

Basel Committee on Banking Supervision

CRE

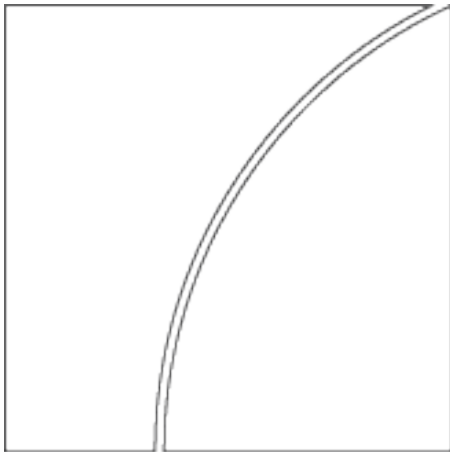
Calculation of RWA for credit
risk

CRE35

IRB approach: treatment of
expected losses and
provisions

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First version in the format of the consolidated
framework



BANK FOR INTERNATIONAL SETTLEMENTS

Introduction

35.1 This chapter discusses the calculation of expected losses (EL) under the internal ratings-based (IRB) approach, and the method by which the difference between provisions (eg specific provisions, partial write-offs, portfolio-specific general provisions such as country risk provisions or general provisions) and EL may be included in or must be deducted from regulatory capital, as outlined in the definition of capital standard [CAP10.19](#) and [CAP30.13](#). The treatment of EL and provisions related to securitisation exposures is outlined in [CRE40.36](#).

Calculation of expected losses

35.2 A bank must sum the EL amount (defined as EL multiplied by EAD) associated with its exposures (excluding the EL amount associated with equity exposures under the probability of default / loss-given-default (PD/LGD) approach and securitisation exposures) to obtain a total EL amount. While the EL amount associated with equity exposures subject to the PD/LGD approach is excluded from the total EL amount, [CRE35.3](#) and [CRE35.10](#) apply to such exposures.

35.3 Banks must calculate an EL as $PD \times LGD$ for corporate, sovereign, bank, and retail exposures both not in default and not treated as hedged exposures under the double default treatment. For corporate, sovereign, bank, and retail exposures that are in default, banks must use their best estimate of expected loss as defined in [CRE36.88](#) and banks on the foundation approach must use the supervisory LGD. For specialised lending exposures subject to the supervisory slotting criteria EL is calculated as described in paragraphs [CRE33.8](#) to [CRE33.12](#). For equity exposures subject to the PD/LGD approach, the EL is calculated as $PD \times LGD$ unless [CRE31.38](#) to [CRE31.41](#) apply. Securitisation exposures do not contribute to the EL amount, as set out in [CRE40.36](#). For all other exposures, including hedged exposures under the double default treatment, the EL is zero.

Calculation of provisions

Exposures subject to the IRB approach for credit risk

35.4 Total eligible provisions are defined 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 approach. 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.

Portion of exposures subject to the standardised approach for credit risk

- 35.5** Banks using the standardised approach for a portion of their credit risk exposures, either on a transitional basis (as defined in [CRE30.47](#) and [CRE30.48](#)), or on a permanent basis if the exposures subject to the standardised approach are immaterial ([CRE30.49](#)), must determine the portion of general provisions attributed to the standardised or IRB treatment of provisions according to the methods outlined in [CRE35.6](#) and [CRE35.7](#) below.
- 35.6** Banks should generally attribute total general provisions on a pro rata basis according to the proportion of credit risk-weighted assets subject to the standardised and IRB approaches. However, when one approach to determining credit risk-weighted assets (ie standardised or IRB approach) is used exclusively within an entity, general provisions booked within the entity using the standardised approach may be attributed to the standardised treatment. Similarly, general provisions booked within entities using the IRB approach may be attributed to the total eligible provisions as defined in [CRE35.4](#).
- 35.7** At national supervisory discretion, banks using both the standardised and IRB approaches may rely on their internal methods for allocating general provisions for recognition in capital under either the standardised or IRB approach, subject to the following conditions. Where the internal allocation method is made available, the national supervisor will establish the standards surrounding their use. Banks will need to obtain prior approval from their supervisors to use an internal allocation method for this purpose.

Treatment of EL and provisions

- 35.8** As specified in [CAP10.19](#) and [CAP30.13](#), banks using the IRB approach must compare the total amount of total eligible provisions (as defined in [CRE35.4](#)) with the total EL amount as calculated within the IRB approach (as defined in [CRE35.2](#)). In addition, [CAP10.18](#) outlines the treatment for that portion of a bank that is subject to the standardised approach to credit risk when the bank uses both the standardised and IRB approaches.
- 35.9** Where the calculated EL amount is lower than the provisions of the bank, its supervisors must consider whether the EL fully reflects the conditions in the market in which it operates before allowing the difference to be included in Tier 2 capital. If specific provisions exceed the EL amount on defaulted assets this assessment also needs to be made before using the difference to offset the EL amount on non-defaulted assets.

35.10 The EL amount for equity exposures under the PD/LGD approach is risk-weighted at 1250%. Provisions or write-offs for equity exposures under the PD/LGD approach will not be used in the EL-provision calculation. The treatment of EL and provisions related to securitisation exposures is outlined in [CRE40.36](#).