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IFRS Developments

Basel Committee proposes guidance on accounting for expected credit losses

What you need to know

- The Basel Committee has updated its supervisory principles for sound credit risk practices to reflect the move to an ECL accounting model, aimed primarily at internationally active banks and those banks more sophisticated in the business of lending.
- Banks are expected to invest appropriate resources to incorporate all available forward-looking information and macroeconomic factors in the measurement of ECLs, individually or collectively.
- The guidance limits the use of practical expedients and simplifications (low credit risk and more than 30 days past due).
- The guidance does not apply to debt securities nor does it address capital requirements.

The guidance aims to drive consistent interpretations and practices rather than drive convergence between different ECL accounting frameworks.

Introduction

On 2 February 2015, the Basel Committee on Banking Supervision (the Committee) issued a *Consultative Document: Guidance on accounting for expected credit losses* (the guidance) that outlines supervisory expectations regarding sound credit risk practices associated with implementing and applying an expected credit loss (ECL) accounting framework.

The guidance has largely retained the Committee's current principles on sound credit risk assessment and valuation of loans (SCRAVL) that were issued in 2006, but has been revised to reflect the move from an incurred loss to an ECL accounting model. This follows the publication of IFRS 9 *Financial Instruments* by the International Accounting Standards Board (IASB), application of which is mandatory for financial years beginning on or after 1 January 2018.[1]

The main section of the guidance will be applicable in all jurisdictions and contains supervisory principles on sound credit risk practices. The guidance is supplemented by an appendix that outlines supervisory requirements specific to jurisdictions applying the IFRS 9 ECL model. We are aware of at least one banking regulator that is proposing that internationally active banks certify their compliance with the guidance and that auditors attest this certification. The comment period on the Committee's consultative document ends on 30 April 2015.

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[1] See our recent publications, *Applying IFRS – Impairment of financial instruments under IFRS 9* and *IFRS Developments Issue 87: IASB issues IFRS 9 Financial Instruments – expected credit losses*.

Building a better working world

‘Internationally active banks and more sophisticated banks in the business of lending’ are expected to invest in resources and systems to achieve the highest-quality implementation of ECL models.

Objective and scope

The guidance will apply to ‘internationally active banks and more sophisticated banks in the business of lending’. For ‘less complex banks’, supervisors may determine a ‘proportionate approach’ in implementing the guidance that is commensurate with the size, nature and complexity of their lending exposures.

The guidance aims to provide banks and supervisors with the requirements for sound credit risk practices associated with implementing ECL accounting models for the banks’ lending exposures, including loans, loan commitments and financial guarantee contracts, but excluding debt securities. The guidance does not intend to drive convergence between different ECL accounting frameworks, but it aims to drive consistent interpretations and practices where commonalities exist and when the same accounting framework applies. Regulatory capital requirements are not addressed.

Supervisory requirements for sound credit risk practices using expected credit loss measurement

The guidance is based on 11 principles that apply to banks and supervisors. The key guidance for banks to assess and measure ECLs is outlined below:

> ***Principle 1:*** *A bank’s board of directors (or equivalent) and senior management are responsible for ensuring that the bank has appropriate credit risk practices, including effective internal controls, commensurate with the size, nature and complexity of its lending exposures to consistently determine allowances in accordance with the bank’s stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.*

The Committee emphasises the importance of the board of directors’ and senior management’s roles and responsibilities in maintaining appropriate ECL allowances and an effective internal control system for credit risk assessment and measurement.

> ***Principle 2:*** *A bank should adopt, document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring the level of credit risk on all lending exposures. The robust and timely measurement of allowances should build upon those methodologies.*

The guidance stresses the need for banks to have a sound methodology for assessing credit risk and measuring ECL allowances. Forward-looking information and related quality factors used in regulatory ECL estimates should be consistent with input to other relevant estimates in the financial statements, budgets, strategic and capital plans and other regulatory reporting. The Committee recognises that stressed scenarios developed for regulatory purposes are not intended to be used directly for accounting purposes.

> ***Principle 3:*** *A bank should have a process in place to appropriately group lending exposures on the basis of shared credit risk characteristics.*

The Committee indicates that an effective credit risk rating system should incorporate all relevant forward-looking and macroeconomic factors and allow banks to track changes in credit risk, regardless of the significance of the change, and consequent changes in credit risk ratings. The Committee expects banks to seek consistency in credit ratings assigned to lending exposures for regulatory capital calculations and financial reporting.

The grouping of lending exposures into portfolios with shared credit risk characteristics must be re-evaluated regularly (including re-segmentation in light of relevant new information). Groupings must be granular enough to assess changes in credit risk and changes in a part of the portfolio and must not be masked by the performance of the portfolio as a whole. Moreover, the guidance suggests that the entire portfolio should migrate to a higher credit risk rating if the level of credit risk is assessed to have increased on a group basis.

Principle 4: *A bank's aggregate amount of allowances, regardless of whether allowance components are determined on a collective or an individual basis, should be adequate, as defined by the Basel Core Principles, which is an amount understood to be consistent with the objectives of the relevant accounting requirements.*

The Committee clarifies that, when forward-looking information and macroeconomic factors cannot be applied at the individual exposure level, these exposures should be placed in a group with shared credit risk characteristics and assessed collectively using a top-down approach. Also, robust methodologies to estimate ECLs should consider the full spectrum of reasonable information and different potential scenarios and not rely purely on subjective, biased or overly optimistic considerations.

Principle 5: *A bank should have policies and procedures in place to appropriately validate its internal credit risk assessment models.*

As credit risk assessment may involve the use of models and extensive judgement, the Committee stresses the importance of a sound model validation framework that incorporates regular validation of the models (at least annually). There should be an independent party responsible for independent review of the model validation process.

Principle 6: *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.*

Available forward-looking information and macroeconomic factors should not be avoided on the basis of excessive or unnecessary cost.

The Committee recognises that incorporating forward-looking information and macroeconomic factors into the estimate of ECLs is challenging, costly and requires significant judgement. However, the consideration of forward-looking information and macroeconomic factors is critical to a robust implementation of an ECL model. As such, banks are required to incorporate all reasonably available forward-looking information and macroeconomic factors when estimating ECLs. The associated costs should not be avoided on the basis that they are excessive or unnecessary. The Committee recognises that it may not always be possible to demonstrate a strong link in formal statistical terms between the set of information and credit risk of some exposures and that a bank's experienced credit judgement will be crucial in establishing the appropriate level for the individual or collective allowance.

Principle 7: *A bank should have a sound credit risk assessment and measurement process that provides it with a strong basis for common systems, tools and data to assess and price credit risk, and account for expected credit losses.*

The Committee believes that the use of common processes, systems, tools and data will strengthen the reliability and consistency and increase the transparency of the resulting ECL estimates for accounting and capital adequacy purposes.

Principle 8: *A bank's public reporting should promote transparency and comparability by providing timely, relevant and decision-useful information.*

The Committee encourages banks to improve their disclosures in order to fairly depict their exposures to credit risk and underwriting practices.

Supervisory requirements specific to jurisdictions applying IFRS

The appendix to the guidance provides additional supervisory requirements for three key areas that are specific to banks reporting under IFRS.

Loss allowance at an amount equal to 12-month ECL

The Committee expects a bank's definition of default adopted for accounting purposes to be guided by the definition used for regulatory purposes, which includes both a qualitative 'unlikeliness to pay' criterion and a quantitative '90-days-past-due' criterion, described by the Committee as a 'backstop'. The regulatory definition should be supplemented by other elements such as a collective assessment and adjustments to reflect current conditions, forward-looking information and macroeconomic factors, to ensure the 12-month ECL is sufficiently sensitive to all relevant sources of credit risk. Exposures originated with a high credit risk are expected to be monitored closely and move quickly to lifetime ECL measurement.

Assessment of significant increases in credit risk

The Committee expects banks to look widely and holistically for information, including forward-looking information and macroeconomic factors that are relevant to the assessment of whether increases in credit risk are significant. It is critical that banks have processes in place to ensure that financial instruments, whether assessed individually or collectively, are moved from the 12-month to the lifetime ECL measurement as soon as credit risk has increased significantly.

The Committee strongly endorses the IASB's view that lifetime ECLs are generally expected to be recognised before a financial instrument becomes past due or other lagging borrower-specific factors are observed. It is important that banks' analyses will consider that credit losses very often begin to deteriorate a considerable period of time (months or years) before an actual delinquency occurs.

In assessing whether there has been a 'significant' increase in credit risk, banks should not rely solely on quantitative analysis. The guidance emphasises that certain conditions would suggest a significant increase in credit risk (e.g., an increased credit spread for a particular loan, a downgrade by a credit rating agency, expectation of forbearance). Also, the guidance stresses that the sensitivity of probability of a default to rating downgrades increases strongly as rating quality declines. For example, although a downgrade from AAA to AA may not be indicative of a significant increase in credit risk, it is possible that a significant increase in credit risk could occur even before a one-notch downgrade. Particular care should be taken when some, but not all, of a bank's exposures to a counterparty are deemed to have significantly deteriorated.

The Committee notes that the simplification in IFRS 9 allowing banks to set a maximum credit risk for a portfolio on initial recognition is only relevant if segmentation of the portfolio is sufficiently granular to enable the analysis to be consistent with IFRS 9.

Use of practical expedients

IFRS 9 includes a number of practical expedients to ease the implementation burden of measuring ECLs and assessing significant increases in credit risk. However, as banks are in the business of lending and it is unlikely that obtaining relevant information will involve undue cost or effort, the Committee emphasises that many of these practical expedients are inappropriate for use by 'internationally active banks and those banks more sophisticated in the business of lending'. The Committee stresses:

- The long-term benefit of a high-quality implementation of an ECL model that takes into account all reasonable and supportable information far outweighs the associated costs.
- The use of the low credit risk simplification is considered a low-quality implementation of the ECL model and is expected to be used in rare and appropriate circumstances. The 'investment grade' category used by ratings agencies is not considered homogeneous enough to be automatically considered low credit risk. Banks are expected to rely primarily on their own credit assessments.
- Significant reliance on past-due information would be considered a very low-quality implementation of the ECL model. Banks are not expected to fall back on the more than 30 days past due rebuttable presumption, unless they have demonstrated that no forward-looking factors have any substantive correlation with the level of credit losses.

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