Prudential Treatment of Expected Losses: IFRS9

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AGENDA

- Introduction
- Current Treatment of Accounting Provisions
- Proposal to Mitigate the Prudential Effect of New Standard
- Basel Committee Proposals
- Conclusion

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Introduction

- There is a very important future change in the worldwide accounting Standards that may potentially impact significantly the capital ratios of banks, the new accounting provisions under an "expected credit loss" model (ECL). This is taking the form of:

- The new ECL standards are intended to meet the G20's post-crisis call for "more provisions sooner" and so should increase the role and amount of provisions compared to the prior "incurred loss model." These new accounting standards will:
    - Reduce the CET1 of each institution at the implementation date without any change in their risk profiles, although there is likely to be variance from firm to firm. (This unintended consequence should be avoided or minimized)
    - Given the increases in the level of capital for credit risk, there is a good case that the Basel Committee should recognize the new dynamic between provisions and capital.

- Unless this issue is addressed, there would be a significant overlap of measures to cover the same potential losses.

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Current treatment of accounting provisions

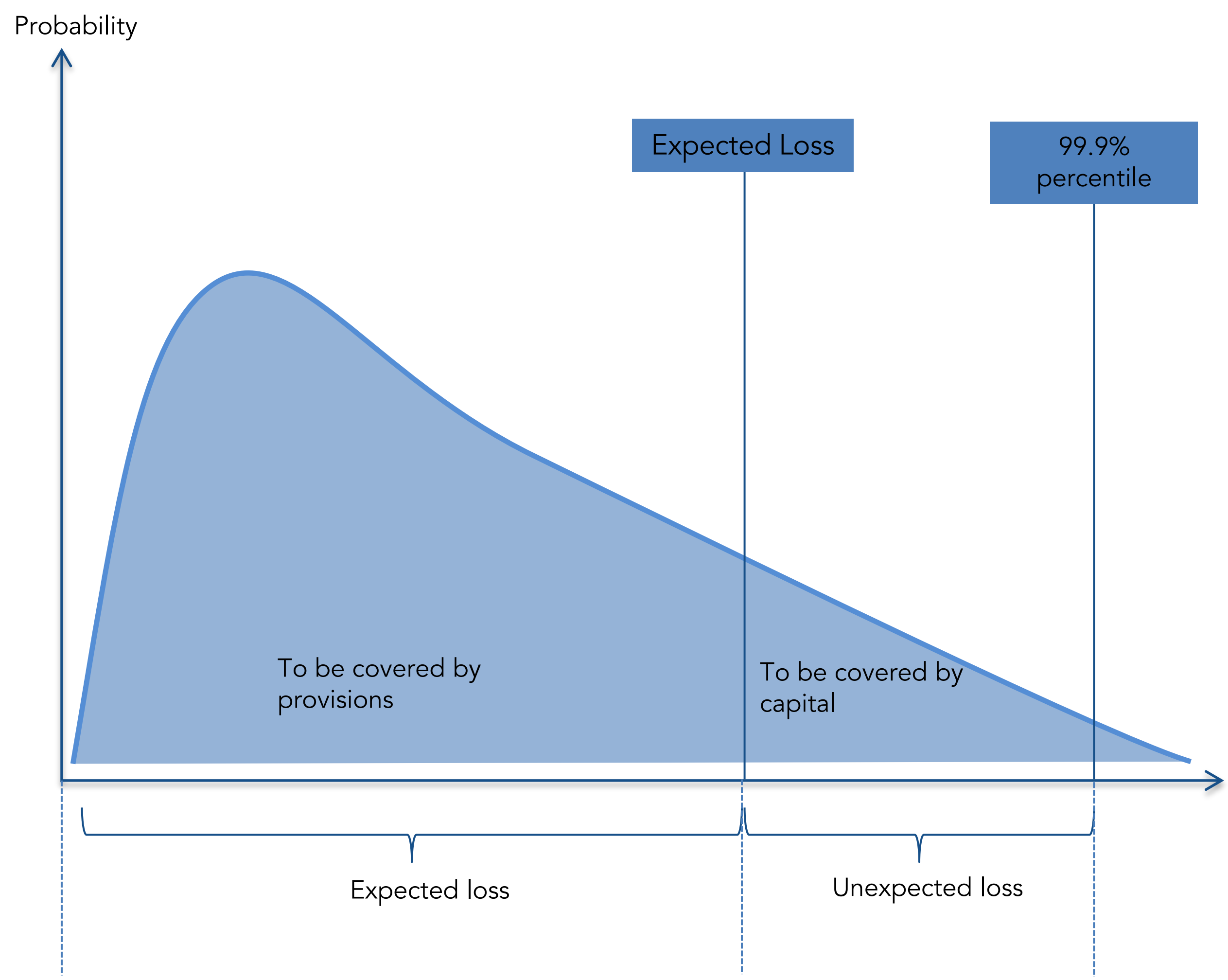
- The Basel framework is based on assigning capital to cover unexpected losses occurring within a one year time horizon with a certain confidence level, and for doing that the calculation of expected losses (EL) over the same time horizon is needed. This is reflected in the formula for risk weighting under the IRB approach:

$$RW = \left(LGD \cdot N\left(\frac{1}{\sqrt{1-R}} \cdot G(PD) + \sqrt{\frac{R}{1-R}} \cdot G(0.999) \right) - LGD \cdot PD \right) \cdot \frac{1 + (M - 2{,}5) \cdot b}{1 - 1{,}5 \cdot b} \cdot 12{,}5 \cdot 1{,}06$$

Adjustment for expected loss

Current treatment of accounting provisions

Graphically:

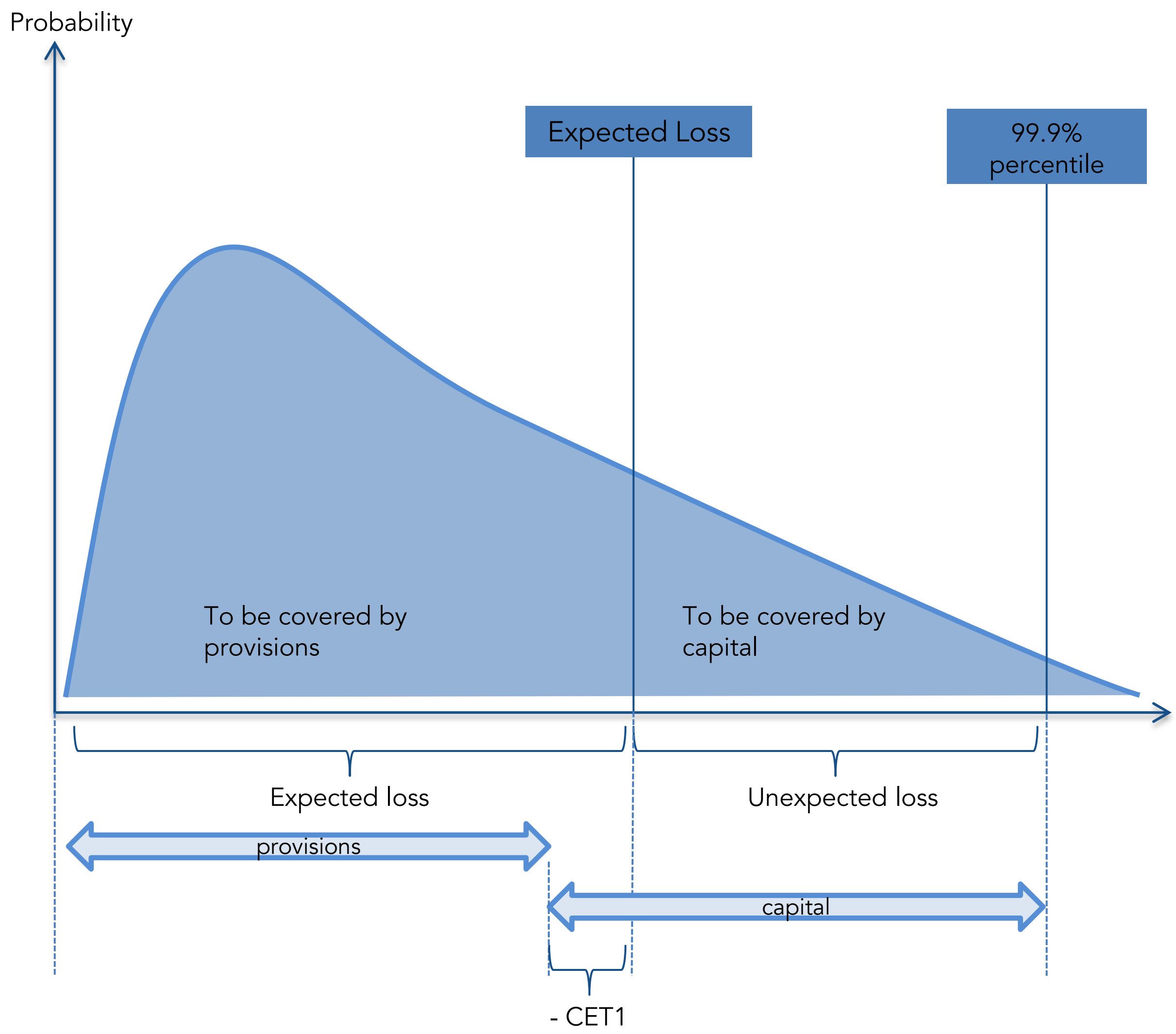


Current treatment of accounting provisions Continued: **IRB Criteria**

- The expected loss considered in the Basel formula has a prudential definition, which is unrelated to current accounting provisions under the "incurred loss model".
    - Such provisions can actually be higher or lower than the prudential "expected losses"; the framework was originally designed to avoid any overlapping of measures (i.e. expected losses covered with provisions should not be also covered with capital).
    - However, the final design of Basel II is not symmetrical and also had to take into consideration not only banks under the IRB approach but also those under the Standardized one.
- For banks under IRB the criteria are as follows:

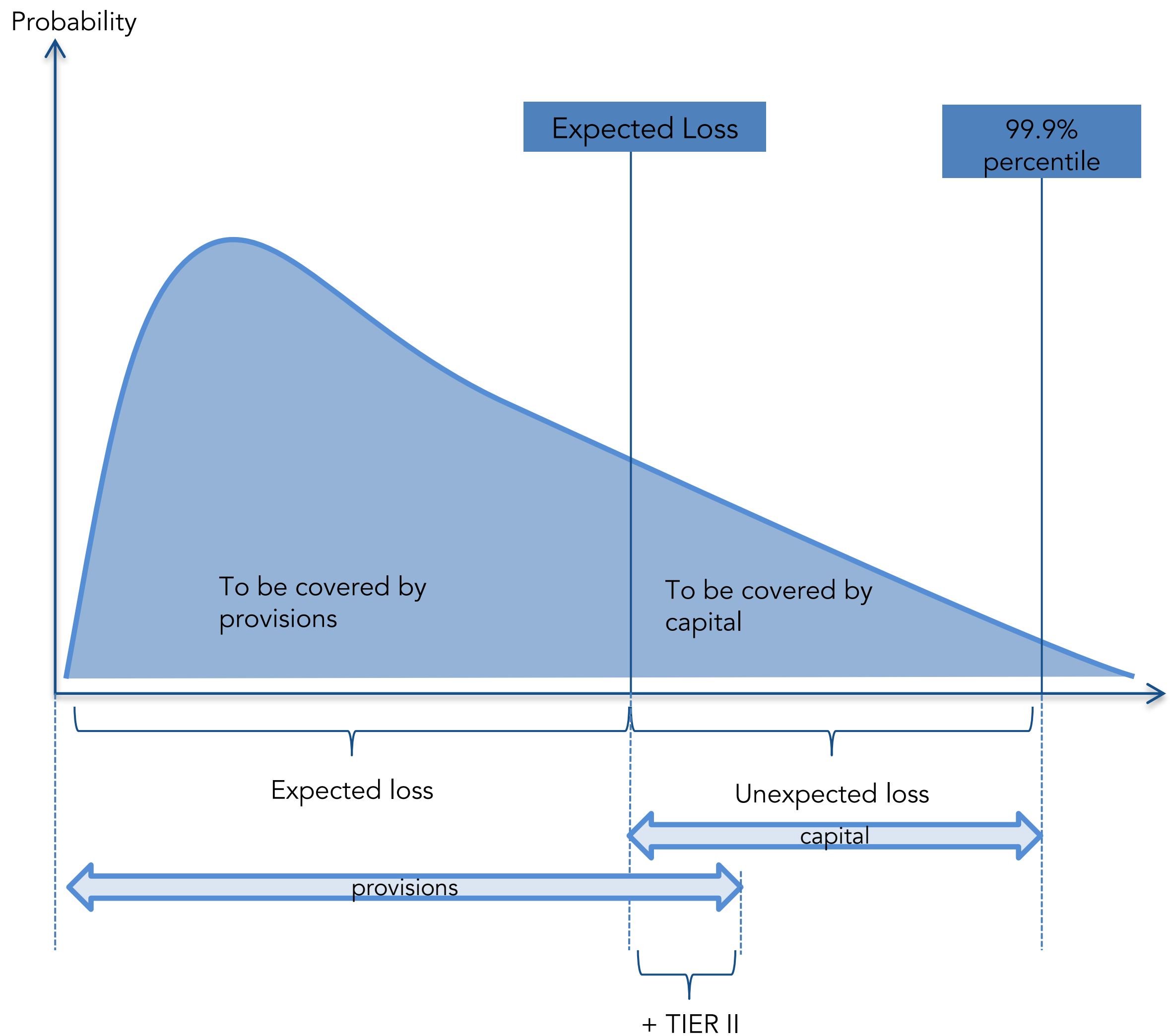
IRB Criteria

1. If accounting provisions are less than the prudential expected loss:



IRB Criteria

2. If accounting provisions are higher than the prudential expected loss:



IRB Criteria

Therefore it is not a symmetrical treatment:

Accounting Provisions Less than Expected Losses

1 year expected loss amount

Accounting provisions | *Deduction CET1*

Accounting Provisions More than Expected Losses

1 year expected loss amount | *Tier II (Capped)*

Accounting provisions

Current treatment of accounting provisions Continued: **Standardized Approach**

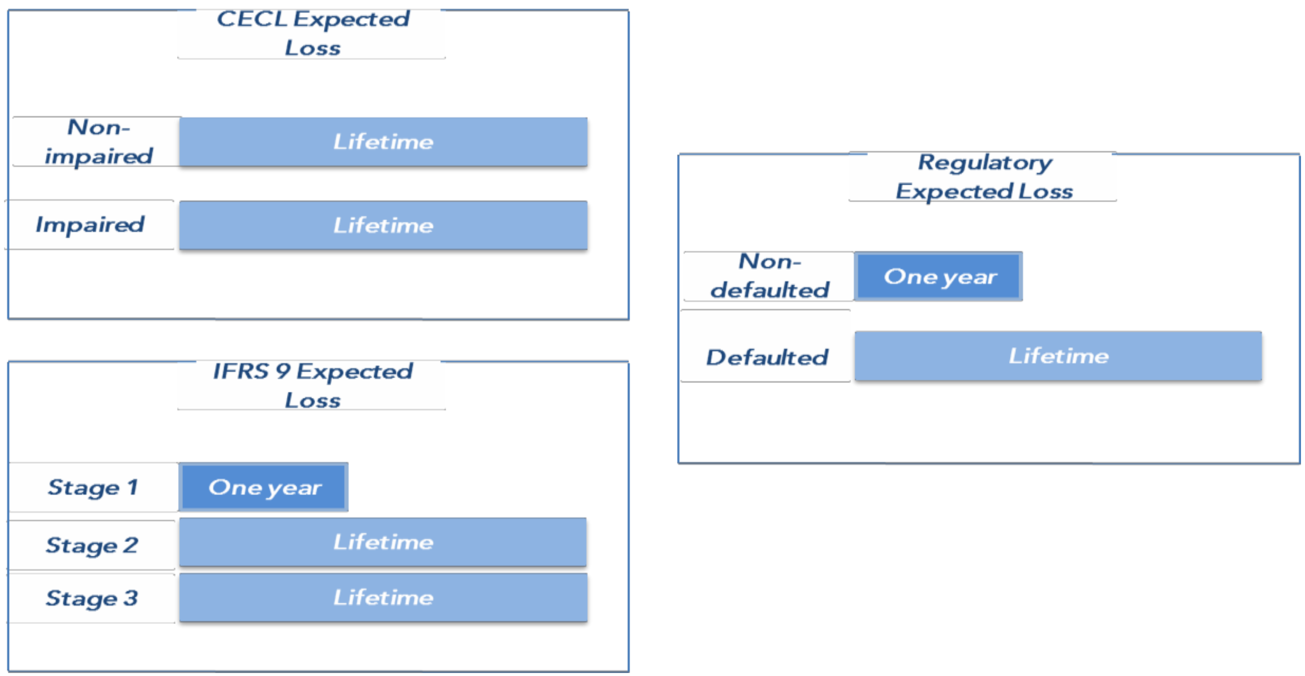
- For banks under the Standardized approach there is no RW formula and therefore no calculation of any expected loss. There are only look up tables with preassigned risk weightings for different asset classes.
- For this reason the treatment is different from IRB banks, and also takes into consideration whether the provisions are "specific" or "general":

    1. Specific provisions are deducted from the exposure at default (EAD).
    2. General provisions are added to Tier II capital.

		Standardized Approach
1	Adjustment of Specific Provisions	Specific provisions are netted from the exposure value
2	Adjustment of General Provisions	General provisions recognized in TIER II up to 1.25% of credit risk RWA's

IFRS9: Differences in "Expected Losses" for Accounting & Solvency Purposes

- It is true the Basel framework is based on allocating capital to "unexpected losses", and that future accounting for credit losses will be looking at "expected credit losses". Consequently it could be thought that there should not be any conflict between the two frameworks but as the Committee knows, this is not the case for two reasons:
    1. The time horizon of the two frameworks is very different.
    2. The parameters used to calculate expected loss (EL) for capital and ECL for accounting are not the same.



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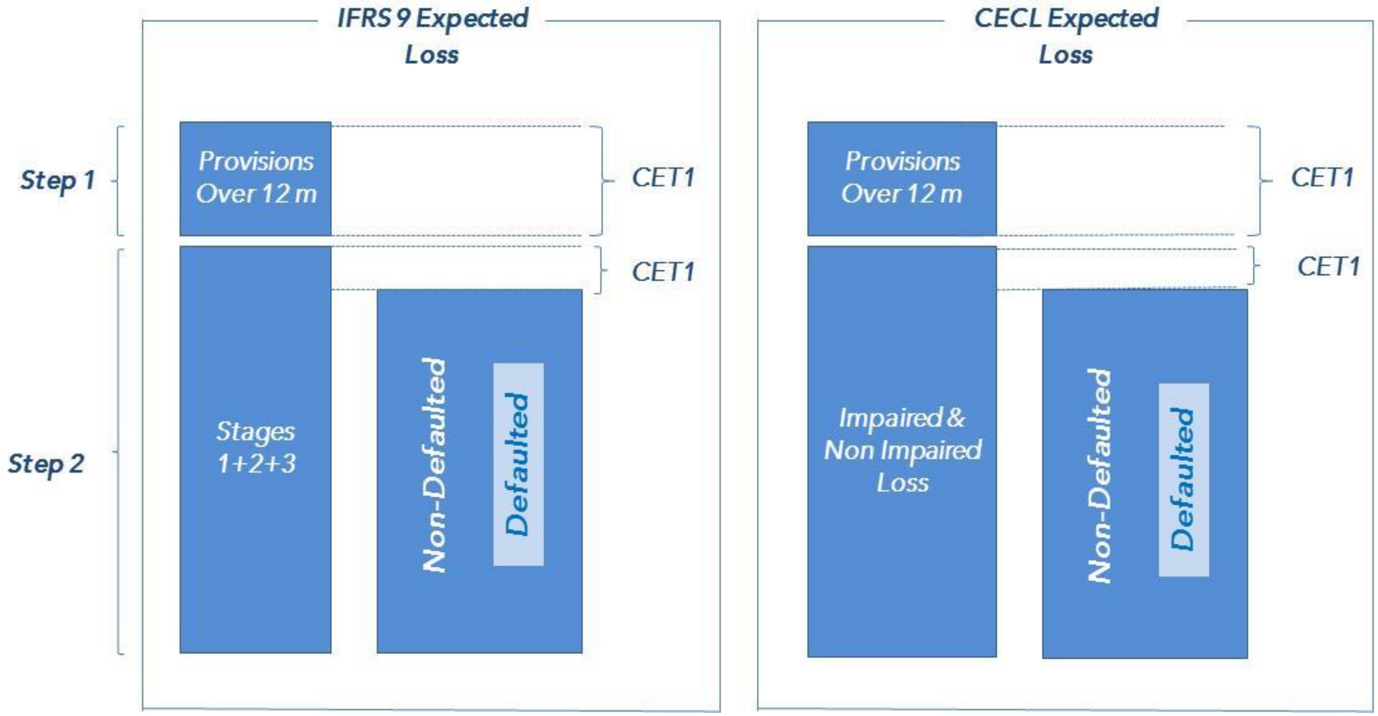
Proposal to Mitigate the Prudential Effect of the New Accounting Standard

- The change of accounting Standards on impairment may have as a result a significant impact on the CET1 capital of many banks, purely as a result of the accounting change, without any corresponding economic or risk change.
- For this reason that impact should be analyzed, measured and mitigated to the extent possible, while at the same time assuring a leveled playing field among banks under the IRB and the standard approaches, as well as among banks under IFRS9 and CECL.
- Several options could be envisaged. Among them:

Proposed Option 1

- Take a two-step approach:

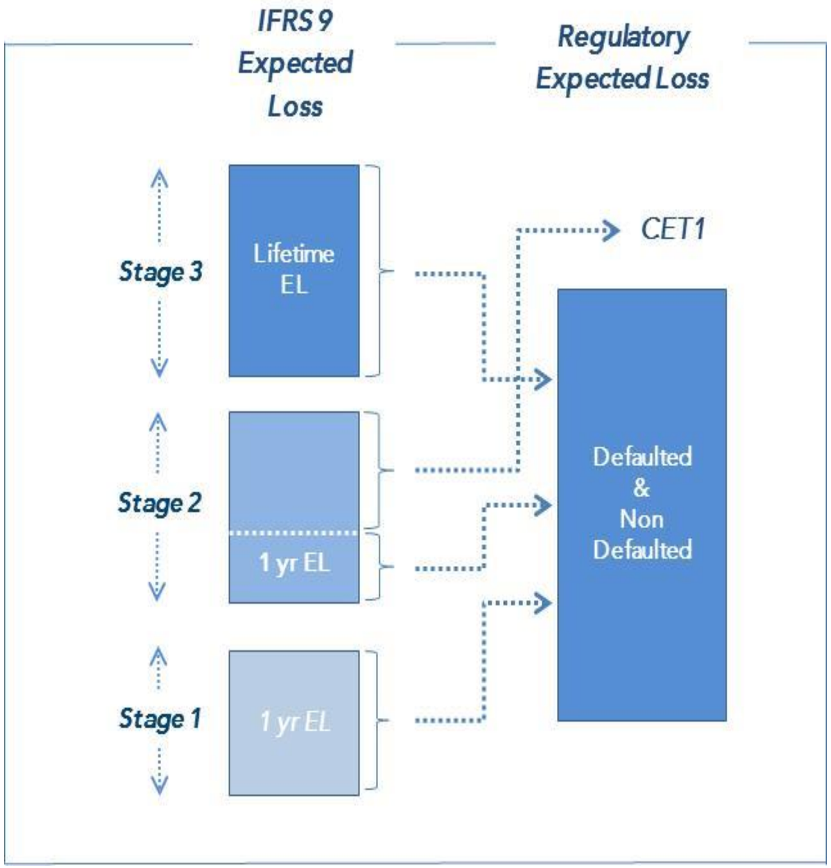
1. Accounting provisions over the 12 month time horizon should be put back to CET1
2. Additionally, for the remaining provisions after the first step:
    a. For banks/portfolios under IRB, compare the accounting provisions with the prudential expected losses, and any excess or defect should be taken to CET 1, without adjustment.
    b. For banks/portfolios under the Standardized approach, keep the actual treatment (i.e. provisions are deducted from the EAD or Exposure at Default).



Proposed Option 1 Continued

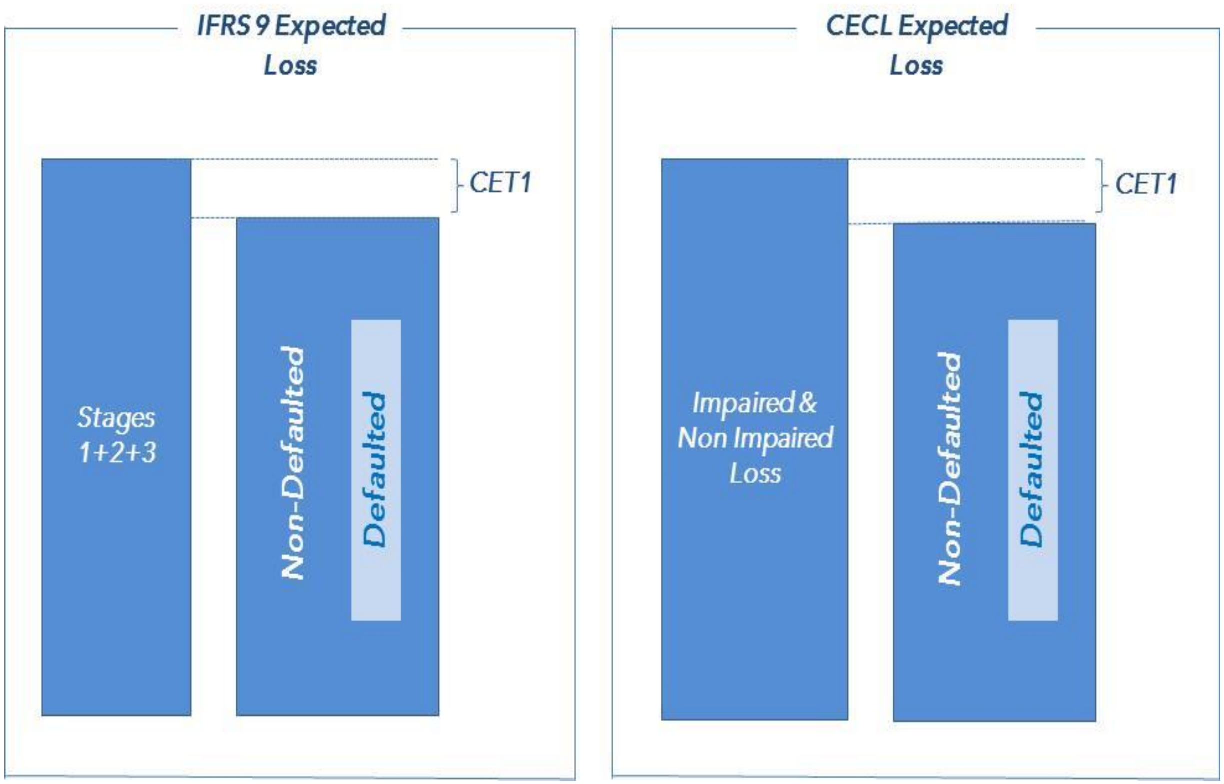
- Additionally, for smaller banks with no capabilities to calculate the prudential EL, the following simplifications could be made:

  Graphically:



Proposed Option 2

- Another option would be to compare the prudential expected loss with the total amount of provisions, and any excess/defect would go back to CET1.



Proposed Option 2 Continued

- This option has a main drawback that should, if chosen, be addressed; it is the risk of weighting of Standard loans/portfolios. For the IRB loans/portfolios, the risk weighting formula already considers the expected loss, but that is not the case for the "revised" standard model that still "factors in" the current solvency framework.

- If the above mentioned concern is addressed, then Option 1 and 2 should not give very different outputs.

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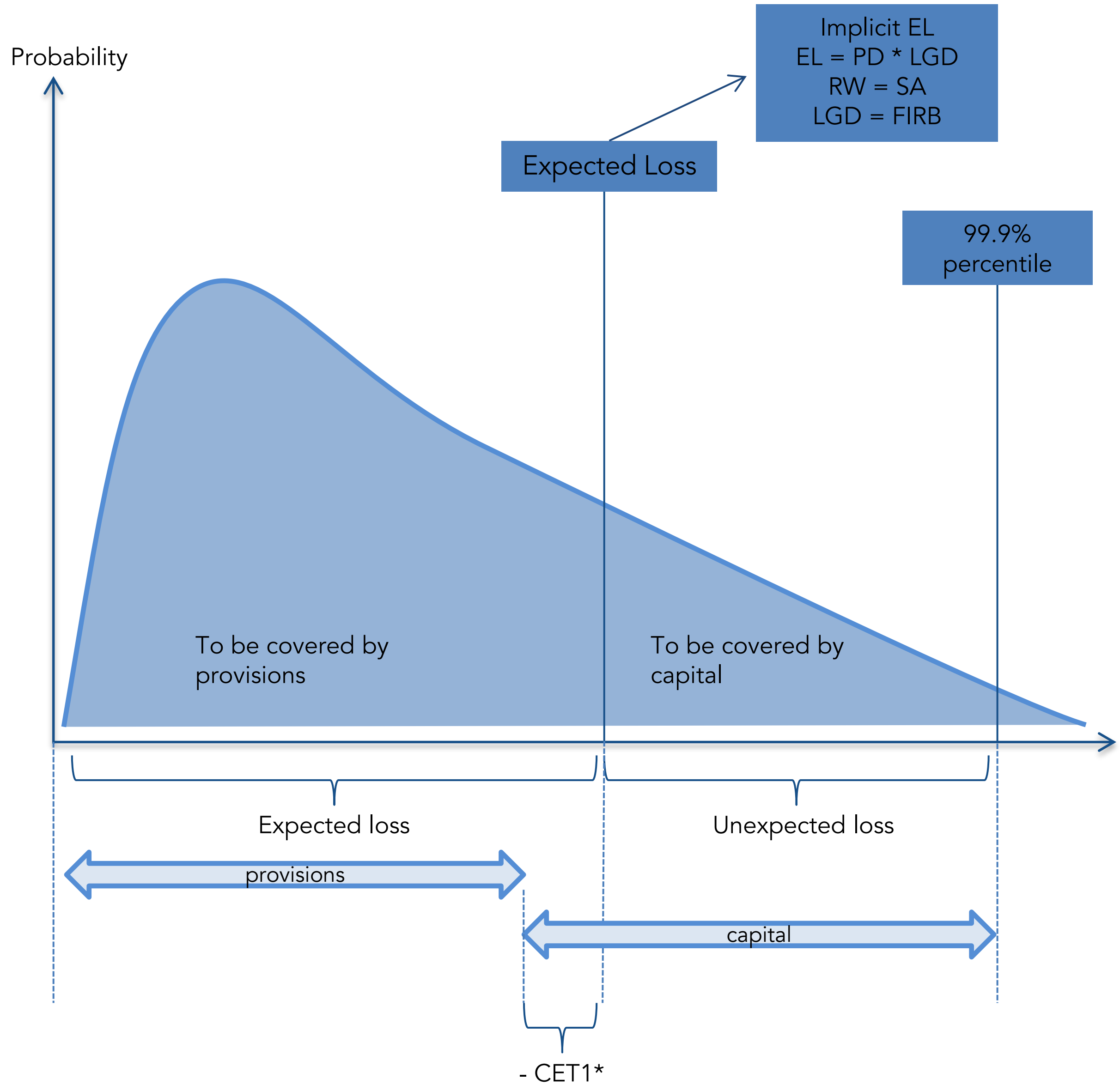
Long-Term Policy Options Outlined in the Basel Committee Discussion Paper

- In a discussion paper on Regulatory Treatment of Accounting Provisions, released October 2016, the Basel Committee on Banking Supervision has discussed and is considering several possible ways forward.
- The following are the preliminary approaches under discussion:
    - **Policy 1**: To retain the current regulatory treatment of provisions, including the distinction between GP and SP, as a permanent approach.
    - **Policy 2**: To introduce a universally applicable and binding definition of GP and SP.
    - **Policy 3**: Fundamentally change the current regulatory treatment of provisions – remove the GP/SP distinction and introduce regulatory EL under SA.
- Although these policy options should be viewed as the starting point for a dialogue on the issues, as the Committee is open to comments and proposals other than those raised in the discussion paper.

Under Proposed **Policy 3**, the methodology for deriving standardized regulatory EL rates follows the IRB logic. Graphically:



*If accounting provisions do not reach the floor amount, the shortfall would be deducted from CET1 capital. The treatment of excess provisions tentatively would be the same as the current IRB approaches (i.e. inclusion in the TIER 2 capital up to 0.6% of credit RWAs).

Open Issues

There are other open questions that merit some discussion and that are not addressed properly. They are:

1) Definition of default: There is a definition of default within the solvency framework, but there is not one for the accounting framework.

2) Definition of what are specific and general provisions. Those definitions might be relevant depending on which solution is finally adopted and also for the interim solution.

3) Procyclicality: IFRS9 is volatile by construct, in line with the accounting framework. That volatility could flow into the capital ratios depending again on which solution is finally adopted.

Conclusion

- Given the relevance of the accounting changes in the provisioning of assets and its implications in the solvency ratios of banks, a revision of the prudential framework become imperative.
- That revision needs to be done with sufficient time so as to allow jurisdictions to have all the legislative changes in place at the time of entering into force of the new accounting Standards.
- Failing to do so, or doing it too late, would create unnecessary and unwanted strain in the capital ratios of banks and will make them too volatile and consequently too difficult to manage.

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