be significantly higher if granted at the reporting date than what it was at the origination of exposures.
2. Senior management decision to strengthen collateral for new lending exposures that are similar to existing exposures because of changes in their credit risk.
3. Downgrade of a borrower by a rating agency or by the internal credit risk rating system
4. For individually monitored performing exposures, a weaker internal credit assessment
5. Deterioration of relevant determinants of credit risk for an individual borrower or pool of borrowers.
6. Expectation of modification due to financial difficulties

Principle 2 – Sound Expected Loss (ECL) methodologies

Assessment of significant increase in credit risk – Factors to be taken into account

1. Deterioration of the macroeconomic outlook relevant to a particular borrower or to a group of borrowers.
2. Deterioration of prospects for the sector or industries within which a borrower operates.

When using the changes in the probability of default (PD) for identifying changes in the risk of default, credit institutions should take into consideration the significance of a given change in PD expressed as a ratio proportionate to the PD at origination (change in PD/PD at origination).

“Significant” should also not be judged in terms of the extent of impact on a credit institution’s primary financial statements.

For modified credit exposures, excluding those that result in derecognition, the assessment of whether there is a significant increase in credit risk should be made by comparing the risk of default at the reporting date on the basis of the modified contractual terms with the risk of default at origination of the credit exposures on the basis of the original unmodified contractual terms.

Principle 2 – Sound Expected Loss (ECL) methodologies

<u>Assessment of significant increase in credit risk – Modified or renegotiated credit exposures</u>

For these exposures, ECL estimates should take into account whether the modifications or renegotiations have improved or restored the ability of the credit institution to collect interest and principal payments compared to the situation upon origination. This would entail an assessment of the borrower's ability to repay the debt considering, among others, current conditions, macroeconomic forecasts and prospects for the sector/industry within which the obligor operates.

Credit exposures that were transferred to lifetime ECL that are subsequently modified/renegotiated, should not be moved back to 12-month ECL measurement unless there is sufficient evidence that the criteria for recognition of lifetime ECL are no longer met. Evidence could include a history of up-to-date and timely payment performance against the modified contractual terms.

Principle 2 – Sound Expected Loss (ECL) methodologies

Use of simplifications (practical expedients)

1. The information set: IFRS 9 states that ECL estimations should be based on reasonable and supportable information that is available without undue cost and effort. Credit institutions should not interpret this restrictively and should use all reasonable and supportable information that is relevant for the credit exposures.

2. "Low credit risk" exemption: Any use of the low-credit-risk exemption allowed by IFRS 9, should be accompanied by clear evidence that credit risk as at the reporting date is sufficiently low so that a significant increase in credit risk since initial recognition could not have occurred.

3. More-than-30-days-past-due rebuttable presumption: credit institutions could use the more-than-30-days-past-due as a backstop but they should not use it as a primary indicator of transfer to lifetime ECL. They should have in place processes to ensure that credit risk increases are detected well ahead of exposures becoming past due or delinquent. On the other hand, credit institutions should not assert that this presumption is rebutted unless they can support it by thorough analysis clearly evidencing that 30 days past due does not entail a significant increase in credit risk.

Principle 3 – Credit risk rating process and grouping

An effective credit risk rating process should capture the changing level, the nature and the drivers of credit risk that may manifest themselves over time, to ensure that all lending exposures are properly monitored and that ECL allowances are appropriately measured. It should enable credit institutions to identify both migration of credit risk and significant changes in credit risk.

Issues to note:

1. The elements of the credit rating system should be clearly defined and the different roles assigned to relevant staff should be designated.
2. The credit rating process should include an independent review function to review the assignment of credit risk grades by front-line lending staff.
3. A number of criteria should be used for assigning a credit risk grade upon initial recognition such as product type, terms and conditions, collateral type and amount, borrower characteristics and geography.
4. For subsequent changes in grades additional factors should be considered such as changes in industry outlook, business growth rates, consumer sentiment, changes in the economic forecasts and underwriting weaknesses identified after initial recognition.
5. Credit risk grades assigned should be reviewed on a periodic basis, for example annually, as well as whenever relevant new information is received or the credit institution's expectation of credit risk has changed.

Principle 3 – Credit risk rating process and grouping

When grouping of exposures, credit institutions should ensure that exposures grouped have shared credit risk characteristics that are sufficiently granular in order to enable the assessment of changes in credit risk.

The basis of grouping exposures should be documented and reviewed by senior management to ensure that they remain relevant for assessing changes in credit risk. Where necessary, exposures should be re-segmented.

Exposures should not be grouped in such a way that an increase in the credit risk of particular exposures is obscured by the performance of the group as a whole.

Principle 4- Adequacy of the allowance

The aggregate amount of provisions should be adequate and consistent with the objectives of the applicable accounting framework.

To achieve this, the credit institutions' credit risk methodologies should take into account the relevant factors and expectations at the reporting date that may affect collectability over the life of exposures.

The information to be considered should not be limited to historical and current data but also take into account reasonable and supportable forward-looking information, including macroeconomic factors.

The assessment approach could be on an individual or collective basis but it should be aligned with how the credit institution manages the lending exposures.

Principle 5 – ECL model validation

Credit institutions should have robust policies and procedures in place to appropriately validate the accuracy and consistency of the models used to assess the credit risk and measure ECL, including its model-based credit risk rating systems and processes and the estimation of all relevant risk components, at the outset of model usage and on an ongoing basis.

Model validation should be performed independently of the model development process and by staff with the necessary experience and expertise. The validation should include a review of model inputs, model design and model outputs/performance to ensure that the models are suitable for their proposed usage, at the outset and on an ongoing basis.

Principle 6 – Experienced credit judgement

The use of experienced credit judgment, especially in the consideration of reasonable and supportable forward-looking information, including macroeconomic factors, is essential to the assessment of credit risk. Information on historical loss experience or the impact of current conditions may not fully reflect the credit risk in lending exposures.

Credit institutions should be able to demonstrate that the forward-looking information factored into the ECL estimation process has a link to the credit risk drivers for particular exposures or portfolios.

Consideration of forward-looking information is essential for the estimation of ECL and should not be avoided for reasons of excessive cost.

Principle 7 – Common processes, systems, tools and data

Credit institutions should have a sound credit risk assessment and measurement process that provides them with a strong basis for common processes, systems, tools and data to assess credit risk, to account for expected losses and, to the maximum extent possible, determine expected losses for capital adequacy purposes.

A communication line should be established to ensure that information on estimates on ECL, changes in the credit risk and actual losses experienced on lending exposures is shared among credit risk experts, accounting and regulatory reporting staff and the loan underwriting staff. This will enable the credit institution to periodically review its credit risk practices.

Common processes, systems, tools and data could include credit risk rating systems, estimated PDs (subject to appropriate adjustments), past-due status, loan-to-value ratios, historical loss rates, product type, amortisation schedule, down payment requirements, market segment, geographical location, vintage and collateral type.

Principle 8 - Disclosure

A credit institution’s public disclosures should promote transparency and comparability by providing timely, relevant and decision-useful information.

Both quantitative and qualitative disclosures should be made and as a whole should communicate to users the main assumptions/inputs used to develop ECL estimates. These could include information on the basis for grouping lending exposures into portfolios with similar credit risk characteristics, the definition of default used, factors that cause changes in ECL estimates and the way senior management’s experienced credit judgment has been incorporated, how forward-looking information has been incorporated into the ECL estimation process and an explanation of significant changes to the estimation of ECL from period to period.

Key messages

Credit institutions should build their data bases and credit risk models in such a way that they have a deep and regularly updated knowledge of the quality of their lending portfolio, what factors would cause a deterioration in the quality and what is the size of the credit losses that could arise from such a deterioration.

Everything needs to be clearly documented and justified with clear responsibilities for the different roles in the processes. Models need to be properly validated to ensure that the estimates they produce are adequate.

Credit institutions should use common systems, tools and data to assess credit risk, to account for ECL and, to the maximum extent possible, determine expected losses for capital adequacy purposes.

Interaction of accounting ECL and regulatory capital

Different approaches for banks using the standardised approach and banks using internal rating based (IRB) methods to calculate their regulatory capital.

For banks using the standardised approach, regulatory capital is calculated on the basis of their accounting figures. Supervisors are able to impose additional capital requirements under Pillar II to address any shortfall between the accounting provisions and supervisory ECL.

For banks using the IRB methods, regulatory capital is calculated on the basis of their accounting figures but any shortfall between the accounting provisions and supervisory ECL is deducted from their regulatory capital.

Transitional arrangements to mitigate the capital impact of IFRS 9

The global general expectation is that, with the application of IFRS 9, banks' stock of provisions could increase significantly with a consequent negative impact on banks' capital.

The Basle Committee issued in March 2017 a standard allowing supervisors to introduce transitional arrangements as regards regulatory capital requirements in order to allow banks to take the hit on regulatory capital over a period of maximum five years.

On 23 November 2016, the European Commission published for consultation its proposals for the review of the CRR/CRDV and these include, in line with the standard introduced by the Basle Committee regarding IFRS 9 (at that time it was a consultation paper), transitional arrangements to mitigate the effect of the introduction of IFRS 9 on regulatory capital. The Commission proposals state that the option to apply the transitional arrangements rests with the banks and not the supervisors and allow for a five year transitional period with full neutralisation of the impact in the first year.

On 6 March, 2017, the EBA issued an opinion on the European Commission proposals pointing to certain areas where the European Commission proposals should be stricter. The European Commission has not yet issued the final proposals.

THANK YOU

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