BCBS's view on the new impairment model under IFRS 9

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Abstract

On 2 February 2015, the Basel Committee on Banking Supervision ("BCBS") issued a Consultative Paper setting forth guidelines for a robust and consistent implementation of the new Expected Credit Loss (ECL) accounting framework across all jurisdictions. The guidance outlines supervisory expectations for ECL accounting in the form of 11 principles that are consistent with the applicable accounting standards established by the IASB and other standard setters. Comments from the industry are expected by 30 April 2015.

For banks reporting under IFRS, the paper provides additional useful guidance on certain aspects of the ECL requirements in the impairment sections of IFRS 9, such as the loss allowance at an amount equal to 12-month ECL and the assessment of significant increases in credit risk. Moreover, the Committee shares its view on the use of practical expedients that are possible under IFRS 9 (e.g. the exception for "low" credit risk exposures and the 30 days-past-due rebuttable presumption), judging them to be "inappropriate for use by internationally active banks" because – given their business –the cost of obtaining relevant information is not considered to be likely to involve "undue cost or effort".

This Practice Note presents an overview of the proposed guidelines highlighting areas that are critical for a robust and successful implementation of the expected credit loss model under IFRS 9.

New BCBS guidelines on accounting for expected credit losses

The proposed BCBS guidance on accounting for expected credit losses is structured around 11 principles: 8 principles that set out the requirements for sound credit risk practices that interact with expected credit loss measurement and 3 principles that set requirements for supervisory evaluation of credit risk practices.

Requirements for sound credit risk practices relate to governance, policies, procedures and controls, grouping of lending exposures, model validation, reasonably available forward-looking information and macroeconomic factors, commonality in the systems, tools and data to assess and price credit risk, and account for expected credit losses and, finally, disclosure of information.

Requirements for banking supervisors relate to the periodic evaluation of the effectiveness of credit risk practices, the review of the methodology to determine loan allowances and the consideration of credit risk practices when assessing a bank's capital adequacy.

For banks reporting under IFRS, which are currently at early stages of their IFRS 9 implementation projects, the Consultative paper provides additional useful guidance on certain aspects of the ECL requirements in the impairment sections of IFRS 9, such as the loss allowance at an amount equal to 12-month ECL, the assessment of significant increases in credit risk and the use of practical expedients.

In this paper, we propose to highlight the BCBS's view on 4 areas that are critical from the point of view of implementing IFRS 9:

1. Incorporate forward-looking information and macroeconomic factors;
2. Assess and measure the 12-month ECL;
3. Identify significant increases in credit risk (transfer criteria);
4. Use of practical expedients.

Forward-looking information

IFRS 9 requires that institutions consider all available information including forward-looking information. Concretely, this will translate

into risk estimates that are dependent on macroeconomic forecasts.

Consistent with IFRS 9, Principle 6 states that 'a bank's use of experienced credit judgment, especially in the robust consideration of forward-looking information that is reasonably available and macroeconomic factors, is essential to the assessment and measurement of expected credit losses".

The Committee estimates that the costs of incorporating forward-looking and macroeconomic factors into the estimate of ECL should not be avoided on the basis that a bank considers them to be excessive or unnecessary.

Banks must demonstrate that forward-looking (as well as past and current) information selected is linked to the credit risk of particular loans or portfolios.

Macroeconomic forecasts and other relevant information should be applied consistently across portfolios, where the credit risk drivers of the portfolios are affected by these forecasts/assumptions in the same way. Furthermore, when developing ECL estimates, a bank should apply its experienced credit judgment to consider its point in the credit cycle, which may differ between jurisdictions, and how this should affect allowances.

Finally, the Committee expects that banks will exercise prudence, defined as exercising appropriate care and caution when determining the level of ECL and the allowances to be recognized for accounting purposes to ensure that the resulting estimate is appropriate (i.e. consistent with neutrality and neither understated or overstated).

Assess and measure the 12-month ECL

"All losses arising from default events within 12 months"

IFRS 9 defines an amount equal to the 12-month ECL as the "portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date". The Committee emphasizes that an amount equal to the 12-month ECL is *not* only the losses expected in the next 12 months; rather, it is the expected cash shortfalls over the life of the lending exposure or group of lending exposures, due to loss events that could occur in the next 12 months. In other words, if using a probability of default/loss given default (PD/LGD) measurement approach, PD is assessed over a 12-month time horizon while LGD is assessed over the life of the lending exposure.

The Committee also emphasizes that, to assess whether a financial instrument should move to a lifetime expected credit loss (LEL) measure, the change in the risk of a default occurring *over the expected life* of the financial instrument must be considered. In some circumstances, IFRS 9 allows the risk of a default occurring over the next 12 months to be used to make this assessment; however, this may not always be appropriate, and particular attention is drawn to the examples set out in IFRS 9, paragraph B5.5.14.

Lastly, the Committee expects that a bank will always measure ECL for all lending exposures, and that a nil allowance will be rare (an example where a bank may have a nil allowance is for fully collateralized loans) because ECL estimates are a probability-weighted amount that should always reflect the possibility that a loss will occur.

No definition of default in IFRS 9

IFRS 9 does not directly define default, but requires entities to define default in a manner consistent with that used for internal credit risk management. IFRS 9, paragraph B5.5.37, also includes a rebuttable presumption that default does not occur later than 90 days past due. The Committee expects that the definition of default adopted for accounting purposes will be guided by the definition used for regulatory purposes.

The default definition provided in the Basel capital framework includes both:

(a) a qualitative criterion that requires a bank to identify credit deterioration before the exposure becomes delinquent ("unlikeliness to pay" events); and

(b) an objective indicator based on a material delinquency status equivalent to the rebuttable presumption in IFRS 9, paragraph B5.5.37 (the obligor being past due by more than 90 days).

In accordance with the Basel capital framework, a default event occurs when either of the criteria (a) and (b) above is met or both are met. In this context, the "unlikeliness to pay" criterion of the debtor is regarded as a primary indicator, while the 90-days-past-due criterion is a backstop. Furthermore, the list of elements provided in the Basel framework as indications of unlikeliness to pay should be supplemented with other elements that affect the borrower's ability or willingness to meet contractual obligations, as identified on either an individual or a collective basis, and adjusted to incorporate current conditions and forward-looking information.

The inclusion of those other elements is aimed at capturing indicators of credit risk that precipitate eventual cash shortfalls.

An amount equal to 12-month ECL measurement may be determined on an individual or collective basis. The Committee expects that a robust implementation of the IFRS 9 ECL requirements, taking into account the migration of credit risk, will allow increases in credit risk to be reflected in increased allowances well before exposures move, either individually or collectively, to LEL measurement.

Identify significant increases in credit risk

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

A timely recognition of allowances is crucial

At least two elements in this definition are important.

First, the timing of recognition. The Committee strongly endorses the IASB's view that "lifetime expected credit losses are generally expected to be recognized before a financial instrument becomes past due" and that "typically, credit risk increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example a modification or restructuring) are observed".

In order to recognize allowances on a timely basis in line with the IFRS 9 requirements, banks will need to:

- assemble data and forward projections for the key drivers of credit risk in their portfolios; and
- be able to quantify the credit risk in each of their exposures or portfolios based on these data and projections. This will both enable management to judge whether there has been a significant increase in credit risk, and form a key input to the measurement of ECL and allowances.

It is important that banks' analyses take into account the fact that the determinants of credit losses very often begin to deteriorate a considerable time (months or, in some cases, years) before any objective evidence of delinquency appears in the lending exposures affected. Delinquency data is generally backward-looking, and the Committee believes that it will seldom be appropriate in the implementation of an ECL approach by banks.

For example, within retail portfolios adverse developments in macroeconomic factors and borrower attributes (such as the sector from which they earn their primary income) will generally lead to an increase in the objective level of credit risk long before this manifests itself in lagging information such as delinquency. Thus, the Committee believes that, in order to meet the objective of IFRS 9 in a robust manner, banks will need to have a clear view – supported by persuasive analysis – of the linkages from macroeconomic factors and borrower attributes to the level of credit risk in a portfolio. This will be obtained through analysis of past data, adjusted using experienced credit judgment for differences between historic, current and forward-looking information and macroeconomic factors.

The Committee expects analyses of this kind to be also performed for large, individually managed exposures. For example, for a large commercial property loan, banks must take account of the considerable sensitivity of the commercial property market in many jurisdictions to the general macroeconomic environment, and use information such as levels of interest rates or vacancy rates to determine whether there has been a significant increase in credit risk.

How to define "significant"?

A second key element is the definition of a "significant" increase in credit risk. Banks must have a clear policy, including well developed definitions, of what constitutes a "significant" increase in credit risk for different types of lending exposures.

The Committee endorses the IFRS 9 requirements that, when making the assessment of significant increases in credit risk, this assessment is made over the entire life of the asset and before consideration of the effects of credit risk mitigants such as collateral or guarantees.

In developing their definitions, the Committee expects banks to consider each of the 16 classes of indicators in IFRS 9, paragraphs B5.5.17 (a)–(p), and consider whether there is further information that should be taken into account. Furthermore, the Committee proposes 6 additional conditions that would suggest that there has potentially been an increase in credit risk:

a) a discretionary decision by management such that, were an existing loan newly originated at the reporting date, the element of the price of the loan that reflects the credit risk of the exposure would be higher than it was when the

loan was actually originated as a result of the change in credit risk since inception;

b) a decision by management to strengthen collateral and/or covenant requirements for new exposures that are similar to exposures already advanced because of changes in the credit risk of those exposures since initial recognition;
c) a downgrade of a borrower by a recognised credit rating agency, or within a bank's internal credit rating system;
d) for performing credits subject to individual monitoring and review, an internal credit assessment summary indicator that is weaker than upon initial recognition;
e) deterioration of relevant factors (e.g. future cash flows) for an individual obligor (or pool of obligors); and
f) expectation of forbearance or restructuring.

In addition, the assessment of whether there has been a significant increase in credit risk of a lending exposure should take full account of more general factors like the deterioration of the macroeconomic outlook relevant to a particular borrower or group of borrowers and the deterioration of prospects for the sector or industries within which a borrower operates.

Finally, the Committee draws the attention to the fact that the sensitivity of default probability to rating grade is not linear, rather it increases strongly as rating quality declines (for example, the default probability over five years of an exposure rated BB is around three times that of one rated BBB, based on current data and analyses applicable to certain jurisdictions). This implies that banks should not simply define "significant" as based on a given change in the probability of default or a number of "notches" that a rating downgrade entails.

Modified or renegotiated lending exposures

IFRS 9, paragraphs 5.5.12 and B5.5.25–B5.5.27, sets out the requirements for the assessment of significant increases in credit risk for lending exposures whose contractual terms and resulting cash flows have been renegotiated or modified. In particular, for modifications that do not result in de-recognition in accordance with IFRS 9, a bank must assess whether credit risk has increased significantly by comparing (a) the risk of a default occurring at the reporting date based on the modified contractual terms with (b) the risk of default occurring upon initial recognition based on the original, unmodified contractual terms.

When determining if there is a significant increase in credit risk for a modified lending exposure, the Committee expects banks to demonstrate whether such modifications or renegotiations have improved or restored the ability of the bank to collect interest and principal payments compared with the situation upon initial recognition. The Committee proposes a non-exhaustive list of factors to consider in this assessment. Banks should consider:

- whether the modification or renegotiation of the contractual terms and resulting cash flows is economically beneficial to the obligor, compared with the original, unmodified contractual terms, and how the modification economically affects the obligor's ability to repay the debt;
- whether factors can be identified that support a bank's assessment of the obligor's ability to repay the debt, including circumstances leading up to the modification, and future prospects of the obligor as a result of the modifications, considering current conditions, macroeconomic forecasts, and prospects for the sector/industry within which the obligor operates, the obligor's business model, and the obligor's business (management) plan that outlines the obligor's expectation on its future performance, financial resilience and cash flows; and
- whether the obligor's business plan is feasible, realizable and consistent with the repayment schedule of interest and principal under the modified contractual terms of the lending exposure.

Use of practical expedients

IFRS 9 includes a number of practical expedients, intended to ease the implementation burden for a wide range of companies in recognition of the fact that IFRS 9 will be used by a variety of entities, including firms outside the banking industry.
The Committee regards many of these practical expedients as inappropriate for use by internationally active banks and those banks more sophisticated in the business of lending, particularly because – given their business – the cost of obtaining relevant information is not considered by the Committee to be likely to involve "undue cost or effort".

In the Consultative paper, the Committee details its reasoning regarding the following practical expedients: limiting the information set which an entity must consider in measuring ECL; the exception for "low" credit risk exposures; and the 30-days-past-due rebuttable presumption.

IFRS 9 implementation in the EU

The IFRS 9 endorsement process was officially launched in December 2014 and is expected to last about a year. In its letter to the European Financial Reporting Advisory Group (EFRAG) requesting endorsement advice, the European Commission (EC) added a list of important elements to be considered in addition to the technical criteria set out in the Standard in order to reach the endorsement decision.

Amongst others, this list includes the interrelation with IFRS 4, comparison with IAS 39 (impact on financial stability, use of fair values, effects of the use of AFS, reclassification principles and the effect of removing the embedded derivatives bifurcation for assets), impairment for loans with early loss pattern (and impact on lending practices including on long term investments.

A draft EFRAG endorsement advice is expected to be issued on 30 April 2015 for a 60 day public comment period. The final endorsement advice is expected to be sent to the EC on 31 July 2015. The EC is expected to vote for draft Regulation in its meeting of 17 September. If the vote is favourable and that the European Parliament and the Council either approve it or if 3 months elapse without opposition, the draft regulation will be adopted. After adoption, it will be published in the Official Journal and will enter into force on the day laid down in the Regulation (January 2018).

Appendix –The bucket model in IFRS 9

Change in credit risk since initial recognition
Improvement ← → Deterioration

	Stage 1 No significant increase in risk	Stage 2 Significant increase in risk	Stage 3 Credit impairment
Impairment recognition	12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Criterion	12-month expected credit losses	Credit risk has increased significantly since initial recognition	Objective evidence of impairment
Interest revenue	Cash flows include gross carrying amount	Cash flows include gross carrying amount	CF-s include net carrying amount (i.e. less provisions)
Covered in IAS 39	No	No	Yes
Expected impact	Very significant	Very significant	Limited

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