Supervisors' Key Roles as Banks Implement Expected Credit Loss Provisioning

By Gerald A. Edwards, Jr.*

In 2014, the International Accounting Standards Board (IASB) published IFRS 9, *Financial Instruments*, that includes a new standard for loan loss provisioning based on "expected credit losses" (ECL), which will be effective in 2018.[1] The U.S. Financial Accounting Standards Board (FASB) published its final provisioning standard based on "current expected credit losses" in 2016 which will be effective starting in 2020 for listed companies and 2021 for all other firms.[2] The new standards responded to calls for action by the G20 Leaders, investors, regulatory bodies and prudential authorities following the global financial crisis which highlighted the need for improved loan loss provisioning standards and practices.[3] Once effective, the new loan impairment standards are expected to result in a significant rise in the level of provisioning for many banks – perhaps increases of up to 25% for loan loss provisions for most banks, coupled with a decline of up to 50 basis points in core Tier 1 capital ratios, perhaps more for other institutions – based on recent global surveys of banks' IFRS 9 implementation progress, as discussed more fully below.

Central banks and other prudential authorities continue to have a strong interest in this important topic and the Basel Committee on Banking Supervision (BCBS) has issued final supervisory guidance on ECL provisioning under the new standards and a consultative paper on possible capital treatments. Other organizations have been reviewing banks' progress in implementing the new standards and addressing issues associated with appropriate governance, auditor efforts, and transition risk disclosures. Supervisors should carefully consider the impact of the new ECL requirements on supervisory provisioning matrices, financial reports, analysis reports, asset quality reviews, stress tests and other supervisory tools to ensure that prudential objectives are met. With little more than one year remaining before mandatory implementation, this article explores the significant role that banking supervisors can have in encouraging robust implementation of IFRS 9 in a manner that promotes transparency, strengthens bank governance and auditor reviews, and avoids undue burden on banking organizations.

1. An introduction to the new expected credit loss provisioning approach

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 based on past or current information. In addition, the current 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".

The experience of the global 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."

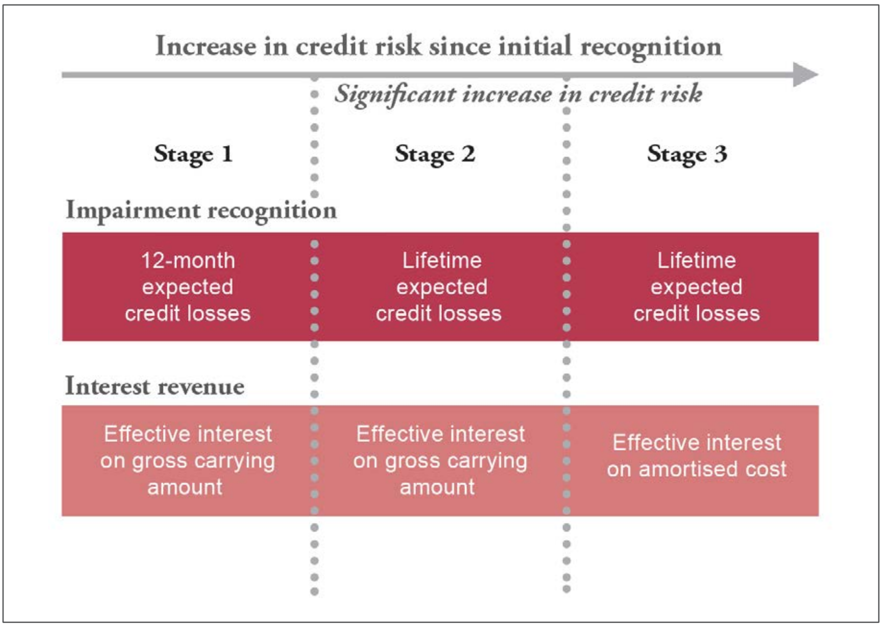
As part of a joint approach to address the reporting issues arising from the global financial crisis, the IASB and FASB formed the Financial Crisis Advisory Group (FCAG) in October 2008 and asked FCAG to consider how improvements in financial reporting could help enhance investors' confidence in financial markets. FCAG's members were senior leaders with broad international financial markets experience and were joined by participating official observers representing the Financial Stability Board (FSB), BCBS and key global banking, insurance and securities regulators. In July 2009, the FCAG report identified delayed recognition of credit 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. Moreover, this recommendation was also consistent with investors' comments and FSB and BCBS recommendations to the G20 Leaders and accounting standard setters in 2009. Since 2009 the BCBS has also provided extensive technical comments to the IASB and FASB on their proposed impairment standards through its High Level Working Group on the G20 Accounting Recommendations and the Accounting Task Force (now the "Accounting Experts Group").[4]

The new impairment requirements of IFRS 9 are designed to provide financial statement users with more useful information about a company's ECL on financial instruments that are not accounted for at fair value through profit or loss (e.g., trading portfolios). The impairment approach requires banks and other companies to recognize ECL and to update the amount of expected credit losses recognized at each reporting date to reflect changes in the credit risk of financial assets. The IASB approach is forward-looking and eliminates the threshold for the recognition of expected credit losses, so that it is no longer necessary for a "triggering event" to have occurred before credit losses are reported. IFRS 9 requires companies to base their measurements of ECL on reasonable and supportable information that is available without undue cost or effort, and that includes historical, current and – *for the first time* – forecast information. Thus, the effects of possible future credit loss events on expected credit losses must be considered.[5]

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 IFRS 9's impairment rules. This includes loans and other financial assets measured at amortized cost or that are reported at "fair value through other comprehensive income" (like today's available-for-sale assets), trade receivables and lease receivables, loan commitments and financial guarantee contracts.

As summarized below and in Figure 1, IFRS 9 requires banks and other companies to report ECL in three stages as deterioration in credit quality takes place after initial recognition of loans.[6] 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.

Figure 1
IFRS 9 Impairment Stages



Source: Adapted from IASB Project Summary: *IFRS 9 Financial Instruments*, July 2014.

Stage 1. As soon as a financial instrument is originated or purchased, 12-month ECL are recognized as an expense and a loss allowance is established. This serves as a proxy for the initial expectations of credit losses. For financial assets, interest revenue is calculated on the gross carrying amount (i.e., without adjustment for the loss allowance).

A bank or other company would calculate 12-month ECL as the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date. The IASB stresses that this is not the expected cash shortfalls over the next twelve months—instead, it is the effect of the entire credit loss on an asset weighted by the probability that this loss will occur in the next 12 months. Also, 12-month ECL are not the credit losses on assets that are forecast to default in the next 12 months, and if a bank can identify such assets or a portfolio of such assets that are expected to have increased significantly in credit risk, their lifetime ECL must be recognized.

If a financial instrument is determined to have "low credit risk" at the reporting date – for example, a loan or debt security with an investment grade rating – a bank may assume that the credit risk of the financial instrument has not increased significantly since initial recognition. Credit risk is considered low if the financial instrument has a low risk of default, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its obligations.

Stage 2. When the credit risk increases (or credit quality deteriorates) significantly and the resulting credit quality is not considered to be "low credit risk," full lifetime ECL would be reported (if the credit quality deteriorates significantly from that at origination or purchase). The increase in the provisions resulting from a move from 12-month to lifetime ECL is typically expected to be significant. The calculation of interest revenue on financial assets remains unchanged from the approach set forth for Stage 1.

Under IFRS 9, lifetime ECL are an expected present value measure of losses that arise if borrowers default on their obligations throughout the life of the financial assets. They are the weighted average credit losses with the probability of default as the weight. Since expected credit losses consider the amount and timing of payments, a credit loss (i.e., a cash shortfall) arises even if the bank expects to be paid in full but later than when contractually due. Banks and other companies should base their measurement of ECL on relevant information about past events, including historical credit loss events for similar financial instruments, current conditions and reasonable and supportable forecasts.

Assessment of significant increases in credit risk may be done on a collective basis, for example on a group or sub-group of financial instruments. This should ensure that lifetime ECL are recognized when there is a significant increase in credit risk even if evidence of that increase is not yet available on an individual level. However, regardless of the way in which an entity assesses significant increases in credit risk, there is a *rebuttable presumption* that the credit risk on a financial asset has increased significantly since initial recognition when contractual payments are more than 30 days past due. The IASB stresses that the rebuttable presumption is not an absolute indicator, but is presumed to be the latest point at which lifetime ECL should be recognized even when using forward-looking information.

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. Lifetime ECL would continue to be reported for loans in this stage of credit deterioration but interest revenue is calculated based on the lower net amortized cost carrying amount (i.e., the gross carrying amount adjusted for the loss allowance).

Thus, the IFRS 9 approach initially recognizes a portion of the lifetime expected credit losses, and then the full lifetime ECL 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.

As discussed below, IFRS 9 also includes new guidance on loan write-offs which was not included in the current standard, IAS 39, *Financial Instruments: Recognition and Measurement*. Moreover, IFRS 9 requires extensive new qualitative and quantitative disclosures about credit risk management policies, expected credit losses, loan write-offs, and changes in the credit risk of the loan portfolio and other financial instruments subject to its impairment approach.

The standard is mandatorily effective for annual periods beginning on or after January 1, 2018, although earlier adoption is permitted.

2. Summary of the main differences between the IASB and FASB approaches

Two key differences between the IASB and FASB expected credit loss approaches will be addressed in this article. First, the FASB has adopted a single measurement objective that results in the recognition of lifetime ECL for all exposures in scope and, thus, there is no need to categorize these exposures as being in Stages 1, 2 or 3. This is illustrated in Figure 2.

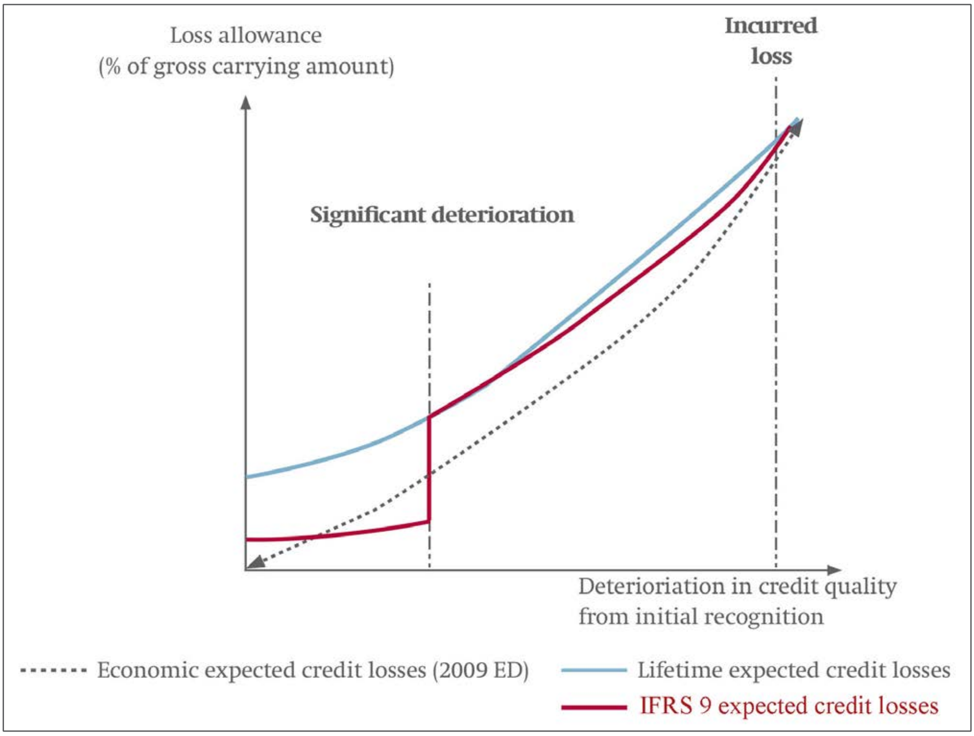
Figure 2

Expected credit losses (ECL) measurement			
	Performing assets	**Underperforming assets (assets with a significant increase in credit risk)**	**Impaired assets**
IASB	**"Stage 1"** **12-month ECL**	**"Stage 2"** **Lifetime ECL**	**"Stage 3"** **Lifetime ECL**
FASB		**Lifetime ECL**	

Source: *Regulatory treatment of accounting provisions*, BCBS, October 2016.

Since lifetime ECL are recorded for all exposures, the recognition of credit losses is expected to be earlier and more significant under the FASB approach. This is illustrated in Figure 3.

Figure 3



Source: Adapted from Snapshot: *Financial Instruments: Expected Credit Losses*, IASB, March 2013.

Figure 3 illustrates that expected loss impairment approaches of both the IASB and FASB should result in earlier recognition of credit losses than under the incurred loss impairment model. In Figure 3, the red line approximates the recognition of credit losses under the IASB's expected credit loss approach (12-month ECL for loans in Stage 1, followed by lifetime ECL for loans experiencing significant credit quality deterioration in Stages 2 and 3). The blue line in Figure 3 approximates the way that the FASB expected loss approach (essentially, lifetime expected credit 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 3). In addition, 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 3, as the blue line (the FASB approach, essentially, lifetime ECL) initially exceeds the red line (the IASB 12-month ECL 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 ECL).

From a supervisory perspective, the second key IASB-FASB difference involves income recognition on problem loans. IFRS 9 continues to allow the accrual of interest income on nonperforming loans but in some cases this may exceed the amount of interest income that the bank receives in cash. Unlike IFRS 9, the new FASB standard does *not* provide proscriptive guidance that precludes a bank from putting an instrument on nonaccrual status, but instead permits existing U.S. nonaccrual accounting practices to continue. As with current U.S. generally accepted accounting principles (GAAP), the new FASB standard allows a bank or other creditor to use existing accounting methods for recording payments received on nonaccrual assets, including a cash basis method, a cost recovery method, or some combination of both. Concern has been expressed that income recognition on nonperforming loans coupled with inadequate loan loss provisioning and delayed loan write-off practices have provided disincentives for banks in certain countries following IFRS to reduce their excessive levels of nonperforming loans.[7] Similar concerns prompted the European Central Bank (ECB) to recently propose including information on both accrued interest income on nonperforming loans as well as cash interest income received (similar to nonaccrual treatment) for nonperforming loans for supervisory reporting purposes and to also propose public disclosure of this information by banks to promote transparency and market discipline.[8] This type of information in both supervisory reporting and public risk disclosures could provide important incentives for certain banks to implement more effective strategies for reducing their nonperforming assets.[9]

3. BCBS guidance on expected credit loss provisioning[10,11]

After extensive consultation, in December 2015 the BCBS published its final supervisory guidance to address how ECL accounting approaches – whether set forth in IASB, FASB or other accounting standards -- should interact with a bank's overall credit risk practices. It expresses the BCBS' support for the use of ECL approaches and encourages their application in a manner that will provide incentives for banks to follow sound credit risk management practices and achieve earlier recognition of credit losses than takes place using incurred loss provisioning approaches. Recent BCBS consultative documents issued in October 2016 address possible approaches to regulatory capital requirements on expected loss provisioning under the Basel capital framework. The December 2015 guidance replaces the BCBS' 2006 loan loss provisioning guidance[12] and has four main parts:

- An introduction to the objectives, scope and application of the guidance;
- Supervisory guidance for banks on credit risk and accounting for ECL (eight principles);
- Supervisory evaluation of credit risk, ECL, and capital adequacy (three principles); and
- An appendix presenting supervisory guidance specific to banks applying IFRS.

At the beginning of the policy document, it states, "This paper is intended to set out supervisory guidance on accounting for expected credit losses that does not contradict applicable accounting standards established by standard setters. Representatives of the IASB have been provided with the opportunity to comment on this document and have not identified any aspects of it that would prevent a bank from meeting the impairment requirements of International Financial Reporting Standard (IFRS) 9 Financial Instruments."

The BCBS understands that the implementation of ECL accounting frameworks will require an investment in resources and in system development and system upgrades. However, because the accounting standard setters have given banks and other firms over three years to transition to the new accounting requirements, the BCBS expects internationally active banks to ensure a disciplined, high-quality implementation of the ECL accounting requirements.

The BCBS notes that banks may have well-established regulatory capital models for the measurement of expected losses. However, due to differences between the objectives and inputs for accounting versus capital purposes, while these models may be used as important starting points for estimating ECL for accounting purposes, regulatory capital models may *__not__* be directly usable without adjustment in the measurement of accounting ECL. For example, as illustrated in Figure 4, the Basel capital framework's expected loss calculation for regulatory capital differs from accounting ECL in that the Basel capital framework's probability of default (PD) may be "through the cycle" and is based on a 12-month time horizon. Additionally, loss-given-default (LGD) in the Basel capital framework reflects downturn economic conditions.[13]

Figure 4
Differences between IASB and FASB ECL approaches and Basel Capital Models

<table>
<tr><td colspan="5">Performing assets and under-performing assets
(with a significant increase in credit risk)</td></tr>
<tr><td colspan="2"></td><td>IASB</td><td>FASB</td><td>Basel Committee</td></tr>
<tr><td rowspan="2">PD</td><td>Measurement period</td><td>12 months (Stage 1)
Lifetime (Stage 2-3)</td><td>Lifetime</td><td>12 months</td></tr>
<tr><td>Cycle sensitiveness</td><td colspan="2">Point-in-time, considering forward-looking information, including macroeconomic factors</td><td>Economic cycle</td></tr>
<tr><td>LGD/ EAD</td><td>Measurement</td><td colspan="2">Neutral estimate, considering forward-looking information, including macroeconomic factors</td><td>Downturn estimate</td></tr>
</table>

Source: Adapted from *Regulatory treatment of accounting provisions*, BCBS, October 2016.

Consistent with the Basel Core Principles, the BCBS recognizes that supervisors may adopt proportionate approaches that should enable banks to adopt sound allowance methodologies commensurate with the size, complexity, structure, economic significance, risk profile and all other relevant facts and circumstances.

The principle of materiality is important to accounting practices. However, the BCBS stresses that this should not result in individual exposures or portfolios being considered immaterial if, cumulatively, these represent a material exposure to the bank. In addition, materiality should not be assessed solely based on potential impacts on the profit and loss statement at the reporting date. For example, in the BCBS’ view, large portfolios of high-quality credit exposures should be considered material.

The 11 principles for banks and supervisors are listed in Figure 5. In discussing the principles in the supervisory guidance, the BCBS highlights that:

- Sound bank methodologies for assessing credit risk and estimating ECL should cover all lending exposures, including for restructured and credit impaired loans;
- Robust bank credit risk rating processes should result in sufficiently granular groupings based on shared credit risk characteristics, and should be subject to independent reviews;
- The information that banks consider in estimating ECL must go beyond historical and current data to consider relevant forward-looking information, including macroeconomic factors, that affect collectability and credit risk;
- Clear roles and responsibilities for model validation are needed along with adequate independence and competence, sound documentation, and independent process review;
- Appropriate model validation scope and methodology include a systematic process of evaluating the model’s robustness, consistency and accuracy as well as its continued relevance to the underlying portfolio, and should include a review of model inputs, model design and model outputs/performance;
- Experienced credit judgment is essential to the estimation of expected credit losses (e.g., in adjusting historical information to reflect current conditions and trends, and assessing the potential impact of all reasonable and supportable forward-looking information on ECL estimates) and the use of experienced credit judgment needs appropriate documentation and oversight; moreover, banks should use their experienced credit judgment in determining the range of relevant information that should be considered and whether information is considered reasonable and supportable; and
- Supervisors may make use of the work performed by banks’ internal and external auditors in reviewing banks’ credit risk assessment and ECL measurement functions.

Figure 5
BCBS principles for banks and supervisors

Supervisory guidance principles (expectations for banks)
Principle 1 – Board and management responsibilities: A bank's board of directors (or equivalent) and senior management are responsible for ensuring that the bank has appropriate credit risk practices, including an effective system of internal control, to consistently determine adequate allowances in accordance with the bank's stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.
Principle 2 – Sound ECL methodologies: A bank should adopt, document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring credit risk on all lending exposures. The measurement of allowances should build upon those robust methodologies and result in the appropriate and timely recognition of ECL in accordance with the applicable accounting framework.
Principle 3 – Credit risk rating process and grouping: A bank should have a credit risk rating process in place to appropriately group lending exposures on the basis of shared credit risk characteristics.
Principle 4 – Adequacy of the allowance: A bank's aggregate amount of allowances, regardless of whether allowance components are determined on a collective or an individual basis, should be adequate and consistent with the objectives of the applicable accounting framework.
Principle 5 – ECL model validation: A bank should have policies and procedures in place to appropriately validate models used to assess and measure expected credit losses.
Principle 6 – Experienced credit judgment: A bank's use of experienced credit judgment, especially in the robust consideration of reasonable and supportable forward-looking information, including macroeconomic factors, is essential to the assessment and measurement of expected credit losses.
Principle 7 – Common data: A bank should have a sound credit risk assessment and measurement process that provides it with a strong basis for common systems, tools and data to assess credit risk and to account for expected credit losses.
Principle 8 – Disclosure: A bank's public disclosures should promote transparency and comparability by providing timely, relevant and decision-useful information.
Evaluation principles for supervisors
Principle 9 – Credit risk management assessment: Banking supervisors should periodically evaluate the effectiveness of a bank's credit risk practices.
Principle 10 – ECL measurement assessment: Banking supervisors should be satisfied that the methods employed by a bank to determine accounting allowances lead to an appropriate measurement of ECL in accordance with the applicable accounting framework.
Principle 11 – Capital adequacy assessment: Banking supervisors should consider a bank's credit risk practices when assessing a bank's capital adequacy.

Source: *Guidance on credit risk and accounting for expected credit losses*, BCBS, December 2015.

The Appendix with guidance for banks following IFRS provides additional supervisory expectations on the loss allowance for 12-month ECL, the assessment of significant increases in credit risk, and the use of practical expedients. It should be read in conjunction with the main section of the guidance.

For allowances for 12-month ECL, the BCBS expects banks will always measure ECL for all lending exposures, and that a nil (zero) allowance will be rare because ECL estimates are a probability-weighted amount – informed by management's experienced credit judgment – that should always reflect the possibility that a credit loss will occur. Consistent with IFRS 9, the BCBS guidance emphasizes that 12-month ECL is the expected cash shortfalls over the life of the lending exposure or group of lending exposures, due to loss events that could occur in the next 12 months, considering all relevant information. The guidance recommends using the BCBS' regulatory default definition (*Revisions to the Basel II market risk framework*, available at www.bis.org/publ/bcbs158.htm, para, 542). For any high-credit-risk exposures with ECL initially measured at 12-month ECL, banks should closely monitor for significant increases in credit risk.

With respect to IFRS 9's required assessment of significant increases in credit risk, this is very challenging and the guidance sets forth the BCBS expectations in this area. For example, the BCBS:

- Strongly endorses the IASB's view that lifetime expected credit losses are generally expected to be recognized before a financial asset becomes past due and that credit risk typically increases significantly before a financial instrument becomes past due or other lagging borrower-specific factors (for example a modification or restructuring) are observed.
- Gives specific guidance on assessing for significant credit risk increases, as summarized in Figure 6; and
- Emphasizes that, when assessing whether credit risk has increased significantly, banks should consider changes in the risk of default occurring over the expected life of the credit exposure, since it may not always be appropriate to use changes in the 12-month risk of default for this purpose.

Figure 6
Conditions and factors that may indicate a significant increase in credit risk

- A discretionary decision by management such that, were an existing loan newly originated at the reporting date, the element of the price of the loan that reflects the credit risk of the exposure would be significantly higher than it was when the loan was originated because of an increase in the credit risk of the specific borrower or class of borrowers since inception;
- Management's decision to strengthen collateral and/or covenant requirements for new exposures similar to exposures already advanced because of changes in the credit risk of those exposures since initial recognition;
- Borrower downgrades by a recognized credit rating agency, or within a bank's internal credit rating system;
- For performing credits subject to individual monitoring and review, an internal credit assessment summary credit-quality indicator that is weaker than upon initial recognition;
- Deterioration of relevant determinants of credit risk (e.g., future cash flows) for an individual obligor (or pool of obligors); and,
- Expectation of forbearance or restructuring due to financial difficulties.
- In addition, banks should consider more general factors such as the deterioration of the macroeconomic outlook relevant to a specific borrower or group of borrowers; and deterioration of prospects for the sector or industries within which a borrower operates.

Source: *Guidance on credit risk and accounting for expected credit losses*, BCBS, December 2015.

In addition to the conditions and factors summarized in Figure 6, the BCBS cautions that modifications or renegotiations of loans and other financial assets can mask increases in credit risk, resulting in ECL being underestimated, delaying the transfer to lifetime ECL for obligors whose credit risk has significantly deteriorated, or can inappropriately result in a move from lifetime ECL measurement back to 12-month ECL measurement. When assessing whether there is a significant increase in credit risk for a modified lending exposure, the BCBS expects a bank to demonstrate whether such modifications or renegotiations have improved or restored the bank's ability to collect principal and interest payments compared with the situation upon initial recognition.

With respect to the use of the practical expedients mentioned in IFRS 9, the BCBS expects banks will make limited use of the "low credit risk" exception and will not use "30 days past due" as a primary indicator of when it is appropriate to recognize lifetime ECL. The BCBS expects that any use by banks of these practical expedients should be documented and should be reviewed by banking supervisors.

Capital adequacy considerations.[14] The BCBS recognizes that the new ECL provisioning standards will introduce fundamental changes to banks' provisioning practices and that higher provisions are possible due to the lifetime loss concept and the inclusion of forward-looking information in the assessment and measurement of ECL. While supporting ECL provisioning standards, the BCBS is considering the implications for regulatory capital, *since the impact of ECL provisioning could be significantly more material than currently expected and result in an unexpected decline in capital ratios*, and considering the two-year difference between the IASB and FASB implementation dates.[15] In October 2016, the BCBS released a consultative document that proposed to retain for an interim period the current regulatory expected loss (EL) treatment of provisions under the standardized and the internal ratings-based (IRB) capital approaches for credit risk. In addition, the BCBS requested comments on whether the following possible transition approaches are warranted to allow banks time to adjust to the new ECL accounting standards:

- **Approach 1:** Day 1 impact on CET1 capital spread over a specified number of years;
- **Approach 2:** CET1 capital adjustment linked to Day 1 proportionate increase in provisions; or
- **Approach 3:** Phased prudential recognition of IFRS 9 Stage 1 and 2 provisions.

The BCBS mentioned that its current preference is for Approach 1 because it directly addresses a possible "capital shock" in a straightforward manner. Nevertheless, comments on Approaches 2 and 3 are encouraged because they consider the ongoing evolution of ECL provisions during the transition period and not just the impact at the date of adoption of ECL accounting on banks' provisions and CET1 capital. Once finalized, any transition approach would be accompanied by related Pillar 3 disclosure requirements.

At the same time the BCBS also issued for public comment a discussion paper on policy options for the long-term regulatory treatment of provisions under the new ECL standards, but noted that it has not yet decided to pursue any of the approaches presented in the paper. Comments from the public on the two consultative documents should be provided by January 13, 2017.

4. Enhanced risk disclosure needed during the transition period to IFRS 9

The importance to market confidence of useful disclosure by financial institutions of their risk exposures and risk management practices has been underscored during the global financial crisis and its aftermath. In May 2012, the FSB appointed a private-sector task force to develop principles for improved bank disclosures and identify leading practice risk disclosures. The Enhanced Disclosure Task Force (EDTF) was comprised of senior officials and experts representing financial institutions, investors and analysts, credit rating agencies, and external auditors. In October 2012, it reported recommendations to the FSB in which were welcomed by the G20 Leaders, FSB, and the chairs of the IASB and FASB.[16] Each year from 2013 to 2015 the EDTF reported ever improving global voluntary implementation of these recommendations in annual implementation progress assessments. For example, in its implementation progress survey for 2015 annual reports, 40 major international banks from Asia, Australia, Europe, and North America participated in the survey.[17]

Given the importance of the new IASB and FASB ECL accounting standards for the banking industry, the FSB requested the EDTF to recommend disclosures to help market participants understand the upcoming changes resulting from ECL approaches and to promote consistency and comparability. The EDTF's report, published in December 2015, found that investors and other financial report users want to understand the specific reasons for any changes at transition in ECL loan loss provisions compared to the existing approach and the ongoing drivers of variability in credit losses.[18] Key areas of user focus during the transition period include:

- concepts and policies developed to implement the new ECL approaches, including the "significant increase in credit risk" assessment required by IFRS 9;
- the specific bank methodologies and estimation techniques developed;
- the impact of moving from an incurred loss approach to an ECL approach;
- understanding the dynamics of changes in credit losses and their sensitivity to significant assumptions, including those resulting from the application of macro-economic assumptions;
- any changes made to the governance over financial reporting, and how they link with existing governance over other key areas including credit risk management and regulatory reporting; and
- understanding the differences between accounting ECL and regulatory capital EL.

The EDTF recommended that a gradual and phased approach during the transition period would be most useful to users to give them clearer insights as implementation progresses into the likely impacts of the new ECL standards and to allow users to make increasingly useful comparisons between banks.[19] The initial focus should be on qualitative disclosures but quantitative disclosures – including the impact of ECL approaches – should be added as soon as they can be practicably determined and are reliable but, at the latest, in 2017 annual reports for banks following IFRS. For example, the EDTF recommends banks following IFRS should provide:

- **qualitative disclosures** about general ECL concepts, differences from the current approach, and implementation strategy starting with 2015 and 2016 annual reports;

- **qualitative disclosures** about detailed principles, governance organization, and capital planning impact starting with 2016 annual reports; and
- **disclosure of quantitative assessments** of the impact of adoption of the ECL approach starting when practicable and reliable, but at the latest in 2017 annual reports.

In addition, the EDTF recommended that the granularity of disclosures should improve each year during this transition period. When IFRS 9 becomes effective in 2018 or when adopted if earlier, banks would provide the IASB's required ECL disclosures.[20]

5. Banks' progress in implementing IFRS 9's ECL impairment rules

In 2016, global surveys by major accounting firms and other organizations noted progress by banks in implementing IFRS 9's ECL impairment approach but found considerable work remains to be completed before 2018. For example, Deloitte's Global Banking IFRS Survey captured the views of 91 banks – 16 from the Asia-Pacific region, seven from Canada, and 69 from Europe, Middle East and Africa – including 16 global systemically important financial institutions (SIFIs).[21] Key findings in 2016 include:

- 60% of banks either did not disclose or could not quantify the transition impact of IFRS 9. **Of the banks who responded, the majority estimate that total impairment provisions will increase by up to 25%** across asset classes due to the new ECL approach. (PwC's 2016 global survey of 43 institutions across 10 countries found that, "Overall the majority of the institutions expect IFRS 9 to increase their provision requirements: 19% of respondents expect an increase of 0%-10% in provisions, 32% expect an increase between 10%-30%, while we note that 30% of respondents do not yet have an indication of the impact of IFRS 9."[22])
- **70% of respondents anticipate a reduction of up to 50 bps in core tier 1 capital ratios due to IFRS 9.** However, most banks do not yet know how their regulators will incorporate IFRS 9 ECL allowance estimates into regulatory capital estimates.
- Total estimated program budgets continue to increase. However, more than three quarters of these budgets have yet to be spent, with less than two years to the IFRS 9 effective date.
- Almost half of banks do not have enough technical resources to complete their IFRS 9 project and almost a quarter of these do not believe sufficient skills will be available in the market to cover shortfalls.
- Most price makers expect that moving to an ECL model will have an impact on product pricing, while most price takers still think that this is unlikely to have an impact on product pricing.
- In general, approximately half of participants are unsure of the answer to many key ECL modelling design questions, which may delay banks' IFRS 9 implementation programs.

- Data quality and the availability of the origination lifetime PD (needed as part of the assessment to determine whether a significant increase in credit risk has occurred) are the biggest data concerns for most banks.
- Despite IAS 8 requirements and the 2015 EDTF recommendations for improved ECL transition disclosures, over 40% of banks do not plan to disclose quantitative information before 2018. (Ernst & Young's 2016 survey of 36 top-tier financial institutions worldwide found that "most banks expect to disclose a first quantitative impact assessment to the markets during 2017." Of the 36 surveyed banks, 28 have already implemented the EDTF's 2012 recommendations but only 23 plan to implement the EDTF's recommended ECL disclosures.[23])

In addition, in November 2016, the European Banking Authority (EBA) published its report on the IFRS 9 implementation progress of over 50 financial institutions across the European Economic Area.[24] The survey was launched in January 2016 and found many of the same broad types of issues related to banks' implementation progress that had been noted in the global surveys summarized above.

- The EBA found that the involvement of some key stakeholders in IFRS 9 implementation seemed limited currently and that sufficient resources needed to be assigned by banks to ensure high quality implementation. As the implementation process requires collaboration between different departments within banks, key functions should be involved in this effort, including senior credit risk experts, audit committees and the board of directors.

- While noting that quantitative estimates provided by survey respondents were preliminary, the EBA report estimated the increase of loan loss provisions compared to the current levels of provisions under IAS 39 will be 18% on average and up to 30% for 86% (75th percentile) of respondents. CET1 and total capital ratios are estimated to decrease, on average, by 59 bps and 45 bps respectively. CET1 and total capital ratios are estimated to decrease by up to 75 bps for 79% of respondents (75th percentile).

These summary survey results indicate a need for central banks and other prudential authorities to become more active in encouraging banks in their jurisdictions to devote more resources to implement ECL provisioning requirements in a more robust, consistent and transparent manner.

6. How supervisors can promote robust implementation of IFRS 9 ECL impairment rules

The BCBS recognizes that banking supervisors have a strong interest in promoting the use of sound credit risk and provisioning practices by banks. Experience during financial crises has shown that poor credit quality and deficient credit risk assessment and measurement practices for accounting and capital purposes are significant causes of bank failures. Delays in identifying, measuring and recognizing increases in credit risk can aggravate and prolong bank problems. Inadequate credit risk policies may lead to delayed recognition and measurement of increases in credit risk, which adversely affects banks' capital adequacy and provisioning and hampers proper credit risk management. Supervisors expect banks to provide useful public disclosures about credit risk exposures, credit risk management, provisioning and related matters to bring about transparency that facilitates market discipline.[25] Principles 17, 18 and 28 of the Basel Core Principles emphasize that banks must have adequate credit risk management processes, including prudent policies and processes to identify, measure, evaluate, monitor, report and control or mitigate credit risk on a timely basis, and covering the full credit life cycle. Furthermore, adequate bank policies and processes must be in place for the timely identification and management of problem assets, and the maintenance of adequate provisions and public disclosures.[26]

My earlier article in this journal discussed how prudential authorities had a key role in encouraging accounting standards setters to issue the new ECL accounting standards. Central banks and other prudential authorities can also have a very important role in promoting high quality bank implementation practices through their banking supervisory activities in a manner that compliments the efforts of accounting standards setters.[27] For example, prudential authorities can promote high quality implementation practices through the following activities with key stakeholders:

1. **Encourage industry and supervisory participation in seminars and dialogue about the new standards and their implementation**. Leaders as well as technical experts at supervisory authorities and banks need to understand the new ECL standards; bank implementation strategies, and needed systems, controls, governance, reasonable and supportable forward-looking information, write-off policies, and related issues; and implications for capital adequacy, supervisory reporting and public disclosures. Prudential authorities should ensure periodic training programs for their officials and supervisory experts, but should also encourage and participate in periodic industry seminars and roundtables on key implementation topics. Participating in these programs can also help foster dialogue about important issues arising during the transition period. For example, in the U.S. the Federal Reserve Board (FRB), Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the U.S. banking agencies) have taken a leading role in encouraging attention by banks, auditors, and supervisory teams to the FASB's Current Expected Credit Loss approach (CECL) not only this year when the final standard was published but also for many years before its issuance.[28]

2. **Require banks to periodically present updates that will enable supervisors to monitor their ECL implementation strategies and efforts, and related timetables and understand their implementation challenges.** For example, the ECB announced earlier this year that it would be undertaking a review of IFRS 9 implementation practices. Also, certain supervisors in the Asia-Pacific

region have asked domestic and foreign banks to provide them with qualitative and quantitative information on their implementation efforts and the updated estimated impact of the ECL standard, and to meet to discuss these updates. Some supervisors have also incorporated IFRS 9 implementation reviews into their follow up with banks about asset quality reviews (AQRs).

3. **Encourage those charged with bank governance to achieve a greater understanding of IFRS 9 and related implementation efforts and to be more active in discussing these matters during meetings of the Board of Directors (or its equivalent) and its Risk and Audit Committees.** In addition to the principles and other guidance in the BCBS supervisory guidance previously discussed, those charged with governance may find useful the paper published by the Global Public Policy Committee (GPPC) on implementation of IFRS 9's impairment requirements.[29] The paper includes recommendations on governance and controls, and factors affecting the selection of modelling approaches and transition approaches. It also includes 10 questions that audit committees of SIFIs and other institutions can use to focus their discussions with management about implementation efforts. These 10 questions address the following four broad topic areas:
   - Important IFRS 9 decisions and interpretations;
   - Sophistication of ECL modelling;
   - Key systems and controls; and
   - Transparency to support effective internal governance and market discipline.

4. **Encourage auditors to achieve a greater understanding of IFRS 9 and related implementation efforts and supervisory guidance, and supervisors should gain a better understanding of auditor roles, meeting with them when appropriate. This could be helpful in encouraging an improvement in the quality of bank auditor practices.** As previously mentioned, the BCBS supervisory guidance recognizes that supervisors may make use of the work performed by banks' internal and external auditors in reviewing banks' credit risk assessment and ECL measurement functions. Thus, it is very important that auditors understand the accounting requirements and supervisory guidance, *and* that supervisors fully understand the role of auditors when determining whether to "rely" on their work, in whole or in part. The following documents could be helpful in this respect:
   - The International Auditing and Assurance Standards Board's (IAASB) ISA 540 Task Force has been reviewing ECL issues and challenges for external auditors and published a paper setting forth its preliminary views in March 2016. This IAASB paper was developed by a task force comprised of representatives from the IAASB, BCBS, the International Association of Insurance Supervisors, bank auditors, and the Public Company Accounting Oversight Board, the U.S. audit regulator. It highlights audit issues arising from the shift to ECL provisioning approaches, summarizes related audit challenges and provides initial thinking on how these challenges may be addressed under the current International Standards on Auditing (ISA).[30]

- BCBS supervisory guidance on internal audit (2012) and external audit (2014), which includes guidance on audit committee efforts that can contribute to the improvement of audit quality.[31]
- The 2016 report of the International Forum of Independent Audit Regulators (IFIAR) on its 2015 Inspection Findings Survey summarizes key inspection results from the audits of public companies, including SIFIs, and audit firm systems for quality control submitted by 35 IFIAR members in jurisdictions around the world. Inspection findings are deficiencies in audit procedures that indicate that the audit firm did not obtain sufficient appropriate audit evidence to support its opinion on the financial statements. For audits of SIFIs, the survey found the highest number of deficiencies related to (i) internal control testing, (ii) *auditing of loan loss allowances and loan impairments*, (iii) auditing the valuation of investments and securities, and (iv) use of experts and specialists.[32] Furthermore, the problems noted in this report led IFIAR to request the GPPC audit firms to undertake an extensive review of their internal quality control processes for external audits and to substantially reduce these audit quality deficiencies. *Thus, this report by audit regulators can provide supervisors with keen insights about potential problems with bank external auditors' practices involving provisioning that should be rectified.*

5. **Encourage banks in your jurisdiction to implement the EDTF's 2012 recommended disclosures and its 2015 recommended ECL transition disclosures (during the transition period), as well as the ECL disclosures required by the IASB once IFRS 9 is adopted.** The EDTF's 2012 report includes extensive recommendations for improved bank credit risk disclosures that major investors and banks have agreed are useful, and the EDTF's 2015 report shows how these can be updated for useful and reliable qualitative and quantitative information about the transition to ECL provisioning.[33]

6. **Consider the impact of ECL requirements on supervisory provisioning matrices, supervisory financial reports, analysis reports, AQRs, stress tests and other tools to ensure that prudential objectives are met.** The potential impacts of the new impairment standards will be important for leaders in the Asia-Pacific region and other regions 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.[34] 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. For example, prudential authorities will need to understand and address whether revisions should be made to their current national provisioning matrices or other requirements that have

contributed in the past to robust provisioning levels. This will be particularly important if surveys or other analyses indicate that the level of provisions of certain banks might be reduced when implementing ECL provisioning.[35] Furthermore, supervisors will need to place more emphasis in their analyses, AQRs, and stress tests on ECL considerations, including on financial assets that are 30 days or more past due since there is a rebuttable presumption in IFRS 9 that a significant increase in credit risk has occurred for those exposures, resulting in the recognition of lifetime ECL. In addition, in jurisdictions not requiring nonaccrual treatment for nonperforming assets, supervisors should consider requiring that banks' supervisory reports and public disclosures provide both (1) the amount of interest income accrued on nonperforming assets and (2) the cash interest income received on nonperforming assets to provide incentives to appropriately recognize interest income and provisions for these exposures and to provide incentives for certain banks to implement more effective strategies for reducing their nonperforming assets.

7. **Working with banks, the BCBS, accounting standard setters, investors, and auditors, consider how to achieve important transparency goals and prudential objectives while also reducing the regulatory burden associated with ECL provisioning.** The move to ECL provisioning by accounting standard setters is an important step forward in addressing the weakness identified during the global financial crisis that credit loss recognition was too little, too late. The development of ECL approaches is also consistent with the April 2009 call by the G20 Leaders for accounting standard setters to "strengthen accounting recognition of loan loss provisions by incorporating a broader range of credit information."[36] In this respect, the underlying principles supporting IFRS 9's ECL approach are broadly reasonable and are an improvement over IAS 39. However, the adoption of IFRS 9 will require significant enhancements to banks' governance and management engagement, data, systems and controls, and quantitative models, resulting in more complexity and volatility in reporting, and substantial investments by banks. This move to ECL approaches requires significant updates to models beyond those used for regulatory capital purposes at a time when the BCBS has been exploring ways to reduce undue dependence on models for certain capital adequacy purposes.[37] *Are there ways to achieve the transparency principles underlying IFRS 9 and the BCBS' desire for robust credit risk management and provisioning practices, while at the same time reducing unnecessary burden on banks, including smaller institutions?* This topic is quite complex and beyond the scope of this article, but given the significant systems and modelling updates and investments involved, it would be worthy of future constructive dialogue between banks, the BCBS, IASB, investors and auditors.

The new era of expected credit loss provisioning will arrive soon and significant transition efforts are underway by banks, supervisors and auditors. Implementation of the new ECL impairment standards should improve transparency to investors and help banks' financial reporting of credit losses to better reflect the emerging risks inherent in their loan portfolios. Important BCBS consultation documents on capital treatment, once finalized, and the BCBS December 2015 supervisory guidance on ECL provisioning will help guide banks and supervisors during the transition period and the initial years of implementation. Supervisors can also be proactive in promoting sound practices by key stakeholders that will contribute to high quality implementation of credit risk management and robust ECL provisioning. Working with the banking industry, accounting standards setters, investors and auditors, supervisors can have a significant role in helping to secure the potential benefits of the new ECL provisioning regime in ways that enhance transparency and risk management, and reduce undue burdens on banks.

Gerald A. Edwards, Jr., Chairman, JaeBre Dynamics, LLC, has held important positions with both the U.S. Federal Reserve Board and the Financial Stability Board and has served as an expert adviser to the International Monetary Fund for technical assistance and FSAP missions. He retired in 2013 with over 30 years' experience from the U.S. Federal Reserve Board's Division of Banking Supervision & Regulation in Washington, DC, USA, where he most recently held the official position of Senior Adviser and had served earlier as Associate Director and Chief Accountant. Previously, from mid-2005 to end-2012, he served as Senior Advisor on Accounting and Auditing Policy with the Financial Stability Board (FSB, and its predecessor, the Financial Stability Forum), with a dual senior advisory role with the Basel Committee's Accounting Task Force, at the Bank for International Settlements (BIS) in Basel, Switzerland. He was heavily involved in the international efforts to address the global financial crisis and its aftermath and participated in the development of international policy recommendations to promote financial stability. He also co-chaired the Basel Committee's High Level Working Group on the G20 Accounting Recommendations from 2009 to 2012. In addition, He served as the FSB's representative on the IASB-FASB Financial Crisis Advisory Group and on other key accounting and auditing advisory groups. He has also developed seminars and assessments about ECL provisioning for central banks and international organizations.

Endnotes

1. IFRS 9 *Financial Instruments*, IASB, July 2014. IFRS 9 also includes new rules for classification and measurement of financial instruments and hedge accounting.

2. Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, FASB, June 2016. The FASB standard refers to its new provisioning approach as being based on "current expected credit losses" or "CECL."

3. My earlier article in this Journal in May 2014, *The Upcoming New Era of Expected Loss Provisioning*, addressed key efforts of the G20, Financial Stability Board (FSB and its predecessor, the Financial Stability Forum, or FSF) and BCBS that encouraged the development of these new standards, summarized the IASB and FASB approaches (and why convergence was not achieved) and explored their potential impacts and implementation challenges before IFRS 9 was published. See www.seacen.org/products/702003-100340-PDF.pdf.

4. Moreover, questions were raised about whether the incurred loss model contributed to procyclicality. This topic and related FSB and BCBS efforts to address this matter and encourage improvements to provisioning standards are discussed more extensively in my earlier article.

5. IFRS 9 applies the same impairment approach to all financial assets that are subject to impairment accounting, thus removing a source of current complexity.

6. Project Summary: *IFRS 9 Financial Instruments*, IASB, July 2014.

7. Staff Discussion Note (SDN/15/19): *A Strategy for Resolving Europe's Problem Loans*, IMF, September 2015. See www.imf.org/external/pubs/ft/sdn/2015/sdn1519.pdf.

8. *Draft guidance to banks on non-performing loans*, ECB, September 2016. See Annex 7 in www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl/npl_guidance.en.pdf.

9. IFRS 9 also includes more extensive guidance on write-offs than IAS 39 by requiring write-offs when the bank has no reasonable expectations of recovering a financial asset in its entirety or a portion thereof (and related disclosures), but it does not specify the number of days past due or other information often considered by banks as a basis for loan write-offs. Generally, the FASB CECL

standard allows write-offs to continue to be made under banking practices for writing off uncollectible loans -- practices that have been shaped in large part by U.S. supervisory guidance and practices. U.S. GAAP and bank supervisory financial reports (e.g., FFIEC Reports of Condition and Income ["Call Reports"], and FR Y-9C reports for holding companies) require extensive public disclosures about bank write-offs.

10. *Guidance on credit risk and accounting for expected credit losses*, BCBS, December 2015. The consultative version of the guidance had been published in February 2015.

11. *Regulatory treatment of accounting provisions – interim approach and transitional arrangements*, BCBS, October 2015, and *Regulatory treatment of accounting provisions*, BCBS, October 2016.

12. *Sound credit risk assessment and valuation for loans*, BCBS, June 2006.

13. Under both IASB and FASB ECL standards, the use of a PD/LGD method to measure ECL is not required and other methods can be used (e.g., a loss rate method).

14. *Regulatory treatment of accounting provisions – interim approach and transitional arrangements*, BCBS, October 2016; and *Regulatory treatment of accounting provisions*, BCBS, October 2016.

15. As previously mentioned, IFRS 9 will be effective in 2018 and the FASB's CECL standard will be effective starting in 2020 for listed companies and 2021 for all other firms.

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

17. *2015 Progress Report on Implementation of the EDTF Principles and Recommendations*, EDTF, December 2015. See www.fsb.org/2015/12/2015-progress-report-on-implementation-of-the-edtf-principles-and-recommendations/.

18. *Impact of Expected Credit Loss Approaches on Bank Risk Disclosures*, EDTF, November 30, 2015. See www.fsb.org/2015/12/impact-of-expected-credit-loss-approaches-on-bank-risk-disclosures/.

19. In making these recommendations, the EDTF understood that paragraph 30 of IAS 8 applies when an entity has not yet applied a new IFRS that has been issued but is not yet effective, with expectations for disclosure of information on expected impacts of the new standard, if reasonably estimable. Likewise, there are also U.S. requirements regarding disclosures about impending accounting changes (e.g., SEC SAB Topic 11-M) and other jurisdictional requirements. The EDTF recognized that these requirements continue to apply although they typically do not require the full range of specific useful information investors desire, as set forth in the EDTF's ECL transition disclosure recommendations.

20. A similar approach, adjusted for the applicable transition period years, would be used for banks subject to U.S. GAAP, including FASB's CECL standard.

21. *Sixth Global IFRS Banking Survey – No time like the present*, Deloitte, May 2016.

22. *IFRS 9: Impairment - Global banking industry benchmark*, PricewaterhouseCoopers UK, May 2016.

23. *EY IFRS 9 impairment banking survey*, Ernst & Young, 2016.

24. *"Report on results from the EBA impact assessment of IFRS 9,"* EBA, November 2016. See the report at: www.eba.europa.eu/documents/10180/1360107/EBA+Report+on+impact+assessment+of+IFRS9.

25. *Guidance on credit risk and accounting for expected credit losses*, BCBS, December 2015.

26. *Core Principles for Effective Banking Supervision*, BCBS, September 2012.

27. These supervisory activities focus on encouraging *sound implementation practices* and not on developing accounting standards or interpretations, so they do not infringe on the roles and independence of accounting standard setters. In my experience, such carefully developed, sound activities are appreciated by accounting standard setters and securities regulators.

28. For example, in September 2016, the U.S. accountancy association, the American Institute of Certified Public Accountants (AICPA), held a three-day national banking conference with over 1,400 in attendance and nearly 80% of the sessions were about the CECL standard and key implementation issues, with U.S. banking agency experts participating as speakers and attendees. Earlier, Thomas Curry, the U.S. Comptroller of the Currency, gave the keynote speech at the 2013 AICPA national conference and included remarks about the importance of CECL provisioning. The U.S. banking agencies also hold substantial interagency and agency-only conferences for their supervisory teams that address key implementation issues.

29. *The implementation of IFRS 9 impairment requirements by banks -- Considerations for those charged with governance of systemically important banks*, Global Public Policy Committee, June 2016. The Global Public Policy Committee ("GPPC") is the global forum of representatives from the six largest international accounting networks - BDO, Deloitte, EY, Grant Thornton, KPMG, and PwC. Its public interest objective is to enhance quality in auditing and financial reporting.

30. *Project to Revise ISA 540 (An Update on the Project and Initial Thinking on the Auditing Challenges Arising from the Adoption of Expected Credit Loss Models)*, IAASB, March 2016.

31. *The internal audit function in banks*, BCBS, June 2012 (available at www.bis.org/publ/bcbs223.pdf); and *External audits of banks*, BCBS, March 2014 (available at www.bis.org/publ/bcbs280.pdf). Consistent with the BCBS external auditor policy, supervisors should also have discussions about these provisioning and audit quality matters with audit regulators when appropriate. While very informative and helpful, unfortunately, the above BCBS policies were issued before IFRS 9 was published and have not yet been updated for ECL provisioning considerations.

32. *Report on 2015 Survey of Inspections Findings*, IFIAR, March 2016. (See the report at the following link: www.ifiar.org/IFIAR/media/Documents/General/About%20Us/IFIAR-2015-Survey-of-Inspection-Findings.pdf.)

33. See the earlier section of this article for links to these important EDTF reports.

34. *Loan loss provisioning practices of Asian banks*, Frank Packer and Haibin Zhu, BIS Working Paper No. 375, April 2012.

35. In October 2016, Fitch Ratings published an alert that transition to IFRS 9, or its local equivalent, is likely to create operational challenges across many of Asia-Pacific's (APAC) banking systems, leading to a negative initial effect on capital, and potentially raise the volatility of earnings and regulatory capital ratios. However, Fitch stated that "…there are some countries in the region where the financial impact of IFRS 9 for banks could be softened by *regulatory framework practices*. These include Australia, Hong Kong, Korea, Malaysia, the Philippines, Singapore and Taiwan. Banks will still face provisioning pressures in these markets, but their current regulatory frameworks either already involve elements of the expected-loss approach or banks hold reserves that regulators did not allow them to fully release when IAS 39 was introduced. Regulators in most of these countries have also been progressively forcing banks to hold higher reserves, which will provide a buffer against potential losses. Nevertheless, the impact from moving to ECL is likely to vary from bank to bank even in the most prepared systems, reflecting the underlying riskiness of their assets and their own internal system capabilities." (*emphasis added*). *IFRS 9 Poses Implementation Challenges for APAC Banks,* Fitch Ratings, October 2016.

36. Available at www.g20.org.

37. For example, a recent consultative document sets out the BCBS’ proposed changes to the advanced internal ratings-based approach and the foundation internal ratings-based approach. The proposed changes discuss complementary measures, including the elimination of certain model-based approaches, that aim to: (i) reduce the complexity of the regulatory framework and improve comparability; and (ii) address excessive variability in the capital requirements for credit risk. *Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches*, BCBS, March 2016.