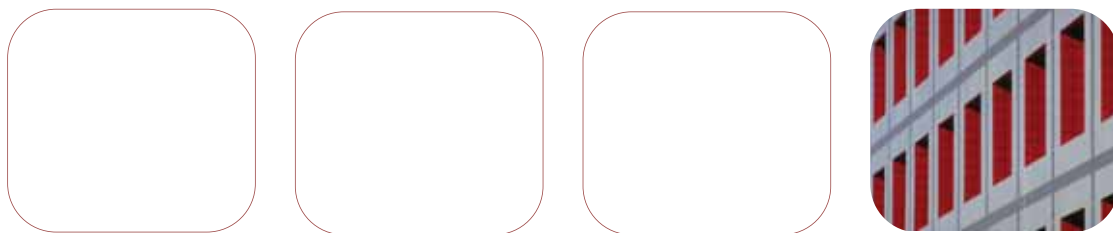


Joining the dots - Tackling the Basel II and IFRS debate



IFRS – Global Reporting Revolution

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Joining the dots - Tackling the Basel II and IFRS debate

Welcome to the sixth in a series of papers dedicated to discussing International Financial Reporting Standards and the impact on the banking industry.

This paper compares some of the synergies and differences between the Basel II and IFRS frameworks*. In particular, it tackles the IFRS approach to loan loss provisioning and the Basel II approach to calculating capital requirements.

I hope that you find this paper thought-provoking and insightful. If you would like to discuss any of the issues addressed in more detail, please speak with your usual contact at PricewaterhouseCoopers or those listed at the end of this paper, as this helps us to ensure that we are addressing the issues that you are most focused on.

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Introduction

There has recently been significant debate in the banking industry in connection with the crossovers and linkages between the IFRS approach to loan loss provisioning and the Basel II approach to calculating capital requirements. Many banks have expressed their desire to utilise models that are being developed under their Basel II implementation plans for the purposes of performing their provisioning calculations. Given the investment being made by the banking sector to achieve Basel II compliance¹, it is only fitting that banks should investigate whether an IFRS compliant approach could be aligned to a Basel II methodology.

Whilst many of the requirements, and consequently the source data, are extremely similar under both approaches, banks should not lose sight of the fact that the aims of IFRS and Basel II are fundamentally very different. The objective of IFRS is to ensure that the financial statements adequately reflect the losses that are incurred at the balance sheet date, whilst Basel II's objective is to ensure that the lender has sufficient provisions or capital to support its expected losses over the course of the next 12 months² and support any unexpected credit losses³. IFRS clearly states that it is an incurred loss model; Basel II is all about expected and unexpected losses.

This distinction has been somewhat confused by the fact that a number of regulators set rules for the level of provisions in financial statements. From an accountant's perspective, it is not a regulator's primary function to determine the amount of provisions a bank should hold, its focus should rather be on capital levels. The regulatory response to a belief that a bank should have higher provisions should not be to impose further provisions that may not comply with Accounting

Standards but instead to require the banks to hold more capital.

Expected and unexpected losses

The decision in October 2003 by the Basel Committee on Banking Supervision ('the Committee') to remove expected losses from the risk weight functions in the Internal Ratings-Based ('IRB') approach (but not from the simpler approaches) has been driven by its belief that provisions should reflect a bank's expected credit losses whereas capital should principally reflect any unexpected losses that may arise.

However, as described later in this paper, the IFRS accounting provision relates strictly to incurred losses which are unlikely to be the same as expected losses. Since the Committee views capital as primarily covering only unexpected credit losses there is a risk of a 'shortfall' between incurred and expected credit losses which are not provided for by either an accounting provision or by capital (see Figure 1 for illustration). However, this has been recognised by the Committee in its January 2004 press release

¹Datamonitor estimates that total spend in Europe on Basel II to exceed \$6 billion by the end of 2005.

²The Internal Ratings-Based approach is based upon a long-run average twelve month probability of default and the bank's most conservative estimate of 'loss given default' across an economic cycle.

³The requirement to distinguish between expected and unexpected losses applies only to those banks that have elected to use the Internal Ratings-Based approach to credit risk.

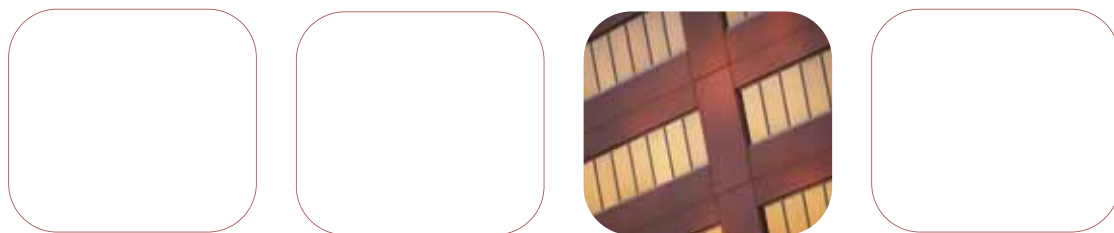
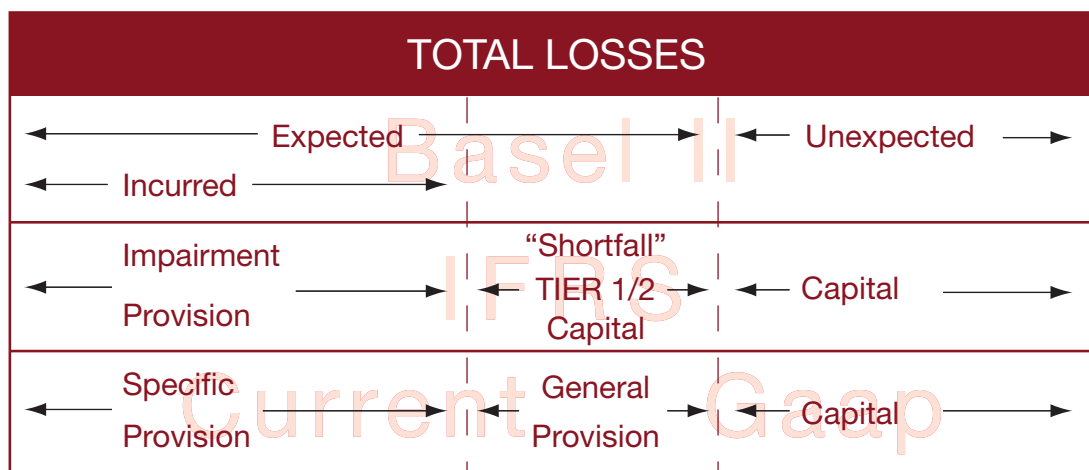


Figure 1:



where it suggested that banks will need to compare the Basel II expected loss calculation with the total amount of provisions they have made. Any 'shortfalls' (where the expected loss exceeds the total provision) must be deducted from capital (50% from Tier 1 and 50% from Tier 2) and any 'excesses' (where the total provision exceeds the expected loss) may be eligible as Tier 2 capital.

It is therefore clear that the calculation of expected losses is still relevant to the Basel IRB capital calculation in order to identify these shortfalls or excesses. Unless a bank has explicitly captured expected losses within its future margin income and can demonstrate this to be the case, the regulator

will need to understand the amount of cushion that is in place to manage expected losses - either within capital or as part of provisions. In theory the regulator should not mind where this cushion for expected losses is positioned - future margin income, provision or capital - just as long as it is somewhere!

The incurred versus expected loss debate

Whilst the debate around 'incurred' versus 'expected' loss models has intensified, the revised IAS 39 issued by the International Accounting Standards Board ('IASB') in December 2003 has helped to shed light on some of the differences between the incurred and expected loss concepts.

IAS 39 now clearly states that the provisioning model it refers to is an incurred loss model, although this still allows for impairment provisions to be raised on portfolios of loans where there is observable data to suggest that there is a deterioration in the expected cash flows from these assets since they were initially recognised. The standard provides two examples of 'triggers' for this deterioration: one relates to changes in economic conditions and the other to changes in the payment status of borrowers which, on aggregate, may often be referred to as 'incurred but not reported' losses (see Figure 2).

'an expected loss is not the same as an incurred one'

Despite the recent changes in the Basel II requirements, the distinction between incurred and expected losses is still relevant - an expected loss is not the same as an incurred one, or even an 'incurred but not reported one'. An incurred loss at the balance sheet date is one where the trigger event that gives rise to an impairment loss has already happened whereas an expected loss is one that is anticipated, irrespective of whether the trigger event has taken place at the balance sheet date. So if, at the balance sheet date, a bank *expects* a certain trigger event to take place, (for example, a rise in unemployment rates) it would include the consequences of this trigger event (in other words, an increase in losses) under an expected loss model, but not under an incurred loss model.

Consequently there are clear differences between the objectives of the two models. Basel II works on statistical modelling of expected losses while IFRS, although allowing statistical models, requires a trigger event to have occurred before they can be used. IAS 39 specifically states that losses that are expected as a result of future events, 'no matter how likely', are not recognised. This is a clear and fundamental area of difference between the two frameworks.

Although the requirements of IAS 39 imply that conditions need to have changed since the exposure was granted for a trigger event to have taken place, it introduces the concept of 'incurred but not reported'. This implies that banks can provide for losses that have not yet crystallised but are likely,

based on past experience, to have been incurred at the balance sheet date. Some banks may view this as the bridge between the IFRS incurred loss provision and the Basel II capital charge, but it does not follow that all expected losses for the following year are incurred at the balance sheet date. Under IFRS banks will have to identify the events that have occurred before the balance sheet date which will cause impairment and they will require empirical evidence to correlate these events to a likely level of loss. Basel II also requires empirical evidence but does not require trigger events to be specifically identified.

Key definitions

In order to identify the similarities and differences between the two approaches, it is helpful to look at the definitions of 'default' under Basel II and 'impairment' under IFRS. It is clear that a Basel II default and an IFRS impairment are similar (see Figure 3).

Figure 2:

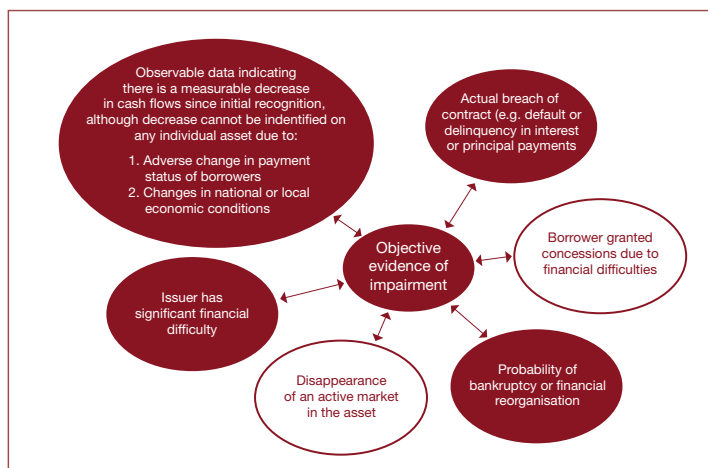


Figure 3:

Default definition under Basel II	IFRS impairment indicators
It is determined that the obligor is unlikely to pay its debt obligations (principal, interest or fees) in full.	There is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the asset.
A credit loss event associated with any obligation of the obligor, such as a charge-off, specific provision or distressed restructuring involving the forgiveness or postponement of principal, interest or fees.	Granting of a concession to the borrower.
The obligor is past due more than 90 days on any credit obligation.	Actual breach of contract (i.e. one missed payment).
The obligor has filed for bankruptcy or similar protection from creditors.	Significant financial difficulty of the borrower or probability of bankruptcy or other financial reorganisation of the borrower.
No specific reference to economic conditions as a default trigger, but requires different scenarios to be modelled.	Observable data indicating there is a measurable decrease in the estimated cash flows from a group of assets since their initial recognition due to: <ul style="list-style-type: none"> • adverse changes in the payment status of the borrowers in the group; or • a deterioration in national or local economic conditions that correlate with defaults on the assets in the group.

Is it just a matter of timing?

It is clear from Figure 3 that the significant difference between the two definitions relates to timing. Basel II defines default as the obligor being 90 days past due on the obligation (expanded to 180 days for some products) whereas IFRS refers to

actual breach of contract; technically one missed capital or interest payment. On the face of it IFRS is more conservative but in fact Basel II takes into account all defaults that are likely to occur in the next twelve months while IFRS only recognises impairments incurred up to the balance sheet date.

‘formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets’

IFRS also allows an economic trigger as an indication that impairment may be present in a group of assets. IAS 39.59(f)(ii) states that an adverse change in national or local economic conditions that correlates with defaults on the assets in the group should be used as a basis for determining that there is a measurable decrease in their estimated cash flows. Although the Basel II guidance in this area is not so clearly defined, neither regulators nor banks wish to see volatile movements in the level of capital held arising from changes in economic conditions. Basel II therefore seeks to provide a stable level of capital over the economic cycle whilst IFRS seeks to reflect economic volatility in provision levels. The level of capital in place should be able to cover unexpected losses in adverse economic conditions, in other words, there should be enough of a capital buffer in place to cover losses arising on worst case scenario economic conditions and there is an expectation from the regulators that banks, especially those adopting the requirements of Pillar 2, will scenario and stress test their capital assessments and capital allocation mechanisms to achieve this.

Banks will therefore need to define what they consider to be the economic drivers that

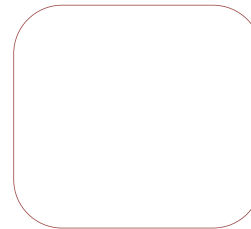
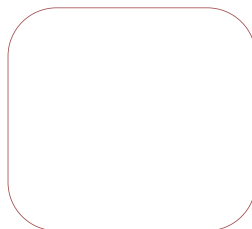
impact both their loss rates as well as the probability that their customers will default. These may include economic factors such as interest rates, unemployment levels and average national or regional house prices. As part of the data collation exercise that they will need to undertake in order to build their historical loss experience for both capital and provision calculations, they should also seek to factor the impact of these economic drivers into their calculations so that a range of loss experience can eventually be built that covers a number of economic scenarios. This form of scenario analysis to reflect current and future economic conditions has been a point of debate between the industry and regulators for a number of years and there is currently no industry-wide approach to stress testing.

Synergies, similarities and differences

IAS 39.AG92 appears to recognise that there will clearly be significant synergies between the two approaches by stating that ‘formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets’ although it does go on to specify that the model should

incorporate ‘the cash flows for all of the remaining life of the asset, (not only the next year)’. Further to say that it should ‘not give rise to an impairment loss on initial recognition’. It can clearly be inferred that the IASB acknowledges that a model based approach may be utilised, and that this model can use data collected for Basel II purposes. However there are clearly some definitional differences that are likely to prevent banks from inserting Basel II data cleanly into the IFRS model.

As previously discussed, one of these significant differences is the point at which an asset is considered to be impaired or defaulted. Others include the precise elements of what makes up a ‘loss’ – under Basel II it is defined as economic loss and will include the direct and indirect costs associated with collecting on the exposure, such as allocations of internal overheads and other non-cash costs. Under IFRS an impairment loss is defined as the difference between the carrying value of the loan and the present value of the expected cash flows discounted at the effective interest rate. Clearly non-cash transactions such as late payment charges or indirect costs such as the overheads of a collections department will not form part of the impairment loss



but would be included in a Basel II 'loss given default'. The loss given default requires the inclusion of a cost of capital but IFRS specifically states that the discount rate to be used is the same 'Effective Interest Rate' that is used to recognise income on the asset at the outset, i.e. before it was impaired.

Another key difference arises with the use of the 'Exposure at Default' under the Basel II calculation. On a financial asset with a limit facility (for example a committed loan facility or an overdraft), this 'Exposure at Default' will take into account an expectation of future drawdowns until the default event has occurred by utilising a credit conversion factor. However under IFRS and its incurred loss concept, it is the loan amount outstanding at the balance sheet date that is considered in the calculation and not any future movements and drawdowns, as this could be construed as providing for future losses. Future drawdowns to which a bank is committed would need to be considered separately under IAS 37.

Despite these differences, there are substantial similarities between the two models which mean that the underlying data requirements of the two approaches will also be similar.

For example, both approaches require collateral to be taken into account when estimating the 'loss' that will crystallise. On first reading, it appears that the Basel II approach requires data on losses while the data requirements of IFRS relate to cash flows. However the cash flows that are not received under an IFRS impairment are likely to be very similar to the loss that is crystallised on a Basel II default, subject to the differences noted above. Therefore a model that values cash flows not expected to be received will equate to one that values the cash flows still expected to be received. Many banks are therefore proposing to utilise the loss data collated for the purposes of Basel II in order to estimate the lost cash flows arising on a group of impaired assets. In order to use the Basel II loss data as an approximation for the lost cash flows required by the IFRS model, banks must not lose sight of the timing of these lost cash flows. The Basel II loss will not necessarily equal the net present value of the lost cash flows.

Conclusion

The IFRS-incurred model may be summarised as the expected loss on a loan or portfolio of loans as a result of a particular trigger that has already occurred. Consequently, there are clearly

similarities between the two frameworks and banks will need to leverage as many synergies as possible from the massive data requirements that the implementation of both will necessitate. There will be significant data overlaps and it is likely that the calculation engine generating the numbers will need to be flexible enough to cope with the demands of two methodologies with two different objectives.

Although it would appear that the underlying Basel II data could potentially, with suitable adjustments and further analysis, be used for impairment provisioning under IFRS, the work required and therefore the costs involved in making these adjustments could still be substantial. However, the cost of implementing IFRS in isolation from Basel II would be significantly more. As mentioned previously, the European banking sector is already likely to have to spend over \$6 billion to achieve compliance with Basel II – it should be doing its utmost to avoid spending another small fortune on achieving compliance with IFRS.

PricewaterhouseCoopers

If you would like to discuss any of the issues raised in this paper, please speak with your usual contact at PricewaterhouseCoopers or one of the contacts listed below:

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