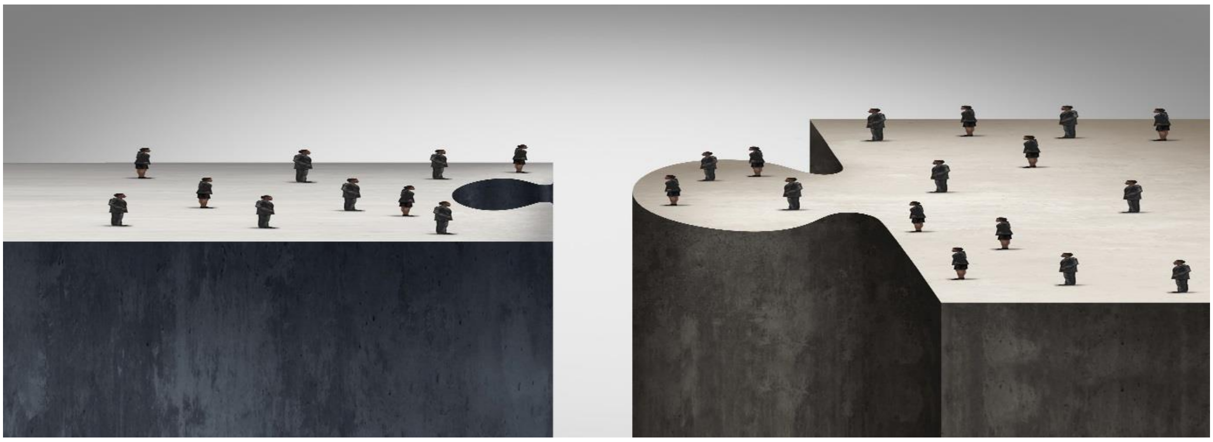
EBF_021542

30th June 2016

Interaction between the prudential and accounting framework - Expected losses



Key messages

- The prudential framework has been strengthened since the beginning of the financial crisis resulting in more resilient financial sector. Some of the concerns that instigated the IASB revision of the impairment model have been in the meantime also addressed by prudential measures. The regulators declared not to focus on further significant increase of overall capital requirements.

- The overall amount of provisions under IFRS 9 includes impairment and expectations of future losses (that may or may not materialize). The provision balance will increase on the adoption of IFRS 9 due to incorporation of such future expected losses on a catch-up basis (retrospective application of IFRS 9). This will have a negative impact on shareholders' equity and CET 1 ratios. What will not change is the overall amount of risk, or losses. A decrease in CET1 ratio without a change in the overall level of expected and unexpected losses is not acceptable.

- Current prudential rules were calibrated on accounting's Incurred Loss Model. Assuming that the prudential expected loss (EL) is correct from a prudential point of view (12 month-EL), the prudential rules need to be recalibrated to reflect the changes of the new accounting model (Lifetime Credit Expected Losses-LTECL) consistently for STA and IRB approaches. Under the current prudential framework, own funds requirements are determined to absorb unexpected losses and there is potentially an overlap between LTECL determined according to IFRS 9 and unexpected losses as defined by the regulatory framework. The delta between 12 m EL and LTCEL is already reflected in the unexpected losses under prudential framework, covered by capital. The impact on capital ratios resulting from the IFRS 9 should be taken into account in the overall calibration of the capital framework to avoid double counting and ensure a level playing field, regardless of the underlying accounting regime.

- Without adjustments to the current capital regime by 2018, CET1 ratios are expected to decrease without a corresponding change in the level of risk, risk appetite, banks' strategy, management or level of losses. The increased cost of capital is expected to impact banks' lending practices and pricing unless the prudential framework is modified to offset the capital impact of IFRS 9 expected loss model.

- A revision is required before 2018. An EU solution must be introduced should the Basel Committee fail to provide a satisfactory solution for 2018.

Interaction between the prudential and accounting framework - Expected losses

1. Background

- The approach adopted by Basel II acknowledges the different characteristics of expected (EL) and unexpected losses (UL). Both are calculated using a 12 month time horizon.

Expected loss	• The probable financial loss over the next 12 months • Confidence level: 50%
Unexpected loss	• The potential financial loss over the next 12 months • Confidence level: 99.9%

- Expected losses, seen as a cost component of doing business, are managed through pricing and provisioning. Unexpected losses are covered by capital given that these represent peak losses exceeding the expected levels. Capital plays a loss-absorbing function covering the risk of occurrence of such peak losses within the 12-month period.

- The entry into force of IFRS9 on January 1st 2018 changes the interaction between capital and provisions, since the new accounting standard introduces a notion of expected losses for provisioning purposes replacing the incurred losses model set by the current accounting standard (IAS39). This represent a *fundamental change in how loss allowances (provisions) are accounted for as bank no longer needs to* wait for the evidence of impairment but will be required recognize the allowances on this expected loss basis

  For all financial assets that are essentially performing as expected (i.e. for those that have not significantly increased in credit risk – stage one assets), IFRS9 requires loss allowance for the entire credit loss (not the expected cash shortfalls over the 12 month period) weighted by the probability that the loss will occur in the next 12 months after the reporting date.

- For financial assets for which credit risk has increased significantly since initial recognition (stage 2 assets) or which are credit impaired (stage 3 assets), IFRS 9 requires loss allowances for lifetime expected losses, meaning the expected losses that result from all possible default events over the expected life of the financial asset.

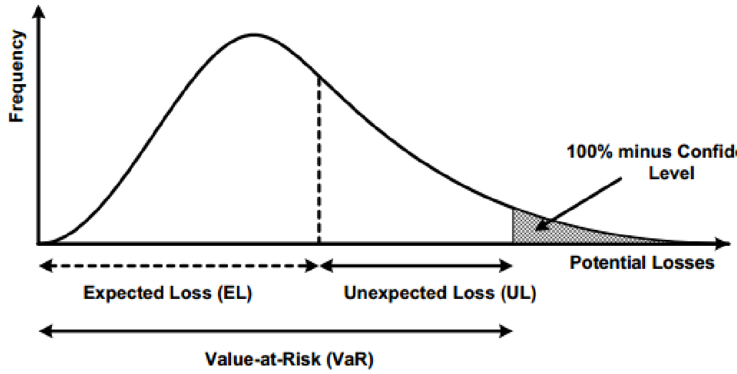
- Loan loss P&L Expense is often the biggest expense in a bank's P&L and a key aspect of bank's profitability. Increase in balance sheet allowances under IFRS 9 will result in decrease in shareholders' equity and in the CET 1 under the current prudential framework (See Annex I). What however will not change under IFRS 9 is the overall amount of risk and losses. [1]

[1] Disclaimer: this paper is not intended to present a full view of neither the capital nor the accounting framework. For a complete picture please refer to the documents quoted in this paper and the complete regulatory standards.

2. Interaction between provisions and capital under the current prudential framework

Figure 1 shows the approach for describing losses in the Basel II framework[2]:

Figure 1



As holding capital for every potentially remote unexpected credit event would not be efficient, capital is set to maintain a supervisory fixed confidence level, and the Value-at-risk at this confidence level represents the sum of expected and unexpected losses. The likelihood that the bank will remain solvent over a one-year horizon is equal to the confidence level. In Basel II and subsequently, this confidence level has been set at 99.9% and a 12-month time horizon.

However, as provisions for credit risk under the current accounting standard (IAS39) are accounted for based on an incurred loss model, the capital framework demands entities demonstrate that they have adequate provisions to preserve a prudent level of overall funds ensuring the required loss absorption capacity. To do so, a comparison between the regulatory EL and the current levels of provisions is conducted, with two possible outcomes:

- If there is a shortfall of provisions against the regulatory EL, entities must deduct this shortfall from their Common Equity Tier 1 (CET1) capital.

- Where the total expected loss amount is less than the total eligible provisions recognized in the accounting, banks may recognise the difference in Tier 2 capital up to a maximum of 0.6% of credit risk weighted assets calculated under the IRB approach.

For portfolios with no regulatory EL available (standardised approach), another treatment is applied:

- Specific provisions are deducted from the exposure to determine own funds requirements for the denominator of the capital ratio computation

- General provisions are accounted for as Tier II capital up to a limit of 1,25% of the credit RWA calculated under the standardized approach.

[2] BCBS, July 2005, 'An explanatory note on the Basel II risk weight functions'

'*Too little too late*' issue

After the 2008 crisis, the regulatory community agreed that the loss absorption mechanisms available at that time have been proven unable to timely react to the credit quality deterioration of the banking industry.

Consequently, and among other reactions, the G20 called in its April 2009 meeting for measures to mitigate procyclicality in the industry's loss absorption capacities[3].

Since then, both the accounting and prudential standard setters have put forward measures to address the G20 call such as:

1) The IASB and the FASB, to respond to the criticism of incurred loss models as providing too little and too late provision, are putting in place provisioning standards based on an expected loss model, that strengthen accounting recognition of loan-loss provisions for credit risk by requiring a recognition of expected credit losses on the whole portfolio (and not only on assets having experienced an incurred loss) and by incorporating a broader range of credit data, including forward-looking information.

2) At the same time, prudential regulators are putting in place measures and mechanisms to reinforce the loss absorption capabilities of entities. A non-exhaustive list is:

   - Capital buffers: conservation and counter-cyclical buffer, buffers for systemically important institutions (G-SII and O-SII), systemic risk buffers (Europe only)
   - Review of the standards of capital calculation: credit and operational
   - Restrictions to IRB calculations: floors, non-modellable portfolios, etc.
   - TLAC and MREL
   - Etc.

Due to the different expert teams involved in developing regulation, different nature of the measures and time constraints, there is an overlap between some measures , resulting in "double counting" of the loss absorption capacities. In particular, there is a duplication of loss absorbing resources between the new accounting standards (forward-looking loss provisions) and prudential regulations (regulatory capital).

Conceptually, given the same level of underlying losses and putting aside any difference in calculation between prudential 12 months EL and accounting 12 months ECL, there is a duplication for Stage 2 assets, given that the expected loss provision under IFRS 9 goes beyond the 12 months' time horizon of the prudential framework.

The BCBS has stated that they '*…will review the Committee's proposals on the risk-weighted framework and the design and calibration of capital floors at or around the end of 2016. The Committee will conduct a quantitative impact assessment during the year. As a result of this assessment, the Committee will focus on not significantly increasing overall capital requirements"*.

[3] Declaration on strengthening the financial system, London Summit, 2 April 2009

Given the aim of the regulators to not significantly increase the overall capital requirements, the calibration of the new prudential regime must include the effects of the modified accounting regime to avoid double counting and ensure level playing field regardless of the underlying accounting regime.

3. Review of the prudential framework in light of the changes to the accounting provisioning model

In order to be compatible with the most imminent changes in the IFRS accounting framework, the prudential rules need to be recalibrated to offset the changes of the new accounting model before IFRS 9 enters into force in 2018[4].

Without adjustments to the current capital regime by 2018, CET1 ratios are expected to decrease without a corresponding change in the level of risk, risk appetite, banks' strategy, management or level of losses. The increased cost of capital is expected to impact banks' lending practices, potentially including to pass to their customer the increased requirements through pricing. Banks can adjust to higher capital requirements either by raising fresh capital – a scenario that after the earlier considerable efforts by banks in Europe in this regard is not feasible – or by deleveraging. This adjustment will need to take place against the backdrop of operating conditions that leave the return on equity of many banks below the cost of funding and the market volatility experienced by contingent convertible instruments. Further increases in capital requirements can only further restrict banks' capacity to finance the economy.

The modification of the prudential framework must be conceptually sound, applicable under both IRB and STA approaches, understandable, operational and fairly applicable to different accounting regimes to ensure a level playing field among jurisdictions. It furthermore should be consistent with the whole prudential framework which relies on a 12m unexpected loss to be covered by own funds.

In light of the above criteria, to offset the IFRS 9 impact on capital, the EBF suggests the following prudential framework for banks that apply accounting impairment models based on expected losses.

- Accounting provisions beyond the prudential time horizon of 12 months should be considered CET 1 capital both under standardized and IRB approach.
    - Furthermore, under the IRB approach, the excesses and shortfalls of 12 m ECL (accounting provisions) in comparison to the 12m EL under prudential framework for IRB portfolios should be treated symmetrically. The current cap should be removed or recalibrated.
    - Given that under the STA approach there is no prudential EL, the EBF suggests to calculate accounting ECL for stage 1 and stage 2 with a time horizon of 12 months for prudential purposes. The accounting provisions above the level equal to accounting credit expected loss provisions calculated for bucket 1 and for bucket 2 with a time horizon of 12 months should be considered CET 1 capital.

[4] CRR Article 80.3 "EBA shall provide technical advice to the Commission on any significant changes it considers to be required to the definition of own funds as a result of any of the following:
(a) relevant developments in market standards or practice;
(b) changes in relevant legal or accounting standards;
(c) significant developments in the methodology of EBA for stress testing the solvency of institutions.

Accounting provisions beyond the prudential time horizon of 12 months should be considered as CET 1 capital both under standardized and IRB approach

The Basel framework is set and calibrated to require capital to absorb unexpected losses in a time horizon of one year.

As described in further detail in '*An Explanatory Note on the Basel II IRB Risk Weight Functions*' (BCBS, July 2005), '…*capital is set according to the gap between EL and VaR, and if EL is covered by provisions or revenues, then the likelihood that the bank will remain solvent over a one-year horizon is equal to the confidence level*. '

When calculating the expected loss, '*the Expected Loss of a portfolio is assumed to equal the proportion of obligors that might default within a given time frame (1 year in the Basel context), multiplied by the outstanding exposure at default, and once more multiplied by the loss given default rate*'.

Under IFRS9, as expressed in paragraph 5.5.3 of the IASB IFRS9 Reporting Standard, '…*an entity shall measure the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses if the credit risk on that financial instrument has increased significantly since initial recognition*'. Lifetime ECL are defined as '*the expected credit losses that result from all possible default events over the expected life of a financial instrument'* as opposed to 12-month ECL being '*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*.'

Furthermore IFRS 9 EL shall be measured as an unbiased and probability weighted amount determined by evaluating a range of possible outcome and by integrating forward looking information (cf. IFRS 9§5.5.17).

While the provisions in excess of one year expected credit losses are not set aside against unexpected losses, the defaults they are expected to cover are expected to be outside the time horizon of the capital framework. In case these funds are needed to face losses within the next 12 months, such losses will be unexpected, and the loss absorption capabilities of these provisions would be similar to CET1 capital

Considering the nature and loss absorption capabilities of provisions for expected losses beyond 12 months' time horizon, the EBF suggest these provisions to be considered CET1 capital (add-back), regardless of the capital method used to calculate capital (IRB or STA approach). Such approach will mitigate the inconsistency between the time horizons for calculation of expected losses and neutralise the overlap between the accounting requirements and the prudential framework.

IRB approach: The excesses and shortfalls of 12 m ECL (accounting provisions) in comparison to the 12m EL under prudential framework for IRB portfolios should be treated symmetrically. The current cap should be removed or recalibrated

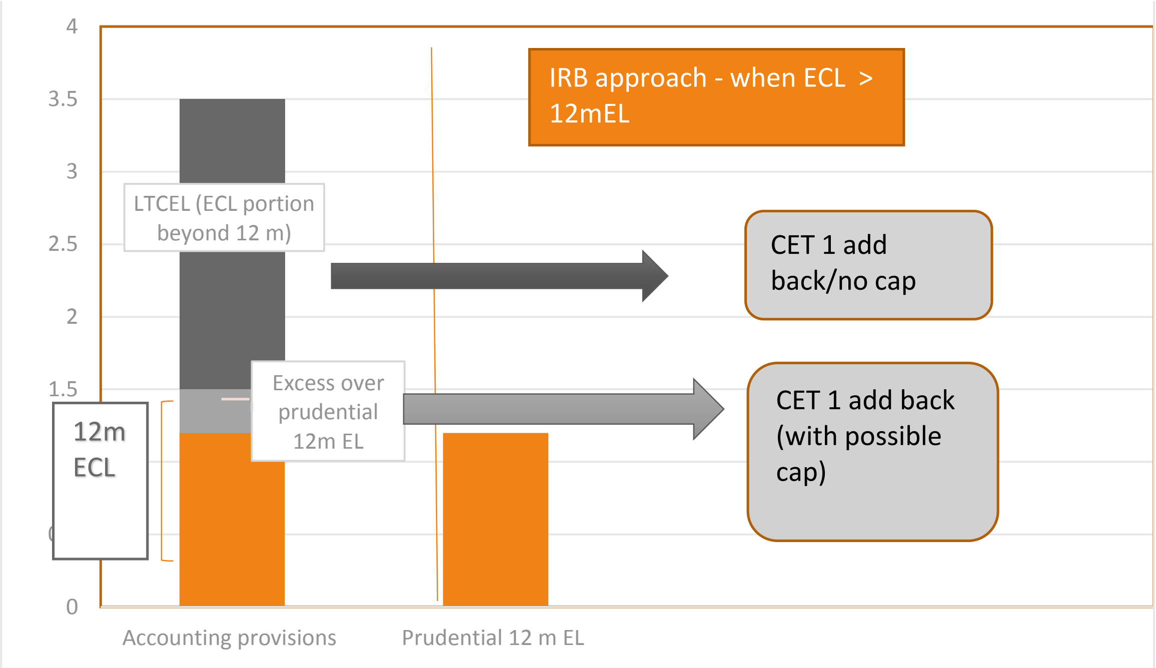
In the view of EBF, the characteristic of IFRS 9 i.e. the incorporation of expected loss on the whole portfolio, the incorporation of forward-looking information, the unbiased probability weighted scenarios, etc. alongside with the more robust capital environment resulting from the new prudential framework justify a consistent treatment of shortfalls and excesses of accounting provisions over regulatory provisions.

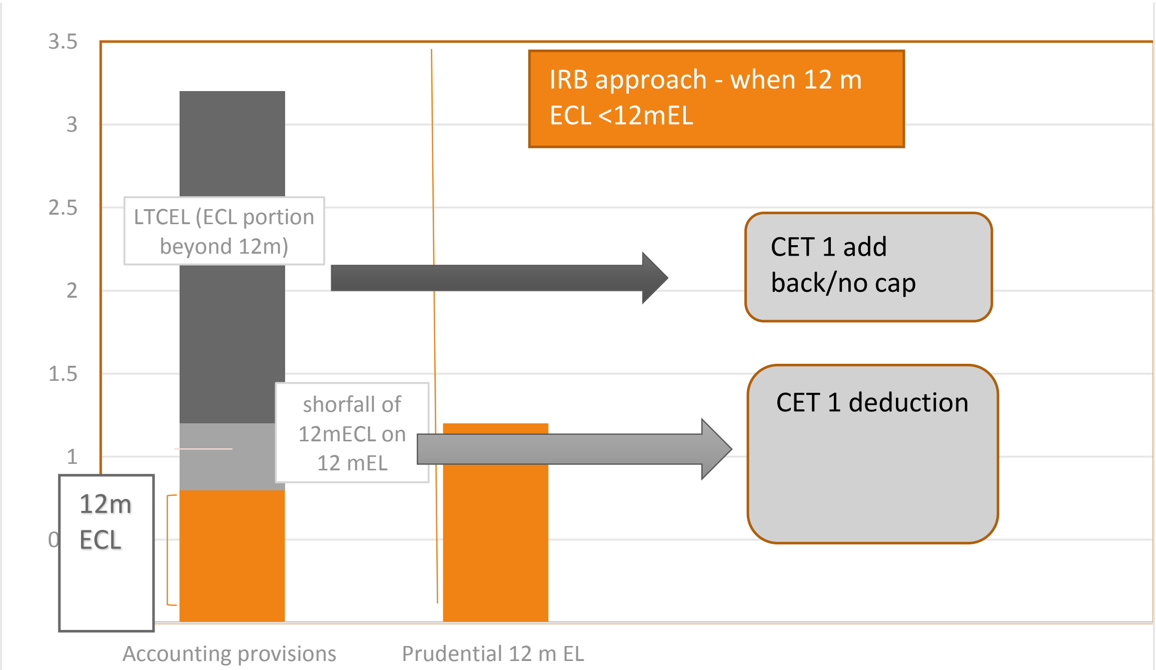
Moreover, in addition to the symmetric treatment, it is necessary to review/eliminate the cap included in paragraph 61 of the Basel III framework[5]. This cap was calibrated with an accounting framework based on incurred losses, and the Basel Committee acknowledged the need to recalibrate it when at a time of change in the accounting framework. ('*The Committee also will review the treatment of excess provisions over expected losses, which currently are capped as a share of risk weighted assets within Tier 2 capital. In particular, the Committee will review this cap within the context of the expected loss approach to provisioning*.'). In 2009, when the last review was carried out IFRS9 development was at early stage and its final characteristics have not been set until 2014.

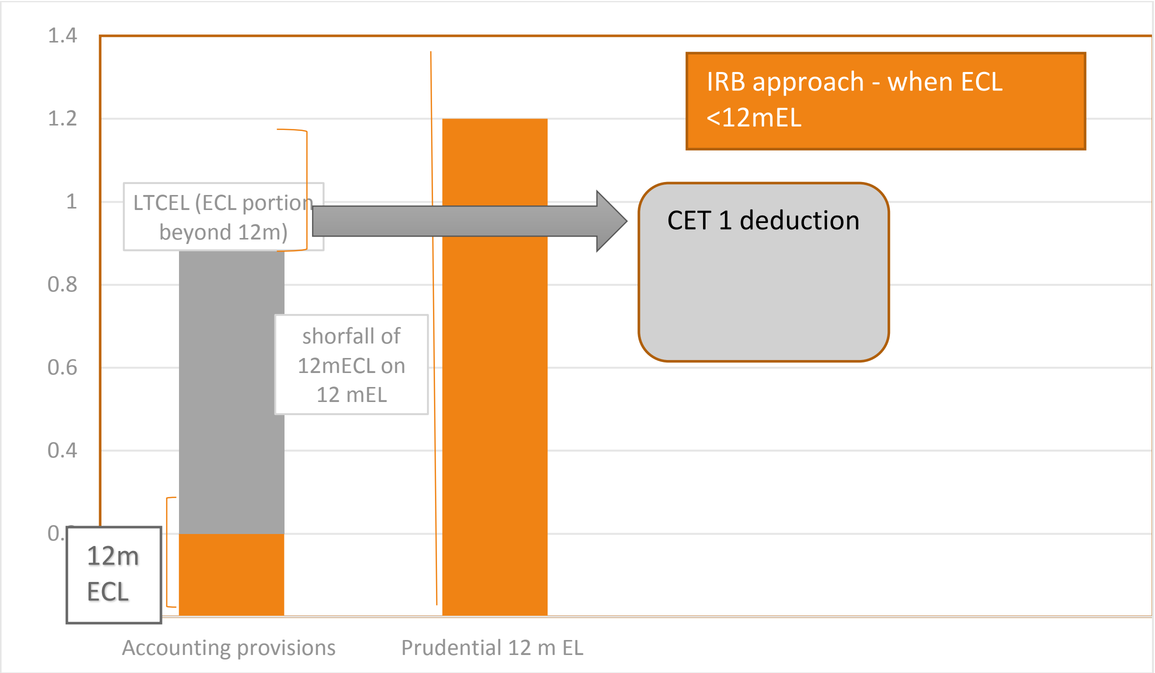
Considering these characteristics (forward-looking information, unbiased probability weighted scenarios, etc.), the EBF is of the view that the cap should be eliminated, or at least recalibrated to be consistent with the new accounting model. **Any possible cap should only apply to the excess of accounting 12 months expected credit loss over the prudential 12 months expected loss.** This will require calculation of 12 m ECL also for all stage 2 assets, above the requirements of IFRS 9. The 12 month ECL for stage 2 will therefore not be published in financial statements and audited given they will be computed for prudential purposes only.

We believe the EBF proposal will be coherent with the approach set in paragraphs 61 and 73 of Basel II comparing 12m time horizon for prudential EL as well as accounting ECL.

[5] BCBS, '*Basel III: A global regulatory framework for more resilient banks and banking systems*', 'Where the total expected loss amount is less than total eligible provisions, […] banks may recognise the difference in Tier 2 capital **up to a maximum of 0.6% of credit risk-weighted assets**'


4
3.5
3
2.5
2
1.5
0
IRB approach - when ECL > 12mEL
LTCEL (ECL portion beyond 12 m)
CET 1 add back/no cap
Excess over prudential 12m EL
CET 1 add back (with possible cap)
12m ECL
Accounting provisions
Prudential 12 m EL


3.5
3
2.5
2
1.5
1
IRB approach - when 12 m ECL <12mEL
LTCEL (ECL portion beyond 12m)
CET 1 add back/no cap
shorfall of 12mECL on 12 mEL
CET 1 deduction
12m ECL
Accounting provisions
Prudential 12 m EL


1.4
1.2
1
0.8
0.6
0.4
0.
IRB approach - when ECL <12mEL
LTCEL (ECL portion beyond 12m)
CET 1 deduction
shorfall of 12mECL on 12 mEL
12m ECL
Accounting provisions
Prudential 12 m EL

STA approach: the accounting provisions above the level equal to accounting credit expected loss provisions calculated for bucket 1 and for bucket 2 with a time horizon of 12 months should be considered CET 1 capital.

This concept affects own funds determination and own funds requirements for portfolios subject to the standardised approach.

Basel acknowledged from the initial phase of the prudential framework, back in 1988, the difficulties to clearly identify general provisions: '*…the Committee accepts, however, that, in practice, it is not always possible to distinguish clearly between general provisions (or general loan-loss reserves) which are genuinely freely available and those provisions which in reality are earmarked against assets already identified as impaired. This partly reflects the present diversity of accounting, supervisory, and, importantly, fiscal policies in respect of provisioning and in respect of national definitions of capital.*'

Basel defines general provisions as "*(60) provisions or loan-loss reserves held against future, presently unidentified losses are freely available to meet losses which subsequently materialise and therefore qualify for inclusion within Tier 2. Provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, should be excluded*."

In the European context, the EBA provides further guidance on the identification of general credit risk adjustments, defined as follows[6]:

(a) are freely and fully available, as regards to timing and amount, to meet credit risk losses that have not yet materialised;
(b) reflect credit risk losses for a group of exposures for which the institution has currently no evidence that a loss event has occurred

Furthermore in the same document:

'4. Subject to meeting the criteria of paragraph 2, the following losses shall be included in the calculation of General Credit Risk Adjustments:

(a) losses recognised to cover higher average portfolio loss experience over the last years although there is currently no evidence of loss events supporting these loss level observed in the past;
(b) losses for which the institution is not aware of a credit deterioration for a group of exposures but where some degree of non-payment is statistically probable based on past experience.

5. The following losses shall always be included in the calculation of Specific Credit Risk Adjustments under paragraph 3:

(a) losses recognised in the profit or loss account for instruments measured at fair value that represent credit risk impairment under the applicable accounting framework;
(b) losses as a result of current or past events affecting a significant individual exposure or exposures that are not individually significant which are individually or collectively assessed;

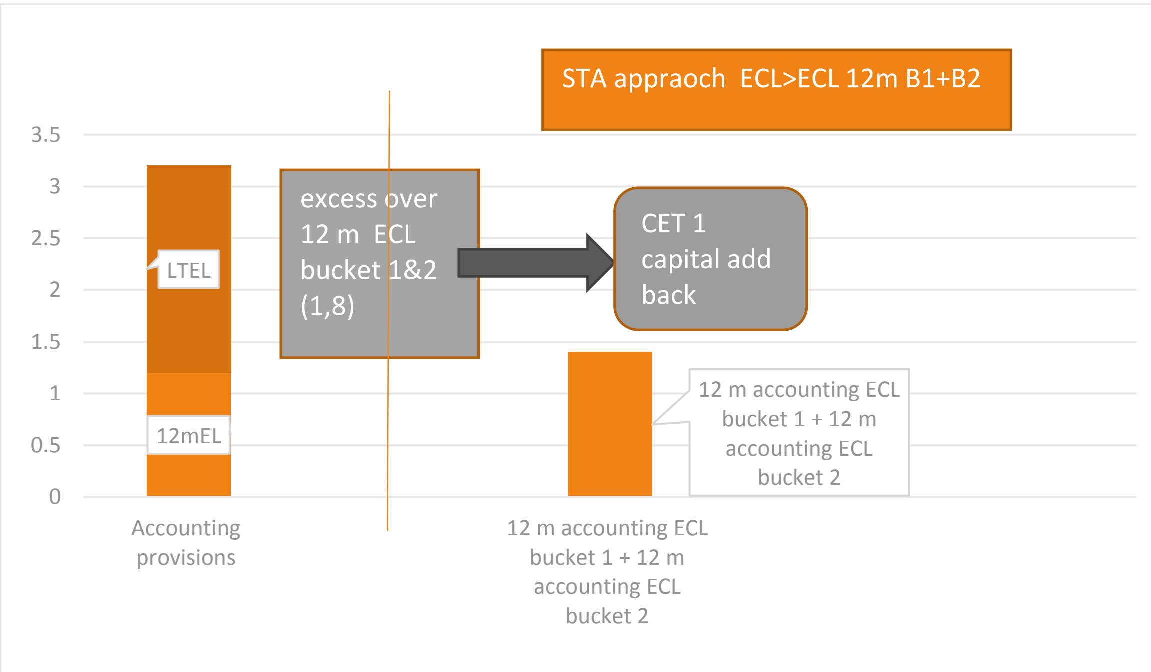
[6] '*RTS On specification of the calculation of specific and general credit risk adjustments*', EBA, July 2013

(c) losses for which historical experience, adjusted on the basis of current observable data, indicates that the loss has occurred but the institution is not yet aware which individual exposure has suffered these losses.'

Under IFRS9, provisions for impaired assets (*stage 3*') can easily be identified as *specific*. However, unimpaired assets, both if they have experienced a significant increase in credit risk (*stage 2*) or not (*stage 1*) can be considered to have met with bullet points 4b or 5c on the previous regulatory reference, making categorization ambiguous.

<u>To ensure consistency with the IRB approach in offsetting the IFRS 9 impact the difference between LTECL and 12 months ECL should be incorporated within CET1</u>. This will require calculation of 12m ECL (IFRS 9 expected credit loss) for all stage 2 assets, above the requirements of IFRS 9. The 12 month ECL for stage 2 will therefore not be published in financial statements and audited given they will be computed for prudential purposes only.

We believe the 12 months accounting EL in bucket 1 and bucket 2 could be used as an approximation of the prudential 12 months for portfolios for which the standardised approach is applied and for which no prudential EL is computed. As prudential EL 12 months is through the cycle (TTC) and accounting ECL is point in time (PIT), there will be a difference between the two measures at the different points in time in the cycle, however the sum of the differences on an average over a cycle should amount to zero..



Concept of general and specific provisions

The practices to differentiate between general and specific provisions under IAS 39 seems to vary between banks and jurisdictions resulting in different prudential outcomes. **To achieve a level playing field and comparability, the EBF suggests reviewing the concept of general and specific credit risk adjustments. Taking into account the EBF proposal to consider the ECL beyond 12 months horizon as CET 1, we are continuing discussions with the objective to propose a consistent treatment of the 12m ECL under prudential framework.**

While distinction between specific and general credit risk adjustments has been used for tax purposes in some jurisdictions, given that the tax treatment is a matter for national authorities, we believe that national authorities can come up with a set of clear and consistent criteria to ensure a fair tax treatment for the entities within their jurisdiction regardless of the underlying accounting treatment.

***

ANNEX I

Effect on regulatory capital ratios

13

- If balance sheet allowances increase by >40%...
  - then core Tier-1 capital ratios for many banks would be materially affected.
- All else equal, this assumes that the impact from accounting transition flows directly to regulatory capital.

Average decrease (%) in core Tier 1 ratio if balance sheet allowance increases by:							
	10%	20%	30%	40%	50%	75%	100%
Canada Banks	-0.10%	-0.19%	-0.29%	-0.38%	-0.48%	-0.72%	-0.96%
Western Europe banks	-0.53%	-1.06%	-1.59%	-2.12%	-2.65%	-3.97%	-5.30%
EEMEA banks	-0.17%	-0.33%	-0.50%	-0.67%	-0.84%	-1.26%	-1.67%
Asia-Pacific banks	-0.16%	-0.32%	-0.47%	-0.63%	-0.79%	-1.19%	-1.58%
Latin America banks	-0.35%	-0.69%	-1.04%	-1.39%	-1.74%	-2.60%	-3.47%

Source: Standard & Poor's report "'Could Ballooning Loss Reserves From New Accounting Rules Deflate Bank Capital Ratios?" & Capital IQ

Source: IASB

22