BANK FOR INTERNATIONAL SETTLEMENTS

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Accounting provisions and capital requirements – Executive Summary

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have both developed new provisioning standards for financial instruments based on expected credit losses (ECL), with effective dates of 1 January 2018 and 1 January 2020, respectively. The ECL accounting approaches under both methodologies have introduced fundamental changes to banks' provisioning practices in qualitative and quantitative ways, and higher provisions are possible with the lifetime loss concept and the inclusion of forward-looking information in the assessment and measurement of ECL.

Impact of accounting provisions on regulatory capital

The new accounting methodologies directly impact the regulatory capital calculations under the Basel Capital Framework, since accounting provisions affect regulatory capital through the profit and loss statement. As the accounting changes are likely to affect bank regulatory capital, in March 2017 the Basel Committee on Banking Supervision (BCBS) issued interim guidance and announced transitional arrangements on the regulatory treatment of accounting provisions.

Under the old "incurred" loss accounting methodology, provisions were only recognised once a loss event occurred. The new accounting ECL standards eliminate this threshold and require banks to provision based on ECL. The FASB rules require the recognition of the entire lifetime ECL at credit inception. Meanwhile, the International Financial Reporting Standards (IFRS) rules initially only require the recognition of the first 12 months of the lifetime ECL, with the full lifetime ECL required once an exposure has experienced a significant increase in credit risk.

Impact of accounting provisions for banks under the standardised approach (SA)

Under the SA, accounting provisions – for regulatory purposes – are classified into Specific Provisions (SP) and General Provisions (GP). GP are provisions held against future, unidentified losses. SP are provisions ascribed to the identified deterioration of particular assets or liabilities that are excluded from GP. GP may be included in Tier 2 capital up to 1.25% of the total credit risk-weighted assets (RWAs). SP may not be included in Tier 2 capital but are netted against the gross exposure amount before applying the risk weights. The impact on Common Equity Tier 1 (CET1) capital is dependent on two components: First, the size of the accounting provisions under ECL versus the incurred loss approach. This is expected to have the largest impact on SA banks, as the ECL approach is a new concept for them. Second, the classification of accounting provisions into SP or GP, based on the criteria defined by regulators in individual jurisdictions.

Impact of accounting provisions for banks under the internal ratings-based (IRB) approaches

Under the IRB framework, the differentiation between SP and GP is not made. Total eligible provisions are defined as the sum of provisions attributed to exposures treated under the IRB approach. IRB banks are required to calculate a regulatory measure of expected loss (EL). Where accounting provisions exceed the regulatory EL amount, the difference may be added back to Tier 2 capital, subject to a threshold of 0.6% of credit RWAs under the IRB framework. If regulatory EL exceeds accounting provisions, the shortfall is deducted from regulatory capital. Since banks under the IRB framework already calculate a regulatory concept of EL in their provisioning estimates, the gap between the regulatory EL amount and the provisions required under accounting ECL approaches may not be as great as for SA banks. However, the parameters required to calculate regulatory EL are not the same as the accounting ECL methodologies. Therefore, there will be added complexity even for IRB banks, as well as the possibility of a capital shock when migrating to the new ECL approaches.

Primary considerations for the interim approach

The BCBS has not yet reached a conclusion on the permanent interaction between ECL accounting and the prudential regime. During the interim period, the BCBS has decided to retain the existing regulatory treatment of accounting provisions under the SA and IRB approaches to credit risk capital measurement. There is a possibility that the impact of ECL accounting might be significantly higher than under the incurred loss accounting frameworks, leading to an unexpected decline in capital ratios. Due to these uncertainties, jurisdictions may choose to introduce a transitional arrangement to mitigate the impact of ECL accounting on regulatory capital. The transitional arrangements should only apply to new provisions arising from changes to the ECL accounting methods and not to provisions that existed prior to the implementation of ECL accounting. The transition period can be no longer than five years.

Proposed transitional model

The BCBS has outlined two possible transitional arrangements:

– Approach A is a "static" approach, where a bank compares CET1 capital based on the opening balance sheet using an ECL accounting standard with CET1 capital based on the closing balance sheet (one day prior to the opening day) under the existing "incurred loss" approach. Where this shows to be a reduction in CET1 capital due to the increase in provisions net of tax effects, this decline in CET1 capital is spread over a specified number of years.

– Approach B is a "dynamic" approach that takes account of the ongoing evolution of ECL provisions during the transition period.

Under both approaches, "adjustment amounts" to CET1 capital flow through to Tier 1 capital and are therefore considered in the leverage ratio and large exposure limits.

Long-term policy

The BCBS has identified a number of preliminary approaches for a longer-term policy for the regulatory treatment of accounting provisions under the SA that are currently under consideration. These include:

– retention of the current regulatory treatment of GP and SP as a permanent approach;

– the introduction of a universally applicable and binding definition of GP and SP in order to eliminate the current jurisdictional variations; and

– removal of the GP and SP definitions and the introduction of regulatory EL under the SA, which would lead to more consistency between the SA and IRB approaches.

At this time, there are no plans to revisit the regulatory treatment of accounting provisions under the IRB approaches.

This Executive Summary and related tutorials are also available in FSI Connect, the online learning tool of the Bank for International Settlements.