Financial Stability Institute | BIS

FSI Briefs

No 3

Expected loss provisioning under a global pandemic

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April 2020

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Authorised by the Chairman of the FSI, Fernando Restoy.

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ISSN 2708-1117 (online)
ISBN 978-92-9259-365-0 (online)

Expected loss provisioning under a global pandemic[1]

Highlights

- *In response to the 2007–09 Great Financial Crisis (GFC), accounting standard setters introduced a new methodology to value loans based on expected credit losses (ECL). The previous approach, based on incurred losses, was viewed as procyclical and inconsistent with prudential objectives.*
- *In the wake of the Covid-19 pandemic, several prudential authorities and the Basel Committee on Banking Supervision (BCBS), introduced a series of measures to clarify how banks should consider various public and private debt relief programmes in their ECL estimates and in their calculation of regulatory capital. These measures are intended to incentivise banks to continue supporting the real economy, while reducing pressure on banks' ECL provisions, earnings and regulatory capital.*
- *Supervisory initiatives that provide capital relief should be augmented by severe constraints on the payment of dividends, bonuses and share buybacks. These joint actions will simultaneously expand banks' lending capacity and enhance their ability to absorb losses.*
- *Prudential authorities face difficult trade-offs as they confront the most severe economic crisis in modern times. Encouraging the use of flexibility in applicable accounting standards, while preserving market trust and transparency in the reported financial statements of banks, will be key in fostering both economic and financial stability.*

1. Introduction

The 2007–09 GFC exposed significant shortcomings in the accounting principles that underpinned banks' loan loss provisioning practices. At the time, the accounting standard for loan loss provisioning was based on a so-called incurred loss (IL) model, limiting the ability of banks to recognise loan loss provisions in advance of a loss event. It was also criticised as being procyclical, because a large amount of provisions were recognised only after losses became evident.

In response, accounting standard setters introduced a loan valuation framework based on expected credit losses (ECL). In 2014, the International Accounting Standards Board (IASB) introduced International Financial Reporting Standards (IFRS) 9, which became effective on 1 January 2018 and are used in many jurisdictions. In the United States, the Financial Accounting Standards Board (FASB) developed its own ECL framework, known as the current expected credit loss (CECL) model. CECL became effective for large listed US banks starting in 2020 and will become applicable for others in 2022.

ECL methodologies have long been promoted by the supervisory community for their potential to enhance the transparency of financial statements and improve the accuracy of reported loan values and associated expected credit losses. In addition, they require banks to provision earlier in the credit cycle, helping to mitigate the excessive procyclicality associated with the IL model.

In the wake of the Covid-19 pandemic, there have been calls to either delay the application of ECL provisioning frameworks or to apply the standards with greater flexibility. These pleas are premised on the notion that banks should support the real economy in these unprecedented times, and that an overly conservative application of ECL provisioning in the current circumstances could lead to a spike in

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banks' non-performing loans, thus increasing provisions, lowering earnings and pressuring regulatory capital. This, in turn, may affect the availability of credit to affected consumers and businesses.

This paper takes stock of the measures introduced in several jurisdictions to influence how ECL methodologies can be applied under the current Covid-19 pandemic. Section 2 compares the key features of incurred and ECL methodologies, while Section 3 summarises the actions taken in the United States and in selected IFRS jurisdictions that have adopted ECL provisioning frameworks. This section also reviews the cumulative impact of these measures on a bank's financial metrics. Section 4 concludes.

2. A comparison of incurred and ECL methodologies

In order to contextualise the prudential measures introduced in several jurisdictions with respect to ECL provisioning, it is useful to take stock of the key differences between the IL methodology and the ECL frameworks as well as the variations within IFRS 9 and CECL.

Under the IL approach (IAS 39), banks are required to estimate provisions only if there is objective evidence of credit impairment. IAS 39 is referred to as an "incurred loss" model because a loss event must have occurred at the reporting date in order to trigger loan loss provisions. Future events, no matter how likely, are generally not considered in determining provisioning estimates. The ECL frameworks under IFRS 9 and CECL eliminate this threshold and require entities to calculate provisions based on expected losses on all credit exposures, considering past, current and reasonable and supportable future events.

Under IFRS 9, as soon as a credit is originated (or purchased), banks are required to recognise provisions based on 12-month expected losses[2] (ie Stage 1 loans). Once a loan has experienced a "significant increase in credit risk" (SICR) since initial credit recognition or is impaired, it should be moved to Stage 2 and Stage 3, respectively, with provisions being recognised based on lifetime expected losses.[3]

The main difference between CECL and IFRS 9 is that the former requires banks to book lifetime expected credit losses for all loans at credit origination. In contrast, IFRS 9 requires lifetime expected losses only when the credit exposure has experienced a SICR since credit origination.

Another important difference between CECL and IFRS is in regard to the accrual of interest income on impaired/non-performing exposures. Under IFRS 9, interest income is accrued on a gross basis for Stage 1 and 2 exposures and on a net basis (net of provisions) for Stage 3 (non-performing) exposures. Meanwhile, under current US accounting standards (covering both the IL methodology and the CECL model), the accrual of interest income on an impaired exposure is not specifically addressed. In the absence of explicit guidance in applicable US accounting standards, US banks typically follow regulatory guidance that prohibits the accrual of interest income (and requires the reversal of previously accrued, but uncollected interest income) on certain problem exposures that are placed on non-accrual status.[4]

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

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

[4] These typically include exposures that are 90 days or more past due unless the asset is well secured and in the process of collection and other exposures where full payment of principal or interest is not expected. This policy also applies to US banks that remain under the incurred loss methodology.

3. Prudential response to ECL provisioning methodologies

Overview

The ECL approach is, in principle, far less procyclical than the IL approach since banks are required to book provisions before actual default occurs. As such, this methodology should help to smooth banks' reported earnings over the credit cycle. That smoothing effect, however, would not exist in the case of an abrupt, seismic shock such as the Covid-19 pandemic. In this case, ECL methodologies can trigger a substantial increase in provisions, as the sudden nature and scale of the pandemic leads to a significant reassessment of expected losses, even in the absence of credit default. This, in turn, may amplify procyclicality and could lead to a sharp decline in banks' reported net income, which could have implications for their ability and willingness to provide credit to the real economy (see Borio and Restoy (2020)).

In this context, many authorities have taken various actions, aiming to mitigate the procyclical impact of the ECL accounting approaches. Those actions also affect the accounting treatment of the various debt relief measures that authorities have implemented to help affected borrowers and industries that are encountering short-term cash flow problems.

In IFRS-compliant jurisdictions, authorities have issued guidance to clarify how such measures should be considered in implementing ECL methodologies, emphasising the flexibility allowed under IFRS 9. In the United States, authorities have taken even bolder steps through the legislative process that allows large listed banks that are subject to CECL beginning in 2020 the option to delay its application. If this option is exercised, the entire US banking system will remain under the IL approach for the time being.

At the international level, the BCBS recently clarified the regulatory treatment of different payment moratoriums and government guarantees in the context of risk-based capital requirements. They also agreed on certain amendments to the existing transitional arrangements in regard to the recognition of ECL provisions in regulatory capital, to mitigate any potential cliff effects with the application of ECL frameworks in the current environment. These amendments allow jurisdictions the option to add back into Common Equity Tier 1 (CET 1) up to 100% of the provisions attributable to the application of ECL provisioning methodologies in 2020 and 2021. If this option is exercised by all BCBS members, it means that only accounting provisions related to incurred losses will be reflected in the calculation of banks' CET 1 measures in 2020 and 2021.[5]

Prudential response in IFRS jurisdictions

In IFRS-compliant jurisdictions, prudential authorities that have issued guidance – while varying in their level of prescription – aim at avoiding an overly conservative interpretation of IFRS 9, thus, reducing the strain on banks' ECL provisioning levels and their published income statements. Other jurisdictions, however, have not made public comments on the application of IFRS 9. In this regard, the Hong Kong Monetary Authority (HKMA) announced an innovative means[6] of providing banks with more capacity to lend to affected borrowers, without modifying their expectations for IFRS 9 implementation.

In general, authorities that have provided guidance focus on three aspects of IFRS 9 and seek to alleviate the amount and timing of ECL provisions that might otherwise apply in normal circumstances:

[5] These transitional arrangements are subject to appropriate disclosures, comparing the bank's regulatory capital ratios in relation to the bank's "fully loaded" capital ratios, had the transitional arrangements been not in place.

[6] In Hong Kong SAR, banks have been required for some time to maintain regulatory provisions in excess of IFRS 9 provisions that are held as a component of (non-distributable) retained earnings. On 3 April, the HKMA announced that it will release half of the banking industry's regulatory reserves (HKD 200 billion) to provide banks with more flexibility to expand their lending capacity.

- Treatment of payment holidays/deferrals;
- Treatment of modified debt; and
- Use of reasonable and supportable forward-looking information.

Treatment of payment holidays: IFRS 9 requires entities to reclassify loans from stage 1 to stage 2 (and thus require lifetime expected losses) if there has been a significant increase in credit risk since initial credit recognition. There is a rebuttable presumption under the standard that loans more than 30 days past due are assumed to have experienced a SICR and should thus be moved to stage 2.

While broadly similar, various approaches have been taken with respect to payment deferrals. Several authorities (Canada, 27 member states of the European Union[7] and the United Kingdom), the BCBS and the IASB have clarified that the utilisation of a payment deferral programme should not result in an automatic trigger for SICR and, thus, would not necessarily require a migration of loans from stage 1 to stage 2/3. Jurisdictions such as Australia have been less prescriptive, specifying only that relief measures, such as repayment deferrals should be taken into account when determining expected credit losses under IFRS 9. A third approach is debt moratorium programmes that are directed and/or coordinated by the prudential authority (Malaysia, Singapore), in collaboration with banks. While these authorities have not publicly opined on how such exposures should be treated under IFRS 9, they have provided guidance on who qualifies for such programmes and the interest charges associated with the deferred payments.

Treatment of modified debt: IFRS 9 requires an entity to assess whether there has been a SICR in regard to the risk of a default occurring at the reporting date under the modified terms as compared with the risk of a default occurring at initial recognition (based on the original, unmodified contractual terms). An important dimension of debt modifications under IFRS 9 is, if the revised terms lead to a decline in the expected net proceeds from the loan (eg the net present value of the cash flows reduce after debt restructuring), banks are required to record ECL provisions for the difference.

One authority specifies that Covid-19 related payment moratorium should not be considered as "distressed restructuring" under the regulatory framework (EBA, covering the 27 EU jurisdictions) while another states that modified loans that are driven by regulatory action would not necessarily mean that lifetime expected losses are relevant (Malaysian Accounting Standards Board (2020))[8]. A third jurisdiction (Australia) mentions only that repayment deferrals as part of a government wide Covid-19 package are not considered as restructured for regulatory purposes. These clarifications are important as banks, in general, are reluctant to modify debt (eg extending loan maturities, lowering interest payments etc) if applicable accounting standards require them to book losses on such modifications.

Use of reasonable and supportable forward-looking information: IFRS 9 requires the measurement of ECLs in general and SICRs in particular to be based on reasonable and supportable information on past, current and future conditions that is available without undue cost. In particular, overly pessimistic forecasts of future conditions might result in higher ECL provisions, given the scale of the Covid-19 pandemic.

While all prudential guidance is aimed at tempering excessively dire future forecasts, the details vary. One jurisdiction (Australia) reminds banks to exercise judgment to ensure that the IFRS 9 criterion of "reasonable and supportable" is met in estimating ECL provisions. Others (Canada, the United Kingdom and the IASB) emphasise the need for banks to consider not only the effects of Covid-19, but also the significant government support measures undertaken in determining future forecasts. Lastly, the EBA emphasises the need for banks to consider the extraordinary circumstances when determining which information can be considered "reasonable and supportable", while taking into account the expected nature of the shock (ie temporary or not) and the dearth of available and reliable information.

[7] For the purposes of this paper, the guidance of the 27 member states of the European Union (EU) is based on statements made by the European Banking Authority, the umbrella prudential banking regulator of EU member jurisdictions.

[8] Statement made by the Malaysian Accounting Standards Board.

Prudential response in the United States[9]

In response to the Covid-19 pandemic, various measures have been taken to encourage bank lending to consumers and businesses and to provide regulatory capital relief. These measures include: (i) providing an option to delay the adoption of CECL; (ii) mitigating the effects of ECL provisions in regulatory capital; and (iii) providing guidance on the treatment of payment holidays and restructured debt.

Delay in the implementation of CECL: The US President signed into law the Coronavirus Aid, Relief and Economic Security Act (CARES Act) in March 2020. Among other items, the CARES Act allows banks that were previously required to adopt CECL on 1 January 2020 the option to delay its implementation until the earlier of 31 December 2020 or the termination date of the current national emergency, declared by President Trump on 13 March 2020 under the National Emergencies Act concerning Covid-19.

Regulatory capital treatment of accounting provisions under CECL: On 27 March 2020, the US banking agencies issued an interim final rule that allows banks that elect to adopt CECL in 2020 (despite having the option to delay under the CARES Act) to mitigate the effects of implementing CECL in their regulatory capital for up to two years. This is on top of a three-year transition period applicable to all banks. In other words, even if large listed banks adopt CECL in 2020 for the purposes of recognition in earnings and their published financial statements, any increase in provisions that is due to the application of CECL versus the IL methodology will not be reflected in regulatory capital during this two-year period.

Treatment of payment holidays: The Federal Deposit Insurance Corporation (FDIC) has specified that borrowers who were not past due prior to Covid-19 and then subsequently receive payment holidays would not be reported as past due for regulatory purposes. No specific guidance is provided on how such payment holidays should be treated in the calculation of incurred or ECL provisioning methodologies.

Restructured debt: The US agencies have confirmed, in consultation with FASB, that short-term loan modifications made on a good faith basis to borrowers affected by Covid-19 and who were paying as agreed prior to the debt modification would not be considered a "troubled debt restructuring" for accounting or regulatory purposes.[10] This approach was also enshrined in the CARES Act, which provides banks with greater flexibility in restructuring loans to affected borrowers. In effect, this means that a further analysis on whether a bank experiences a loss (based on net present value analysis) associated with the restructuring does not have to be made and thus no provisions need to be taken for such exposures.

Accrual of interest income on payment deferrals: The FDIC directs banks to refer to regulatory reporting instructions and banks' internal accounting policies on whether loans with payment deferrals should be placed on non-accrual status (see footnote 4 for the US definition of a non-accrual asset).

Estimating credit losses (under IL or ECL methodologies) for loans with payment accommodations: Given the possibility that some US banks may elect to adopt CECL, while most others will remain under the IL approach, the FDIC tailored their guidance accordingly (albeit at a very high level). For banks that adopt CECL in the first quarter of 2020, they are required to consider all available information and to make a good faith estimate of the net amount of expected credit losses, including the use of forward-looking information that is reasonable and supportable. For banks that remain under the IL approach, the guidance is broadly similar, but focuses on the use of all information available **prior** to filing the report (reflecting the limitations of the IL approach that future events should not be considered) in order to estimate **probable** losses (ie "probable" is the US equivalent of "incurred" losses, reflecting a higher threshold for provisions to be triggered under the IL approach).

9 The US response to the Covid-19 pandemic in regard to the application of CECL and IL methodologies are based on guidance provided by the Federal Deposit Insurance Corporation; and their views should not necessarily be construed as being similar to those of other US banking agencies including the Office of the Comptroller of the Currency and the Federal Reserve Board.

10 This includes short-term (up to six months) modifications such as payment deferrals, fee waivers, extensions of repayment terms or other delays in payments that are considered insignificant.

Impact of Covid-19 support measures on banks' financial metrics

The cumulative impact of the extraordinary support measures are likely to have a material impact on banks' provisions, earnings and CET 1 capital. Tables 1 and 2 summarise these measures.

IFRS jurisdictions – impact of measures on provisions, earnings and CET 1 — Table 1

Applicable measures	Impact on provisioning	Impact on net income	Impact on CET 1
Banks can accrue interest on payments that have been deferred.*	[redacted]	increase	increase
Use of payment deferral programme should not automatically lead to a migration of loans to stage 2.	decrease	increase	increase
In use of forward-looking information in determining ECL provisions, consider exceptional circumstances and government support.	decrease	increase	increase
For risk-based capital requirements on loans subject to a government guarantee, the credit risk of the sovereign should be used. (BCBS)	[redacted]	[redacted]	increase
Payment deferral programmes related to Covid-19 do not need to be treated as past due for risk-based capital requirements. (BCBS)	[redacted]	[redacted]	increase
Transitional rules on impact of ECL provisions on CET 1 capital. (BCBS)	[redacted]	[redacted]	increase

* IFRS 9 allows banks to accrue interest on stage 1 and 2 loans on a gross basis and stage 3 loans on a net basis.

Source: FSI analysis.

United States – impact of measures on provisions, earnings and CET 1 — Table 2

Applicable measures	Impact on provisioning	Impact on net income	Impact on CET 1
Option to defer application of CECL until 4Q 2020 for large, listed banks.	decrease	increase	increase
Short-term modifications to borrowers affected by Covid-19 and who were paying as agreed prior to the debt modification and would not be considered a "troubled debt restructuring".	decrease	increase	increase
For risk-based capital requirements on loans subject to a government guarantee, the credit risk of the sovereign should be used. (BCBS)	[redacted]	[redacted]	increase
Payment deferral programmes related to Covid-19 do not need to be treated as past due for risk-based capital requirements. (BCBS)	[redacted]	[redacted]	increase
Transitional rules on impact of ECL provisions on CET 1 capital. (BCBS)	[redacted]	[redacted]	increase

Source: FSI analysis.

4. Concluding remarks

Prudential authorities, in concert with the BCBS, have taken unprecedented steps to encourage banks to support the real economy in the wake of the Covid-19 pandemic. These measures are intended to ensure that banks do not take an overly conservative approach to ECL provisioning, by considering the various government support measures that have been introduced. These actions should ease pressure on banks' ECL provisioning practices and their reported earnings, while allowing member jurisdictions the option to fully neutralise the impact of ECL provisions in the calculation of CET 1 capital for 2020 and 2021.

Regulatory measures, should, however, be accompanied by bank-led actions to preserve their capital. These initiatives, which have already been taken by some banks in certain jurisdictions include severe constraints on stock buybacks and payments on dividends and bonuses (see Carstens (2020)), until the global economy regains its footing. These collective measures should help banks to expand their lending capacity, while concurrently boosting their ability to absorb future loan losses.

In dealing with the aftershocks of the current pandemic, prudential authorities face difficult trade-offs. On the one hand, the various measures are designed to encourage banks to support the real economy. On the other, these same measures have promoted the use of flexibility within the confines of ECL provisioning rules and the option to recognise the IL provisioning approach in the calculation of CET 1 capital. Therefore, striking a balance between encouraging the use of flexibility in accounting standards, while preserving market confidence and transparency – such that banks absorb rather than amplify risk – will be key in fostering financial stability.

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