

State Bank of Pakistan(SBP) Comments on BCBS Consultative document:
Regulatory treatment of accounting provisions – interim approach and
transitional arrangements

In response to common criticism of backward looking provision treatment in pre-crises time; regulators and governing bodies across the globe encourage the timely recognition of, and provision for, credit losses for banking sector stability and pro active regulation. With that in mind, SBP recognizes the efforts of the committee to timely recognize the need for regulatory improvements while this proposed regulation and the committee's initiative to gather feedback is a prudent effort. We concur with the proposal of the committee to allow staggering of the impact of additional provisioning arising from the migrating to Expected Credit losses (ECL) model. However, keeping in view the expected challenges due to introduction of standard on ECL, we urge the committee to enhance the interim period of three years to five years for smooth transition to the IFRS-9 standard. We would like to draw the committee's attention towards some of the challenges the jurisdictions may face with the given proposed timelines, as below:

- i. The incremental provision expense, due to migration to ECL model, may not be admissible for tax liability determination in certain jurisdictions. It requires interactions with tax authorities and relevant regulatory bodies. Needless to mention that it would necessitate amendment of certain provisions of law, which is a lengthy process.
- ii. The issuance of relevant supervisory guidelines in light of this proposal would also require consultation with and feedback from, the concerned local standard setting bodies, banking associations, regulatory bodies etc. which may also consume time to form a sector wide consensus.
- iii. ECL model under IFRS-9 may have to be aligned with the 'Expected Loss' determined under IRB approaches for Basel risk based capital regime. As determining provisioning under two independent models may be quite cumbersome and may contradict with the spirit of the standard and the banks' business models.
- iv. Determination of ECL through modeling requires extensive data, reliability of the models, determining optimal cost and regulatory approvals. Also, the jurisdictions have to see the response of the local banking industry prior to set interim approaches.

Our paragraph-specific comments and proposals on the subject documents are given as below:

Para 2.3: *Comments are welcome on the proposal that jurisdictions extend their existing approaches to categorizing 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.*

We noted that the provision charge against any regular portfolio is generally treated as GP (and the benefit of Tier 2 upto 1.25% of RWA is associated with that) while any provision charged (on recognition basis or expected loss basis) against any particular obligor usually considers as specific. However, committee concurred on the proposal to extend existing approaches in jurisdictions. As such, there is a need to explain that if in jurisdiction, the provision is treated as specific to the obligor/asset (particularly in case of exposure classes under IRB), as it would be calculated in ECL methodology (in accordance with the obligors' PDs), then the same warrants deduction from CET1 and thus would reduce the Tier II cushion to a cap for the banks. Thus would impose duality of negative impact on CAR.

Therefore, for the banks opting SA for exposures categories, it may be appropriate to consider such provision as general (not obligor specific) and Tier II benefit may be allowed to a cap to avoid duality of negative impact.

Para 3.1: *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:*

1) The fact that the impact could be significantly more material than currently expected and result in an unexpected decline in capital ratios;

It is true that the actual impact may be significantly larger than expected. Since the provision needs to be accounted for from the date of credit sanctioning. This contradicts fundamental market equilibrium theory. Recognition of expected future losses on day one is difficult and does not reflect the true economics since in all jurisdictions; banks do not expect a loan to go bad at the outset. Further, it may also cause disturbances in the pricing mechanism since the obligors would be priced above the true riskiness to nullify the impact of provision charge against the credit taking. The very determination of an appropriate rate of interest reflects the risk of borrower default at some point.

Therefore, the committee may be consider appropriating more time to comply the standard which would increase transition arrangement since the banks (across the globe) are in process of raising capital to comply Basel III excessive capital buffer and rising capital ratios requirements

2) 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

3) 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.

Currently there is a gap between the ECL and Prudential treatment for the loans and advances. The transitional approach may be appropriate to bridge that gap. But this would require enactment of certain rules/ laws to be enforceable across the board which requires detailed QIS.

Therefore, it is suggested to first publish undergoing QIS to determine any material change in the capital base of the banks as a result of the standard. Whereas, transitional arrangement may be considered in light of costs associated with that (post QIS).

The Committee is aware that the transition to ECL accounting will generally result in an increase in the overall amount of loan loss provisionsissues 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.....

As a response to a wave of re-regulation regime (in post-crises), certain standards requiring increase in capital ratios particularly for G-SIBs e.g., TLAC etc. In addition, Basel III enhanced capital standards have already pushed banks to increase its core capital base, such implementation may pose stress on stable banks and may raise concerns for the institutions already in stress.

It is therefore suggested to extend the implementation timeline of the standard; since it overlaps the Basel III enhanced capital floor deadlines (2019).

Para 3.1 - (iv): *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.*

We are of the opinion that additional provision requirement, if any, under Accounting provision in case of stage 2 (Under-Performing Loans) may be deducted 50% from CET-I and remaining 50% from Tier-1I and if Tier-II is not available then same may be deducted from CET1 with a ratio of 75% in year one while remaining in subsequent year. However provision shortfall against non-performing loans under the ECL approach may be deducted from CET1.

Further, a 5-years period may be the appropriate keeping in view the increasing regulatory standards and capital ratios.

Transitional adjustment (in percentage terms) on a straight line method is a better option because of simplicity and ease of applicability. While the transitional adjustment should be recalculated in light of changes in stock of provisions in post-transition period. Although calculating just once may be suitable for certain jurisdictions.

Para 3.3: *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.*

Considering jurisdiction like Pakistan, at any point of migration, determination of provisioning on ECL would have varied impact on banks depending on their size & loan portfolio. Small banks or banks with relatively weak credit portfolio may require extended transitional period for staggering of incremental provisioning and their admissibility in CET1 during this period.

Therefore, in our opinion, BCBS may finalize QIS on priority basis and prescribe maximum number of years for the transition period; whilst banking regulator may be allowed to take decisions considering size, portfolio health of the local banks.

Para 3.3 (i): *Approach 1: 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 (i.e. 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.*

As appreciated by the committee itself; based on all three approaches the first approach (straight line method) seems to be more appropriate, reason being its simplicity and without too much reliance on bank's internal assessments (since committee's goal is to keep the transitional arrangements as simple as possible). But there is a need to adjust the percentage of provision spread during the transition period.

Another important aspect that needs consideration is impact of additional provisions on profitability. Therefore, it would be appropriate to allow flexibility to the jurisdictions for adjusting additional provisions in their P&L over a period of time say five years. This approach will also minimize impact on profitability in addition to staggering of provisions for impact on CET1.

Para 3.3.3: *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*

The term ‘Modest Amount’ is not clear. The committee should further elaborate the terminology in terms of percentage of additional provision requirement under the ECL approach (IFRS-9) and its impact on regulatory capital.

Para 3.6: *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 recognized 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.*

The growing capital buffer regime wherein banks have to maintain the minimum capital adequacy ratio (CAR) of 12.5% by 2019 along with implementing this standard, may largely affect the profitability/capital adequacy of banks. Thus, the apprehension of the committee of further reducing profitability and eventually dipping capital is valid. Further, this ECL methodology needs detailed modeling, integration of finance, risk, accounting & technology, retrieval of old data, tax system updating, effective collateral valuation for LGDs, operational infrastructure, skill set, etc by banks which comes with certain costs which are difficult to quantify (as elaborated by the Committee). As such, there is a need to publish a detailed QIS for different set of economies to gauge the impact of the approach, before initiating implementation of the new standard.

It may be relevant to highlight that the BCBS has already imposed strict regulations for minimum CAR and countercyclical capital buffers for the banks already suffering from slow down of global economies; coincidentally, the timing of implementation of IFRS-9 and Capital excess buffer seems very close.