The headlines

In February 2015, the Basel Committee on Banking Supervision (the Committee) issued a Consultative Document setting out draft supervisory requirements on sound credit risk practices associated with the implementation and application of the expected credit loss (ECL) accounting model. The purpose of the draft guidance is to promote high quality, robust and consistent interpretation and application of the accounting models by banks across all jurisdictions.

The Committee has published the Consultative Document as part of the process to replace supervisory guidance on Sound Credit Assessment and Valuation for Loans (SCRAVL) issued in 2006, which was based on the previous incurred loss impairment model. Implementation of the new requirements will require changes to systems and processes, and greater segmentation of portfolios. Credit risk management systems will also need to be integrated with financial reporting. These implementation issues have been noted in the Consultative Document.

The Committee’s work followed the publication, in July 2014, by the International Accounting Standards Board (IASB) of the final version of IFRS 9 Financial Instruments, which replaces the existing standard IAS 39 Financial Instruments: Recognition and Measurement. For the purposes of impairment of financial assets not measured at fair value through profit or loss, IFRS 9 includes a new expected credit loss (ECL) accounting model. This forward looking model represents a substantial change from the existing incurred loss approach in IAS 39, and will result in greater provisions and earlier recognition of credit losses in comparison with the existing incurred loss model. Other than for financial assets that are credit impaired on initial recognition, a ‘Stage 1’ 12 month ECL allowance will always be recognised on the initial recognition of a financial asset, with a ‘Stage 2 or 3’ lifetime ECL allowance being recognised if there has been a significant increase in credit risk.

The Consultative Document includes an Appendix that sets out supervisory requirements specific to jurisdictions applying IFRS. These are summarised below and, in addition to an overview of the related requirements of IFRS 9, are considered in greater detail later in this publication.

The comment deadline for the Consultative Document is 30 April 2015.
Key IFRS 9 implementation issues addressed in the draft guidance

Loss allowance at an amount equal to 12 month ECL

The Committee expects a nil allowance for the 12-month ECL to be rare, as the 12 month ECL is a probability weighted amount that reflects the possibility of a loss occurring. It expects banks to adopt an active approach to assessing and measuring 12-month ECL that will enable changes in credit risk to be identified on a timely basis. Even if the financial asset remains in Stage 1, a bank must adjust its estimate of 12 month ECL in order adequately reflect changes in credit risk that have taken place. It is emphasised that a 12 month ECL allowance is not simply the losses expected over the next 12 months, but instead the expected lifetime cash shortfalls arising from events that could take place over the next 12 months.

Assessment of significant increases in credit risk

Banks must develop processes to ensure timely recognition of significant increases in credit risk. The Committee emphasises that lifetime expected credit losses are generally expected to be recognised before a financial instrument becomes past due. The following are relevant:

- **Use of forward-looking information**: Banks must go beyond considering historical and current information. The Committee expects banks to consider the impact of forward-looking information and macroeconomic factors in determining the level of provision. The Committee expects that delinquency data should seldom be used.

- **Timely update of estimates**: ECL estimates must be updated on a timely basis to reflect changes in credit risk ratings for either groups or individual exposures.

- **Portfolio groupings**: The Committee expects that lending exposures should be appropriately grouped based on shared credit characteristics that are expected to react to the current environment, forward-looking information and macro-economic factors in a similar way. Groupings need to be re-evaluated and re-segmented as appropriate whenever relevant new information is received or bank’s expectation of credit risk has changed.

- **Leveraging information for risk management and capital adequacy purposes**: The Committee expects banks to leverage and integrate information and processes used for risk management and capital adequacy purposes to the extent possible when developing processes for estimating ECL for accounting purposes.

- **Policies and procedures to validate internal credit risk assessment models**: The Committee expects banks to have processes in place to validate the accuracy and consistency of their credit risk assessment models.

- **Disclosures in addition to those required under accounting standards**: The Committee expects banks to consider any additional disclosures needed to fairly depict their exposure to credit risk, including ECL estimates, and to provide relevant information about underwriting practices.

- **Use of practical expeditents**: the Committee expects internationally active banks substantially to exclude the use of practical expedients and simplifications under IFRS 9.

- **Less complex banks**: Local prudential regulators may adopt a proportionate approach that is commensurate with the size, nature and complexity of less complex banks’ lending exposures.

- **Cost**: The Committee expects banks to incur significant costs in developing resources and systems to apply the new ECL accounting model. It expects internationally active banks and banks with more sophisticated business lending models to have the highest-quality implementation.

- **Draft guidance applies to lending exposures only**: The draft guidance does not apply to debt securities, leases, or trade receivables which are also within the scope of IFRS 9 impairment requirements.
Background – IFRS 9 and the Consultative Document

In July 2014, the Accounting Standards Board (IASB) finalised the main part of its project on financial instruments by publishing IFRS 9 Financial Instruments (2014). The final version of IFRS 9 incorporates the requirements on all three phases of the financial instruments projects – classification and measurement, impairment and hedge accounting. IFRS 9 (2014) applies to annual periods beginning on or after 1 January 2018. A further work stream, covering macro (or portfolio) hedge accounting will result in the issue of a separate IFRS.

The new impairment model under IFRS 9 applies to financial assets that are not measured at fair value through profit or loss, e.g. those measured at amortised cost such as loan receivables, lease receivables and trade receivables, and other assets that are measured at fair value through other comprehensive income (FVOCI) under IFRS 9. The new impairment model also applies to certain loan commitments and financial guarantee contracts.

In light of the finalisation of IFRS 9 and to promote consistent interpretation and application of the ECL model in IFRS 9, the Committee has published this draft consultative document to replace supervisory guidance on Sound credit Assessment and Valuation for Loans (SCRAVL) which was issued in 2006. The Consultative Document provides banks with supervisory requirements on how the ECL accounting model should interact with a bank’s overall credit risk practices and regulatory framework. It does not cover regulatory capital requirements on expected loss provisioning under the Basel capital Framework.

The main body of the draft guidance is intended to apply to all accounting frameworks that use an ECL model, with an appendix setting out how the Committee expects international banks to apply the IFRS 9 ECL model.

The Committee’s draft guidance only covers lending exposures, with other bank exposures such as debt securities being outside its scope. In addition, the draft guidance does not cover lease and trade receivables which, although within the scope of IFRS 9, are not subject to prudential regulation.

Overview of IASB’s impairment model

The impairment model under IFRS 9 is an expected credit loss model based on assessments of, and changes in, credit risk that involves three ‘stages’. The different stages determine how impairment and interest revenue is recognised.

On initial recognition of a financial asset, a loss allowance equal to 12 months of expected credit losses is recognised. After initial recognition, the ‘three stage' expected credit loss model applies as follows:

- **Stage 1**: Credit risk has not increased significantly since initial recognition – continue to recognise 12 months of expected losses and include interest revenue on a gross basis

- **Stage 2**: Credit risk has increased significantly since initial recognition – recognise lifetime expected losses and include interest revenue on a gross basis

- **Stage 3**: Financial asset is credit impaired (using the criteria currently included in IAS 39 Financial Instruments: Recognition and Measurement) – recognise lifetime expected losses and include interest on a net basis (i.e. calculated on the basis of the gross amount of the financial asset less credit allowance).

The recognition of impairment (and interest revenue) is summarised in the table below: Figure 1.

<table>
<thead>
<tr>
<th>Stage</th>
<th>1</th>
<th>2</th>
<th>3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognition of impairment</td>
<td>12 month expected credit loss</td>
<td>Lifetime expected credit loss</td>
<td></td>
</tr>
<tr>
<td>Recognition of interest</td>
<td>Effective interest on the gross amount</td>
<td>Effective interest on the net (carrying) amount</td>
<td></td>
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</tbody>
</table>

Figure 1: Summary of the recognition of impairment (and interest revenue) under the proposals

For more information about the IFRS 9 impairment model please refer to BDO’s publication Need to Know – IFRS 9 Financial Instruments – Impairment of Financial Assets, available from the IFRS section of our website (www.bdointernational.com) at the link below:

http://www.bdointernational.com/Services/Audit/IFRS/Need%20to%20Know/Documents/NTK_IFRS9_print.pdf
Loss allowance at an amount equal to 12-month ECL (under IFRS 9 model)

When recognising a loss allowance equal to 12 months of expected credit losses in Stage 1, the credit losses are those expected to result from default events that are possible within 12 months. The actual loss does not need to take place within the next 12 months. The focus is on whether an event will occur within the next 12 months that will ultimately result in that loss. This is emphasised in the Committee’s draft guidance.

As an example, it is recognised that death of a credit card borrower does lead, in a number of cases, to the outstanding balance becoming impaired. This model requires the prediction on initial recognition of the likelihood of the borrower dying in the next 12 months and hence triggering an impairment event.

The 12-month ECL measurement is based on expected values and not merely estimates of the most likely outcome (i.e. the ECL is a probability weighted amount and should always reflect the possibility of loss (however remote)). Therefore, the Committee expects that a nil allowance for the 12-month ECL will be rare.

The Committee also expects banks to adopt an active approach in assessing and measuring 12-month ECL that enables changes in credit risk to be identified on a timely basis. Hence, it may not be sufficient only to update 12-month ECL at each reporting date, with the update/estimates being performed on a more frequent basis. The Committee expects that the Stage 1 loss allowance will reflect changes in credit risk even before the financial asset moves to Stage 2. Even if an increase in credit risk is not judged to be significant, (i.e. even if the financial asset remains in Stage 1), a bank must adjust its estimate of 12 month ECL to adequately reflect changes in credit risk that have taken place.

Significant increase in credit risk

IFRS 9 sets out a list of factors that can indicate significant increase in credit risk. Some of these include:

- Changes in rates or terms (e.g. more stringent covenants, increased amount of collateral or guarantees, or higher income coverage that would be required if the loan were to be newly originated or issued at the reporting date)
- Existing or forecast adverse changes in business, financial or economic conditions that cause a significant change in a borrower’s ability to pay
- Adverse changes in operating results
- Credit deterioration on other financial instruments of the borrower
- Adverse changes in the value of the collateral, quality of third-party guarantees or credit enhancements (including intra group guarantees and credit enhancements)
- Expected breach of contracts
- Increase in the number of credit card borrowers who are expected to:
  - Approach or exceed their credit limit
  - Pay the minimum monthly amount
  - Delayed payments
- Changes in credit management approach (i.e. the financial instrument becoming more actively or more closely monitored)
- Past due information.

In the draft guidance, the Committee notes that it expects banks not only to take the above indicators into account, but also to consider whether there is any further relevant information.

Under the draft guidance banks must develop processes to ensure the timely recognition of significant increases in credit risk. The guidance requires banks to have processes in place to enable them to transfer financial assets to lifetime expected loss measurement (i.e. Stage 2) as soon as credit risk has increased significantly.

The Committee expects banks to have a clear view (supported by persuasive analysis) of the linkages between the effects of macroeconomic factors and borrower attributes, and the level of credit risk in a portfolio. For example, for a large commercial property loan, banks must take into account the (macroeconomic) effect of the commercial property market and use information such as levels of interest rates or vacancy rates to determine whether there has been a significant increase in credit risk.
Use of forward-looking information

IFRS 9 requires entities to measure ECL using all reasonable and supportable information, including forward looking data (and not just historical data) which is updated as expectations change. It requires entities to consider both borrower specific factors, and economic and other conditions on a macroeconomic level, including both internal and external information such as internal historical credit loss experience, internal ratings, external reports and statistics.

When using historical loss experience data, banks are expected to maintain sufficient historical data over at least a full credit cycle to use as a starting point when estimating ECL. The bank is then expected to adjust the ECL based on historical data for current conditions and forecasts of future conditions that did not affect the period on which the historical data is based.

Consistent with IFRS 9, the Committee emphasises that lifetime expected credit losses are generally expected to be recognised for a bank before a financial asset becomes past due. Delinquency data (i.e. past due information) should seldom be used because they are generally backward looking. The draft guidance states that banks must go beyond considering historical and current information and consider the impact of forward-looking information and macroeconomic factors in determining provisioning levels.

The Committee also expects banks to develop and document the appropriate forward looking scenario as the basis for determining ECL and also demonstrate how ECL estimates would fluctuate with changes in scenarios.

Portfolio groupings

IFRS 9 requires the recognition of lifetime expected credit losses on a portfolio/group basis, when evidence of significant increase in credit risk is not yet available at the individual instrument level. An entity can group financial instruments on the basis of shared credit risk characteristics to enable significant increases in credit risk to be identified on a timely basis, but should not group financial instruments with different risk characteristics. The grouping may change over time as new information becomes available.

Examples of shared credit risk characteristics include the following:

- Instrument type
- Credit risk ratings
- Collateral type
- Date of initial recognition
- Remaining term to maturity
- Industry
- Geographical location of the borrower, and
- The value of collateral relative to the financial asset if it has an impact on the probability of a default occurring (for example, non-recourse loans in some jurisdictions or loan-to-value ratios).

The draft guidance contains an extensive explanation of how the Committee expects banks to implement the IFRS 9 requirements set out above. The Committee expects, where it is apparent that exposures in a group have experienced a significant increase in credit risk, that the relevant group or subgroup will transfer to Stage 2 even though it is not possible to identify this increase in credit risk on an individual exposure basis.

As noted above, lending exposures should be appropriately grouped based on shared credit characteristics that are expected to react in a similar way to the current environment, forward-looking information and macro-economic factors. Groupings should be re-evaluated and re-segmented whenever relevant new information is received or bank’s expectation of credit risk has changed.

For exposures managed on a portfolio basis (such as retail), portfolios must be reviewed regularly to ensure that the exposures are homogeneous in terms of their response to factors affecting credit risk. Changing economic conditions may require re-grouping.

Exposures must not be grouped in such a way that an increase in the credit risk of some individual exposures could be masked by the performance of the portfolio as a whole. Where changes in credit risk affect only some exposures within a group, those exposures must be segmented out of the group into relevant subgroups, to ensure that the ECL allowance is appropriately updated.
Leveraging off information for risk management and capital adequacy purposes

When developing processes for estimating ECL for accounting purposes, the Committee expects banks to leverage and integrate information and processes used for risk management and capital adequacy purposes to the extent possible. This includes leveraging/integrating information from credit risk rating systems, estimated probability of defaults (PDs) (with adjustment), past-due status, loan-to-value ratios, historical loss rates, product type, amortisation schedule, down payment requirements, market segment, geographical location, ageing, and collateral type, along with other forward-looking information.

The Committee expects that adjustments will be made to the expected loss number under the Basel capital framework when estimating ECL for accounting purposes. The Committee expects these adjustments to be well documented.

Policies and procedures to validate internal credit risk assessment models

The Committee expects banks to have processes in place to validate the accuracy and consistency of their credit risk assessment models. As the use of models involves extensive judgment, the Committee expects effective model validation policies to be in place at the outset and on an ongoing basis. The draft guidance notes that a bank should regularly (at least annually) validate its models.

Disclosures in addition to those required under accounting standards

The Committee expects banks not only to comply with the disclosure requirements of accounting standards but also to consider any additional disclosures needed to fairly depict their exposure to credit risk, including ECL estimates, and to provide relevant information on their underwriting practices.

The Committee expects disclosures on how management satisfies itself that lending exposures are properly and appropriately grouped, any changes to the way lending exposures are grouped and the corresponding impacts on ECL estimates.

The Committee also expects banks to disclose similarities and differences in the methodology, data and assumptions used in measuring ECL for accounting purposes and expected losses for regulatory capital adequacy purposes.

Use of practical expedients

To reduce the cost of implementation, the IASB have included the following two practical expedients in IFRS 9:

- 30 day past due rebuttable presumption: If no forward looking information other than the ‘past due’ status is available, there is a rebuttable presumption that credit risk has increased significantly when contractual payments are more than 30 days past due. This means that when payments are 30 days past due, the financial asset is considered to be in Stage 2, and lifetime expected credit losses are recognised. However, entities cannot rely only on this presumption if other more forward looking information is available, even if that information is only at a macroeconomic level. The 30 day past due is meant to act as a ‘back stop’ to Stage 1.

- Low credit risk financial instruments: It is assumed that credit risk for those instruments has not increased significantly at each reporting date. This means that only 12 month expected credit losses will be recorded. An example of a low credit risk financial instrument is an instrument with an ‘investment grade rating’.

The Committee considers that significant reliance on past due information to be a very low quality implementation of an ECL model. Banks are expected to have credit risk assessments and processes that will capture increases in credit risk well before exposures become past due or delinquent. Consequently it is expected that a bank will not use the 30-days-past due rebuttable presumption unless it has demonstrated that all forward looking information that was considered potentially relevant has no substantive relationship with the level of credit losses.

In relation to the low credit risk practical expedient, the Committee notes that not all lending exposures that have an investment grade credit rating can automatically be considered low credit risk. The Committee expects banks to use their own credit risk assessments to evaluate the credit risk of a lending exposure.

Less complex banks

For less complex banks, the Committee recognises that local prudential regulators may adopt a proportionate approach allowing those banks to adopt an approach that is commensurate with the size, nature and complexity of their lending exposures.
Cost
To implement the ECL model in IFRS 9, significant systems changes are likely to be required. These include, for example:

- Develop processes and models to identify Stage 1 loss provisions
- Develop processes and policies to identify when assets transfer from Stage 1 to Stage 2, and from Stage 2 to Stage 3 (and vice versa)
- Develop systems and processes to capture, monitor, update and record credit loss information to ensure that provisioning levels are correct at each stage
- Develop systems to capture the information necessary to meet the new disclosure requirements
- Train staff on both the new system requirements as well as the impairment requirements of IFRS 9.
- Updating credit provisioning policies and documentation.

The Committee expects banks to incur significant costs in developing resources and systems to apply the new ECL accounting model. It expects internationally active banks and banks with more sophisticated business lending models to have the highest-quality implementation.

Draft guidance applies to lending exposures only
IFRS 9 applies to lending exposures as well as debt securities, leases, trade receivables. The Committee’s draft guidance only covers lending exposures, with other bank exposures such as debt securities being outside its scope. The draft guidance does not cover lease and trade receivables because they are not subject to prudential regulation.

Comment period
The document is open for comment until 30 April 2015.