Aptivaa

BCBS Advocates High Quality Implementation of IFRS 9

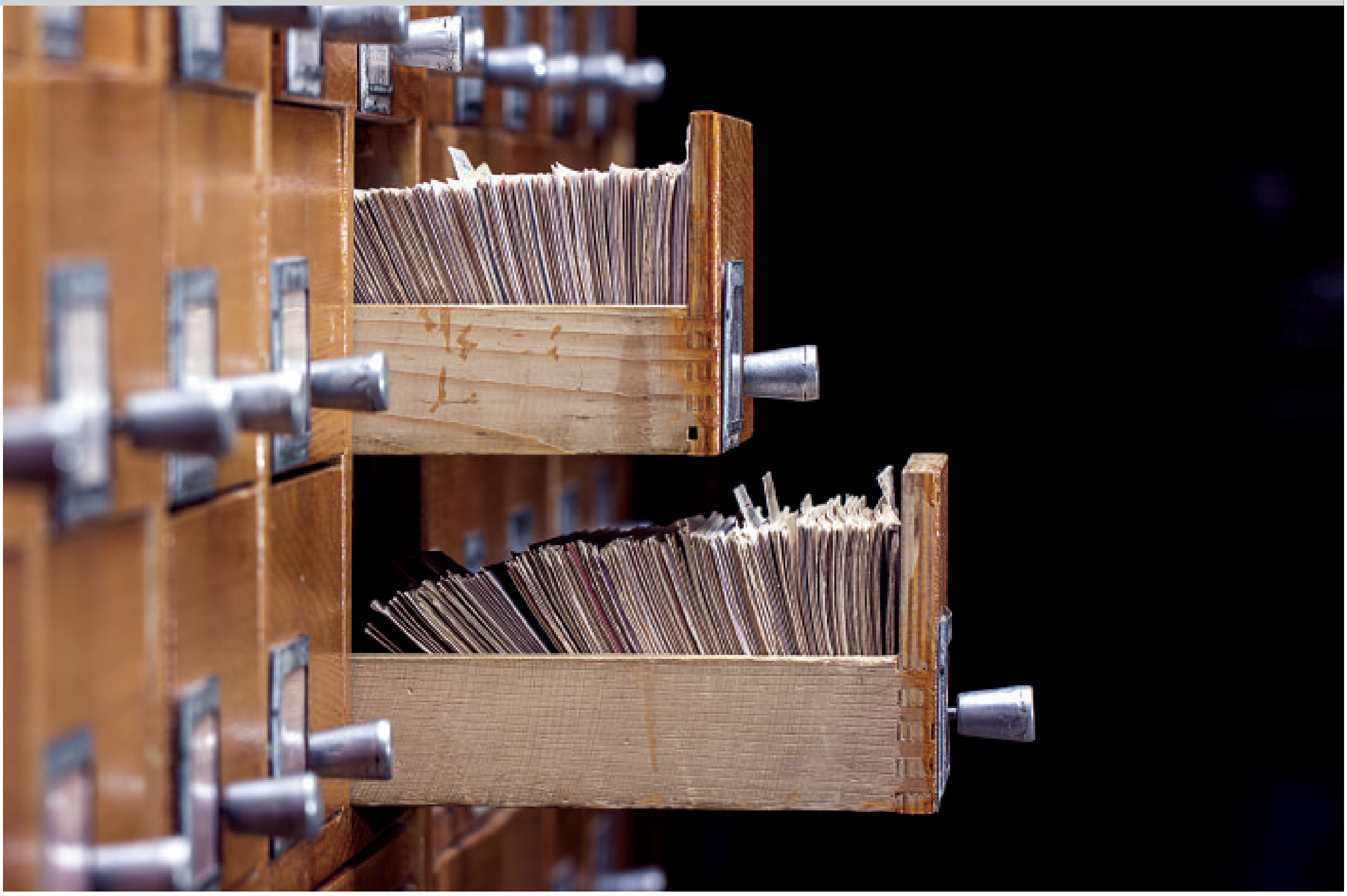
Issues guidelines for Banks & Regulators

BCBS has provided insights on sound credit risk and accounting practices associated with the implementation of Expected Credit Losses accounting frameworks

Highlights of the guidance issued by BCBS on 18th December 2015

- The Basel Committee has finalized its supervisory guidance on how the ECL accounting model should interact with a bank's overall credit risk practices, and provisioning framework, aimed primarily for internationally active banks.
- The new guidance provided by the Committee **replaces the guidance issued in June 2006** on *'Sound credit risk assessment and valuation for loans'*.
- The Committee for the **first time allows for the immediate reversal of allowances**, recognizing that, ECL accounting frameworks are *symmetrical*, though this might introduce some volatility in P&L statement.

- The Committee has clearly outlined that the banks should consider the principle of proportionality and materiality for finalizing the methodology for ECL estimation, as it is very much evident that ***'one size fits all' approach would not be applicable.***
- The Committee has outlined its expectation for inclusion of forward looking information and macroeconomic forecasts to the historical information in the ECL estimation process and over the use of *'temporary adjustments'* to the ECL estimates.
- The Committee has outlined the requirement of robust policies and procedures for ***validation of models***, and maintains its rigorous stance for model governance framework in consistency with regulatory requirements for Basel II IRB purposes.
- Use of IFRS 9 *practical expedients* (such as, more than 30 days past dues, low credit risk exemption, information set) has been limited by the Committee, as these can introduce significant biases which could be an impediment in *high quality* implementation of IFRS9 standards.
- The Committee considers that the long-term benefit of a high-quality IFRS 9 implementation far outweighs the associated costs, which should therefore not be considered *undue*.
- The guidance emphasizes on **periodical *'supervisory evaluation'*** of a bank's credit risk practices, methods adopted by a bank to determine accounting allowances in accordance with the applicable accounting framework.
- To meet the expectation of the Committee's on high quality implementation of ECL estimation, banks need to estimate risk components for the entire lending exposures.



Key guidance's discussed in the paper

Content | Page

The views expressed in this document are based on our understanding of the guidelines provided by the Basel Committee paper. Few excerpts have been reproduced from the guidance note. Entities are advised to consult the texts of any requirements before they apply and seek the advice of their accounting and legal advisors.

1 Basel Committee Expectations on Implementation of **ECL Accounting Framework**

Basel Committee for Banking Supervision (BCBS or the Committee) has acknowledged that historically incurred loss model[1] was the basis for measurement of credit losses for accounting purposes. This was implemented across various jurisdictions, and also within the same jurisdictions with significant differences, primarily on account of a number of practices that were followed at the country, regional, and at the entity level.

For this reason, the Committee has emphasized on the **importance of high-quality, robust, and consistent implementation** of applicable ECL accounting framework, at internationally active banks across all jurisdictions. This can be achieved by consistent interpretation of guidelines and practices where there exist commonalities across accounting frameworks.

Given this, we strongly believe that supervisors across various jurisdictions would be publishing stringent guidelines on accounting of ECL, to support the clearly outlined expectations of BCBS, and there would be limited scope available (after consideration of proportionality and materiality principles) to banks across same jurisdictions to have distinct practices for estimation of credit losses for accounting purposes.

The Committee has also clearly specified that the guidance does not set out any additional requirements regarding the determination of expected loss for regulatory capital purposes.[2] However, the results of accounting standards expected credit losses (ECL) calculations could be different from Basel II calculations (EL), due to use of Point-in-Time PD instead of Through-the-Cycle (TTC) PD, and other differences in the overall calculations methodologies.

As a result, the provisioning treatment on account of IFRS9 accounting standards could lead to either of the two scenarios –

a. When IRB EL is more than IFRS9 ECL – this difference would lead to reduction in Tier 1 capital;

b. When IRB EL is less than IFRS9 ECL – banks may recognise this difference in Tier 2 capital[3]

The key guidance points discussed later in this document are aimed to support the committee's view on how banks should augment their existing credit risk practices to allow for high-quality, robust and consistent assessments and measurements of ECL.

[1] Paragraph 5 of the guidance note, available at www.bis.org/bcbs/publ/d350.pdf
[2] Paragraph 3 and 9 of the guidance note
[3] Paragraph 61 of BCBS paper available at www.bis.org/publ/bcbs189.pdf

2 Responsibilities and Expectations from **Banking Supervisors**

The role and expectations from the banking supervisors of various jurisdictions have been very well defined by BCBS in the guidance note. The Committee has stressed on the 'periodical supervisory prudential review' of the methodologies adopted by various banks for determination of expected credit losses as per the applicable accounting framework.[4] As a result, banks have to gain concurrence from their supervisors that the policies and procedures used by them for ECL estimations are robust, timely and adhere to sound credit risk practices as described in the guidance note.

It has also been made quite clear that, it is the management's responsibility to implement the accounting policies and prepare the financial statements. Therefore, **supervisors are not expected to pre-approve**[5] a banks' ECL accounting model. The Committee expects a prudent review for robustness of credit risk assessment models and policies post implementation.

Many banks have been expecting that the prescriptive model to identify the target state across range of methodologies for IFRS9 ECL estimations may be provided by the statutory auditors and the Investment Committees; however after the release of the final guidance note from the Committee, it is quite apparent that banks have to develop their own prescriptive model, which in turn would be assessed by the supervisors for its appropriateness. And the Committee expects the documentation of the reasons as to why the selected method is appropriate for a bank's portfolios.[6]

Banking supervisors would also be responsible for assessment of level of allowances as an element of a bank's overall capital adequacy. As a part of this exercise supervisors would also assess, how the management of the bank has maintained internal control systems, processes, and policies to establish acceptable allowances estimation framework.[7]

It is expected that if there are any deficiencies observed in the credit risk assessment of ECL measurements, then such deficiencies would be reflected in supervisory ratings by the regulators/ supervisors, or through a higher capital requirement under Pillar 2 of the Basel capital framework. Therefore, we strongly believe that, banking supervisors of various jurisdictions will play a strategic role in high quality implementation of applicable accounting standards across banks.

[4] Paragraph 83 and 85 of the guidance note, available at www.bis.org/bcbs/publ/d350.pdf
[5] Foot note 27 of the guidance note
[6] Paragraph 31 of the guidance note
[7] Paragraph 88 of the guidance note

3 Commonality across **Processes and Infrastructure**

The Committee has highlighted the existence of commonality in the processes, systems, tools and data used for measurement of both ECL for accounting purposes and EL for capital adequacy purposes.[8] Consequently, the Committee has emphasized on the importance of consistent use of information, which is critical in achieving maximum possible consistency across both the purposes.

Accordingly, we strongly support the view of the Committee and believe that these common processes and data are closely interrelated, as there cannot exist variance in the information used for both the purposes, and therefore as an outcome, banks will achieve considerably reliable and consistent ECL estimates which are more transparent to all the stakeholders including investors.

We believe that banks can achieve synergy and can leverage the existing infrastructure for establishment of the ECL accounting framework by using the prevalent tools and systems (such as credit rating systems, collateral management systems); and data could include historical defaults, vintage, product type, days past dues, demographics, pricing, model ratings, collaterals, or other relevant factors. However the methodologies for ECL estimation could be different in comparison to EL computation for capital adequacy purposes.

4 Scope & Application of **Accounting Framework**

The Committee has stated clearly that all the lending exposures to which an ECL framework is applicable, should be considered for ECL estimation[9] and **has provided no exemption bucket for compliance** to accounting standards.

From our extensive experience, we understand that many banks have few parts of lending exposures kept outside the purview of rating system, and in order to comply with the requirements prescribed by the Committee, banks would need to estimate risk components for the entire lending exposures.

To achieve this, banks may have to invest in highly skilled human resources along with upgradation of existing systems or development of new systems.

The Committee has recognised that supervisors across jurisdictions may **adopt a proportionate approach**[10] with regard to the guidelines which supervisors issue to various banks, and this remains consistent with the Basel Core Principles.

We believe that effective implementation of proportionate approach would require banks to initiate with their portfolio assessment and understand the complexity, riskiness and structure of the portfolio, other additional information. This would be followed by defining

[8] Paragraph 69 of guidance note, available at www.bis.org/bcbs/publ/d350.pdf
[9] Paragraph 10 of guidance note
[10] Paragraph 15 of the guidance note, available at www.bis.org/bcbs/publ/d350.pdf

an appropriate prescriptive model to identify target state across range of methodologies varying in sophistication, and then establish the most appropriate methodology for ECL estimation across the entire portfolio. As per our view, it is very evident from the expectation of the Committee that **'one size fits all' would not be possible**, and every Bank has to define its own prescriptive model. For that reason, depending upon the size, portfolio structure, complexities and economic significance of various banks across a jurisdiction, there could be variance in the prescriptive models adopted by various banks.

Considering a bank X with 10 branches across a jurisdiction and, another bank Y with 80 branches in the same jurisdiction. Bank Y is considered as one of the largest banks in the jurisdiction, and offers a greater variety of products in comparison to Bank X. Understandably, the prescriptive model adopted by bank Y could differ from that of Bank X due to its bigger size, higher degree of complexity and greater economic significance.

The Committee has explicated that due consideration should be given to the **application of principle of materiality**, and that any exposure (individual or portfolio exposure) should not be considered immaterial if, cumulatively, these represent a material exposure to the bank. It has further explained that, materiality should not be assessed only on the basis of the potential impact on the profit or loss statement at the reporting date[11]. For instance, large portfolio(s) of high-quality credit exposures should be considered material.

As per our view, prudent materiality assessment is required to be performed by the banks; as this will be one of the crucial building blocks towards the development of prescriptive model and selection of an appropriate ECL estimation methodology for various exposures. This would involve expert judgments from senior management and should be very well documented for supervisory review of the entire process.

5 Applicability of the **Rule of Symmetry**

The Committee has acknowledged that ECL accounting framework is symmetrical in nature, and subsequent changes in the credit risk profile of a debtor (both deteriorations and reversals of those deteriorations) should be considered in measurement of allowances,[12] i.e. **reversal of allowances is allowed.** However, this initiative from the Committee may introduce some volatility in the P&L statement.

In our view, banks would have to invest in the development of system/ tool which should be equipped to manage the movement of allowance across all lending exposures (individually or collectively) due to change in the credit risk of the exposure. This might also require the management to use its experienced credit judgment to consider the movement of exposures across categories and should be documented for supervisory review.

The Committee has also highlighted that reversal of deteriorations (i.e. increase in credit worthiness of the debtor) should be well supported by strong evidence and a debtor should be able to perform consistently over a reasonable period of time.

[11] Paragraph 16 of the guidance note
[12] Paragraph 18 of the guidance note available at www.bis.org/bcbs/publ/d350.pdf

6 Model Validation and Governance Framework

The Committee expects that banks should have well defined credit risk assessment processes that capture the varying level, nature and drivers of credit risk of the portfolio and enables the bank to appropriately group exposures.[13] It is also expected that the entire credit risk rating process should have an independent review function.

For appropriate assessment and measurement of ECL banks would be using a number of models for identification of various aspects including credit risk rating, credit deterioration tiggers, estimates of PD, LGD and EAD, maturity, estimation of allowances for accounting and capital adequacy purposes. The Committee recognizes that development of these models involves extensive judgment and therefore **banks should have robust policies and procedures in place for validation of models**,[14] and the Committee maintains its rigor stance for model governance framework in consistency with regulatory requirements for Basel II IRB purposes.

We strongly support the above view of The Committee on robust model validation process requirement, which remains consistent with IRB regulatory requirements. The Committee has also elaborated the need and key elements of a model validation framework[15] –

a. **Governance framework** – Banks should have well defined governance framework and the senior management of banks need to establish, and the respective boards should approve, comprehensive model validation policy.

b. **Clear roles and responsibilities** – Banks need to ensure that roles and responsibilities for (i) model validation and (ii) independent review of the validation process are clearly and formally defined. Also, the model validation and model development should be performed by independent teams of the bank.

c. **Validation scope and methodology** – Banks need to perform periodic review of model's robustness, consistency, accuracy and its continued relevance to the underlying portfolio. The scope for validation should include a review of model inputs, model design and model outputs/performance.

d. **Model management policy** – The Committee strongly emphasizes on comprehensive documentation across all the dimensions related to ECL estimations, and as a result banks need to ensure that the model validation process is comprehensively documented.

e. **Independent review of model validation process** – Banks should appoint independent parties (e.g. internal or external auditors) to conduct regular reviews of the model validation process.

[13] Paragraph 44 of the guidance note
[14] Paragraph 60 of the guidance note
[15] Paragraph 61 of the guidance note available at www.bis.org/bcbs/publ/d350.pdf

The findings of model validation process need to be reported to the appropiate authority levels across the banks, and the corrective measures (re-calibration or re-development of models) should be promptly taken, if required.

Considering our past experiences, future economic forecasts globally, and other forward looking information, we believe that a robust and effective model governance framework is one of the significant component of sound credit risk practices which would be followed by various banks.

7 Use of forward-looking and macroeconomic forecasts in **ECL Estimations**

The Committee defines that the aggregate amount of allowances irrespective of the ECL estimation methodology should be adequate and comply with the accounting standards requirement.[16] For appropriate measurement of allowance the Committee also expects, banks to consider relevant forward-looking information including macroeconomic factors that are relevant to the exposure being evaluated and must go beyond historical and current available data.[17]

The Committee has very clearly defined its expectations from banks in terms of consideration of supportable forward-looking information into its ECL estimates. **Regardless, of the assessment approach** i.e. whether individual or collective (PD/LGD) assessment adopted by a bank, the ECL estimate should incorporate the expected impacts on account of forward-looking information, including macroeconomic forecasts, that affect the credit risk.[18]

The Committee has clearly outlined that Banks **need not necessarily identify or model every possible scenario**, or use directly the industry-wide stressed scenarios, but shall consider all the relevant forward-looking information and macroeconomic forecasts, which can impact the ECL assessment and have to maintain comprehensive documentation for supervisory review.

The Committee allows for *temporary adjustments*[19] to the allowance, if it becomes evident that a bank's allowance methodology has not considered existing or expected risk factors that could affect ECL estimates, it is expected that such adjustments should be of temporary in nature only, else update of methodology would be required.

However, the use of temporary adjustments is required to be consistent with the forward-looking, including macroeconomic forecasts and should also be supported by appropriate documentation.

We support the view of the Committee on the incorporation of forward looking-information into the ECL estimates and believe that it would be comparatively easier for banks to adopt a collective assessment approach, as incorporation of such information in models would be much easier in comparison to individual assessment approach for ECL estimation which in turn requires high level of expert judgments.

[16] Principle 4 of the guidance note available at www.bis.org/bcbs/publ/d350.pdf
[17] Paragraph 53 of the guidance note
[18] Paragraph 56 of the guidance note
[19] Paragraph 50, 51 and 58 of the guidance note

8 System Implementation for **Credit risk deterioration identification**

IFRS 9, paragraph 5.5.4, states: "The objective of the impairment requirements is to recognise LEL (lifetime ECL) for all financial instruments for which there have been significant increase in credit risk since initial recognition – whether assessed on an individual or on a collective basis – considering all reasonable and supportable information, including that which is forward-looking."

It is evident from the IFRS9 objective stated above that, banks need to timely recognize the 'significant' increase in credit risk since initial recognition,[20] so that individual or group of exposures is transferred to another stage, in accordance with IFRS9 accounting requirements.

The Committee has also explained that **delinquency data is generally backward looking and are lagging indicators** of significant increase in credit risk. In this regard it expects that banks will not use more-than-30-days past-due rebuttable presumption as a primary indicator for transfer to LEL,[21] and will consider each of the 16 classes of indicators in IFRS 9, as set out in paragraphs B5.5.17 (a)–(p) and, banks need to incorporate forward-looking information and economic forecasts in their list of early warning indicators.

IFRS9 ECL estimations require enormous amount of information, data, analysis and use of experienced credit judgment, especially for assessment of significant increase in credit risk and measurement of ECL. Therefore, the Committee emphasizes on the importance of implementation of systems[22] by banks (if not established already) to manage and assess large amount of information that would be required to assess that whether a particular lending exposure or a group of lending exposure has observed significant increase in credit risk.

From our experience in the industry, most of the banks have not implemented or are under the planning stage for considering implementation of 'Early Warning Systems' to monitor the credit deterioration across their portfolio. Therefore, in order to comply with the IFRS9 standards requirements of strong governance, systems, and controls which are required to be in place for developing forecasts using forward-looking information should remain consistent across the entity within a group. Hence, banks have to reinstate their resolve to develop or purchase a third party early warning framework.

[20] Paragraph A16 of the guidance note available at www.bis.org/bcbs/publ/d350.pdf
[21] Paragraph A52, A53, A19 and A20 of the guidance note
[22] Paragraph A15 of the guidance note

9 **Other points** discussed in the paper

Treatment of restructured/ modified lending exposures is also clarified by the Committee, and based on this; our opinion on the treatment of such exposures remains consistent with the Basel II framework. The committee has emphasized on the need to demonstrate consistently satisfactory payment performance, over a reasonable period of time before credit risk would be considered to have decreased, and only then the customer can be moved to low risk category.

The Committee has recognized that if banks are not able to identify for a subgroup of borrowers within a group for which credit risk has increased, then **partial movement of the appropriate proportion of the overall group** should be subject to LEL measurement .

We also strongly support Committee's view regarding the necessity to assess the change in risk of default (i.e. PD) over the effective maturity of the financial instrument for identification of significant increase in credit risk since initial recognition. Therefore, banks **need to include lifetime PD as one the key factors for credit deterioration assessment.** And, the Committee also expects that a bank will always measure ECL for all the lending exposures, and that a nil allowance will be rare because ECL estimates are a probability-weighted amount that shall reflect the possibility that a credit loss will occur.

IFRS 9 does not directly provide the definition of default, and necessitates entities to **define default in a manner consistent with other reporting purposes**. IFRS 9 paragraph B5.5.37, also includes a rebuttable presumption that default does not occur later than 90 days past due. Hence, the Committee recommends that banks adopt the same definition of default for IFRS 9 which they are using for regulatory reporting purposes.

For robust and high quality implementation of IFRS 9 standards, the Committee expects that, practical expedients should have limited use by the banks, as these have the potential to introduce significant bias in the overall ECL assessment process, and which can be deterrent in achieving the objectives of the IFRS 9 standards.[26] Therefore, we don't expect that supervisors of various jurisdictions will allow banks to use just 30 days-past-due as an indicator for movement of exposures to LEL measurement.

[23] Paragraph 39 of guidance note available at www.bis.org/bcbs/publ/d350.pdf
[24] Paragraph A34 of the guidance note
[25] Paragraph A1 and A3 of the guidance note
[26] Paragraph A39 of the guidance note

Feel free to send your IFRS-9 related queries to:

Sandip Mukherjee
Co-Founder and Principal Consultant
Email: sandip.mukherjee@aptivaa.com
Phone: +91- 98210- 41373

About Aptivaa

Aptivaa is a vertically focused finance and risk management consulting and analytics firm with world-class competencies in Credit Risk, Market Risk, Operational Risk, Basel III, IFRS-9, Risk Analytics, COSO, ALM, Model Risk Management, ICAAP, Stress Testing, Risk Data and Reporting. Aptivaa has emerged as a leading risk management solutions firm having served over 100 clients across 22 countries comprising of highly respected names in the financial services industry.

Aptivaa's LEO suite of proprietary tools & frameworks are designed to accelerate IFRS-9 implementation in areas such as classification, stage evaluation, PIT-PD Calibration, Lifetime-PD, LGD, EAD and Lifetime ECL.

UAE | US | UK | India