The Upcoming New Era of Expected Loss Provisioning

By **Gerald A. Edwards, Jr.***

The global financial crisis highlighted the need for significant improvements in the financial reporting of credit losses on loans and other financial instruments held by banks and other companies. After calls for action by the G20 Leaders, investors and other users, regulatory bodies and prudential authorities, the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) have nearly completed the development of new approaches for loan impairment based, for the first time, on an expected loss model. The new loan impairment standards will be finalized and published later this year. Once effective, they are expected to result in a significant rise in the level of provisioning for many banks.

Before introducing the new IASB and FASB expected loss approaches, this article summarizes key efforts of the G20, Financial Stability Board (FSB and its predecessor, the Financial Stability Forum, or FSF) and Basel Committee on Banking Supervision (BCBS) that encouraged the development of these new standards. The article then explores the potential impact of the new standards and the challenges that will be faced by prudential authorities, including in the Asia-Pacific region.

Encouragement to Consider Expected Loss Provisioning

Under both IASB standards (called International Financial Reporting Standards or IFRS) and FASB standards, the accounting model for recognizing credit losses is commonly referred to as an "incurred loss model" because the timing and measurement of losses is based on estimating losses that have been incurred as of the balance sheet date. Provisioning requirements in IASB and FASB standards thus generally limit provisioning to losses that are considered probable as of the balance sheet date. In addition, these accounting standards do not permit credit losses based on events that are expected to occur in the future to be included in provisions until the event or events that would probably result in a loss have occurred, generally supported by observable evidence (e.g., borrower loss of employment, decrease in collateral values, past due status). These events are sometimes referred to as "triggering events."

While the incurred loss model had been ingrained in the thinking of standard-setters for many years, the experience of the financial crisis highlighted the delayed recognition of credit losses caused by the incurred loss standards which, during the "good years" before crises, preclude banks from provisioning appropriately for credit losses likely to arise from emerging risks. These delays resulted in the recognition of credit losses that were widely regarded as "too little, too late." Moreover, questions were raised about whether the incurred loss model contributed to procyclicality.

In its April 2008 Report in response to the request of the G7,[1] the FSF noted that it would examine the forces that contribute to procyclicality in the financial system and develop options for mitigating it. At the G20 Leaders Summit in London in April 2009, the FSF issued a report, "Addressing Procyclicality in the Financial System."[2]

The term "procyclicality" refers to the dynamic interactions between the financial and the real sectors of the economy. These mutually reinforcing interactions tend to amplify business cycle fluctuations and cause or exacerbate financial instability. The global financial crisis was a graphic example of the disruptive effects of procyclicality. Institutions that experienced extensive losses faced growing difficulties in replenishing capital. This, in turn, induced them to cut credit extension and dispose of assets. Their retrenchment precipitated a weakening of economic activity, thereby raising the risk of a further deterioration in their financial strength. Addressing procyclicality in the financial system is an essential component of strengthening the macroprudential orientation of regulatory and supervisory frameworks.

The FSF report examined the forces that contribute to procyclicality in the financial system, and explored possible mitigating actions in three main areas: (i) the Basel II capital accord; (ii) loan loss provisioning; and (iii) valuation and leverage. The recommendations in the report were the result of collaborative work involving national authorities, the BCBS, Bank for International Settlements, Committee on the Global Financial System, International Monetary Fund, International Organization of Securities Commissions (IOSCO), the IASB and the U.S. FASB.

New thinking was needed, based on lessons from the financial crisis, to reform the accounting model for loan losses in a manner that would support the overall goal of improving transparency. To carry forward its analysis on the need for provisioning improvements, the FSF formed a new Working Group on Provisioning, co-chaired by Kathleen Casey, Commissioner, U.S. Securities and Exchange Commission, and Chairman of IOSCO's Technical Committee, and by John Dugan, U.S. Comptroller of the Currency and Joint Forum Chairman. This working group brought together securities regulators, banking supervisors, accounting standard-setters and audit regulators to evaluate this key area. Both U.S. and international perspectives were carefully explored. The IASB and FASB were fully involved, as were BCBS representatives and the chairmen of the International Forum of Independent Audit Regulators and the U.S. audit regulator, the Public Company Accounting Oversight Board. The working group also engaged in outreach involving investors, external auditors and financial institutions. This effort helped to ensure that the group's findings would address the needs of investors while also addressing certain key prudential objectives.

In April 2009, based on the working group's recommendations, the FSF's procyclicality report to the G20 noted that: "Earlier recognition of loan losses could have dampened cyclical moves in the current crisis. . . Earlier identification of credit losses is consistent both with financial statement users' needs for transparency regarding changes in credit trends and with prudential objectives of safety and soundness." The FSF report recommended: "The FASB and IASB should reconsider the incurred loss model by analyzing alternative approaches for recognizing and measuring loan losses that incorporate a broader range of available credit information."

At the London summit meeting in April 2009, the FSF was re-established as the FSB with a broadened mandate to promote financial stability. The G20 Leaders welcomed the accounting recommendations in the FSF's procyclicality report and requested action by accounting standard-setters.[3] The G20 Leaders also called on "the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards."[4] Specifically, the G20 Leaders encouraged accelerated efforts by the IASB and FASB to finalize improved, converged accounting standards and efforts to enhance the governance of the IASB.

The G20 Leaders requested that the FSB monitor implementation efforts, including those addressing accounting issues. Starting with its progress reports to the G20 Leaders in September 2009, the FSB has included recommendations on accounting matters in its communications with the G20, including an assessment of IASB-FASB convergence progress. In its progress report to the G20 Leaders in September 2009, the FSB noted that, "We are particularly supportive of continued work on impairment standards based on an expected loss model."[5] The IASB Chairman, who is a member of the FSB, has periodically updated the FSB on IASB efforts to address accounting recommendations of the G20 and the FSB. The FASB Chairman also provided updates to the FSB on FASB's convergence program. These included updates that were discussed at FSB meetings on IASB and FASB efforts to enhance and converge their standards on loan loss provisioning and the valuation of financial instruments. Moreover, as part of a joint approach to address the reporting issues arising from the global financial crisis, the IASB and FASB formed the Financial Crisis Advisory Group (FCAG) in October 2008 and asked FCAG to consider how improvements in financial reporting could help enhance investors' confidence in financial markets. FCAG's members were senior leaders with broad international experience in the financial markets and were joined by participating official observers representing the FSB, BCBS and key global banking, insurance and securities regulators. In July 2009, the FCAG report identified delayed recognition of losses associated with loans (and other financial instruments) and the complexity of multiple impairment approaches for different types of financial assets as primary weaknesses in accounting standards and their application. The FCAG report included a recommendation that the IASB and FASB explore alternatives to the incurred loss model that would use more forward-looking information.

In addition, in 2009 the BCBS formed the High Level Working Group on the G20 Accounting Recommendations (HLWG) to assist the BCBS in developing approaches to provisioning, fair value accounting and other accounting recommendations of the G20 and to work with the IASB in this respect.[6] The HLWG also worked closely with the BCBS Accounting Task Force with regard to these matters. In August 2009, based on the work of the HLWG the BCBS issued for consideration by accounting standard setters principles for the revision of accounting standards for financial instruments, agreed by all G20 banking supervisors. These BCBS principles encouraged improved standards for provisioning based on expected losses, as well as enhanced guidance for fair value measurement and related disclosures.[7] The BCBS, through its HLWG and Accounting Task Force also met periodically with IASB officials and provided comment letters to the IASB on its proposed standards in order to encourage progress in improving IASB standards in these key areas.

This encouragement from the G20 Leaders, FSB, BCBS, FCAG and key regulatory bodies, together with investor support for a move to an expected loss model, was followed by valuable work by the accounting standard setters. The IASB proposed an expected loss impairment or provisioning model in November 2009. The FASB, after first proposing in May 2010 a modified version of the incurred loss model, worked jointly with the IASB starting in early 2011 on clarifying an expected loss impairment approach. The IASB and FASB subsequently published a joint proposal in 2011 and through July 2012 they continued to develop a common impairment approach based on expected losses. However, in August 2012, FASB decided to amend the common impairment approach to simplify the expected loss measurement objective and address concerns that had been expressed by U.S. investors, preparers, auditors and regulators, and it published this revised expected loss model as an exposure draft in December 2012 for public comment. The IASB published its proposed expected loss model in an exposure draft in March 2013. These proposals are summarized below.

The IASB Expected Loss Impairment Approach[8]

The IASB expected loss impairment approach would be part of IFRS 9, *Financial Instruments.* In summary, all banks and other companies that hold financial assets or commitments to extend credit that are not accounted for at fair value through profit or loss (e.g., trading portfolios) would be affected by this proposal. This includes loans and other financial assets measured at amortized cost or that are reported at fair value through other comprehensive income (similar to today's available-for-sale assets), trade receivables and lease receivables, loan commitments and financial guarantee contracts.

Under the proposal it would no longer be necessary for a credit event to have occurred before credit losses are recognized. Instead, expected credit losses and changes in expectations regarding credit losses would be recognized and would be updated at each reporting date to reflect changes in credit quality.

Under the IASB proposal banks and other companies would report expected credit losses in three stages as deterioration in credit quality takes place after initial recognition of the loan. For stage 1, they would report 12-month expected credit losses and for stages 2 and 3, full lifetime expected credit losses would be reported.[9]

***Stage 1*.** As soon as a financial instrument is originated or purchased, 12-month expected credit losses would be reported in profit and loss and an allowance for expected credit losses (loss allowance) or provision would be established. This would serve as a proxy for the initial expectations of credit losses that are priced into the financial instrument. For loans or other financial assets, interest revenue would be calculated on the gross carrying amount of the financial asset (i.e., without adjustment for the loss allowance).

A bank or other company would calculate "12-month expected credit losses" by multiplying the probability of a default occurring in the next 12 months by the total (lifetime) expected credit losses that would result from that default.

Stage 2. When the credit risk increases (or credit quality deteriorates) significantly and the resulting credit quality is below "investment grade," full lifetime expected credit losses would be reported (if the credit quality deteriorates significantly from that at origination or purchase).[10] The calculation of interest revenue on financial assets remains unchanged from the approach set forth for Stage 1.

Stage 3. This stage occurs when the credit quality of a financial asset deteriorates to the point that credit losses are incurred or the asset is credit-impaired. Interest revenue is then calculated based on the net amortized cost carrying amount (i.e., the gross carrying amount adjusted for the loss allowance). Lifetime expected credit losses would continue to be reported for loans in this stage of credit deterioration.

Under the IASB proposal, lifetime expected credit losses – reported for stages 2 and 3 -- are an expected present value measure of credit losses that arise if a borrower defaults on its obligation throughout the life of a financial instrument. They are the weighted average credit losses with the respective probabilities of default as the weights. Because the measure of credit losses is a present value, a credit loss may result from a delay in the payment of contractually required amounts, even if full repayment of those amounts is expected. Banks and other companies should base their measurement of expected credit losses on relevant information about past events, including historical credit loss events for similar financial instruments, current conditions and reasonable and supportable forecasts.

Thus, the IASB approach recognizes a portion of the lifetime expected credit losses, and then the full lifetime expected credit losses only after significant deterioration in credit quality is expected. The IASB believes that this approach ensures more timely recognition of expected credit losses than the existing incurred loss model; distinguishes between financial instruments that have significantly deteriorated in credit quality and those that have not; and better approximates economic expected credit losses.

The IASB exposure draft proposes extensive disclosures about expected losses and changes in the credit risk of the loan portfolio and other financial instruments subject to its impairment approach.

The IASB has tentatively completed its consideration of comments received on the exposure draft and will proceed with the proposed expected credit loss impairment model that is based on 12-month and lifetime expected credit losses, with certain refinements in response to comments. The IASB plans to provide further clarification, application guidance and illustrative examples, to help banks and other companies with implementation. The completed version of IFRS 9 *Financial Instruments*, including classification and measurement, expected loss impairment, and hedge accounting requirements, is expected to be issued by the IASB in the second quarter of 2014 and would be effective for annual periods beginning on or after 1 January 2018.

The FASB Expected Loss Impairment Approach[11]

As previously mentioned, the IASB's "three-stage" or "three-bucket" impairment model utilizes two different measurement objectives – 12-month expected losses and lifetime expected losses -- to determine the credit impairment for the financial asset, depending on the extent of credit deterioration (or recovery) since it was originated or acquired. During FASB's outreach with users, preparers, auditors, and regulators, it heard significant concerns that the three-stage/bucket impairment model would not be understandable, operable, or auditable. For example, many were confused about how to determine when financial assets should be "transferred out" of Stage 1/bucket 1 (12-month expected losses) and be reported as experiencing credit quality deterioration under Stage 2/bucket 2 or Stage 3/bucket 3 (both reporting lifetime expected losses). In addition, many stakeholders viewed the proposed "transfer criteria" as reintroducing an incurred loss recognition "trigger", which was one of the primary problems identified with the existing impairment model. Finally, some stakeholders expressed concern that the allowance for expected credit losses may not reflect the appropriate amount of risk in the organization's asset portfolio, taken as a whole, considering that historically most loans would be categorized as in Stage 1/bucket 1.

As a result, the FASB exposure draft does not use the IASB's three-stage model but instead sets forth a "current expected credit loss" (CECL) model. This model would replace the multiple impairment models that currently exist for loans and other debt instruments in U.S. generally accepted accounting principles (GAAP). The CECL model uses a single "expected credit loss" measurement objective for the allowance for credit loss. Under this model, the allowance for expected credit losses would reflect management's current estimate of the contractual cash flows that the company does not expect to collect, based on its assessment of credit risk as of the reporting date.

This model removes the "transfer criteria" trigger in the IASB's three-stage model that U.S. stakeholders indicated was inoperable and might inhibit the timely recognition of credit losses. Furthermore, this model considers more forward-looking information than is permitted under current U.S. GAAP. When credit losses are measured under current U.S. GAAP, a bank or other organization generally only considers past events and current conditions in measuring the incurred loss, but the CECL model also would require consideration of reasonable and supportable forecasts that affect the expected collectibility of the financial assets' remaining contractual cash flows. That estimate would be neither a "worst case" nor a "best case" scenario, but rather would reflect management's current estimate of the contractual cash flows that the organization does not expect to collect.

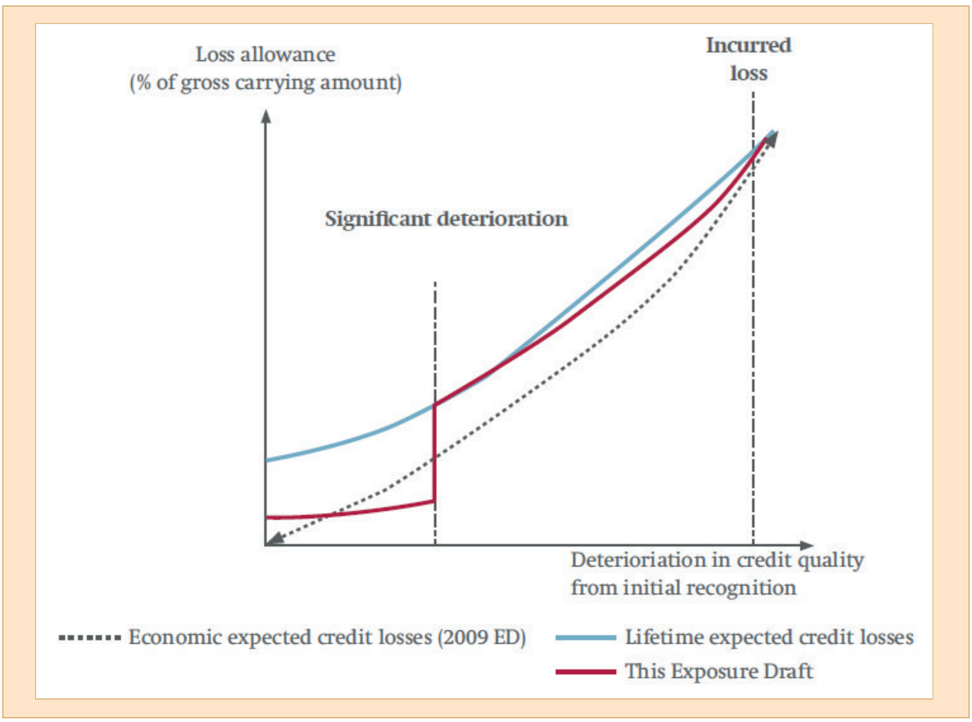
Thus, the balance sheet would reflect the current estimate of expected credit losses over the remaining life of a loan portfolio at the reporting date and the income statement would reflect the effects of credit deterioration (or improvement) that has taken place during the period.[12] The proposal also includes disclosures about expected credit losses and changes in credit risk.

The FASB is continuing its discussions about possible refinements to the CECL model based on consideration of comments on the exposure draft and it expects to issue the final standard in the second half of 2014. The effective date of the standard has not yet been determined.

Potential Impact of the New Standards

It is difficult to estimate precisely the potential impact of the IASB and FASB expected loss provisioning approaches on bank loan loss allowances before the final standards are issued and effective. However, Hans Hoogervorst, IASB Chairman, when discussing the IASB impairment model in a speech in December 2013, stated that, "Our field work shows that it will lead to a significant rise in the level of provisioning."[13] Moreover, Thomas Curry, U.S. Comptroller of the Currency, in a speech at a major banking conference in September 2013, said, "There is no question that implementation of the FASB proposal will require most banks to boost their allowance. But the OCC's impact analysis showed that the increases would be far more modest [than some industry estimates of 200 – 300 percent] – perhaps in the neighborhood of 30 to 50 percent system-wide if applied today. For some banks it will be more; for others, less depending on the loan portfolio and environment at the time of implementation."[14]

Figure 1



Source: IASB Snapshot: "Financial Instruments: Expected Credit Losses," (Exposure Draft), March 2013.

As previously mentioned, when expressing its support for an impairment approach based on expected credit losses, the FSB recommendations to the IASB and FASB in 2009 called for loan impairment approaches to (a) incorporate a broader range of available credit information and (b) result in an earlier recognition of loan losses than under the incurred loss model. The FSB procyclicality report found that these provisioning qualities should improve transparency to investors while also mitigating procyclicality. The IASB-FASB FCAG had also called for impairment approaches to use more forward-looking information. Figure 1, from the IASB, illustrates that expected loss impairment approaches should result in earlier recognition of credit losses than under the incurred loss impairment model. In Figure 1, the red line approximates the recognition of credit losses under the IASB's expected loss approach (12-month expected losses for loans in Stage 1, followed by lifetime expected losses for loans experiencing significant credit quality deterioration in Stages 2 and 3). The blue line in Figure 1 approximates the way that the FASB expected loss approach (essentially, "lifetime expected losses") would recognize credit losses. Assuming robust forward-looking estimates, both impairment approaches would recognize credit losses well before they would be reported under the incurred loss model (the right-most black vertical "dashed" line in Figure 1). Thus, the IASB and FASB new impairment approaches could be among those practices that help mitigate procyclicality.

Officials from the FASB, IASB, the banking industry, and prudential authorities have noted that the FASB approach will likely result in more "upfront" recognition of expected credit losses than the IASB approach. This can be seen in Figure 1, as the blue line (the FASB approach, essentially, "lifetime credit losses") initially exceeds the red line (the IASB 12-month expected credit losses under Stage 1) until serious credit quality deterioration occurs (at which point, in Stages 2 and 3, the IASB approach also requires use of lifetime expected credit losses). However, given the robust nature of U.S. banks' current loan loss provisioning practices, some U.S. stakeholders have expressed concern that the new IASB three-stage impairment approach could lead to a significant reduction in loan loss allowances at U.S. financial institutions if it were adopted in the U.S.[15]

Due to the forward-looking nature of the new impairment approaches, many banks are likely to see a significant impact from the applicable standards, and may need additional systems and processes to collect the necessary forward-looking information about credit risk. For example, the IASB and FASB standards will require consideration of forecasts and their effect on the expected collectibility of the financial assets' remaining contractual cash flows, and bank management must determine which forecasts are reasonable and supportable for this purpose. This aspect alone could result in a significant increase in the number and complexity of management judgments that would be needed to determine the adequacy of expected loss provisions, which could also contribute to challenges for investors, auditors, and supervisors in assessing provisioning levels and practices. Moreover, banks will need to ensure that their risk management systems, including their internal credit risk grading frameworks, appropriately interface with their accounting systems so as to result in robust expected loss provisioning practices and useful risk disclosures.[16]

The BCBS, through its Accounting Expert Group (formerly, the Accounting Task Force), has maintained extensive periodic dialogue with the IASB, FASB, the global banking industry and bank audit firms about the IASB and FASB expected loss approaches. In addition, the BCBS has carefully monitored the IASB and FASB proposals and provided technical comment letters to the boards. After the IASB and FASB final standards are published, the BCBS will consider issuing enhanced supervisory guidance that will address key issues associated with the standards and how supervisors can evaluate expected loss provisioning practices and encourage their banks to maintain sufficient levels of provisions, consistent with a robust expected credit loss impairment model.[17] In addition, the Federal Reserve Board and the other U.S. federal banking agencies have been providing comments to the FASB on its planned CECL impairment standard and are likely to issue supervisory guidance to enhance the provisioning practices of U.S. banking organizations once the final FASB standard is issued and effective.

The potential impacts of the new impairment standards will be important for leaders in Asia-Pacific region to carefully evaluate. Research has highlighted that after the Asian financial crisis, many countries in the Asia-Pacific region enhanced their loan loss provisioning requirements by adopting international standards and overlaying these with prudential rules and other requirements that sought to increase provisioning in good times in response to rising levels of credit risk. These requirements have also led to bank provisioning practices that have tended to be countercyclical in nature in many Asian jurisdictions, for example, in emerging Asia.[18] Care must be taken by prudential authorities so that implementation of the new IASB expected loss provisioning standard will improve transparency while also building on progress in achieving important prudential objectives.[19] For example, under the new expected loss provisioning standards, prudential authorities will need to understand and address whether the following may be needed:

- Revisions to their current national provisioning matrices or other requirements that have contributed in the past to robust provisioning levels (e.g., improved consideration of qualitative factors and other forward-looking information affecting the collectability of loans);

- New guidance on the interrelationship between capital adequacy and expected loss provisioning (e.g., given the different time frames for loss coverage underlying expected losses for capital and financial reporting purposes);

- New guidance on appropriate internal controls, including internal audit and internal credit review procedures, and tests of controls to assess and strengthen banks' internal control systems associated with expected loss provisioning and related risk disclosures; and

- Enhancements to regulatory financial reports that banks provide to prudential authorities and macro-prudential analyses developed for offsite monitoring purposes.

As banks prepare to implement the new expected loss provisioning requirements and their auditors gear up to assess them, supervisors will also need to understand these developments and design new procedures to ensure that banks' new provisioning systems truly capture emerging risks.

The upcoming new era of expected loss provisioning will not guarantee a future free of financial crises. However, implementation of the new IASB and FASB impairment standards should improve transparency to investors and help banks' financial reporting of credit losses to better reflect the risks retained in their loan portfolios in ways that should mitigate procyclicality. Working with the banking industry and auditors, prudential authorities can have an important role in helping to secure the potential benefits of the new expected loss provisioning regime.

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Endnotes

1. "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience," April 2008.

2. See www.financialstabilityboard.org/publications/r_0904a.pdf.

3. G20 Leaders, "Declaration on Strengthening the Financial System – London Summit, 2 April 2009."

4. G20 Leaders, "London Summit – Leaders' Statement, 2 April 2009."

5. "Improving Financial Regulation, Report of the Financial Stability Board to G20 Leaders", September 2009.

6. The HLWG was active from 2009 to 2012 and was co-chaired by the chair of the BCBS Accounting Task Force and the author of this article.

7. "Guiding Principles for the Replacement of IAS 39," BCBS, August 2009. In a letter to the chairs of the IASB and FASB in December 2012, the BCBS updated these principles with respect to loan impairment and reiterated the BCBS' support for use of a converged approach to impairment based on expected losses.

8. IASB Snapshot: "Financial Instruments: Expected Credit Losses," (Exposure Draft), March 2013.

9. These stages were previously referred to as "buckets" in some earlier summaries of the IASB expected loss impairment approach, leading some to refer to the IASB approach as the three-bucket impairment model.

10. This requirement for significant credit risk deterioration before a loan can be reported under Stage 2 is sometimes referred to as the "transfer criteria" to move from Stage 1 (12-month expected credit losses) to Stage 2 (lifetime expected credit losses).

11. FASB in Focus: "Proposed Accounting Standards Update – *Financial Instruments – Credit Losses (Subtopic 825-15)", 20 December 2012.*

12. In contrast, the IASB does not believe that the FASB's proposed approach to recognizing lifetime expected credit losses on loans faithfully represents economic expected credit losses. The IASB believes that the FASB's approach results in: (a) the double-counting of expected credit losses that are priced into a loan; (b) a loss of information about the changes in credit quality (i.e., it may not be apparent whether losses recognized represent an economic loss, or will be compensated by

future interest revenue); and (c) in loans having carrying amounts (net of their credit loss allowance) that would be below their fair value or transaction price on initial recognition.

13. "Why the Financial Industry is Different: *The Relevance of Current Measurement for the Financial Industry,"* Speech at the Joint ICAEW and IFRS Foundation Financial Institutions IFRS Conference, by Hans Hoogervorst, London, 3 December 2013.

14. Remarks by Thomas J. Curry, Comptroller of the Currency, before the AICPA Banking Conference, Washington, D.C., 16 September 2013.

15. For example, see summary of FASB discussions at the Financial Executives International (FEI) blog, "FASB Credit Loss Model CECL Could Drive 20-50% Increase in Allowances: FASB, OCC Studies," September 2013.

16. Many large banks are implementing the recommendations of the FSB's Enhanced Disclosure Task Force, issued in October 2012, in order to improve their risk disclosure practices and transparency to investors. See http://www.financialstabilityboard.org/press/pr_121029.pdf.

17. In view of the difference between expected losses under the Basel Capital Framework and the IASB and FASB expected loss provisioning standards, it also may be helpful for BCBS guidance to address this.

18. Frank Packer and Haibin Zhu, (2012), "Loan Loss Provisioning Practices of Asian Banks," *BIS Working Paper,* No. 375, April.

19. This will be particularly important if surveys or other analyses indicate that the level of provisions of certain banks might be reduced when implementing the final IASB expected loss provisioning standard.