Basel Committee on Banking Supervision

Consultative document

Regulatory treatment of accounting provisions – interim approach and transitional arrangements

Issued for comment by 13 January 2017

October 2016

BANK FOR INTERNATIONAL SETTLEMENTS

This publication is available on the BIS website (www.bis.org).

ISBN 92-9197-996-7 (online)

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Regulatory treatment of accounting provisions – interim approach and transitional arrangements

1. Introduction

The timely recognition of, and provision for, credit losses serve to promote safe and sound banking systems and play an important role in bank regulation and supervision. In response to recommendations by the G20 Leaders and the Basel Committee on Banking Supervision that accounting standard setters consider modifying provisioning standards to incorporate forward-looking assessments in the estimation of credit losses, both the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have adopted provisioning standards that require use of expected credit loss (ECL) models rather than incurred loss models.

The IASB published International Financial Reporting Standard (IFRS) 9 in July 2014, which will take effect on 1 January 2018 (earlier application is permitted). The FASB published its final standard on Current Expected Credit Losses (CECL) in June 2016. The FASB's new standard will take effect on 1 January 2020 for certain banks that are public companies and in 2021 for all other banks, with early application permitted for all banks in 2019.

The Basel Committee supports the use of ECL approaches and encourages their application in a manner that will achieve earlier recognition of credit losses than with incurred loss models while also providing incentives for banks to follow sound credit risk management practices. Nevertheless, the Committee needs to consider the implications for regulatory capital. The new accounting provisioning models introduce fundamental changes to banks' provisioning practices in qualitative and quantitative ways, as higher provisions are possible with the lifetime loss concept and the inclusion of forward-looking information in the assessment and measurement of ECL.

Given the limited time until the effective date of IFRS 9, and to allow thorough consideration of the longer-term options for the regulatory treatment of provisions, the Committee is issuing for consultation the proposal to retain for the interim period the current regulatory treatment of provisions as applied under both the standardised approach (SA) and internal ratings-based (IRB) approaches. Because a distinction between general provisions (GP) and specific provisions (SP) does not exist under accounting frameworks, jurisdictions would extend their existing approaches to categorising provisions as GP or SP to provisions measured under the applicable ECL accounting model.[1] This proposed approach would apply pending further analysis of possible regulatory policy options and a better understanding of the impact of the move to ECL provisioning on capital ratios[2]. Unlike the standardised approach, the IRB framework does not rely on the distinction between GP and SP.

In addition, the Committee has identified a number of reasons why it may be appropriate to introduce a transitional arrangement for the impact of ECL accounting on regulatory capital. It therefore seeks comments on the options proposed in this document, so that the Committee can consider if any transitional arrangement is warranted to allow banks time to adjust to the impact that the new ECL accounting standards will have on capital for regulatory purposes.

The Basel Committee welcomes comments from the public on all aspects described in this document by **13 January 2017** using the following link: www.bis.org/bcbs/commentupload.htm. All comments will be published on the Bank for International Settlements website unless a respondent

1 Extending their existing approaches would not preclude jurisdictions from categorising some ECL provisions as GP even though all provisions for incurred losses have been treated as SP.

2 The Committee has also published its broader policy considerations in the *Discussion paper on the regulatory treatment of accounting provisions*, available at http://www.bis.org/bcbs/publ/d385.htm.

specifically requests confidential treatment. In parallel, the Basel Committee is conducting a quantitative impact study (QIS) to collect evidence on the implications and potential impact of each approach. All calibrations in this document are for illustrative purposes and thus subject to revision.

2. Proposal to retain the current regulatory treatment of accounting provisions for the interim period

When the Basel Committee issued the *International convergence of capital measurement and capital standards* (Basel I),[3] it recognised the close relationship between capital and provisions. Specifically, it sought to distinguish between provisions that have elements of the loss-absorbing characteristics of capital, known as general provisions, and those that should not be included in capital, described as specific provisions. Basel I permitted a limited amount of general provisions to be included in total (Tier 2) capital to reflect that they are freely available to meet future losses that currently are not identified, while excluding all specific provisions from capital.

The Committee also recognised that, under Basel I, the diversity of accounting and supervisory policies in respect of provisioning and capital across countries generated inconsistencies in provisioning, and that in practice it was not always possible to distinguish between specific and general provisions. To address inconsistencies and uncertainties, the Committee decided to retain this treatment of GP when it adopted the Basel II standardised approach for credit risk.[4] Specifically, Basel II therefore confirmed the limit to the additions of general provisions to Tier 2 capital of 1.25% of credit risk-weighted assets (RWAs).

When the Basel Committee designed the IRB approaches under Basel II, the treatment of provisions under those approaches was specified in a manner that allowed all provisions to be treated in the same way for the comparison of total eligible provisions with the total regulatory expected loss (EL) amount (Basel II, paragraph 384), which avoids the need to define which portions of provisions can be considered general or specific. Consequently, the current regulatory capital treatment of provisions under the SA and IRB approaches differ.

A summary of the current regulatory treatment of provisions is set out below:

2.1 Standardised approach

General provisions and specific provisions

General provisions are defined in Basel III, paragraph 60, as follows: "provisions or loan-loss reserves held against future, presently unidentified losses are freely available to meet losses which subsequently materialise and therefore qualify for inclusion within Tier 2".[5] The same paragraph implies that specific provisions include "provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped" that are excluded from general provisions.

Tier 2 add-back

Under the SA, banks are permitted to include general provisions in Tier 2 capital up to a limit of 1.25% of credit RWAs (Basel III, paragraph 60), which is broadly the same as under Basel I and Basel II. Specific provisions do not qualify for inclusion in Tier 2 capital.

3 *International convergence of capital measurement and capital standards*, July 1988, paragraph 8.

4 Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework, available at http://www.bis.org/publ/bcbs128.htm

5 Basel III: A global regulatory framework for more resilient banks and banking systems, available at http://www.bis.org/publ/bcbs189.pdf

Exposure

Under the SA, exposures are risk-weighted net of specific provisions (Basel II, paragraph 52) and gross of general provisions.

2.2 Internal ratings-based approaches

Total eligible provisions

The Basel II framework defines "total eligible provisions" under the IRB approaches as the sum of all provisions (eg specific provisions, partial write-offs, portfolio-specific general provisions such as country risk provisions or general provisions) that are attributed to exposures treated under the IRB approaches (Basel II, paragraphs 380–383). In addition, total eligible provisions may include any discounts on defaulted assets. Specific provisions set aside against equity and securitisation exposures must not be included in total eligible provisions.

CET 1 deduction and Tier 2 add-back

Under the IRB approaches, banks compare the total eligible provisions with the regulatory measure of EL calculated by banks as probability of default (PD) times loss given default (LGD) times exposure at default (EAD). Any shortfall between total eligible provisions and regulatory EL is fully deducted from Common Equity Tier 1 (CET1) capital (Basel III, paragraph 73), whereas any excess is added to Tier 2 capital, up to a limit of 0.6% of credit RWAs calculated under the IRB approaches (Basel III, paragraph 61).

Exposure at default

Under the IRB approach, all exposures are measured gross of specific provisions and partial write-offs (Basel II, paragraph 308).[6] Thus, neither specific provisions nor general provisions are deducted from EAD.

2.3 Proposal to retain the current regulatory treatment of provisions

As banks transition to ECL accounting models, an important issue is to define which, if any, portions of provisions should be regarded as SP and GP for regulatory purposes. Because such a distinction does not exist under accounting frameworks, the Committee is proposing that, for an interim period, jurisdictions would extend their existing approaches to categorising provisions as GP or SP to provisions measured under the applicable ECL accounting model.[7] To ensure consistency within jurisdictions, the Committee would encourage regulators to provide guidance, as appropriate, on categorising ECL provisions as GP or SP in their jurisdiction.

As set out above, for banks that apply the SA, the current regulatory capital framework distinguishes between general and specific provisions. Under this framework, the distinction between GP and SP is critical to SA portfolios because exposures are risk-weighted net of SP, but gross of GP, and GP are included in Tier 2 capital up to a cap. For these reasons, distinguishing between GP and SP under ECL accounting models could also be relevant to IRB portfolios should a capital floor to the IRB approaches be applied based on the SA. In addition, should the IRB approaches no longer be available for certain

[6] Paragraph 308 also requires that: "the EAD on drawn amounts should not be less than the sum of (i) the amount by which a bank's regulatory capital would be reduced if the exposure were written-off fully, and (ii) any specific provisions and partial write-offs. When the difference between the instrument's EAD and the sum of (i) and (ii) is positive, this amount is termed a discount. The calculation of risk-weighted assets is independent of any discounts. Under the limited circumstances described in paragraph 380, discounts may be included in the measurement of total eligible provisions for purposes of the EL-provision calculation."

[7] Extending their existing approaches would not preclude jurisdictions from categorising some ECL provisions as GP even though all provisions for incurred losses have been treated as SP.

exposure classes, such an approach could require IRB banks to apply the SA where the IRB approaches are not permitted. In both cases, it would be necessary for banks that use the IRB approach to distinguish between SP and GP.

Comments are welcome on the proposal that jurisdictions extend their existing approaches to categorising provisions as GP or SP to provisions measured under the applicable ECL accounting model for an interim period. The Committee's consideration of policy options for the long-term regulatory treatment of provisions under the new ECL standards are outlined in the separate discussion paper, which is being published concurrently with this document, *Discussion paper: Regulatory treatment of accounting provisions*.[8]

3. Possible transitional arrangements

3.1 The Committee's primary considerations

The Basel Committee has identified a number of reasons why it may be appropriate to introduce a transitional arrangement for the impact of ECL accounting on regulatory capital. These include:

- the fact that the impact could be significantly more material than currently expected and result in an unexpected decline in capital ratios;
- the fact that the Committee has not yet reached a conclusion on what should be the permanent interaction between ECL accounting and the prudential regime; and
- the two-year gap between the effective dates of the ECL accounting standards under IFRS 9 and CECL.

The Committee has not yet determined whether or not these factors will warrant the introduction of transitional arrangements, and the discussion below should be read with that qualification in mind.[9]

The Committee is aware that the transition to ECL accounting will generally result in an increase in the overall amount of loan loss provisions, which in many cases will reduce the capital ratios of banks as they transition to the ECL approach.[10] It is also aware that transitional issues may be more pressing for banks applying IFRS than those applying US GAAP (Generally Accepted Accounting Principles), because IFRS 9 is scheduled for implementation two years before the earliest required effective date for CECL. In addition, similar transitional issues may arise for non-IFRS banks or jurisdictions which adopt IFRS for the first time subsequent to the effective date of IFRS 9. That said, banks have been aware of IFRS 9 and CECL for some years, and arguably this would mean that banks should be prepared to absorb a "modest" decrease in CET1 capital upon initial application of ECL accounting. Hence, any transitional arrangements should apply only to any portion of a bank's decrease in CET1 capital that is greater than a "modest" amount.

At this point, the magnitude of the impact of the application of ECL accounting on aggregate capital requirements or on capital requirements at individual banks is uncertain. The Committee will continue to assess the impact from QIS exercises and other quantitative impact assessments, including any quantitative analysis that may be provided in response to this consultation paper. In the light of these

8 Available at http://www.bis.org/bcbs/publ/d385.htm.

9 The Committee acknowledges that jurisdictions may choose not to adopt any transitional arrangements to alleviate the potential impact of ECL accounting on regulatory capital.

10 The main exception concerns IRB portfolios where ECL provisioning remains at or below regulatory expected loss, because in this case the shortfall must be deducted from CET1 capital irrespective of the accounting provisioning approach.

assessments, the Committee will consider whether a transitional arrangement is necessary and, if so, what form of transitional arrangement would be appropriate.

Against that background, issues that would need to be considered in the design of transitional arrangements include:

- what capital metric should be referenced (eg CET1 capital);
- the period to be allowed for transition;
- whether the transitional adjustment would be amortised on a straight line or some other basis; and
- whether the transitional adjustment should be calculated just once, at the point of transition, or recalculated in the light, for example, of changes in the stock of provisions post-transition.

It is likely that the appropriate reference metric would be CET1 capital expressed as a "money amount" (ie in currency units). The transitional arrangement would involve adjusting CET1 capital so that the impact of the increase in provisions at the point of transition would not immediately be fully reflected in CET1 capital. Rather, the impact would be phased in over the transition period. The adjusted figure thus obtained for CET1 capital would be used in calculating other measures of regulatory capital (eg total capital) and related measures (such as the leverage ratio and large exposures limits). However, no adjustment would be made to any other aspects of the prudential framework, with the exception of the treatment of: (i) deferred tax assets; (ii) general, specific and excess provisions (all of which are relevant to Tier 2 capital); and (iii) exposure amounts in the SA for credit risk and in the leverage ratio, as noted below.

The Committee currently sees the primary objective of a transitional arrangement as being to avoid a "capital shock" by giving banks time to rebuild their capital resources following a negative impact arising from the introduction of ECL accounting. In light of this, the Committee's working assumption is that the period allowed for transition could be from three up to five years.

The Committee has a strong preference for a simple transitional mechanism if one were to be adopted. That is because the mechanism would be only temporary, the calculation burden on banks and supervisors should be kept to a minimum and it is important that market participants are able to readily observe the impact of the transitional arrangement. The objectives of the transitional adjustment should also be reflected in the approach to amortisation of the adjustment. Straight line amortisation is likely to be preferable on the grounds of simplicity. Another issue is whether any transitional arrangement should attempt to adjust for changes in the size of a bank's provisions after the point of transition. The Committee will assess whether any transition adjustments should be reduced specifically for provisions which cease to exist after the point of transition to ECL accounting – that is, the transitional arrangement would be applied only to provisions extant at the point of transition.

Any transitional arrangement would also need to address how accounting provisions that are not recognised (ie neutralised) in CET1 capital would be treated in other aspects of the regulatory framework. In particular, it would be necessary to include a clear principle that where an ECL accounting provision in effect has not been deducted from CET1 capital because of the application of the transitional arrangement, then:

- any deferred tax asset (DTA) arising from a temporary difference associated with such a non-deducted provision amount should not be subject to deduction from CET1 capital and should not be subject to risk weighting;
- such a provision amount cannot be included in Tier 2 capital, even if the provision meets the definition of "general" or "excess" provisions;
- such a provision will not reduce exposure amounts in the SA even if it meets the definition of a "specific" provision; and
- such a provision amount cannot reduce the total exposure measure in the leverage ratio.

A final consideration in the design of transitional arrangements is disclosure. It will be essential for banks to publicly disclose whether they are applying such an arrangement and, if so, the impact on the bank's regulatory capital compared with a situation where the transitional arrangement had not been applied (ie what the bank's "fully loaded" capital ratios would be). Any transitional arrangement would be accompanied by related Pillar 3 disclosure requirements.

3.2 Some possible approaches

The three approaches described below are examples of how a transitional arrangement might be structured and are solely for illustrative purposes. Each is based on the assumption that the transitional arrangement is applied for three years, and that it is amortised on a straight line basis.

The Committee's current preference is for Approach 1 because it directly addresses a possible "capital shock" in a straightforward manner. However, the Committee also welcomes views on Approaches 2 and 3 because those approaches take account of the ongoing evolution of ECL provisions during the transition period, and not just the impact of ECL accounting on banks' provisions and CET1 capital at the point of transition.

3.3 Approach 1: Day 1 impact on CET1 capital spread over a specified number of years

In this approach, a bank would compare CET1 capital based on the opening balance sheet using an ECL accounting standard with CET1 capital based on the closing balance sheet (ie the day prior to the opening day) under the existing incurred loss accounting approach. Where this shows a reduction in CET1 capital due to an increase in provisions, net of tax effect, the decline in CET1 capital would be spread for regulatory purposes over the number of years specified by the Committee. The mechanism would be applied only to the transitional effect on CET1 capital of initial application of an ECL accounting standard. An example of how this approach would work is given below.

3.3.1 Calculation of transitional adjustment amount

Consider a bank whose accounting provisions immediately before implementation of ECL accounting are €1,000 and immediately after implementation are €1,350.[11] The impact of the adoption of ECL accounting on the bank's CET1 capital amount would be a reduction of €350 (ignoring tax effects). This would be the transitional adjustment amount if the bank applies only the SA.

If, however, the bank applies the IRB approach to some or all of its portfolios, and for these portfolios an IRB provisioning "shortfall" of €50 exists immediately before implementation of ECL accounting,[12] then the transitional adjustment amount would be €350 – €50 = €300 because €300 is the amount by which CET1 capital is reduced as a consequence of the implementation of the new ECL accounting framework (ignoring tax effects).[13] However, if no IRB provisioning "shortfall" exists

[11] The use of Euros as the currency unit in this example is for illustrative purposes only.

[12] That is, accounting provisions are €50 less than regulatory EL immediately before implementation of ECL accounting.

[13] IRB banks are already required to compare total accounting provisions with the IRB estimate of expected loss ("regulatory EL") and to deduct from CET1 capital any "shortfall" between total eligible provisions and regulatory EL. Where accounting provisions are less than regulatory EL immediately before implementation of ECL accounting and the initial application of ECL accounting merely causes total eligible provisions to rise towards – but not above – that regulatory EL level, there will be no direct effect on CET1 capital upon initial application of ECL accounting. The impact of higher accounting provisions on CET1 capital would be offset by a lower deduction from CET1 capital for the "shortfall" of provisions compared with regulatory EL.

immediately before implementation of ECL accounting,[14] then the transitional adjustment amount would be the entire €350.

3.3.2 Mechanics of the transitional arrangement

The transitional arrangement would work through the transitional adjustment amount being partially included in (ie added back to) CET1 capital during the transition period. A fraction of this "transitional adjustment amount" (which the Committee could decide to be less than 100% of the impact of the adoption of ECL accounting on the bank's CET1 capital amount based on the number of years in the transition period) would be included in CET1 capital during the first year of the transition period, with the amount included in CET1 capital phased out each year thereafter during the course of that period.

Taking the figures given above for the bank applying the IRB approach with an IRB provisioning "shortfall", if the transition impact were phased in over three years, for example, using straight line amortisation, the bank would include the following amounts in its CET1 capital:

- <u>First day of Year 1 up to Year 1 end</u>: the bank would include in CET1 capital an "adjustment amount" of €300 * 3/4 = €225.
- <u>First day of Year 2 up to Year 2 end</u>: the bank would include in CET1 capital an "adjustment amount" of €300 * 2/4 = €150.
- <u>First day of Year 3 up to Year 3 end</u>: it would include in CET1 capital an "adjustment amount" of €300 * 1/4 = €75.
- No "adjustment amount" would be included in CET 1 capital beginning on the first day of Year 4 and thereafter.

The "adjustment amount" included in CET1 capital each year during the transition period would flow through to Tier 1 capital, and hence to the leverage ratio and to large exposure limits.

To illustrate the addition to the Basel framework that would be needed to implement a transitional arrangement for the introduction of ECL accounting, draft text for inclusion in the Basel III document on capital that would implement Approach 1 is set out in Annex 2.

3.3.3 A possible modified version of Approach 1 (materiality threshold)

For both IFRS 9 and CECL, there is more than three years between the publication of the final accounting standard and the earliest required effective date. Although the magnitude of the possible increase in accounting provisions arising from the implementation of these ECL accounting frameworks is not yet known, it could be argued that banks should have been taking the potential impact of the change to ECL accounting on CET1 capital into consideration as part of their capital planning during this three-year period. This would mean that banks should be prepared to absorb a "modest" decrease in CET1 capital upon initial application of ECL accounting and that transitional arrangements should apply only to any portion of a bank's decrease in CET1 capital that is greater than a "modest" amount, which may be due, for example, to the effects of a worsening economic forecast on ECL provisioning at the initial application date.

Accordingly, under a possible modified version of Approach 1, a bank would compare CET1 capital based on the opening balance sheet using an ECL accounting standard with CET1 capital based on the closing balance sheet under the existing incurred loss accounting approach. Where the increase in the bank's accounting provisions at the point of transition produces a reduction in CET1 capital, net of tax effect, measured as a percentage of CET1 capital based on the closing balance sheet that exceeds the percentage specified by the Committee, only the portion of the decrease in CET1 capital in excess of the

[14] No IRB provisioning "shortfall" would exist if the amount of a bank's accounting provisions immediately before it implements ECL accounting equal or exceed regulatory EL.

specified percentage, measured in currency units, would be spread for regulatory purposes over the number of years specified by the Committee. The mechanics of the transitional arrangement described under Approach 1 would be applied to this calculated excess amount.

3.4 Approach 2: CET1 capital adjustment linked to Day 1 proportionate increase in provisions

Under this approach, a bank would calculate the amount by which the increase in provisions due to ECL accounting at the point of transition, measured in currency units and net of tax effect, reduces CET1 capital. For banks applying the IRB approaches, the portion of the increase in accounting provisions under ECL accounting at the point of transition that falls within any "shortfall" of accounting provisions compared with regulatory EL at the point of transition would be disregarded, for the reasons set out under Approach 1. Any actual reduction in CET1 capital based on the opening balance sheet under ECL accounting compared with the amount of CET1 capital based on the closing balance sheet under the existing incurred loss accounting approach would be expressed as a percentage of provisions in the closing balance sheet at the point of transition. The transitional adjustment amount would be calculated as that percentage – which would remain fixed throughout the transition period – multiplied by the stock of provisions at a given reporting date, measured in currency units. The resulting transitional adjustment amount at each reporting date during the transition period would then be subject to amortisation fractions as under Approach 1 above.

However, if the stock of accounting provisions under ECL accounting at a given reporting date during the transition period is less than the accounting provisions in the closing balance sheet under the incurred loss accounting approach at the point of transition, the transitional adjustment amount for that reporting date would be zero.

This approach has the advantage of recognising that a bank's stock of provisions is likely to change through time. It does, however, assume that the proportion of total provisions that is due to the new ECL accounting remains constant over time, because that proportion is fixed at the outset.

3.5 Approach 3: Phased prudential recognition of IFRS 9 Stage 1 and 2 provisions

This approach would address the likelihood that the proportion of total provisions that is due to the new ECL accounting will fluctuate over time. In the case of IFRS 9 – but not CECL – provisions are allocated to "Stages", which could allow "new" provisions to be identified. Specifically, it may be that in the context of IFRS 9 the additional provisions created by ECL accounting are broadly those in Stages 1 and 2 – under the assumption that IFRS 9 Stage 3 ECL provisions are roughly equivalent to IAS 39 incurred loss provisions.

Under this approach, instead of Stage 1 and 2 provisions at a given reporting date, net of tax effect, being reflected immediately as a reduction of CET1 capital, a bank would phase in its recognition of these provisions for regulatory purposes over the transition period. That could be done by treating the sum of Stage 1 and 2 provisions at a given reporting date, net of tax effect, as the transitional adjustment amount, and applying to that total a transitional mechanism similar to that under Approach 1. Thus, the amount of Stage 1 and 2 provisions reflected in a bank's regulatory capital during the transition period would depend on both the total amount of such provisions and the amortisation fractions specified by the Committee. For banks applying the IRB approaches, the portion of Stage 1 and 2 provisions under ECL accounting at a given reporting date that falls within any "shortfall" of accounting provisions compared with regulatory EL would be disregarded, for the reasons set out under Approach 1.

For instance, if the transition period were three years, and a straight line amortisation approach were adopted, three fourths of the total of Stage 1 and 2 IFRS 9 provisions, less any IRB "shortfall", at each reporting date during 2018, net of tax effect, would be included in CET1 capital; two fourths of the total of these provisions at each reporting date during 2019, net of tax effect, would be included in CET1 capital;

one fourth of the total of these provisions at each reporting date during 2020, net of tax effect, would be included in CET1 capital; and no addition would be made to CET1 capital from the beginning of 2021 and thereafter.

Two major drawbacks to this approach have been identified. First, it can be applied only to IFRS 9 because CECL does not require the allocation of provisions to "Stages". Second, it is likely that some provisions maintained today for incurred but not reported losses will be allocated to IFRS 9 Stages 1 and 2, so the assumption that all Stage 1 and 2 provisions are "new" may not be justified.

3.6 Request for feedback

At this point, the potential magnitude of the impact of ECL provisions on aggregate capital resources and on capital resources at individual banks is uncertain. The Committee will continue to assess the impact through QIS exercises and other quantitative impact assessments, including any assessments that may be provided in response to this consultative paper. In response to these assessments, the Committee will consider whether any transitional arrangement is necessary and what form of transitional arrangement might be appropriate.

Comments are welcome on the various objectives for potential transitional arrangements identified above as well as on any other possible objectives of such arrangements. Comments are also welcome on the design of any transitional arrangement – in particular, how much importance should be attached to the simplicity of the chosen design, what the reference metric should be, what length of transitional period would be appropriate, and whether or not any such arrangement should be applied only to provisions recognised at the point of transition to ECL accounting. Comments on any implications of the transitional arrangements outlined for banks' IT systems would also be welcome.

The Committee cannot yet determine whether or not the introduction of a transitional arrangement would be appropriate. The Committee is, however, committed to monitoring the situation closely and is open to considering options for the mechanics of possible transitional arrangements, including approaches other than those described above.

Annex 1

Accounting and regulatory expected loss models

1. IASB and FASB ECL models

The main differences between the two ECL accounting models relate to the following factors:

(a) The **FASB** has adopted a single measurement objective that results in the recognition of lifetime expected credit losses for all exposures in scope.

(b) The **IASB**'s measurement model recognises expected credit losses based on a 12-month probability of default (PD) until a significant increase in credit risk on a financial asset or group of financial assets is identified, at which point lifetime expected credit losses are recognised. In other words, provisions for credit losses are based on three stages, with 12-month expected credit losses recognised for Stage 1 and lifetime expected credit losses for Stages 2 and 3.

Stage 1 – Performing loans: when loans first come onto balance sheets, banks must recognise the 12-month expected credit loss for these loans. This is the probability in the next 12 months of a loan defaulting (PD), multiplied by the amount which a bank would lose on the default.

Stage 2 – Underperforming loans: where a loan begins to show a significant increase in credit risk, banks will have to provision for the lifetime expected credit loss (ie based on the lifetime, not the 12-month PD). The increase in the provisions resulting from a move from 12-month to lifetime expected credit loss is typically expected to be sizeable.

Stage 3 – Impaired loans: banks have to recognise the lifetime expected credit losses for these loans, although the provision may already have been taken if the loan has migrated from Stage 2. One of the differences between Stage 3 and Stage 2 is that banks must accrue interest income on loans net of provisions in Stage 3 rather than on the gross carrying amount of loans.

Expected credit losses measurement

	Performing assets	Underperforming assets (assets with a significant increase in credit risk)	Impaired assets
IASB	**"Stage 1"** **<u>12-month</u> ECL**	**"Stage 2"** **Lifetime ECL**	**"Stage 3"** **Lifetime ECL**
FASB		**Lifetime ECL**	

The use of a PD/LGD method to measure ECL is not required and other methods, such as a loss rate method, can be used.

2. Main differences between the IASB/FASB ECL models and the IRB EL model

The table below compares the ECL models of the IASB and the FASB with the EL model in the internal ratings-based (IRB) approach in the Basel III standards. The IRB regulatory EL estimates use a <u>12-month</u>

PD. IFRS 9 uses a 12-month PD in Stage 1 and a lifetime PD in Stages 2 and 3. The CECL model uses a lifetime PD for all assets without regard to Stages.[15]

The Basel LGD and EAD estimates are based on loss severity experienced during economic downturn conditions, while accounting LGD and EAD models represent a neutral estimate based on expected economic conditions. In addition, there are other differences, such as the fact that the Basel LGD estimate includes collection costs which are not included in accounting ECL models.

Given the various differences, it is possible that accounting ECL could be higher or lower than regulatory EL, although **the shift to a lifetime PD is expected to result in accounting ECL exceeding regulatory EL in possibly many cases**. If EAD and LGD were the only factors, accounting ECL would normally be lower than regulatory EL when 12-month PDs are used for both because the use of regulatory downturn EAD and LGD is more conservative than those used under accounting standards. However, the accounting PD could be higher than regulatory PD in down-cycle periods, or where the lifetime PD is applied when estimating lifetime expected credit losses under CECL and in Stages 2 and 3 of IFRS 9.

Performing assets and underperforming assets (with a significant increase in credit risk)

		IASB	FASB	Basel Committee
PD	Measurement period	**12 months (Stage 1)** **Lifetime (Stage 2)**	**Lifetime**	**12 months**
	Cycle sensitiveness	**Point-in-time**, considering **forward-looking** information, including **macroeconomic** factors		**Economic cycle**
LGD/ EAD	Measurement	**Neutral** estimate, considering **forward-looking** information, including **macroeconomic** factors		**Downturn** estimate

15 Under IFRS 9 and CECL, the use of a PD/LGD method to measure ECL is not required and other methods, such as a loss rate method, can be used.

Annex 2

Draft rules text for Approach 1

If the Committee determines that the transitional arrangement under Approach 1 is warranted to allow banks time to adjust to the impact that the new ECL accounting standards will have on capital for regulatory purposes, the following text would be inserted after paragraph 96 of the Basel III document on capital. For purposes of this example rules text, a three-year transitional period is assumed.

96A The Committee is introducing a transitional arrangement for the impact on regulatory capital of the initial application of expected credit loss (ECL) accounting. Banks should implement this arrangement as follows:

a) A bank will compare CET1 capital based on its opening balance sheet using an ECL accounting standard with CET1 capital based on its closing balance sheet under the existing incurred loss accounting approach. Where this shows a reduction in CET1 capital due to an increase in provisions, net of tax effect, the decline in CET1 capital (the "transitional adjustment amount") will be spread for regulatory purposes over the number of years (the "transition period") specified by the Committee, commencing on the day of transition to ECL accounting.

b) During the transition period, the transitional adjustment amount will be partially included in (ie added back to) CET1 capital. A fraction of the transitional adjustment amount (based on the number of years in the transition period) would be included in CET1 capital during the first year of the transition period, with the proportion included in CET1 capital phased out each year thereafter during the course of that period on a straight line basis.

   Taking as an example a bank with a transitional adjustment amount of €300, and assuming that a three-year transition period was set by the Committee, the bank would include the following amounts in its CET1 capital:

   - First day of Year 1 up to Year 1 end: the bank would include in CET1 capital an "adjustment amount" of €300 * 3/4 = €225.
   - First day of Year 2 up to Year 2 end: the bank would include in CET1 capital an "adjustment amount" of €300 * 2/4 = €150.
   - First day of Year 3 up to Year 3 end: the bank would include in CET1 capital an "adjustment amount" of €300 * 1/4 = €75.
   - No "adjustment amount" would be included in CET1 capital from the beginning of Year 4 and thereafter.

c) The transitional adjustment amount included in CET1 capital each year during the transition period must be taken through to other measures of capital as appropriate (eg Tier 1 capital and total capital), and hence to the calculation of the leverage ratio and of large exposures limits.

d) Where an ECL accounting provision in effect has not been deducted from CET1 capital because of the application of the transitional arrangement, then:

   - any deferred tax asset (DTA) arising from a temporary difference associated with such a non-deducted provision amount should not be subject to deduction from CET1 capital and should not be subject to risk weighting;
   - such a provision amount cannot be included in Tier 2 capital, even if the provision meets the definition of a "general" or an "excess" provision;

- such a provision will not reduce exposure amounts under the standardised approach for credit risk, even if it meets the definition of a "specific" provision; and
- such a provision amount cannot reduce the total exposure measure in the leverage ratio.

e) A bank must publicly disclose the impact on its regulatory capital compared with a situation where the transitional arrangement had not been applied (that is, what the bank's "fully loaded" capital ratios would be).