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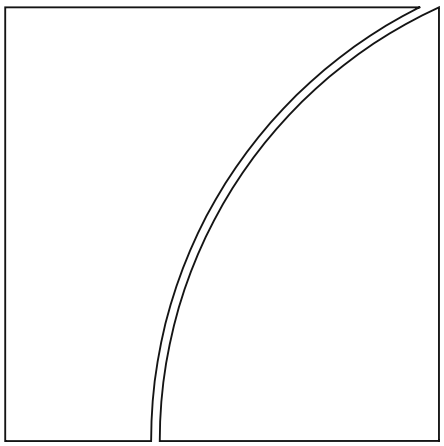

Prudential policy considerations under expected loss provisioning: lessons from Asia

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Executive summary

Loan loss provisioning practices have always been an area of focus for supervisory authorities due to their significant effect on banks' financial condition. Determining what constitutes an adequate level of provisions to absorb credit losses is often subject to debate between banks and supervisors, as changes in provisioning estimates immediately impact bank earnings and, eventually, regulatory capital. In many jurisdictions, loans often represent the largest portion of bank assets. Therefore, the collective judgments banks make on whether they expect to be repaid on their credit extensions, and, if not, how much and when they expect to recover the amounts due, have major implications for the safety and soundness of individual banks and the broader financial system.

The financial asset impairment principles under International Accounting Standards (IAS) 39 raise a number of concerns. First, by relying on the concept of incurred rather than expected losses, the standard does not adequately reflect the actual value of financial assets held at amortised cost, such as loans and receivables. Second, the incurred loss approach makes the reported accounting value of the assets and, therefore, the profit and loss (P&L) account excessively procyclical.

To account for the prudential shortcomings of IAS 39, Basel II required all banks under the internal ratings-based (IRB) approaches to credit risk capital measurement to compare their accounting provisions with total regulatory expected loss[2] (EL), with any shortfalls being deducted from regulatory capital. While this mechanism has continued for IRB banks under Basel III, no such internationally agreed framework exists for smaller, less complex banks.

In some jurisdictions, notably in Asia[3], authorities have adopted regulatory regimes, applicable to all banks, to address the limitations of the incurred loss approach under IAS 39. This has been achieved through the use of prudential backstops[4] for accounting provisions. By doing so, they have gone beyond the minimum requirements of the Basel framework, which only prescribes the deduction of EL provisioning shortfalls from regulatory capital for IRB banks.

The shift from incurred to expected credit loss (ECL) provisioning under International Financial Reporting Standard (IFRS) 9 is a significant improvement. IFRS 9 takes effect in 2018 and should provide market participants with more useful information on reported asset valuations and

1 Fernando Restoy, Raihan Zamil, Bank for International Settlements.

The views expressed in this paper are those of the authors and not necessarily those of the Bank for International Settlements or the Basel-based standard setters. We would like to thank Nestor A Espenilla, Jr and Fernando Vargas Bahamonde for their valuable input and comments.

2 Under the IRB approaches, total regulatory EL is calculated by banks as the sum of the probability of default times the loss-given-default times the exposure at default. Depending on the level of approval granted, some of these parameters are pre-specified by supervisors, while others can be determined by banks, subject to supervisory review and validation.

3 Prudential approaches to provisioning are also prevalent in Latin America (see P Baudino, J Orlandi and R Zamil, 2018) and Eastern Europe (see World Bank 2014). In addition, the European Central Bank (ECB) issued for consultation a prudential backstop for non-performing exposures, with any shortfalls with respect to accounting provisions being deducted (by banks) from common equity tier 1, subject to a comply or explain process (see ECB, 2017).

4 While the design of regulatory provisioning frameworks varies across Asian jurisdictions, in general, if prescribed regulatory provisions (which include provisions for "unimpaired" loans) exceed IAS 39 accounting provisions, the shortfall is deducted from either the income statement or regulatory capital.

associated expected credit losses. IFRS 9 is also more forward-looking, as it requires banks to provision earlier in the credit cycle, thereby helping to mitigate the excessive procyclicality associated with IAS 39.

The implementation of ECL provisioning is subject to a range of challenges. IFRS 9 is a complex standard and its implementation requires a more intricate use of experienced credit judgment than is required under IAS 39. This may lead to heterogeneous provisioning practices across banks and jurisdictions. Since the reliability of the P&L account is a key element of banks' financial statements, accounting standard setters, audit firms and securities market regulators will play a critical role in facilitating a high-quality implementation of ECL provisioning.

The implementation challenges also have prudential implications. While the application of experienced credit judgment has always been an integral part of the loan loss provisioning process, IFRS 9 requires a degree of management judgment that is comparable with the discretion permitted under Basel III's most advanced approaches to credit risk capital measurement – which are generally applicable to the most sophisticated global banks. If there is unwarranted divergence in provisioning practices, it could undermine the comparability and reliability of regulatory capital measures. These tensions raise a fundamental question on whether and which prudential policy approaches should be considered in relation to the application of IFRS 9, given the potential for banks to "game" credit risk models.[5]

This paper examines a range of prudential policy issues that may need to be considered once banks migrate to ECL provisioning under IFRS 9. It identifies policy considerations based, in part, on a review of relevant guidance from the Basel Committee on Banking Supervision (BCBS) and the International Accounting Standards Board (IASB), together with the results of an FSI survey on loan loss provisioning practices in 15 Asian jurisdictions. Asian jurisdictions were selected for their extensive experience with regulatory classification and provisioning standards. The Asian experience therefore helps to illuminate the interactions between accounting and regulatory frameworks, and to assess what role such regulatory frameworks can play in the introduction of ECL provisioning.

In designing a policy strategy, authorities may find it useful to take stock of applicable BCBS guidance on credit risk and provisioning. Three key references provide relevant guidance as follows: the Committee's expectations on the application of key aspects of IFRS 9 ECL provisioning;[6] guidance on harmonised definitions of non-performing and forborne exposures;[7] and the Committee's plan to retain, on an interim basis, the existing regulatory capital treatment of accounting provisions[8], while providing authorities with discretion to determine what portion of IFRS 9 provisions can be recognised in regulatory capital under the standardised approach to credit risk capital measurement.

Against this background, several prudential policy issues may arise in conjunction with the shift to IFRS 9 ECL provisioning, depending on jurisdiction-specific circumstances. Some considerations are of a general nature, while others are more relevant for banks under the standardised and IRB approaches to credit risk capital measurement, respectively:

- *Policy considerations applicable for all banks include*: outlining supervisory expectations for the implementation of IFRS 9; assessing the role of prudential asset classification frameworks and their interactions with the IFRS 9 three-stage classification requirements (ie "performing", "underperforming" and "impaired"); exploring regulatory or supervisory measures to address the accounting impact of accruing interest income on a non-performing asset (NPA); reviewing prudential criteria for forborne loans; and enforcing loan write-offs in line with IFRS 9 requirements.

5 See BCBS (2013).

6 See BCBS (2015).

7 See BCBS (2017b).

8 See BCBS (2017a).

- *Policy considerations specific to banks under the standardised approach (SA) to credit risk capital measurement include*: assessing the pros and cons of developing mechanisms to backstop IFRS 9 provisions for the purpose of determining regulatory capital; determining what portion of IFRS 9 provisions can count towards Tier 2 capital; and reviewing the treatment of collateral under IFRS 9 and applicable regulatory provisioning frameworks.
- *Policy considerations specific to banks under the IRB approach to credit risk capital measurement include*: assessing the interactions between the regulatory EL parameters for IRB banks with the IFRS 9 ECL provisioning concept. IRB EL and IFRS 9 ECL do not use the same modelling inputs, which can lead to different provisioning outcomes, with clear implications for regulatory capital.

Regardless of the policy options being considered, there is a rationale for supervisors to seek powers to impose adjustments to regulatory capital when accounting provisions are insufficient to cover expected losses from a prudential perspective. Such powers can help to address supervisors' prudential concerns while fully respecting the role of the accounting standard setters in establishing the criteria that governs the valuation of assets and the financial statements of banks.

Introduction

1. **Sound accounting standards that promote market transparency and foster market discipline are key linchpins of a well functioning financial system.** In this regard, a fundamental issue is the extent to which banks' financial statements provide market participants with reliable information. For bank investors and creditors, the question often revolves around how banks value loans that are held at amortised cost in their financial statements; and whether their valuation methods give investors an accurate picture of a bank's credit risk profile and overall financial condition.

2. **Accounting standard setters are responsible for establishing sound asset valuation principles that govern the recognition of financial assets.** They also establish criteria for the ongoing measurement of financial assets held at amortised cost – such as loans and receivables – including the circumstances when such assets need to be written down to reflect their estimated recoverable value. Such write-downs are reflected through the loan loss provisioning process and impact banks' P&L accounts.

3. **Prudential authorities attach particular importance to sound loan valuation and provisioning practices at banks, given their significant impact on key performance measures and regulatory capital ratios that are widely used by market participants and bank supervisors**. Even the most conservative regulatory capital rules can be circumvented if there are shortcomings in the loan loss provisioning process. Capital is the difference between the value of a bank's assets and its liabilities. As most bank liabilities are carried at amortised cost, the amount reported as "capital" can be sensitive to changes in asset values. Since loans represent a large portion of bank assets in many countries, major changes to the carrying value of loans may have material implications for regulatory capital.[9]

4. **The IAS 39 accounting standard on loan impairment does not sufficiently contribute to market transparency and is inconsistent with prudential objectives.** The standard is unsatisfactory because it only requires banks to write down the value of financial assets held at amortised cost, such as loans, based on incurred losses. Since this valuation process explicitly ignores all future expected losses, it does not adequately reflect a loan's actual value, making it difficult for both market participants and bank supervisors to assess a bank's true financial state. This approach also exposes the P&L account to undue volatility and excessive procyclicality. In the absence of any prudential measures, accounting provisions – through the P&L account – would immediately impact regulatory capital.

5. **To address these prudential concerns, the BCBS has developed a framework to control how accounting provisions affect regulatory capital for IRB banks.** Under the Basel capital framework, banks using internal ratings to calculate risk weights associated with their credit exposures (IRB approach) must calculate expected losses according to a pre-established methodology and deduct from regulatory capital any shortfall of accounting provisions in relation to expected losses.[10] Note, this approach has no influence on the balance sheet or the P&L account, which continue to be governed by accounting standards. It simply introduces adjustments to the calculation of regulatory capital, which lies within the domain of prudential authorities.

6. **It should be noted, however, that the IRB EL framework that has backstopped accounting provisions is prone to model risk.** As part of its post-crisis reform agenda, the BCBS conducted a study to evaluate whether IRB models were being consistently applied across banks and jurisdictions. They found that banks with broadly similar credit portfolios arrived at different capital levels when using internal models. These findings raise supervisory concerns that banks may have "gamed" their IRB models to

[9] For example, a 5% decline in loan values eliminates the minimum Common Equity Tier 1 capital requirement under Basel III. For illustrative purposes, this relationship would hold if loans comprised 100% of total assets.

[10] This approach generally ensures that, at least for IRB banks, regulatory capital covers unexpected losses.

deliver results that required less capital,[11] and have contributed to the Committee's decision to constrain the use of internal credit risk models.

7. **In some jurisdictions, notably in Asia, regulators have developed policies to control the impact of accounting provisions on regulatory capital that go beyond the minimum requirements established under the Basel capital framework**. In this regard, domestic regulatory provisioning rules in several Asian jurisdictions require non-IRB banks to apply adjustments to regulatory capital when accounting provisions are below the level specified by regulation. Moreover, in a few Asian jurisdictions, the required volume of provisions is set according to domestic rules established by the prudential regulator, not on the basis of IAS 39.

8. **The shift from incurred to expected credit loss (ECL) provisioning under IFRS 9 constitutes a much needed improvement of the accounting standards.** IFRS 9 should make reported asset valuations more informative for both market participants and supervisors. In addition, since banks will need to recognise loan loss provisions based on expected credit losses at credit origination, it should help to curtail their procyclical behaviour, particularly during economic upswings.

9. **The introduction of ECL provisioning may increase the heterogeneity in loan loss provisioning practices across banks and jurisdictions.** The implementation of IFRS 9 significantly expands the role of judgment on a process that is inherently discretionary in nature. This, in turn, could generate excess variability in provisioning outcomes and, therefore, may have implications for banks' reported earnings and capital levels. For these reasons, both the accounting profession and prudential regulators have a stake in ensuring a robust application of IFRS 9 ECL provisioning. For prudential authorities, an added consideration is that the notion of what constitutes expected credit losses from an accounting perspective may not necessarily be the same as when viewed through a prudential lens.

10. **Accounting and audit standard-setting bodies, together with audit firms play a key role in ensuring high-quality implementation of ECL accounting methodologies.** The IASB, through its development of the IFRS 9 standard and supported by its implementation guidance, sets the broad context in which the ECL methodologies should be applied. Meanwhile, the International Auditing and Assurance Standards Board is in the process of revising its standard on the auditing of complex accounting estimates, as it will be applied by audit firms to determine whether the accounting estimates and related disclosures are reasonable. Finally, the world's six largest audit firms, under the auspices of the Global Public Policy Committee (GPPC),[12] have issued two papers[13] to promote effective ECL implementation and to help guide audit firms in their development of internal methodologies to audit ECL provisioning estimates by banks. Collectively, these efforts should help to facilitate a robust implementation of IFRS 9.

11. **The BCBS has also issued supervisory guidance on accounting for ECL provisioning,[14] which aims to support high-quality implementation of IFRS 9.** This document outlines sound credit risk practices associated with the implementation and ongoing application of ECL accounting frameworks, including the Committee's expectations on the application of key aspects of IFRS 9 ECL provisioning.

12. **This paper outlines prudential policy considerations once IFRS 9 ECL provisioning becomes effective.** In this regard, it draws on the different policies applied in Asia – where the menu of approaches

[11] See BCBS (2013).

[12] The GPPC comprises representatives of the six largest accounting firms, namely BDO, Deloitte, Ernst and Young, Grant Thornton, KPMG and Price Waterhouse Coopers.

[13] The first paper, published in June 2016 as *The implementation of IFRS 9 impairment requirements by banks* is intended for audit committees who oversee implementation and bank managers who are implementing the new requirements. The second paper, published in July 2017 as *Considerations for the audit of expected credit losses* is aimed at advancing high-quality audit procedures over complex accounting estimates under ECL provisioning. While both papers are aimed at systemically important banks, the principles contained in the document may also be applicable to other financial institutions. Copies of both papers can be downloaded from the respective firms' websites.

[14] See BCBS (2015).

is particularly rich – and discusses some possible lessons for the construct and role of regulatory classification and provisioning frameworks and their interactions with the accounting framework. The rest of the paper is structured as follows: Section II explains the differences in provisioning requirements under IAS 39 and IFRS 9 and highlights key elements of the BCBS guidance on expected credit losses. Section III summarises key findings from the FSI survey on provisioning practices in Asia. Section IV identifies key issues for prudential policy once IFRS 9 becomes effective. Section V provides some concluding remarks.

Section II – The accounting framework and BCBS guidance on provisioning

IAS 39

13. **Under IAS 39, banks are required to estimate loan loss provisions only if there is objective evidence of credit impairment as of the balance sheet reporting date**. Future events, no matter how likely, cannot be considered in determining whether a loan is impaired. For this reason, IAS 39 is often referred to as an "incurred loss" model; that is, a credit loss event must have occurred as of the balance sheet date in order to trigger loan loss provisions.

14. **If a determination is made that a loan is impaired, the amount of loan loss provisions required is heavily dependent on the value of collateral, if any, that can be used to meet the defaulted credit obligation.** Unless collateral is highly liquid and can be immediately accessed, the market value of collateral can be difficult to estimate and, while IAS 39 does not prescribe valuation standards, it requires entities to consider the time and costs to foreclose and liquidate collateral (ie the time value of money concept) in determining the estimated value of collateral.

15. **The IAS 39 provisioning standard was viewed by some as contributing to, and exacerbating, the 2007–09 financial crisis.** This is, in part, because IAS 39 limits the ability of banks to recognise loan loss provisions in advance of credit impairment, contributing to the widely held view of the standard as "too little, too late". IAS 39 has also been criticised as procyclical, because a large amount of provisions were recognised at a time when bank earnings and capital were already under pressure from large loan losses. In response to these criticisms, in July 2014, the IASB introduced a new provisioning standard based on expected credit losses, while the US Financial Accounting Standards Board (FASB) developed their own expected credit loss model.[15]

IFRS 9

16. **IFRS 9 is a significant improvement on IAS 39 in that it requires banks to recognise expected rather than incurred credit losses.** This subtle but important conceptual shift has long been supported by banking supervisors, and should lead to the recognition of more timely and possibly higher loan loss provisions. Moreover, from the point of view of the transparency of financial statements, IFRS 9 makes the valuation of loans more informative by incorporating a more accurate estimate of their expected

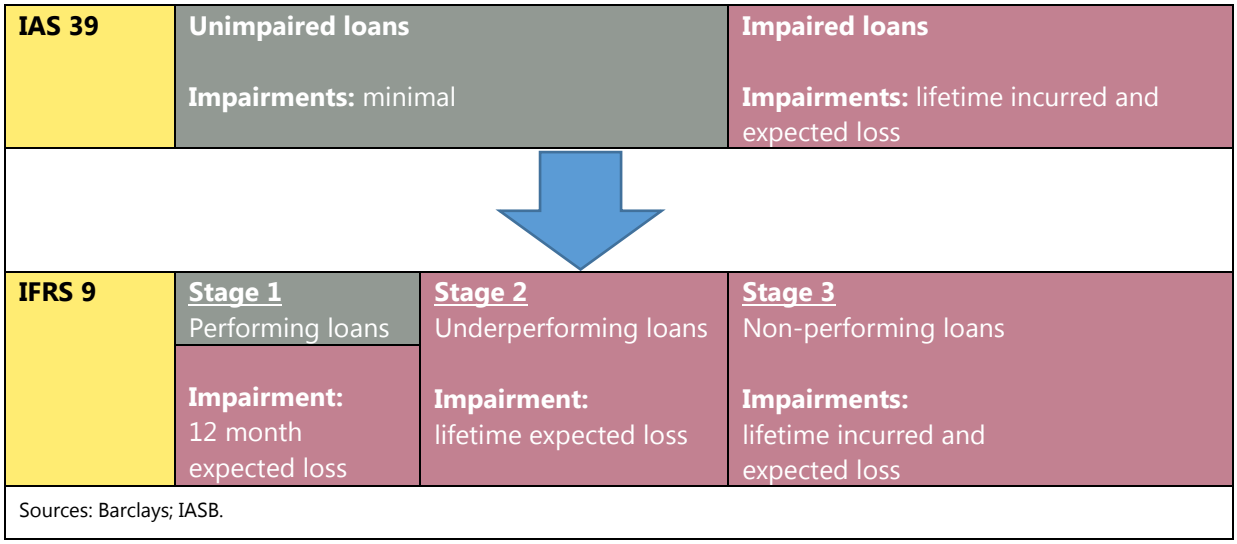
[15] Following the financial crisis, the FASB and the IASB initially worked jointly to develop a converged standard for expected credit losses (ECL), but they were unable to reach consensus. In June 2016, the FASB issued the current expected credit loss (CECL) model, with a 2020 effective date. The main difference between CECL and IFRS 9 ECL is that the former requires banks to book **lifetime** expected credit losses for all loans at credit origination; in contrast, IFRS 9 requires lifetime ECL for Stage 2 and 3 loans only (ie loans where a significant increase in credit risk has occurred since initial recognition or loans that are non-performing), with a 12-month ECL requirement for Stage 1 loans (ie performing loans where no significant increase in credit risk has occurred since credit origination).

future cash flows.[16] The major differences between IAS 39 and IFRS 9 provisioning requirements are illustrated in Figure 1 below.

17. **IFRS 9 addresses two of the major shortcomings of IAS 39 and requires a more comprehensive assessment of credit risk.** First, it eliminates the (IAS 39) requirement that a loss event must have occurred in order to trigger the recognition of credit losses. Under IFRS 9, all loans are subject to provisioning requirements based on expected credit losses. Second, it requires entities to consider future events/forecasts[17] in determining credit loss expectations. In addition, IFRS 9 provides a more granular assessment of credit risk by requiring entities to place financial instruments into three distinct risk buckets, including "performing" (Stage 1), "underperforming" (Stage 2) and "non-performing" (Stage 3) rather than the "unimpaired" and "impaired" categories under IAS 39.

18. **While the "impaired" category and the associated provisioning requirements under IAS 39 is virtually identical to the Stage 3 category under IFRS 9, there are significant differences in the treatment of the "unimpaired" category between IAS 39 and IFRS 9.** In particular, unimpaired loans under IAS 39 require minimal provisions, while IFRS 9 requires banks to disaggregate unimpaired loans into Stage 1 (performing) and Stage 2 (underperforming) categories and to determine provisions based, respectively, on 12-month and lifetime expected credit losses. In this regard, as soon as a credit is originated (or purchased), banks are required to recognise provisions based on 12-month expected losses[18] (ie Stage 1 loans). Once a loan has experienced a "significant increase in credit risk" since initial credit recognition (although it may still be making timely payments), it should be moved to Stage 2 with provisions being recognised based on lifetime expected losses.[19] Collectively, most of the provisions associated with Stage 1 and 2 loans can generally be considered as "new" provisions that were not required under IAS 39.[20]

Figure 1: Comparing impairments under IAS 39 and IFRS 9



Sources: Barclays; IASB.

16 The one exception might be loans that are assessed on a portfolio basis.

17 Forward-looking information should be considered if it is reasonable and supportable and can be obtained at a reasonable cost.

18 That is, the likelihood of default over the next 12 months multiplied by the loss-given-default.

19 That is, the likelihood of default over the life of the loan multiplied by the loss-given-default.

20 Under IAS 39, banks are required to provision for so-called "incurred but not yet reported losses" (IBNR), which generally relate to unimpaired loans, even though a portion of these provisions are for incurred losses. Therefore, a portion of IBNR provisions that are deemed to be related to "unimpaired" loans should be netted against Stage 1 and 2 loans to derive a more accurate assessment of the new provisions required under IFRS 9.

19. **Notwithstanding these enhancements, IFRS 9 raises a range of implementation challenges.** First, it continues to allow banks to accrue interest income on a NPA,[21] following the same practice permitted under IAS 39. Second, it significantly expands the role of credit judgment that may accentuate differences in loan loss provisioning outcomes across banks and jurisdictions, given a similar set of facts and circumstances.

20. **Experienced credit judgment will be particularly important in at least six key areas, all of which can materially influence both the timing and size of recognised credit loss provisions:**

- *Estimating ECL provisions for performing (Stage 1) loans*: Many banks may not have sufficient data and/or a robust framework to support credit loss estimates for performing loans based on a 12-month ECL. This could result in significant variation in provisioning practices across banks.
- *Triggers used to migrate loans from Stage 1 to Stage 2*: The timing of reclassifications from Stage 1 to Stage 2 can materially influence the level of provisions held, as the former (Stage 1) requires provisions based on a 12-month ECL, while the latter (Stage 2) requires lifetime ECL provisions. Banks are required to reclassify loans from Stage 1 to Stage 2 if there has been a "significant increase in credit risk". The difficulty arises because the term is not specifically defined, although the standard does indicate that there is a presumption that a loan should migrate to Stage 2 once it is more than 30 days past due. While some banks may use the 30-day past due criteria[22] to place a loan in Stage 2, others may use more qualitative, forward-looking triggers.
- *Estimating lifetime ECL for Stage 2 loans*: Once a determination is made that a loan is in the Stage 2 category, the obligation to estimate/project the likelihood of credit default over its remaining life is a new requirement that will require a significant amount of professional judgment, possibly leading to different provisioning outcomes.
- *Use of forward-looking information*: Practices could vary significantly across banks regarding the type of forward-looking information used (ie what constitutes "reasonable and supportable" information), the time horizon (ie how far into the future to look) and how to incorporate the information in determining ECL provisions.
- *Criteria used to reclassify forborne (restructured) loans from Stage 2/3 to Stage 1/2*: If a borrower has demonstrated its repayment capacity based on the revised terms over a "period of time", banks are allowed to upgrade the credit quality of the loan. As the standard does not define what constitutes a "period of time", practices could vary significantly across banks in the absence of relevant supervisory guidance.
- *Loss estimation for Stage 3 loans and collateral valuation*: For most Stage 3 loans, the probability of default will be at or close to 1. Therefore, the incurred losses related to Stage 3 loans will be heavily driven by the value assigned to collateral. While the challenges in collateral valuation practices are not specific to IFRS 9, inflated collateral values will materially understate the level of required credit loss provisions, particularly for non-performing (Stage 3) assets. In this regard, a critical component in deriving reasonable collateral values is to ensure that banks realistically consider the time and costs required to access and sell collateral (time value of money) as a key part of the collateral valuation process. This is particularly important in jurisdictions where the judicial framework results in long delays for banks seeking access to the collateral of defaulted borrowers.

[21] For Stage 3 (or impaired) loans, interest income is recognised based on the amortised cost (ie the gross carrying amount of the loan less any associated allowance for loan losses).

[22] If a bank uses the past due criteria to place a loan in Stage 2, this would be a backward-looking approach that defeats the intent of the new standard.

BCBS guidance on accounting for expected credit losses

21. **In December 2015, the BCBS issued supervisory guidance on accounting for ECL, following the IASB's publication of IFRS 9.** The guidance focuses on the implementation of the ECL accounting model and how it should interact with a bank's overall credit risk practices; it also presents the BCBS's views on the appropriate application of the ECL accounting standards.[23]

22. **The Appendix of the guidance is intended for banks reporting under IFRS 9 and outlines supervisory expectations on the following elements:**

- *estimating credit loss provisions on Stage 1 loans*;
- *defining "default" for accounting purposes in a manner that is consistent with the definition used for regulatory purposes*;
- *determining whether an exposure has experienced significant increase in credit risk*;
- *evaluating forborne (restructured) exposures*; and
- *limiting the use of practical expedients*,[24] including the use of a more than 30 days past due criteria to reclassify a loan from Stage 1 to 2 and an exception that "low credit risk" exposures do not need to be assessed for a "significant increase in credit risk".

Section III – FSI survey on provisioning practices in Asia

23. **Some 15[25] Asian jurisdictions were surveyed in July 2016 on their asset classification and provisioning practices.** Conducted by the FSI in concert with the South East Asian Central Banks (SEACEN) Research and Training Centre,[26] the survey sought to understand the design and role of regulatory classification and provisioning frameworks and how they interact with IAS 39 provisioning requirements. In general, regulatory classification and provisioning frameworks in Asia have co-existed with IAS 39 provisioning rules and apply to all banks under the standardised approach (SA banks) to credit risk capital measurement. IRB banks operate under a globally harmonised provisioning framework.[27] Key findings are outlined in this section, while the Annex provides more detailed survey responses.

24. **The survey results confirm the wide variety of practices in asset classification (ie credit risk identification), loan loss provisioning (ie credit risk measurement) and the prudential treatment of accounting provisions in regulatory capital across surveyed jurisdictions.** Collectively, these variations

[23] The paper outlines eight principles for banks and covers board oversight, ECL provisioning methodologies, model validation, credit risk rating process, the adequacy of the allowance, the critical role of experienced credit judgment in measuring expected credit losses, the use of common data and disclosure. Three principles are for supervisors and address supervisory review of credit risk management, ECL methodologies and capital adequacy.

[24] IFRS 9 contains a number of practical expedients to ease the implementation burden for various entities that will need to comply with the standard, beyond the banking industry. The BCBS expects that internationally active banks will not use the more than 30 days past due rebuttable presumption as a primary trigger to transfer to Stage 2. In addition, while the "low credit risk" exemption is provided as an option under IFRS 9, the BCBS expects banks to conduct assessments of significant increases in credit risk for all lending exposures.

[25] The surveyed jurisdictions were Brunei, Cambodia, China, Chinese Taipei, Hong Kong SAR, India, Indonesia, Japan, Malaysia, Mongolia, Nepal, the Philippines, Singapore, Sri Lanka and Thailand.

[26] SEACEN comprises 20 central banks in Asia that cooperate on learning programmes, research work, networking and collaboration platforms.

[27] Under Basel II, all IRB banks are required to compare accounting provisions with their regulatory expected loss measure, with any shortfall deducted from regulatory capital. If accounting provisions exceed the regulatory expected loss figure, the "surplus" can be added to Tier 2 capital, up to 0.6% of gross risk-weighted assets.

make it difficult to compare the reported credit risk profile and regulatory capital requirements across surveyed jurisdictions.

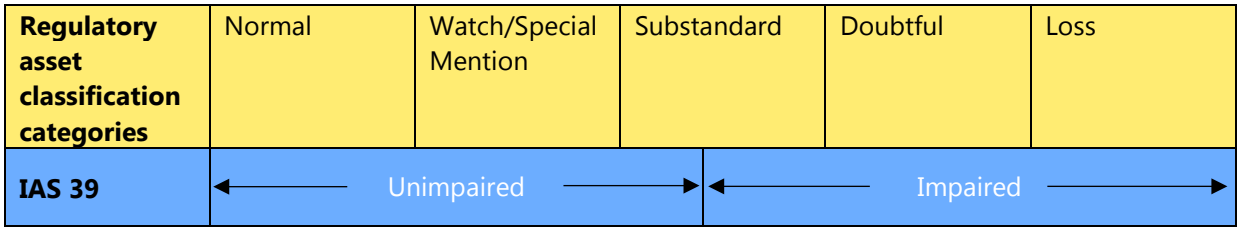
25. **At the same time, the regulatory asset classification and provisioning frameworks of Asian jurisdictions generally provide effective prudential safeguards against a number of perceived shortcomings of IAS 39.** First, they provide supervisors with more granular asset quality information on a bank's overall credit risk profile, rather than relying solely on the IAS 39 "unimpaired" and "impaired" designations. Second, they provide authorities with various means of backstopping IAS 39 provisions, either by overriding the accounting rules or by ensuring that provisioning shortfalls in relation to expected losses are deducted from regulatory capital for all banks. Third, they enable authorities to either prohibit the accrual of interest income once a loan is determined to be non-performing or require banks to hold a commensurate level of provisions.

26. **Collectively, the measures taken establish the minimum level of regulatory provisions that must be recognised in regulatory capital, even if the required provisions held under IAS 39 are below that amount.** Going forward, a key question for regulatory policy is what role such regulatory classification and provisioning frameworks should play, if any, once accounting moves to IFRS 9 ECL provisioning.

Regulatory asset classification frameworks in Asia

27. **The vast majority of surveyed jurisdictions in Asia (14 of 15) have regulatory asset classification systems.** Banks are required to classify credit exposures into various regulatory risk buckets (with the most common being: "Normal", "Watch/Special Mention", "Substandard", "Doubtful" and "Loss") based on perceived levels of credit risk, considering both qualitative and quantitative criteria. Figure 2 provides a conceptual illustration of the interaction between regulatory asset classification categories used in Asia with the IAS 39 "impaired" and "unimpaired" concept.

Figure 2: Mapping regulatory classification regimes to IAS 39 (conceptual example only)



28. **For authorities that use a five-bucket risk categorisation system, regulatory definitions for "Normal" and "Watch" and possibly the better-quality "Substandard" loans[28] may be considered "Unimpaired", while the more severe 'Substandard' and all of 'Doubtful' and 'Loss' are likely to fall in the 'Impaired' category under IAS 39.** For this reason, regulatory asset classification categories provide meaningful information to Asian supervisors, together with a bank's own internal credit grading system, rather than relying solely on the "impaired" and "unimpaired" designation under IAS 39.

29. **Notwithstanding the benefits of regulatory asset classification systems, it is difficult to compare the level of "problem assets" across jurisdictions due to various differences in the definitions that underlie regulatory classification frameworks and how they are implemented.** The key differences are summarised below:

[28] This would be the case to the extent that "Substandard" loans are placed in this category by banks and/or supervisors prior to impairment based on forward-looking, qualitative criteria.

- *Supervisory application of asset classification guidance*: it is unclear the extent to which supervisors in each jurisdiction rely on past due criteria or more forward-looking qualitative factors when they place a loan in one of the more severe regulatory risk categories (ie "Watch/Special Mention" or worse).
- *Differences in delinquency triggers*: to the extent that borrower delinquency is relied upon to place loans in the more adverse regulatory risk classification categories, the minimum number of days past due to place a loan in "Watch/Special Mention", "Substandard", "Doubtful" and "Loss" varies across jurisdictions.
- *Exit criteria for restructured NPLs*: the criteria for upgrading a restructured loan from non-performing to performing status vary across jurisdictions.
- *Reported value of an NPL*: what gets reported to the supervisory authority as an "NPL" – a key measure of asset quality – varies, with most jurisdictions requiring gross NPL values, while some allow net NPL figures (net of provisions).
- *Write-off criteria*: many jurisdictions do not require banks to write off fully provisioned NPLs, thereby distorting NPL coverage ratios used by both market participants and supervisors in assessing the credit risk profile of individual banks.

Regulatory provisioning frameworks in Asia

30. **The use of regulatory asset classification systems is typically accompanied by minimum provisioning requirements.** Of the 14 jurisdictions that reported their use, 12 explicitly prescribe a range of minimum provisioning requirements that are linked to each regulatory asset classification category.[29] Among these jurisdictions, some authorities require banks to follow regulator-prescribed rules as the basis for estimating and recognising provisions in the P&L statement. Other jurisdictions follow IAS 39 accounting standards as the basis for recognising provisions in earnings, but still require banks to calculate provisions based on regulatory rules, with any shortfalls (with respect to accounting provisions) being deducted from regulatory capital. Of the two authorities that do not prescribe minimum regulatory provisions for each asset classification category, together with the only authority in Asia (among surveyed jurisdictions) that does not utilise an asset classification system, all three still impose some form of a regulatory provisioning backstop to IAS 39 provisions for the purpose of determining regulatory capital. Figure 3 provides an illustration of the interaction between accounting and regulatory provisions in Asia.

[29] This includes minimum provisioning requirements for regulatory asset classification categories such as "Normal" or "Watch", both of which are likely to be considered "unimpaired" under IAS 39 and would be subject to little or no provisioning requirements under IAS 39.

Figure 3: IAS 39 vs regulatory provisions in Asia – provisioning requirements are shaded in red

IAS 39	**Unimpaired**	Minimal or no provisions required	Recognised in P&L
	Impaired	Provisions required for incurred losses	
Regulatory provisions in Asia	**Unimpaired**	Regulatory provisions required for "Normal" and "Watch" loans	• Some Asian jurisdictions have accounting powers to require banks to recognise only regulatory provisions in the P&L • Some require banks to recognise regulatory provisions in the P&L only if the amount is higher than IAS 39 or if they are not satisfied with a bank's implementation of IAS 39 • Other jurisdictions: If regulatory provisions > IAS 39 provisions, the difference is generally deducted from regulatory capital – but the calculation of the shortfall varies across jurisdictions
	Impaired	Regulatory provisions required for "Substandard", "Doubtful" and "Loss" loans	

31. **All seven authorities that have adopted IAS 39 provisioning requirements for recognition in the P&L also apply some variation of a regulatory provisioning backstop (Figures 4 and 5).** This approach provides a floor on the baseline amount of provisions that are either recognised in the P&L or adjusted in regulatory capital, irrespective of the IAS 39 provisioning figures.

Provisioning requirements Graph 1

Figure 4

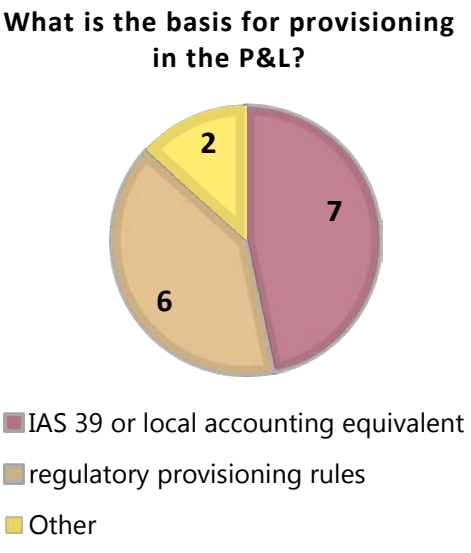
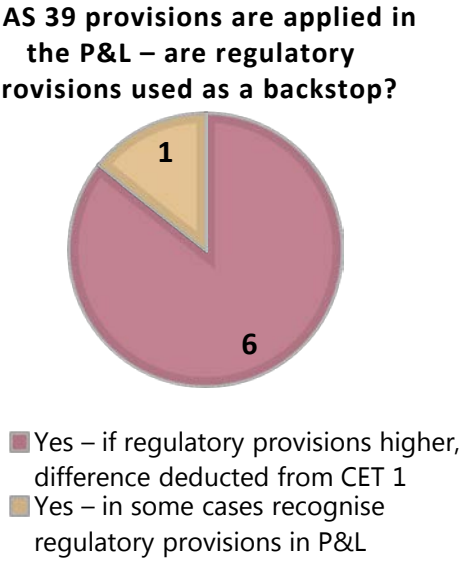


Figure 5



Source: FSI survey

32. **The design and target of regulatory provisioning backstops vary by jurisdiction, including how provisioning shortfalls are calculated.** In Figure 5, six authorities note that, if regulatory provisions are higher than accounting provisions, the shortfall is deducted from regulatory capital. In calculating the shortfall,[30] four authorities compare the aggregate level of accounting provisions with applicable regulatory provisioning requirements for "Normal", "Watch", Substandard" "Doubtful" and "Loss" assets.[31] For the other two authorities, the primary focus of the regulatory shortfall is to ensure that a baseline level of regulatory provisions for "unimpaired" loans only are accounted for in determining regulatory capital.[32]

33. **Another interesting observation is that 11 of the 15 authorities surveyed either prohibit the accrual of interest income on an NPA (ie placing loans on "non-accrual" status) or require banks to hold a commensurate amount of provisions, thereby neutralising the impact on earnings.** Nevertheless, the timing of when a loan gets placed on NPL status – and therefore when interest accruals stop – can vary across jurisdictions.

34. **Notwithstanding the usefulness of regulatory provisioning frameworks, the various differences in their construction and application make it difficult to compare reported provisioning levels, earnings and regulatory capital figures across surveyed jurisdictions.** These differences are summarised below:

- *Asset classification practices*: differences in asset classification practices (ie the extent to which supervisors rely on forward-looking vis-à-vis past due indicators to place loans in the more severe regulatory risk buckets) can influence the level of minimum regulatory provisioning requirements.
- *Provisioning ranges*: provisioning ranges per regulatory asset classification categories vary across jurisdictions.
- *Collateral recognition*: some authorities allow banks to deduct collateral values from a loan's outstanding balance prior to imposing regulatory provisioning rules, while others do not recognise collateral for the purpose of determining regulatory provisioning requirements.
- *Collateral valuation*: In jurisdictions where collateral values are deducted from a loan's outstanding balance, collateral may or may not be subject to supervisory haircuts; in jurisdictions that follow IAS 39, differences in judicial frameworks can materially impact the net present value estimated for collateral (due to the time required to foreclose and gain access to collateral), which in turn can materially impact the level of required provisions.

Treatment of accounting provisions in regulatory capital

35. **The concepts of "general" and "specific" provisions are not part of the international accounting standards.** They are regulatory constructs that were initially designed by the BCBS to provide incentives for banks to be conservative in their provisioning practices. Under Basel I, general provisions (GP) were defined as provisions, held against future, currently unidentified losses that are freely available

[30] It should be noted that, in calculating the shortfall, some authorities formulate conclusions based on a review of a representative sample of an institution's loan portfolio. Therefore, the shortfall is considered as a floor and banks are directed to conduct a more detailed assessment of their credit portfolio to ascertain if additional provisions are needed.

[31] In general, these authorities prescribe a minimum range of provisions per regulatory asset classification category, with provisioning ranges increasing with the severity of the regulatory asset classification category. For example, "Normal" (or performing) loans may require provisions up to 1%, while "Loss" loans generally require provisions of up to 100%.

[32] In these two cases, one of the authorities requires banks to account for any shortfalls in CET 1 if collective provisions under IAS 39 are less than 1.2% of net loans (net of specific provisions), while another authority requires banks to hold regulatory reserves to cover expected but not yet incurred losses (usually between 0.5% and 1% of gross loans based on supervisory discretion); and this amount is deducted from CET 1.

to meet losses which subsequently materialise. Specific provisions (SP) relate to provisions held against an identified deterioration in particular assets or known liabilities, whether individual or grouped.

36. **Basel I permitted a certain portion of GP to be included in total (Tier 2) capital, while SP were deducted from gross risk-weighted assets.** Under Basel II, the BCBS elected to continue its regulatory capital treatment of GP and SP when it adopted the SA credit risk framework.[33] Most recently, the BCBS's March 2017 publication on the regulatory treatment of accounting provisions confirmed the Committee's plan to retain, for an interim period, the current regulatory treatment of GP and SP under Basel III.

37. **There does not yet exist a globally harmonised framework to map accounting provisions with the regulatory concepts of GP and SP.** Each authority has therefore developed its own definitions for GP and SP. Since a portion of GP gets added back to Tier 2 capital, policy choices made by relevant jurisdictions can influence the overall reported level of capital of both individual banks and national banking systems.

38. **The vast majority of surveyed Asian jurisdictions allow GP to be included in Tier 2 capital but the definition of what constitutes a GP varies significantly across Asian jurisdictions.** The choice depends mainly on whether authorities have elected to define GP by using regulatory provisions tied to specific asset classification categories; or considering a subset of accounting provisions only; or using a combination of the two. In regard to the latter option – and to further illustrate the variations in the definition of GP used in Asia – of the three jurisdictions in Figure 7 that checked "Other", two authorities define GP as the sum of collective provisions and regulatory reserves (up to 1.25% of gross RWA), but each has a different definition of what constitutes "regulatory reserves". These differences accentuate not only the challenges in comparing Basel III capital measures across jurisdictions, but also the need to seek convergence on the definitions for GP and SP across jurisdictions.

Treatment of accounting provisions in regulatory capital — Graph 2

Figure 6 – Treatment of general provisions in regulatory capital

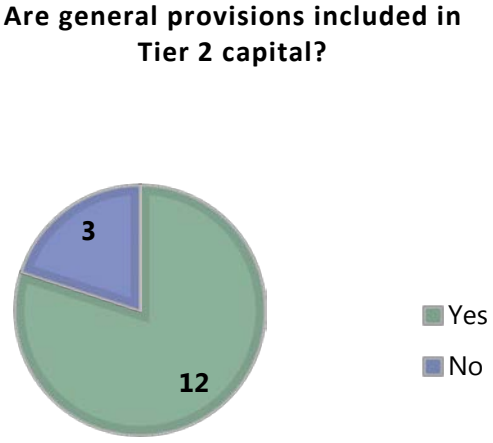
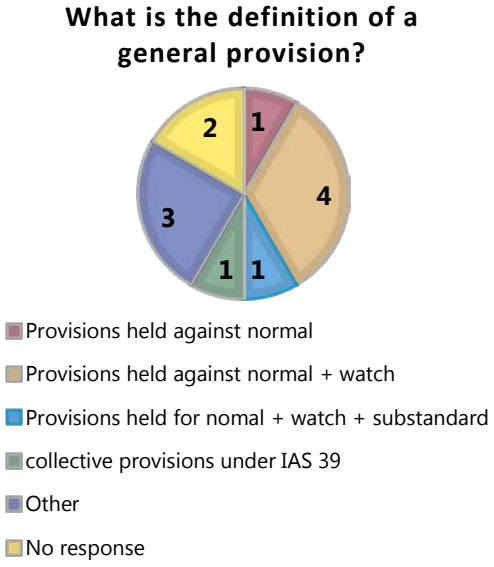


Figure 7 – Definition of general provision



Source: FSI survey

[33] The introduction of the IRB approaches under Basel II, however, eliminated the need for IRB banks to distinguish between "GP" and "SP". For IRB banks, the treatment of accounting provisions was specified in a manner that allowed accounting provisions to be compared against total regulatory expected loss (EL), with any shortfalls being deducted from regulatory capital.

Section IV – Implications for policy upon migration to IFRS 9 ECL provisioning

39. **The implementation of regulatory classification and provisioning frameworks in Asia have effectively enabled prudential authorities to extend an expected loss provisioning framework to all banks, as a prudential backstop for accounting provisions.** While the design of regulatory provisioning frameworks vary, one common feature across surveyed Asian jurisdictions that have adopted IAS 39 provisioning requirements is that all require expected losses to be deducted in either the P&L or, at least, from regulatory capital. By adopting this approach, they have gone beyond the minimum requirements of the Basel capital framework, which only prescribes the deduction of provisioning shortfalls in relation to expected losses from regulatory capital for IRB banks. As a result, regulatory capital in these jurisdictions is closer to satisfying the principle that it should only be depleted when unexpected losses arise. To the extent that these regulatory provisioning frameworks have resulted in higher provisions (which are deducted from the P&L or regulatory capital) than that required under applicable accounting standards, the regulatory capital impact associated with the migration to IFRS 9 in these jurisdictions may be less significant than in other jurisdictions with no prudential backstop in place.

40. **Going forward, a key question is whether these regulatory backstops will remain relevant after the introduction of IFRS 9.** In other words, whether there remains a need to maintain (or introduce) prudential classification and provisioning frameworks (to backstop accounting provisions for non-IRB banks) and to retain the IRB regulatory EL concept (to backstop accounting provisions for IRB banks), once accounting standards require all institutions to estimate provisions based on expected credit losses.

41. **One (more conceptual) view is that, after the introduction of IFRS 9, the provisioning figures generated from the accounting should flow from the P&L and directly into regulatory capital.** The main argument supporting this view is that the adoption of expected credit losses in the accounting framework makes regulatory backstops, which are also based on expected losses, conceptually irrelevant.

42. **The alternative (more practical) view is that, since the implementation of IFRS 9 ECL provisioning represents such a significant methodological shift in provisioning practices, a more cautious regulatory stance is warranted, particularly during the initial stages of implementation.** Proponents of this approach argue that the prudential measures being contemplated to backstop IFRS 9 provisions are simply a continuum of constraints that regulators have established post-crisis, beginning with the introduction of the leverage ratio (ie to backstop risk-based capital measures) together with the narrowing of modelling choices and constrained discretion for IRB banks. [34]

43. **While the conceptual arguments for removing regulatory backstops may be sound, the practical challenges associated with the implementation of IFRS 9 have significant prudential implications.** The introduction of IFRS 9 ECL provisioning requires all banks (in IFRS jurisdictions) and their auditors to apply a high degree of discretion in determining/modelling expected credit losses for the entire credit portfolio. Indeed, IFRS 9 requires banks to calculate their expected credit losses using a degree of credit judgment that is at least comparable to what is currently permitted for sophisticated banks (that have obtained prior supervisory approval) to use their internal models in calculating credit risk capital requirements (ie the advanced IRB approaches). With this in mind, it is important to note that the BCBS has undertaken certain measures to constrain the use of models and to reduce excess variability in risk-weighted assets that was driven largely by variations in the modelling choices of IRB banks.[35]

[34] See BCBS (2016).

[35] See BCBS (2013).

44. **Against this background, supervisory authorities may need to explore various policy considerations in conjunction with the introduction of IFRS 9 based on jurisdiction-specific needs and circumstances.** Some of these measures are relevant for all banks, while others will only affect either SA or IRB banks, respectively. Below, we provide examples of possible policy considerations that are broadly compatible with IFRS 9, while also addressing the prudential concerns associated with its implementation. Those considerations derive in part, from relevant BCBS guidance and the experience of various Asian jurisdictions, as described above.

Prudential issues relevant for all banks

- *Outline supervisory expectations for the application of IFRS 9 provisioning based on a bank's risk profile and the nature of credit products originated in local markets*: For example, authorities may consider specifying that large and complex banks should not rely on the practical expedients noted in the standard. In this regard, the appendix to the 2015 *BCBS Guidance on credit risk and accounting for expected credit losses*[36] outlines supervisory expectations specific to banks applying IFRS 9 that are a useful reference for all supervisory authorities. In addition, certain loan products with term structures[37] that might understate the likelihood of default if viewed solely from a 12-month time horizon could be subject to supervisory guidance with a view to facilitating a consistent application of IFRS 9 provisioning rules.
- *Specify supervisory expectations for restructured (forborne) exposures to facilitate risk assessments*: IFRS 9 allows banks to upgrade a restructured loan (ie from "impaired" to "underperforming" or from "underperforming" to "performing") if a customer has demonstrated its repayment capacity based on the revised terms over a "period of time", without specifically defining the term. This leaves substantial scope for a variation in practices across jurisdictions unless supervisory expectations are clarified. In this regard, recent BCBS publications outline supervisory expectations for banks when assessing the credit risks associated with forborne exposures[38] and provide globally harmonised definitions for forborne exposures,[39] including entry and exit criteria that can serve as useful references for all supervisory authorities.
- *Specify supervisory expectations in relation to loan write-offs upon the introduction of IFRS 9*: IFRS 9 requires banks to write off loans in their entirety or a portion thereof, if there is no reasonable expectation of recovery. Most surveyed jurisdictions in Asia, however, do not require banks to write off loans, even in cases where loans are fully provisioned. To the extent that such loans remain on a bank's books, they can significantly impact key asset quality measures used for supervisory risk assessments.
- *Assess the role of prudential asset classification frameworks under IFRS 9*: Authorities should determine whether the IFRS 9 three-stage credit classification requirements ("performing", "underperforming" and "impaired") are sufficient for supervisory monitoring purposes or whether supervisors could

36 See BCBS (2015).

37 For example, 20-year interest-only mortgage loans with balloon payment at maturity might result in different approaches to IFRS 9 ECL measurement. For example, one bank might measure this product under Stage 1 (12-month ECL) while another bank might measure the same loan under Stage 2 (lifetime ECL). This would result in vastly differently provisioning outcomes for the exact same credit exposure, unless supervisory expectations are clarified.

38 See BCBS (2015), Appendix A.

39 See BCBS (2017b).

benefit from regulatory asset classification requirements that provide more granular risk categories to help support the supervisory assessment of credit risk.[40]

- *Explore possible regulatory or supervisory measures in relation to accruing interest income on non-performing assets (NPAs)*: While IFRS 9 (and IAS 39) allows the accrual of interest income on an NPA, some supervisory authorities have explicit powers to prohibit the accrual of interest on NPAs or can offset the impact by requiring banks to hold a commensurate amount of associated provisions. In the absence of such powers and without challenging the application of IFRS 9, authorities could require banks to report the amount of interest income accrued on NPAs so that other prudential measures, such as deductions from CET 1 or Pillar 2 add-ons can be considered if deemed necessary.
- *More generally, there is rationale for supervisory authorities to gain powers (if not already available) to deduct provisioning shortfalls from CET 1*: Whenever supervisors determine that accounting provisions established are inadequate to absorb incurred and expected credit losses from a supervisory vantage point, they should have the power to take this into account when determining the regulatory capital held by financial institutions. If those powers do not exist, supervisors could still require a capital add-on under Pillar 2 to cover the provisioning shortfall. This alternative approach, however, is much less transparent and does not facilitate the comparability of regulatory capital figures across banks.

Prudential issues relevant for Standardised Approach (SA) banks

- *Evaluate the pros and cons of establishing a regulatory provisioning backstop for banks under the SA approach to credit risk capital measurement*: Supervisory authorities should assess if regulatory provisioning backstops – as widely used in Asia under IAS 39 – should be retained or developed upon the introduction of IFRS 9. To the extent that such approaches are being considered, their aims (ie what portion of IFRS 9 provisions should be subject to a backstop), design and application require careful deliberation. Regulatory provisioning backstops might be particularly useful for smaller or less complex banks that may not, initially, have the ability to develop, implement and maintain robust ECL provisioning methodologies and for all other SA banks whose methodology/practices do not meet supervisory expectations.
- *Map IFRS 9 provisions to the regulatory concepts of general (GP) vs. specific provisions (SP)*: The BCBS's March 2017 publication on the Regulatory treatment of accounting provisions[41] confirms the Basel Committee's plan to retain, for an interim period, the current regulatory capital treatment of accounting provisions.[42] During this time, jurisdictions can extend their existing approaches to categorising provisions as GP or SP. For SA banks, a key policy issue is to determine what portion of IFRS 9 provisions constitute GP vs SP, as a part of GP is included in Tier 2 capital. Against this background, policy decisions need to be made, first in regard to whether any accounting provisions under IFRS 9 should be counted as "GP"[43] and, if so, whether provisions related to Stage 2 loans[44] are

[40] For example, 14 of the 15 jurisdictions surveyed in Asia apply regulatory classification frameworks, with a five-bucket system being the most common ("Normal" "Watch" "Substandard" "Doubtful" and "Loss"). In general, the last three risk categories map to Stage 3 loans, while the first two regulatory risk categories have similar features to the Stage 1 and Stage 2 IFRS 9 categories, respectively.

[41] See BCBS (2017a).

[42] Under the current approach, GP can be included in Tier 2 capital up to 1.25% of gross risk-weighted assets (RWA), while SP is deducted from RWA.

[43] Some supervisory authorities have argued that, since all provisions under IFRS 9 are for "expected" losses while capital is for "unexpected" losses, there should be no provisioning add-backs to Tier 2 capital. Under this approach, all IFRS 9 provisions would be considered "SP".

[44] Stage 2 loans are "underperforming" and placed in this category if they have experienced a "significant increase in credit risk" since credit origination. Therefore, this category fills the space between "performing" and "non-performing", and provisions related to Stage 2 loans should also be considered to lie within this grey zone.

considered "GP" or "SP". Based on the range of practices in Asia regarding the definition of "GP" vs "SP", globally harmonised definitions of "GP" vs "SP" could further enhance the comparability of Basel III capital measures across jurisdictions.

- *Review applicable regulatory provisioning frameworks in regards to the treatment of collateral*: Under IFRS 9, banks are required to take into consideration the time and cost required to gain access to and sell collateral in determining the amount of provisions required if a borrower defaults. In contrast, several regulatory provisioning frameworks in Asia allow for collateral recognition with pre-specified supervisory haircuts (depending on the type of collateral) for purposes of determining loan loss provisions. As these two approaches can lead to different outcomes in collateral valuations and provisioning requirements, they merit further analysis.

Prudential issues relevant for internal ratings-based (IRB) banks

- *Assess the interactions between the regulatory EL provisioning parameters applicable for IRB banks with the IFRS 9 ECL provisioning concept*. Under Basel II/III, all IRB banks are required to calculate so-called regulatory EL provisions and to compare the amount with accounting provisions under IAS 39, with any shortfalls deducted from regulatory capital. On the other hand, if accounting provisions exceed IRB EL, the excess can be included in Tier 2 capital up to a specified limit (ie 0.6% of gross credit risk-weighted assets).

  Now that IFRS 9 also introduces an ECL provisioning concept, supervisory authorities might find it useful to take stock of the similarities and differences in modelling inputs between IRB EL and IFRS 9 ECL provisioning concepts as part of the supervisory review process. The table below illustrates the differences in modelling parameters between IRB EL and IFRS 9 ECL. These differences make it a difficult exercise to compare which of the two expected loss parameters are more conservative, as the outcomes could vary based on the economic cycle, differences in discount rates and the volume of loans that are assessed under the 12-month as opposed to the lifetime probability of default under the two different models.

Comparison between IRB EL and IFRS 9 ECL modelling inputs — Table 1

Modelling inputs	Basel II IRB EL	IFRS 9 ECL
Probability of default (PD)	Through the cycle	Point-in-time
Time horizon (PD)	12 months for all loans	12 months: for Stage 1 loans Lifetime: for Stage 2 and 3 loans
Loss-given-default (LGD)	Downturn; fixed LGDs for foundations IRB	Point-in-time
Discount rate	Weighted average cost of capital	Effective interest rate

Nevertheless, given that IRB EL parameters have remained static – while accounting has shifted from incurred to ECL provisions – there is now a greater likelihood that IFRS 9 ECL provisions will exceed IRB EL provisions (due to differences in modelling inputs), leading to greater add-backs to Tier 2 capital than those occurring under IAS 39.[45] If such add-backs are considered inappropriate from a prudential standpoint, authorities may monitor the level of add-backs and take relevant actions, if warranted.

[45] This could lead to a situation where accounting provisions are recognised in the P&L, but the full impact of those provisions is not reflected in regulatory capital.

Section V – Concluding remarks

45. **How loan losses are treated by banks in their financial statements is of particular relevance for prudential supervisors.** Deficiencies in the calculation of provisions automatically raise supervisory concerns regarding reported asset quality, profit and loss, and solvency indicators. Moreover, if loan loss provisions cover only incurred losses, reported capital figures are exposed to both expected and unexpected losses. This is an area of prudential concern given that regulatory capital, as a general principle, is intended to be a bank's last line of defence, by absorbing only unexpected losses. Such an approach also makes reported income figures and solvency indicators more volatile and procyclical.

46. **The adoption of IFRS 9, by replacing the incurred loss with an expected loss provisioning approach, is a significant improvement.** This new standard, if implemented properly, should help to enhance the transparency of financial statements and improve the accuracy of reported asset values. Importantly, it will also facilitate a better alignment of the accounting standards with prudential objectives.

47. **The actual implementation of IFRS 9, however, raises challenges.** The calculation of ECL provisioning methodologies entails significant complexity and substantial credit judgment, which could lead to heterogeneous practices across banks and jurisdictions. Therefore, accounting standard setters will need to continue their efforts to facilitate a robust application of IFRS 9, as will the accounting profession and securities market regulators.

48. **Supervisors also have a key role to play in addressing the prudential implications associated with the implementation of IFRS 9.** The implementation challenges may affect the comparability of asset quality, profit and loss metrics and Basel III capital measures across institutions. In this context, supervisors may find it difficult to assess solvency properly, particularly for banks that are less able to prepare and maintain reliable models for calculating expected losses. Against this background, prudential authorities could consider the adoption of various policy actions – as noted above – that are within their domain, depending on jurisdiction-specific circumstances.

49. **Above all, some supervisors may need to seek powers to impose adjustments to regulatory capital when accounting provisions are not considered sufficient to cover expected losses from a prudential standpoint.** The powers that currently exist under the minimum requirements of Basel II/III for IRB banks could be extended to all banks. This would help to address supervisors' prudential concerns while fully respecting the role of the accounting standards in establishing the criteria that govern asset valuation and the determination of the income statement in banks' published financial statements.

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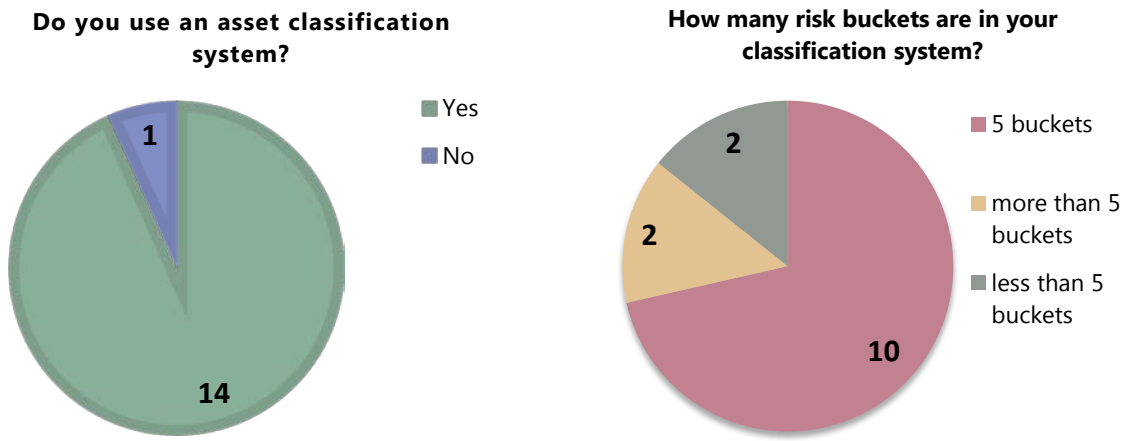
Annex – FSI survey on asset classification and provisioning practices in Asia

In July 2016, the FSI – in concert with the South East Asian Central Banks (SEACEN) Research and Training Centre – conducted a survey on asset classification and loan loss provisioning practices in 15 Asian jurisdictions to understand the design and role of regulatory classification and provisioning frameworks and how they interact with IAS 39 provisioning requirements. The surveyed jurisdictions were Brunei, Cambodia, China, Chinese Taipei, Hong Kong SAR, India, Indonesia, Japan, Malaysia, Mongolia, Nepal, the Philippines, Singapore, Sri Lanka and Thailand. Survey responses are outlined below:

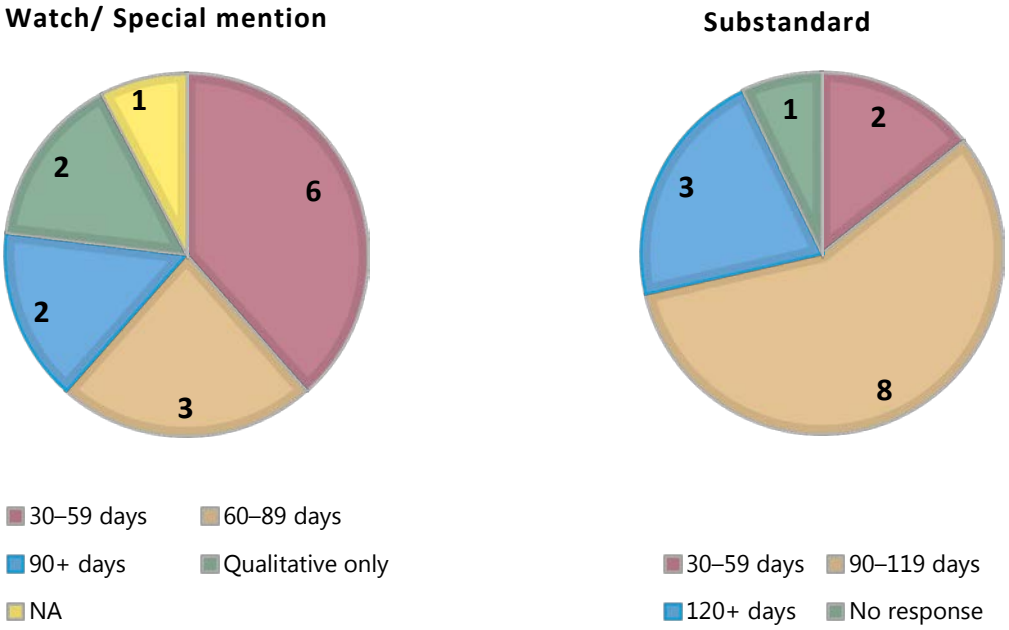
Asset classification

Use of asset classification systems in prudential framework — Graph 3



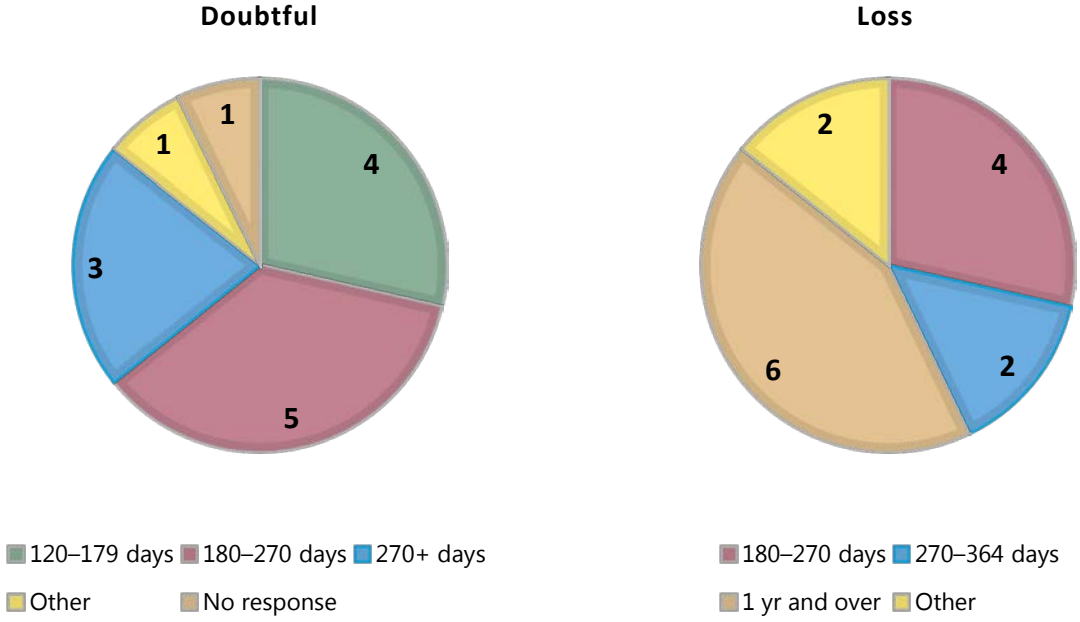
Source: FSI survey

Past due criteria for "Watch"[46] and "Substandard" loans — Graph 4



Source: FSI survey

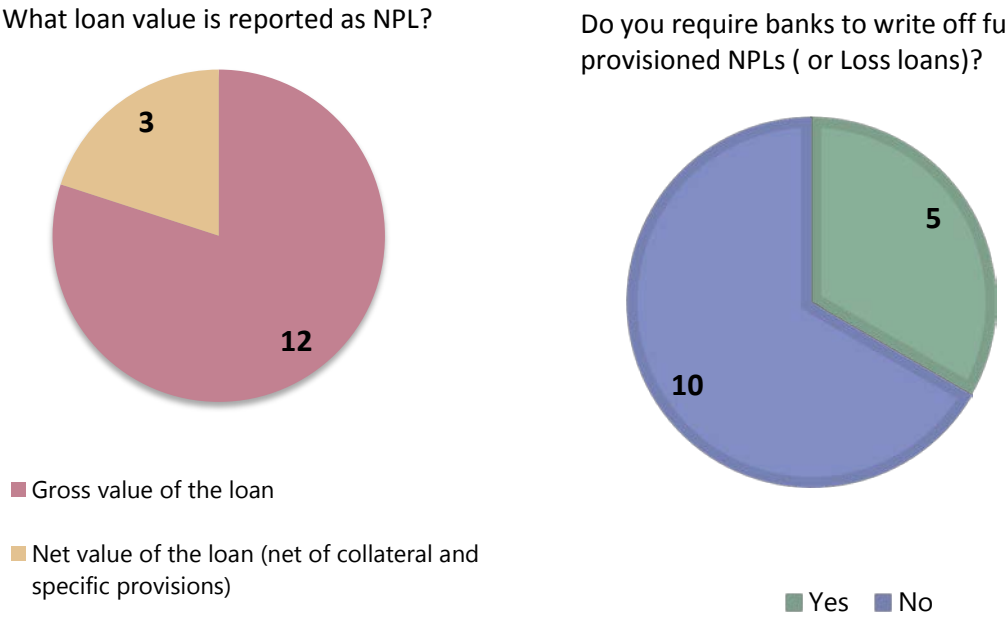
Past due criteria for "Doubtful" and "Loss" loans — Graph 5



Source: FSI survey

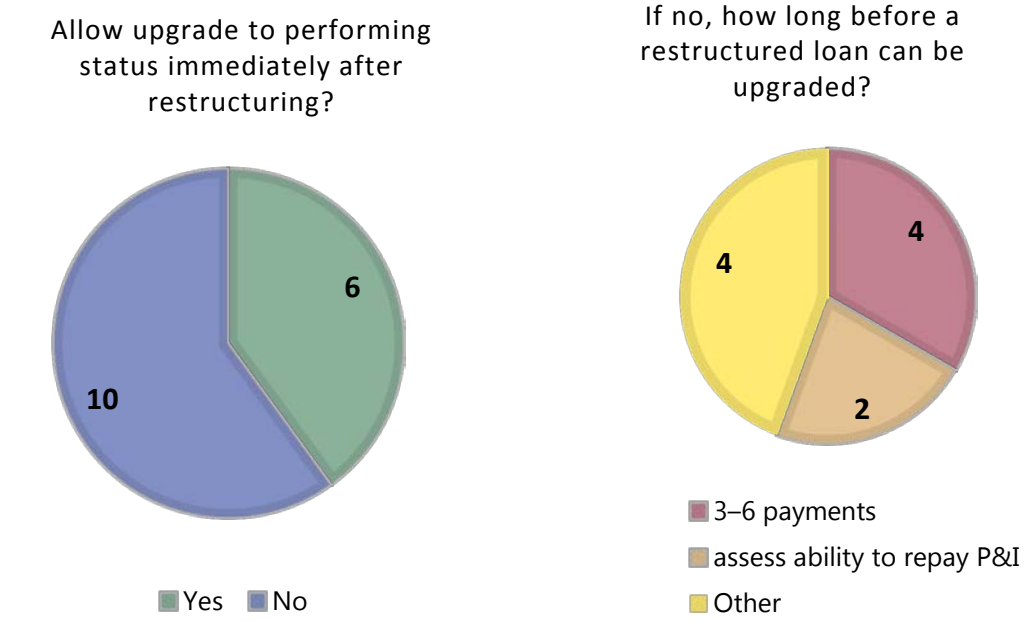
[46] The authority listed as "NA" does not have a regulatory classification category for "Watch or Special Mention". In addition to past due criteria, almost all authorities also have qualitative forward-looking criteria for placing loans in the "Watch" or "Substandard" categories.

Treatment of non-performing loans Graph 6



Source: FSI survey

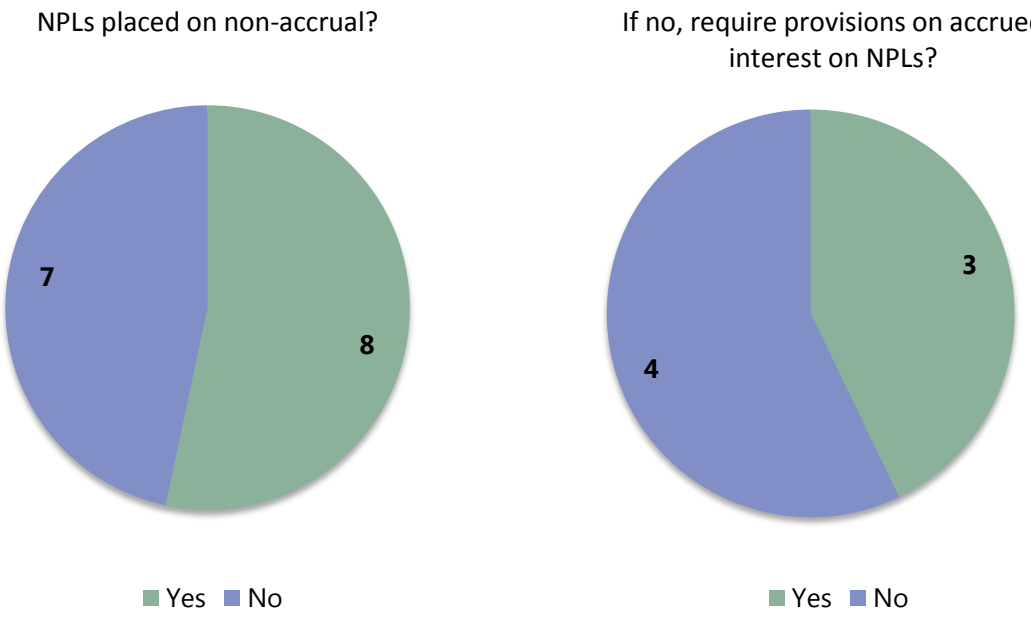
Treatment of restructured loans Graph 7



Source: FSI survey

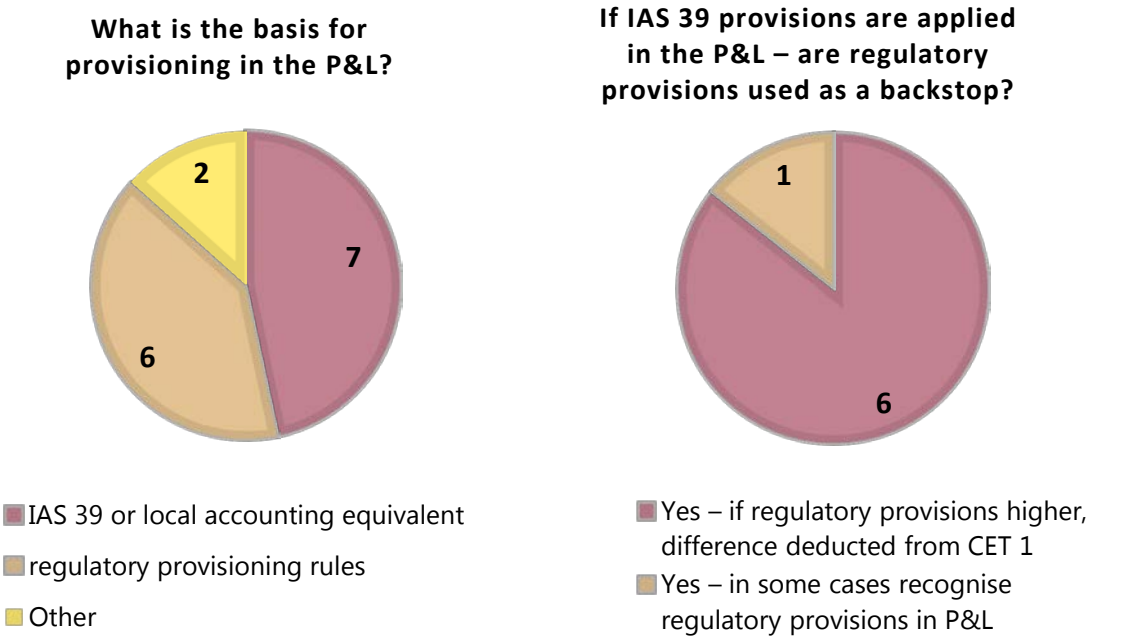
Provisioning

Treatment of non-accrual loans — Graph 8



Source: FSI survey

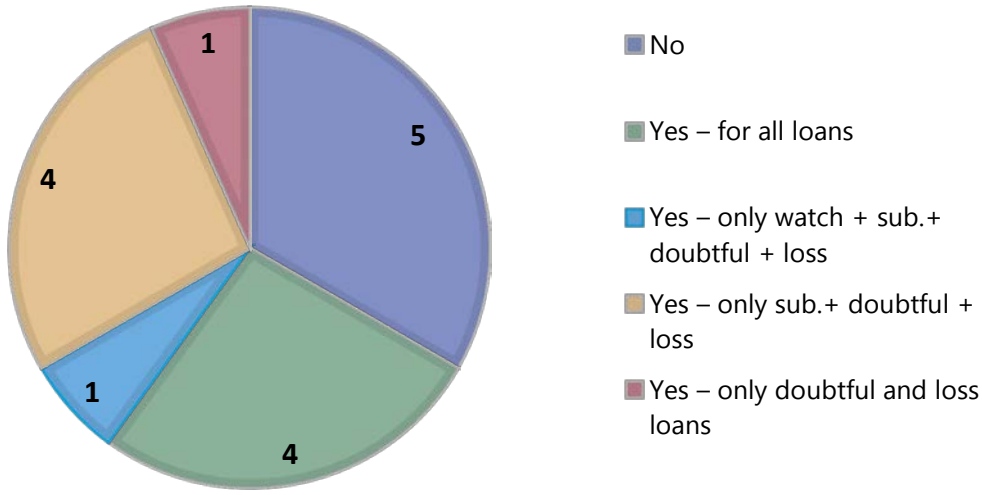
Provisioning requirements — Graph 9



Source: FSI survey

Role of collateral in loan loss provisioning Graph 10

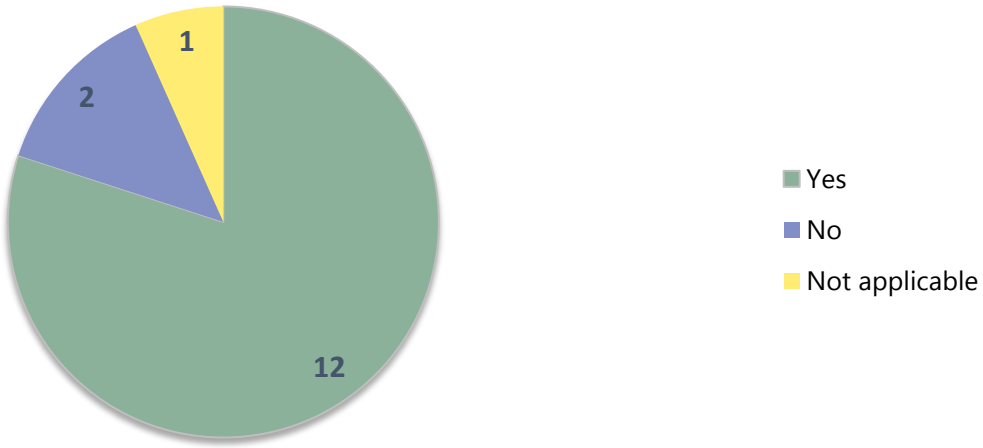
Is collateral deducted from loan value prior to provisioning?



Source: FSI survey

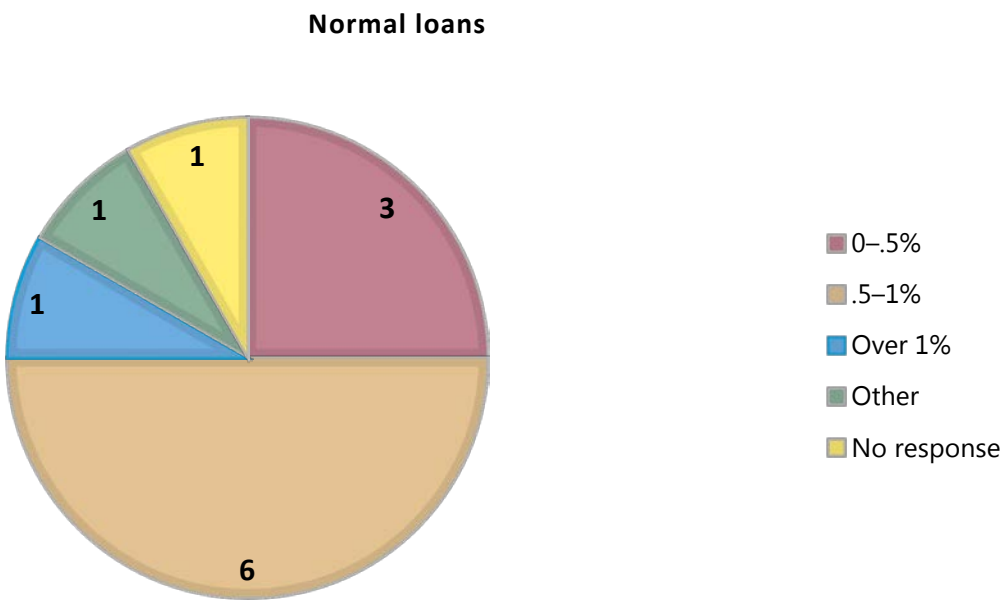
Asset classification systems and prescribed regulatory provisions Graph 11

If you use an asset classification system, do you prescribe a minimum range of provisions per asset classification category?



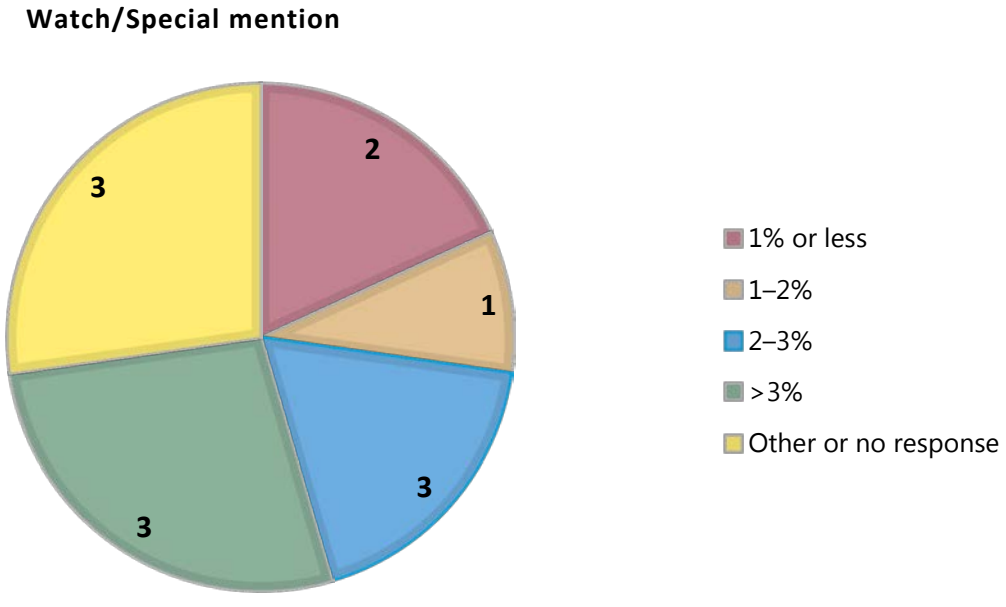
Source: FSI survey

Regulatory provisioning ranges for "Normal" loans Graph 12



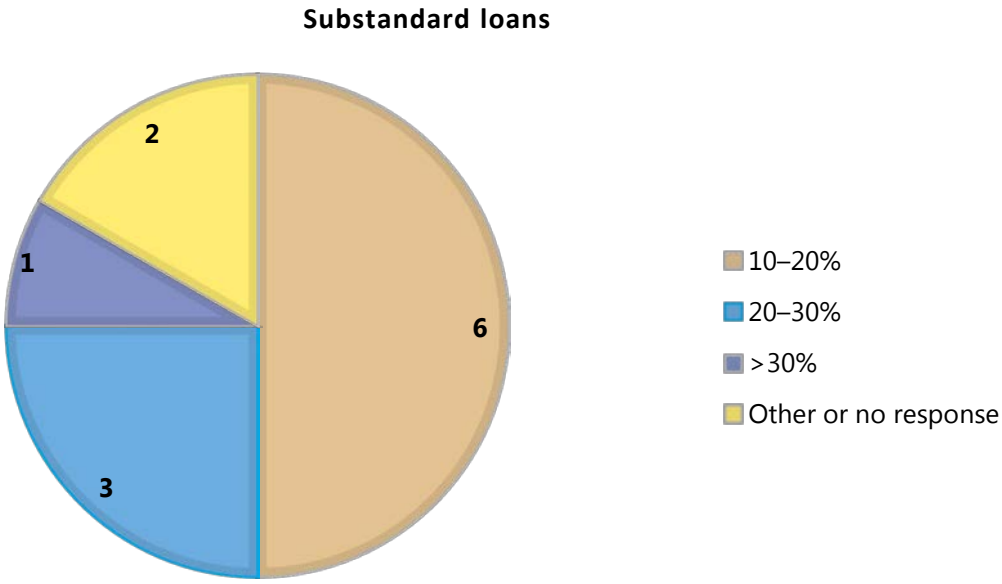
Source: FSI survey

Regulatory provisioning ranges for "Watch" loans Graph 13



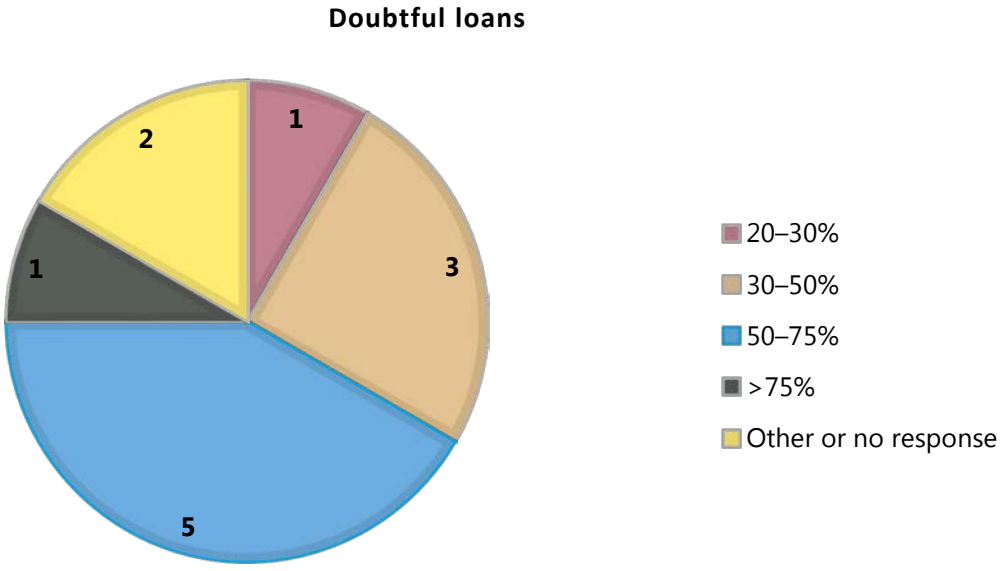
Source: FSI survey

Regulatory provisioning ranges for "Substandard" Graph 14



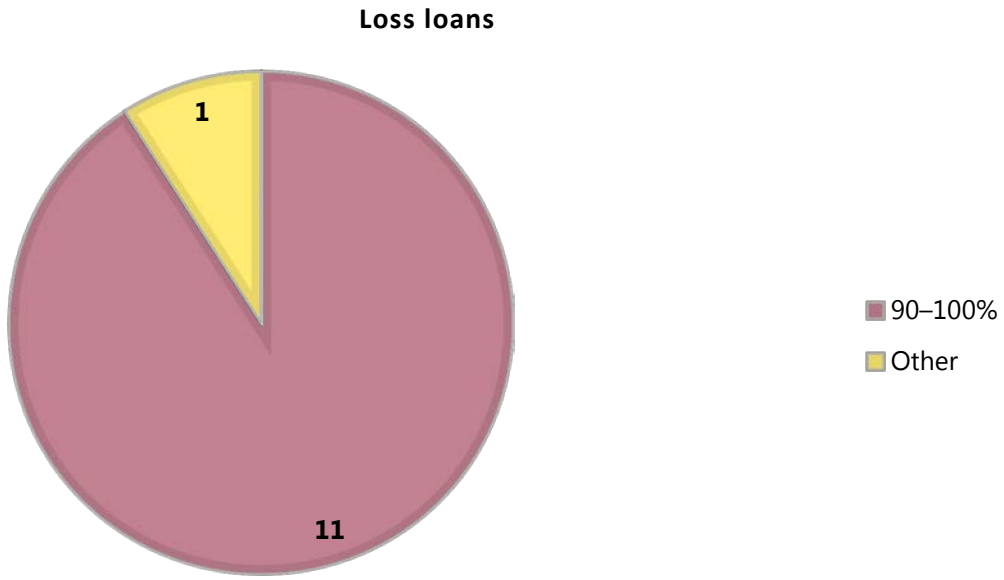
Source: FSI survey

Regulatory provisioning ranges for "Doubtful" Graph 15



Source: FSI survey

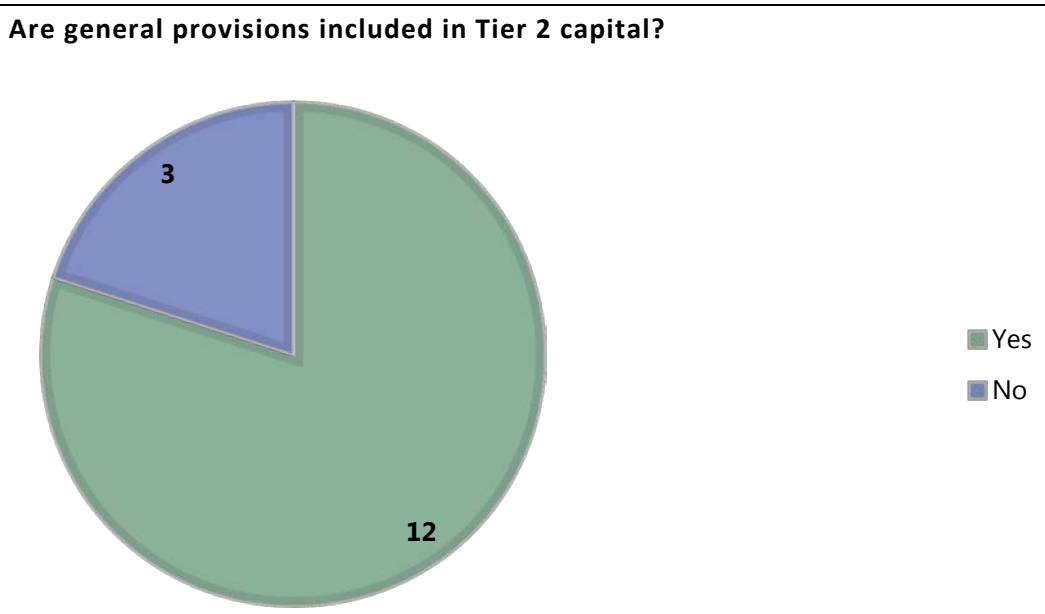
Regulatory provisioning ranges for "Loss" Graph 16



Source: FSI survey

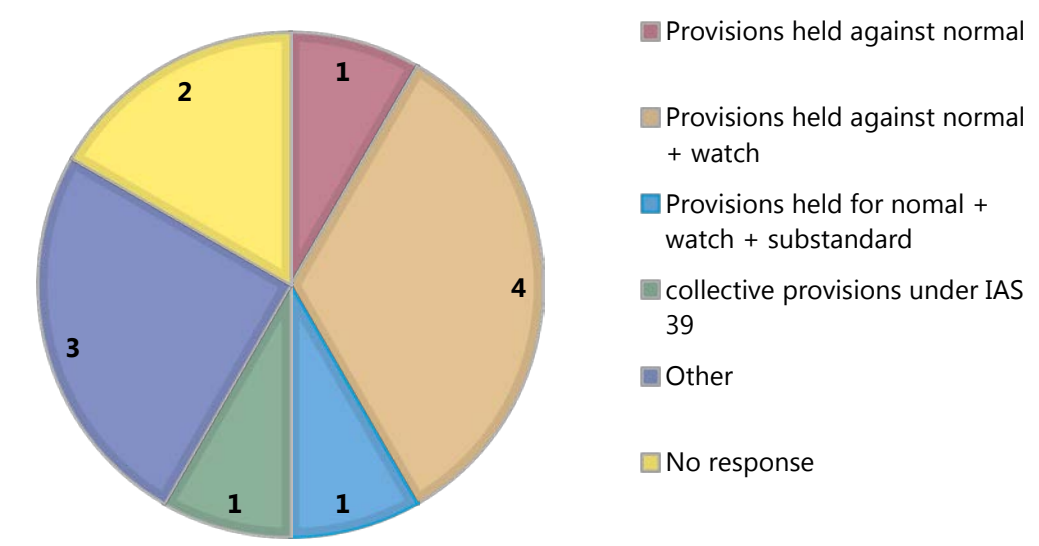
Treatment of accounting provisions in regulatory capital

Treatment of general provisions in regulatory capital — Graph 17



Source: FSI survey

Definition of general provision — Graph 18



Source: FSI survey