In depth
A look at current financial reporting issues

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Basel Committee guidance on accounting for expected credit losses for banks

At a glance

In December 2015, the Basel Committee on Banking Supervision ('the Committee') issued its Guidance on credit risk and accounting for expected credit losses ('the Guidance'). The Guidance sets out supervisory guidance on sound credit risk practices associated with the implementation and ongoing application of expected credit loss (ECL) accounting frameworks, such as that introduced in IFRS 9, Financial Instruments.

The Committee expects a disciplined, high-quality approach to assessing and measuring ECL by banks. The Guidance emphasises the inclusion of a wide range of relevant, reasonable and supportable forward looking information, including macroeconomic data, in a bank's accounting measure of ECL. In particular, banks should not ignore future events simply because they have a low probability of occurring or on the grounds of increased cost or subjectivity.

In addition, the Guidance notes the Committee's view that that the use of the practical expedients in IFRS 9 should be limited for internationally active banks. This includes the use of the 'low credit risk' exemption and the 'more than 30 days past due' rebuttable presumption in relation to assessing significant increases in credit risk.

We would encourage banks to talk to their local regulator about the extent to which their regulator expects the guidance to apply to them.

This In depth focusses primarily on the accounting aspects of the Guidance, rather than the governance or supervisory matters raised in the Guidance.

Background

In July 2014, the IASB issued the complete version of IFRS 9, Financial Instruments, which is effective for accounting periods beginning on 1 January 2018.[1] IFRS 9 replaces IAS 39's incurred loss impairment approach, with a new forward looking expected credit loss (ECL) approach to impairment provisions for financial assets.

[1] IFRS 9 has yet to be endorsed by the EU.

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Further details about the new ECL model in IFRS 9 are included in our In depth INT 2014-06 IFRS 9: Expected Credit Losses.

The Basel Committee on Banking Supervision ('the Committee') issued its 'Guidance on credit risk and accounting for expected credit losses' in December 2015. This sets out supervisory guidance on sound credit risk practices associated with an ongoing application of ECL accounting frameworks, such as that introduced by IFRS 9.

The Committee's Guidance replaces its existing guidance on 'Sound credit risk assessment and valuation for loans' that was issued in June 2006. Furthermore, it builds on, and takes into account many of the comments raised on, the preceding Consultation Draft published in February 2015.

Objective

The objective of the Guidance is to achieve sound credit risk practices with regard to ECL accounting frameworks.

The Guidance provides banks with supervisory guidance on how the ECL accounting model should interact with a bank's overall credit risk practices and regulatory framework, but does not set out any additional requirements on expected loss provisioning for regulatory capital purposes.

The Guidance states that it does not contradict the applicable accounting standards established by accounting standard setters, but instead gives the Committee's view of the appropriate application of those standards. Included is an Appendix specifically about the application of IFRS 9's impairment requirements.[2]

PwC observation:

Banks are required to comply with accounting standards. This Guidance is intended to complement IFRS 9, although it may have the effect of reducing the options available to banks within IFRS 9.

We observe that the Guidance does not comment on all the impairment requirements in IFRS 9 (for example, the Guidance does not refer to the use of changes in the risk of a default occurring over the next 12 months as a reasonable approximation of the changes in the lifetime risk of default occurring for assessing significant increases in credit risk). Furthermore, as implementation projects progress and practice develops over time, more detailed considerations will arise that are not covered by the Guidance.

The implementation of IFRS 9's impairment requirements will require an investment in both resources and system developments and upgrades. However, given the considerable time allowed to transition to the new accounting requirements, the Committee has significantly heightened supervisory expectations that internationally

[2] The Guidance is also applicable to banks applying the US Financial Accounting Standards Board's (FASB's) proposed standard on expected credit losses, which was not yet final at the time of publication.

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active banks will have a high-quality implementation of an ECL accounting framework.

The Committee emphasises the importance of consistent interpretations and practices within and across jurisdictions where the same accounting framework is applied and where there are commonalities across different ECL accounting frameworks. This includes providing disclosures that facilitate comparisons with a bank's peers. The Guidance emphasises the need to regularly review disclosure policies to ensure that the information disclosed is relevant to the bank's risk profile, product concentrations, industry norms and current market conditions.

PwC observation:

Banks will need to consider what their peers are doing to help achieve consistency of implementation of the new ECL requirements. For example, are banks with access to the same information about future events, consistently considering that information in respect of portfolios with similar credit risk characteristics? However, we note that, despite this, banks may make different judgements depending upon their specific facts and circumstances. We expect consistency of implementation of IFRS 9 to be an evolving process over time.

In addition, banks should have regard to the recommendations of the Enhanced Disclosure Task Force (EDTF), which will help with consistency of disclosures. For further information see our In brief INT2016-02 EDTF recommends IFRS 9 impairment disclosures for banks.

Scope

The Guidance states that its focus is on lending exposures, such as loans, loan commitments and financial guarantee contracts, to which the impairment requirements apply.

PwC observation:

The Committee's focus on lending exposures is narrower than the scope of the impairment requirements in IFRS 9. For example, debt securities, which are commonly found in liquidity portfolios and in asset portfolios backing insurance contracts, may be outside the scope of the Guidance. Aspects of the Guidance that have the effect of limiting the application of some of the options in IFRS 9 that would otherwise be permitted (such as the 'low credit risk' practical expedient in IFRS 9 which simplifies the assessment of significant increases in credit risk) may not apply to such instruments.

We recommend that banks talk to their local regulators to clarify which financial assets are expected to be in the scope of the Guidance in their jurisdiction.

The Guidance refers generally to banks, although it does also specifically refer to internationally active banks. More generally, as noted in the Committee's Charter, its published guidelines are particularly aimed at internationally active banks.

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PwC observation:

The Guidance clearly applies to internationally active banks, rather than small domestic banks. However there is a grey area in the middle, which includes large more sophisticated banks that are not internationally active, where the scope of the Guidance is unclear. We recommend that such banks talk to their local regulator to determine the extent to which their regulator expects the Guidance to apply to them.

Principles underlying the Guidance

The guidance is structured around 11 principles: 8 concerning supervisory guidance for credit risk and accounting for ECLs and 3 concerning the supervisory evaluation of credit risk practices, accounting for ECLs and capital adequacy. These underlying principles are summarised in the Appendix to this In Depth.

Application of the ECL requirements in IFRS 9

In accordance with IFRS 9, at the reporting date a bank must assess whether the credit risk on a financial instrument has increased significantly since initial recognition, considering all reasonable and supportable information, including that which is forward looking. The objective of the impairment requirements in IFRS 9 is to recognise lifetime ECL for all financial instruments for which there have been significant increases in credit risk since initial recognition ('stage 2' assets). However, if at the reporting date the credit risk on a financial instrument has not increased significantly since initial recognition (a 'stage 1' asset), a bank will measure the loss allowance at an amount equal to 12-month ECL.

IFRS 9 requires that a bank should measure (both lifetime and 12-month) ECL in a way that reflects: an unbiased and probability-weighted amount that is determined by evaluating a range of outcomes; and reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions.

Below we consider some of the key accounting aspects of the Guidance (general and IFRS 9 specific), as follows:

- Proportionality, materiality and symmetry.
- Reasonable and supportable information (including the consideration of forward looking information).
- Grouping of exposures.
- Credit risk grades.
- Assessment of significant increases in credit risk.
- Measurement of ECL.
- Use of practical expedients.

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Proportionality, materiality and symmetry

The Guidance acknowledges the importance of materiality, and allows proportionate approaches to be adopted provided that this does not jeopardise the high quality implementation of IFRS 9. The Guidance discusses the use of approaches to ECL estimation that would generally be regarded as an approximation to "ideal" measures. This should enable banks to adopt allowance methodologies for the various different credit exposures they have commensurate with the size, complexity, structure, economic significance, risk profile of those exposures and any other relevant facts and circumstances. However, the use of approximation methods should not introduce bias. Furthermore, the Guidance cautions that individual exposures or portfolios should not be considered immaterial if, cumulatively, they represent a material exposure to the bank.

PwC observation:

While applying materiality and proportionate approaches is clearly a judgemental area, the Guidance appears to acknowledge that, even within larger banks, there may be some portfolios where it may be appropriate to make more use of approximation methods. This may include, for example, smaller portfolios in less data rich jurisdictions.

As well as considering cumulative materiality, banks should also consider whether such approximation methods will remain appropriate in potentially more stressed economic conditions in the future.

The Guidance also recognises that the ECL framework in IFRS 9 is symmetrical, such that subsequent changes (both deteriorations and reversals of those deteriorations) in the credit profile of a debtor should be considered.

Reasonable and supportable information

IFRS 9 requires banks to use a wide range of information about past events, current conditions and forecasts of future economic conditions. Information which is included in the assessment of credit risk and measurement of ECL should be reasonable and supportable and relevant to the particular product, borrower, business model or regulatory and economic environment related to the lending exposure being assessed. Banks should use their experienced credit judgment in determining the range of relevant information that should be considered and in determining whether information is considered to be reasonable and supportable.

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PwC observation:

The need for sound judgement is particularly key when considering what forward looking information is reasonable and supportable. This issue was discussed by the IASB's Transition Resource Group for Impairment of Financial Instruments (ITG) at its meeting in September 2015. As noted by the ITG, judgement is needed to strike a balance between:

- inappropriately excluding forward looking information that is relevant; and
- including all views on future possibilities, including those of a speculative nature that have no or little basis.

For more information about the ITG's discussion see our In transition INT2015-02 Transition Resource Group debates IFRS 9 impairment implementation issues.

Consideration of forward looking information

The Guidance highlights that the consideration of forward looking information, including macroeconomic factors, is a distinctive feature of the ECL model and is critical to the timely recognition of ECL. Banks should employ sound judgement consistent with generally accepted methods for economic analysis and forecasting.

The Guidance emphasises that forward looking events and information should not be ignored:

- simply because they have a low probability of occurring;
- because the effect on credit risk or the amount of ECL is uncertain; or
- on the grounds of increased cost or subjectivity.

The Committee notes that as credit risk is a core competence of banks, it expects that a bank's consideration of forward looking information will be supported by a sufficient set of data. This means that, in the Committee's view, banks should not claim that they cannot obtain reasonable and supportable forward looking information because to do so would take 'undue cost and effort'. The Guidance emphasises that delinquency data, which is backward looking, will seldom on its own be appropriate in the implementation of IFRS 9's impairment requirements by banks.

PwC observation:

The extent to which banks already have and use forward looking information will vary by bank and by portfolio of financial asset. However one of the key implementation issues in practice is how to ensure that a bank has sufficient forward looking information, and uses both its existing data and data from new sources, when assessing significant increases in credit risk and measuring ECL.

The Committee does not view the unbiased consideration of forward looking information as speculative, but acknowledges that in certain, exceptional circumstances, information may not be reasonable and supportable and so should be excluded from the ECL assessment and measurement process. In such circumstances the Committee expects banks to provide a clearly documented robust justification.

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PwC observation:

This has particular relevance for one-off uncertain events, for example a future referendum about the independence of a territory (eg at its meeting in September 2015, the ITG discussed the referendum in Scotland for independence from the UK).

What constitutes an 'exceptional circumstance' is unclear and could be viewed differently by a regulator than by a bank. We note that the more uncertain the effect on credit risk of such a future event is, the less supportable the forward looking information becomes.

The Guidance highlights that forward looking information, including economic forecasts, should be consistent with information used in managing and reporting by the bank (eg financial statements, budgets, strategic and capital plans). However the Committee recognises that stressed scenarios developed for industry-wide regulatory purposes are not intended to be used directly for accounting purposes.

PwC observation:

Downturn scenarios used for capital and stress testing for regulatory purposes may not be relevant for determining ECL for accounting purposes. This is because ECL should be an unbiased estimate that is determined by evaluating a range of possible outcomes.

However it may be helpful to understand the differences between what is used for capital purposes and what is needed for an ECL estimate in accordance with IFRS 9. For example, through the cycle probability of default (PD) approaches are used for regulatory purposes, whereas point in time PDs should be used for IFRS 9 ECL calculations.

For some lending exposures, banks may find it difficult to incorporate the impact of forward looking information, including macroeconomic forecasts, into assessments for individual borrowers. In such cases they may instead incorporate forward looking information on a collective basis. However, where reasonable and supportable forward looking information has been incorporated in the individual assessment of ECL, an additional forward looking assessment should not be conducted on a collective basis if that could result in double counting.

PwC observation:

It is also important not to double count the effect of forward looking information in both the models used to determine ECL and any overlays used to incorporate information otherwise not captured through the modelling. However determining the extent of any potential double counting may not always be obvious. For example, geopolitical uncertainty due to increased tension in a specific region may well be included in macroeconomic forward looking information, but could also inherently be included to some extent in historical PDs.

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The Committee expects banks to provide qualitative disclosures on how forward looking information has been incorporated into ECL estimates, in particular when the assessment is carried out on an individual basis.

PwC observation:

Determining what forward looking information is relevant, reasonable and supportable and how to incorporate that information into the estimate of ECL can be highly judgmental and can have a significant effect on the level of ECL provisions. This highlights the importance of meaningful disclosures in the financial statements, as well as good governance, controls, due process and robust analysis in this area.

Grouping of exposures

Where significant increases in credit risk or the resulting measurement of a loss allowance is performed on a collective basis, IFRS 9 requires portfolios of financial assets to be grouped on the basis of shared credit risk characteristics. The objective is to enable significant increases in credit risk to be identified on a timely basis.

The Guidance highlights that groups of financial instruments should be sufficiently granular. Exposures must not be grouped in such a way that an increase in the credit risk of particular exposures is masked by the performance of the group as a whole.

The Guidance notes the need for re-evaluating and re-segmenting the grouping of exposures if relevant new information is received, or the bank's changed expectations of credit risk suggest that a permanent adjustment is warranted.

PwC observation:

Banks will need a mechanism for managing the ongoing re-evaluation and re-segmentation of groups of financial instruments. As emphasised in the Guidance movements between portfolios are only needed when there is new information and a permanent move is considered necessary, which should help prevent unnecessary or excessive changes to portfolios.

Credit risk grades

The Guidance notes that credit risk grades should be reviewed whenever relevant new information is received or a bank's expectation of credit risk has changed. In addition, credit risk grades should be formally reviewed at least annually, and more often for higher risk grades, so that they are accurate and up to date.

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PwC observation:

IFRS 9 requires ECL to reflect information that is available at the reporting date. However updating all credit gradings at the reporting date may not be practical, particularly for large corporate exposures. Furthermore, information available for credit risk grade reviews could be some months out of date. These factors highlight the need to establish procedures to identify relevant new information since the last formal credit risk review and incorporate it into the assessment of significant increases in credit risk and measurement of ECL at the reporting date. This is consistent with the discussion of the ITG during its meeting in April 2015 (as discussed in our In transition INT2015-01 ITG holds first meeting since issuance of IFRS 9). We expect that this may require enhancements to credit risk processes in many banks.

Assessment of significant increases in credit risk

The Guidance notes that the timely determination of whether there has been a significant increase in credit risk is crucial. Banks should have processes in place to achieve this, combined with strong governance, systems and controls, which are able to handle and assess large amounts of information.

IFRS 9 requires that when making the assessment of significant increases in credit risk since initial recognition an entity shall use the change in the risk of default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses. In other words, this assessment is made in terms of the risk of a default occurring and not expected credit loss (ie before the consideration of the effects of credit risk mitigants such as collateral or guarantees).

Definition of default

IFRS 9 does not define default, but requires entities to apply a default definition that is consistent with the definition used for internal credit risk management purposes and considers qualitative indicators (for example, financial covenants) when appropriate. However, there is a rebuttable presumption in IFRS 9 that default does not occur later than when a financial asset is 90 days past due. To rebut this presumption an entity needs reasonable and supportable information that demonstrates that a more lagging default criterion is more appropriate.

The Committee recommends that the definition of default used for IFRS 9 be 'guided by' the definition used for regulatory purposes. The default definition in the Basel capital framework combines a qualitative 'unlikeliness to pay' criterion with an objective '90 days past due' criterion. The 'unlikeliness to pay' criterion permits identification of default before the exposure becomes delinquent, with the '90 days past due' criterion acting as a backstop.

For regulatory purposes a supervisor may substitute a figure up to 180 days past due for different products. However the Guidance notes that this possibility should not be read as an exemption from the application of the 90 days past due rebuttable presumption in IFRS 9.

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PwC observation:

It is not entirely clear what is meant by being 'guided by' the default definition used for regulatory purposes. However, it is clear from IFRS 9 that the 90 days past due rebuttable presumption cannot be rebutted solely on the grounds that more than 90 days past due (eg 180 days past due) is used for regulatory purposes. A key point is that banks should be able to justify, with appropriate analysis and evidence:

- using a different definition of default for accounting purposes than that used for regulatory purposes; and
- rebutting the IFRS 9 90 days past due presumption, even when 180 days past due is used for regulatory purposes.

Use of PDs and movements in credit grading systems

IFRS 9 states that the significance of a change in credit risk since initial recognition should be assessed against the risk of a default occurring at initial recognition. The guidance notes that where a bank uses changes in PD as a means of identifying changes in the risk of a default occurring, the significance of a given change in PD can be expressed as a ratio (or the rate of fluctuation) proportionate to the PD at initial recognition, as follows:

$$S\ (\Delta CR) = \frac{\Delta PD}{PD_0}$$

where S (ΔCR) is the significance of a change in credit risk; ΔPD the change in PD since initial recognition (ie the PD at the reporting date less the PD at initial recogition); and PD_0 is the PD at initial recognition of a particular lending exposure.

However, the Committee also acknowledges that the "width" of the change in PD itself (ie PD at the reporting date minus PD at initial recognition) should also be taken into consideration.

PwC observation:

The IFRS 9 impairment model is based on an assessment of relative increases in credit risk since initial recognition. Provided that this objective is met, IFRS 9 does not specify particular methods for assessing significant increases in credit risk.

The Committee's acknowledgement that the width of the change in PD should be taken into consideration as well as the proportionate change, since initial recognition, is helpful. This is because it shows some sympathy for the use of alternative approaches where the objectives of IFRS 9 are still met, as appropriate depending upon the particular facts and circumstances.

The Guidance notes that, as illustrated in IFRS 9, it is possible to set a maximum credit risk for particular portfolios upon initial recognition that would lead to assets within that portfolio moving to lifetime ECL when credit risk increases beyond that maximum level. However this is an example of the application of the principle of a relative increase in credit risk in the Standard, rather than an exception to that principle. The Committee notes that this simplification is only relevant when exposures are segmented on a sufficiently granular basis such that the bank can

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demonstrate that a significant increase in credit risk had not occurred for items in the portfolio before the maximum credit grade was reached.

The guidance emphasises that banks need to look beyond how many 'notches' or 'grades' a rating downgrade entails. Particular attention has to be paid to internal or external rating systems and their granularity, as a change in PD for a one-notch movement may not be linear and a significant increase in credit risk could occur prior a movement in the credit grade.

PwC observation:

It may be appropriate to use movements between internal credit risk grades as a means of identifying significant increases in credit risk when an entity derives internal credit risk grades by taking into account all reasonable and supportable information, the grades are sufficiently granular and the portfolios of lending exposures appropriately segmented. However, not all movements between credit risk grades will carry the same weight when evaluating whether there has been a significant increase in credit risk since initial recognition.

The Guidance observes that 'significant' should not be equated with statistical significance and should not be based solely on quantitative analysis. For portfolios which have a large number of individually small credits and a rich set of historical data, it may be possible to identify significant increases in credit risk in part by using formal statistical techniques. However for other exposures, that may not be feasible.

In addition the Guidance notes that 'significant' should not be judged in terms of the extent of impact on a bank's primary financial statements. This is because the identification and disclosure of increases in credit risk are likely to be as important to users seeking to understand trends in the intrinsic credit risk of a bank's loans, even when there is no impact on the allowance made, for example, because the exposure is fully collateralised.

Renegotiated or modified loans

For modified loans that do not result in derecognition, IFRS 9 requires that a bank must assess whether there has been a significant increase in credit risk by comparing the risk of default occurring at the reporting date based on the modified contractual terms with the risk of default occurring at initial recognition based on the original, unmodified, contractual terms.

The Guidance notes that modifications or renegotiations can mask increases in credit risk. Modified or renegotiated loans that have not been derecognised should not move back to stage 1 unless there is sufficient evidence that the credit risk over the life of the exposure has not increased significantly compared with that at initial recognition. The Committee emphasises that typically a customer would need to demonstrate consistently good payment behaviour over a period of time on the revised terms before credit risk is considered to have decreased. For example, a history of missed or incomplete payments would not typically be erased by simply making one payment on time following a modification of the contractual terms.

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PwC observation:

The Guidance implies that a track record of payments is needed to move modified or renegotiated loans from stage 2 to stage 1. We observe that individual regulators may have differing views as to what a 'reasonable period of time' may be.

In contrast, a modified or renegotiated loan that is derecognised is treated as a new loan. Such modified loans would be in stage 1 (unless it is credit-impaired on origination), until there was a further significant increase in credit risk from the date of the modification or renegotiation. This distinction highlights the importance of appropriately determining whether a modification or renegotiation results in the derecognition of the loan.

Measurement of ECL

The Committee expects that a bank will always measure ECL for all lending exposures. A nil allowance will be rare because ECL estimates should always reflect the possibility that a credit loss will occur.

PwC observation:

While it would be usual to expect ECL estimates to have some value, we observe that nil allowances may be appropriate in certain circumstances. For example, nil allowances may be appropriate for mortgage loans that are over collateralised based on both current and reasonably expected property values over the remaining life of the loan, and after taking account of any relevant adjustments such as forced sale discounts.

Temporary adjustments

The Guidance notes that temporary adjustments to the allowance are adjustments that may be used when it becomes evident that existing or expected risk factors have not been considered in the credit risk rating and modelling process. Such temporary adjustments might arise in short-term circumstances, or when there is insufficient time to appropriately incorporate relevant new information into the existing credit risk system, or to resegment existing groups of lending exposures, or when lending exposures within a group react to factors or events differently than initially expected.

The Committee expects that such adjustments would be used only as a temporary solution and that it is not appropriate to continually use a temporary adjustment for a continuing risk factor over the long term. Instead the Guidance notes that the bank's allowance methodology should be updated in the near term to incorporate the factor that is expected to have an ongoing impact on the measurement of ECL.

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PwC observation:

A distinction should be made between:

- temporary adjustments that arise for the reasons set out above and that will in due course be incorporated into the underlying modelling; and
- other management 'overlays' that are macro adjustments made as part of the modelling and estimation process, with this being the most appropriate way to incorporate some types of information into the ECL estimate.

We note that IFRS 9 does not stipulate specific methods for measuring ECL, provided that the objectives in the standard are met.

12-month ECL

IFRS 9 requires that if at the reporting date the credit risk on a financial instrument has not increased significantly since initial recognition (ie the instrument is in 'stage 1'), an entity shall measure the loss allowance at an amount equal to 12-month ECL. IFRS 9 defines 12-month ECL as the portion of lifetime ECL that represent the ECL that result from default events on a financial instrument that are possible within the 12 months after the reporting date. The Committee emphasises that 12-month ECL should not only include the expected losses in the next 12 months, but also the expected cash shortfalls over the life of the lending exposure due to loss events that could occur within the next 12 months.

Use of practical expedients

IFRS 9 includes a number of practical expedients, intended to ease the implementation burden for the wide range of entities that will apply IFRS 9.

The Committee expects that the use of the following three practical expedients by internationally active banks to be limited. This is because, given their business, the cost of obtaining the relevant information is not considered by the Committee likely to involve 'undue cost or effort'.

The information set

IFRS 9 states that an entity should consider reasonable and supportable information that is available 'without undue cost or effort' and that an entity 'need not undertake an exhaustive search for information'. However, the Committee expects banks not to read these statements restrictively.

The Committee expects banks to develop systems and processes that use all reasonable and supportable information, including forward looking information, that is relevant to the group or individual exposure, as needed to achieve a high quality, robust and consistent implementation of IFRS 9. Although this may require costly upfront investments in new systems and processes, the Committee considered that the long term benefit of a high quality implementation far outweighs the associated costs, which should not be considered undue. Nevertheless, the Committee does not expect additional cost and operational burden to be introduced where it does not contribute to a high quality implementation of IFRS 9.

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PwC observation:

As previously mentioned, obtaining reasonable and supportable information, including forward looking information, will be a key area of focus when implementing IFRS 9. If a bank does not currently have sufficient data for the purposes of IFRS 9, it can start collecting more data now. For example, in a number of territories, there is industry, credit bureau and rating agency data that is available to be purchased.

Low credit risk exemption

IFRS 9 permits a bank to assume, without further analysis, that the credit risk on a financial instrument has not increased significantly since initial recognition if the financial instrument is determined to have 'low credit risk' at the reporting date. An external rating of 'investment grade' is an example of a financial instrument that may be considered as having low credit risk.

The Committee expects that the use of this exemption should be limited, so that a loan should always be moved to stage 2 if there is a significant increase in credit risk. In the Committee's view, in order to achieve a high quality implementation of IFRS 9, any use of the low credit risk exemption must be accompanied by clear evidence that the credit risk at the reporting date is sufficiently low that a significant increase in credit risk since initial recognition could not have occurred.

Furthermore, the Committee is of the view that all lending exposures that have an external 'investment grade' rating cannot automatically be considered low credit risk.

PwC observation:

The need for clear evidence to justify using the low credit risk exemption, so that a significant increase in credit risk is not overlooked, may mean the exemption in IFRS 9 is not much of a relaxation in practice for internationally active banks in respect of their loan portfolios.

More than 30 days past due rebuttable presumption

IFRS 9 contains a backstop rebuttable presumption that the credit risk of a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. An entity can rebut this presumption if it has reasonable and supportable information, that is available without undue cost or effort, that demonstrates that the credit risk has not increased significantly since initial recognition, even though the loan is more than 30 days past due.

To ensure the timely detection of increases in credit risk, the Committee does not expect an internationally active bank to use the more than 30 days past due rebuttable presumption as a primary indicator of a significant increase in credit risk. However the appropriate use of this rebuttable presumption as a backstop measure, alongside other earlier indicators for assessing significant increases in credit risk, would not be precluded.

The Committee expects that if an internationally active bank rebuts the more than 30 days past due presumption, it will provide a thorough analysis clearly evidencing that 30 days past due is not correlated with a significant increase in credit risk.

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What's next?

Banks will need to consider the implications of the Guidance from the perspective of accounting, systems and processes, governance and control aspects, and the extent to which they need to incorporate it into their IFRS 9 implementation programmes. In doing so, banks will need to consider the views of their local regulators.

The Guidance has the greatest implications for internationally active banks, for example, in respect of the limitations over the use of the practical expedients in IFRS 9 and the Committee's expectation that temporary adjustments that are ongoing should be incorporated into a bank's modelling process. However other large and more sophisticated banks should also consider the extent to which the Guidance applies to them and consult their local regulators in this regard.

PwC observation:

Implementing the impairment requirements in IFRS 9 involves significant management judgements, new data and changes to processes, systems, and governance and control procedures. It is important not to underestimate the time, resource and effort needed to implement IFRS 9.

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Appendix

Principles underlying the Guidance

Supervisory guidance for credit risk and accounting for expected credit losses

Principle	Description
Principle 1 Responsibility	• A bank's board of directors and senior management are responsible for ensuring appropriate credit risk practices, including an effective system of internal control, to consistently determine adequate allowances.
Principle 2 Methodology	• The measurement of allowances should build upon robust methodologies to address policies, procedures and controls for assessing and measuring credit risk • Banks should clearly document the definition of key terms and criteria to duly consider the impact of forward-looking information including macro-economic factors, different potential scenarios and define accounting policies for restructurings
Principle 3 Credit Risk Rating	• A bank should have a credit risk rating process in place to appropriately group lending exposures on the basis of shared credit risk characteristics
Principle 4 Allowances adequacy	• A bank's aggregate amount of allowances should be adequate and consistent with the objectives of the applicable accounting framework • Banks must ensure that the assessment approach (individual or collective) does not result in delayed recognition of ECL, e.g. by incorporating forward-looking information incl. macroeconomic factors on collective basis for individually assessed loans
Principle 5 Validation of models	• A bank should have policies and procedures in place to appropriately validate models used to assess and measure expected credit losses
Principle 6 Experienced credit judgment	• Experienced credit judgment in particular with regards to forward looking information and macroeconomic factors is essential • Consideration of forward looking information should not be avoided on the basis that banks consider costs as excessive or information too uncertain if this information contributes to a high quality implementation
Principle 7 Common systems	• 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
Principle 8 Disclosure	• A bank's public disclosures should promote transparency and comparability by providing timely, relevant, and decision-useful information

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Supervisory evaluation of credit risk practices, accounting for expected credit losses and capital adequacy

Principle	
Principle 9 Assessment of Credit Risk Management	• Banking supervisors should periodically evaluate the effectiveness of a bank's credit risk practices
Principle 10 Approval of Models	• Supervisors should be satisfied that the methods employed by a bank to determine accounting allowances lead to an appropriate measurement of expected credit losses
Principle 11 Assessment of Capital Adequacy	• Banking supervisors should consider a bank's credit risk practices when assessing a bank's capital adequacy

Questions?

PwC clients who have questions about this *In depth* should contact their engagement partner.

Authored by:

Sandra Thompson
Partner
Phone: +44 (0)20 7212 5697
Email: sandra.j.thompson@uk.pwc.com

John McDonnell
Partner
Phone: +353 1 792 8559
Email: john.mcdonnell@ie.pwc.com

Hannah King
Senior Manager
Phone: +44 (0)20 7213 8158
Email: hannah.king@uk.pwc.com

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