HIGHLIGHTS

TECHNICAL DISCUSSION MEETING

PROVISIONING PRACTICES AND IFRS 9 IMPLEMENTATION CHALLENGES IN THE AMERICAS

SEPTEMBER 2019

ASBA
ASSOCIATION OF SUPERVISORS OF BANKS OF THE AMERICAS

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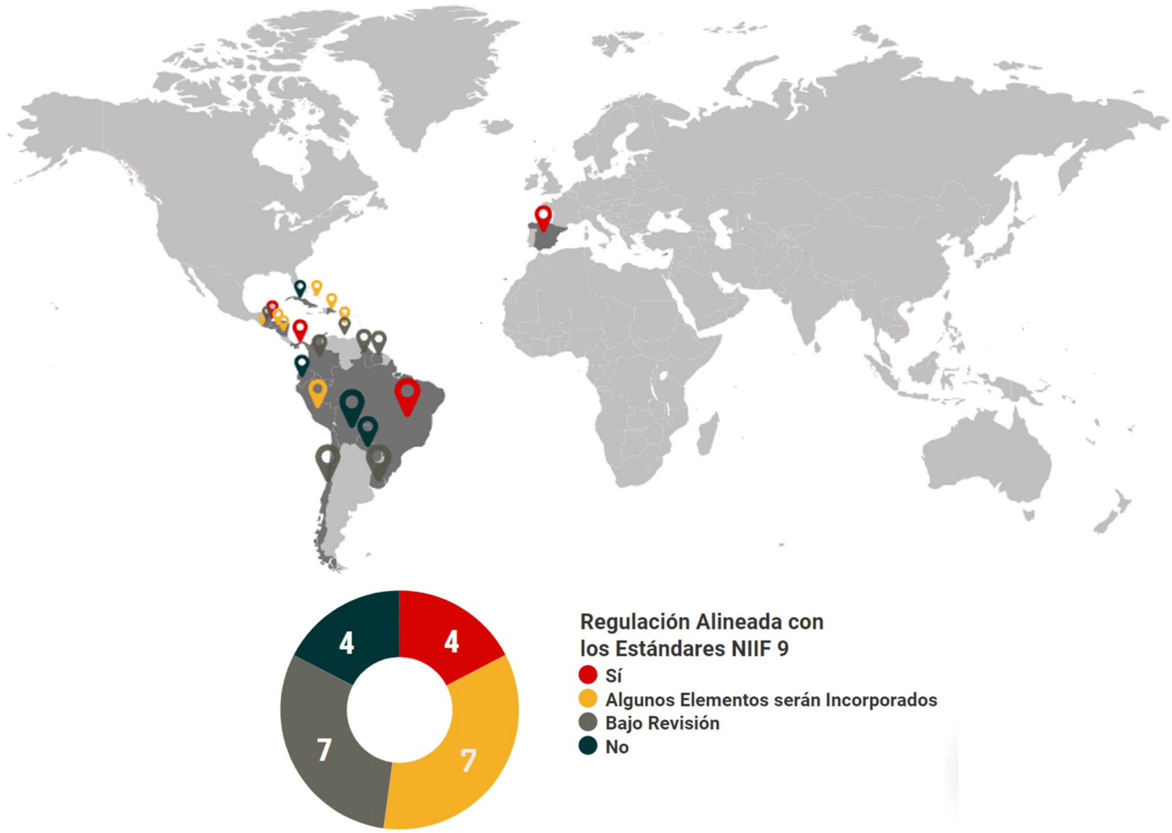
I. INTRODUCTION

The third deadline for the implementation of International Financial Reporting Standards 9 (IFRS 9) finished on January 2018. However, it is not clear when and how this standard can be implemented in Latin America and the Caribbean (LAC). According to the Association for Supervisors of Banks of the Americas (ASBA)'s Supervisory and Regulatory Standards Implementation Report[1], most countries in the region are in the process of reviewing the feasibility of applying the standard, some other countries plan to implement only certain elements, and a minority of countries will implement the full standard, although they are still working on developing guidelines for their implementation (Figure 1).

FIGURE 1. Expectation of Implementing Regulation in Line with IFRS 9 Standards



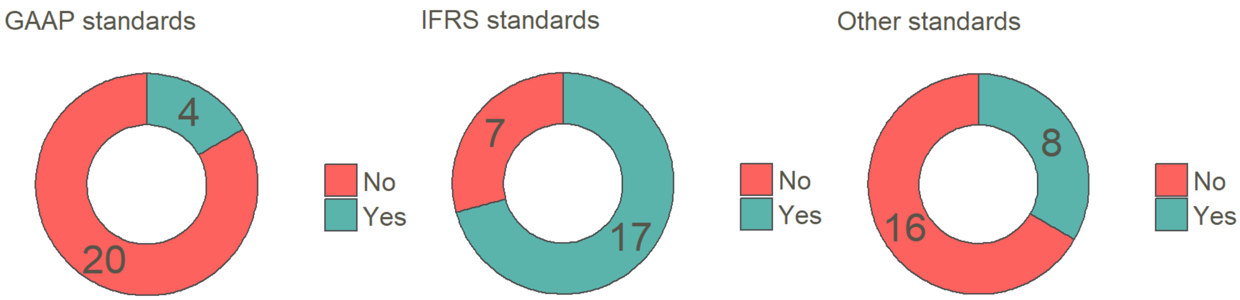
Source: Prepared by ASBA with information from the Supervisory and Regulatroy Standards Implementation Report, distributed to ASBA members in 2018.

1 The following institutions answered the survey: Superintendencia de Bancos y Otras Instituciones Financieras de Nicaragua, Superintendencia de Bancos de la República Dominicana, Superintendencia de Bancos de Panamá, Banco Central de Cuba, Banco Central del Uruguay, Superintendencia de Banca, Seguros y AFP del Perú, Superintendencia del Sistema Financiero de El Salvador, Autoridad de Supervisión del Sistema Financiero de Bolivia, Superintendencia de Bancos de Guatemala, Banco Central de Reserva de El Salvador, Superintendencia Financiera de Colombia, Banco de España, Comisión Nacional de Bancos y Seguros de Honduras, Superintendencia de Bancos del Ecuador, Banco Central Do Brasil, Banco Central del Paraguay, Bank of Guyana, Centrale Bank van Curaçao en Sint Maarten, Central Bank of Belize, The Turks and Caicos Islands Financial Services Commission, Centrale Bank van Suriname y el Eastern Caribbean Central Bank.

The interaction between accounting standards and prudential requirements is a long-standing debate among financial regulatory authorities, considering their impact on bank financial statements and, therefore, on regulatory capital. Currently, there is a significant heterogeneity in provisioning practices among LAC countries. While some countries are fully aligned with the standards of the International Accounting Standards Board 39 (IAS 39), others have developed their own provisioning requirements, mostly based on prudential practices.

In any case, the fundamentals behind IFRS 9 represent a significant improvement over the previous approach. IFRS 9 introduces a more sensitive valuation of assets and its classification principles, as well as a more appropriate and prospective recognition of credit losses through the Expected Credit Loss (ECL) approach. The standard is designed to help mitigate the volatility and procyclicality of banks' financial statements, and to provide authorities and market participants with clearer information on banks' financial condition (See Figure 2).

FIGURE 2. Accounting Standards



Source: Prepared by ASBA with information from the Supervisory and Regulatroy Standards Implementation Report, distributed to ASBA members in 2018.

However, the implementation of the standard can have crucial implications for both financial institutions and authorities. For financial institutions, the standard may involve high costs associated with the development of more sophisticated models, data infrastructures, among other technical and technological foundations. In addition, IFRS 9 requires a high degree of expert judgment in credit risk management, comparable to the discretion allowed under the most advanced Basel III approaches. Therefore, the search and investment in highly qualified personnel by all banks will be essential.

On the other hand, IFRS 9 also involves certain prudential policy concerns for authorities. Although some jurisdictions require banks to calculate provisions based on expected losses, this practice is not homogeneous in all countries. In addition, the high degree of expert judgment needed could undermine the comparability and reliability of regulatory capital. Therefore, some prudential indicators may not be comparable between banks within the same jurisdiction, nor between countries. Moreover, if implemented, IFRS 9 would hinder the prudential treatment of accounting provision estimates between the Standardized Approach and the Internal Ratings-Based Approach (IRB), and may force authorities to review the guidelines and modeling rules for IRB banks (less common in the region).

Authorities in the Americas should continue closely monitoring the work currently under way at the international level and should carry out *a priori* impact studies in their jurisdictions in partnership with financial institutions. The latter will inform authorities of the extent to which changes in the current regulatory framework are necessary to ensure adequate interaction between the prudential capital framework and the new accounting models related to expected credit losses.

II. OVERVIEW IN THE AMERICAS

A significant number of jurisdictions in the Americas have long had a prospective approach, in their accounting standards to deal with impairment in the financial sector. Although many of the accounting standards applicable in countries in the region are based on international standards, the rules for the treatment of impairment are highly aligned with the Basel standardized approach for credit risk, which considers a prospective approach to expected losses. Although the focus is on capital and not on provisions, and the models and variables considered for the calculation are different, the concept is not new to the region.

The feasibility assessment phase for the implementation of IFRS 9 is still ongoing in most jurisdictions in the Americas. Although introducing the standard as a whole presents obvious challenges, its implementation can bring positive externalities to the accounting systems and processes in the financial sector. Although the prospective concept of impairment is not new to the region, the factors to be considered, the models for the calculation, as well as the type and quality of data, necessary diverge with the new international standard. Developing new models and establishing reliable data systems is a challenge that implies costs. However, it is also an incentive to attract new talent to the sector and an opportunity to update accounting processes and systems. For example, in Suriname, banks are expected to comply with IFRS standards by 2020. However, for IFRS 9 the feasibility of an adequate implementation will require it to be phased and over a longer term. Within the first year, banks are expected to use their current credit risk management models and reporting systems. For the next two to three years, the industry is expected to attract new talent and build knowledge to deal with the complexity of the standard.

The prudential approach will continue to prevail in jurisdictions in the region, whether these determine to fully or partially implement IFRS 9. Some of the initial evaluations of jurisdictions in the region indicate that it is very likely that the calculation of provisions under the IFRS standard will be lower when compared to the accounting rules currently applicable at the national level, which are more in line with the prudential view. In this case, the power of supervisors to require a larger charge for provisions (through Pillar 2 requirements), to require deductions on regulatory capital (Pillar 1), to establish minimum levels for provisions, or other security prudential mechanisms (prudential backstops), will continue to be an important part of the accounting regulations applicable in jurisdictions in the region.

In general, supervisory authorities in the region have the power, either directly or indirectly, to reduce provision deficits through regulatory capital or to require additional provisions, if deemed necessary. Since the magnitude of the impact of introducing IFRS 9 on prudential requirements is still unclear, the powers of supervisors in the region can facilitate the implementation and adaptation of the standard to the inherent characteristics of the financial system. For example, in the case of Suriname, there are two banks that are aligned with IFRS standards, under which they have calculated provisions lower than those established by the current prudential regulation. In this case, the Central Bank of Suriname has the power to require provisions based on the calculations according to the accounting standards. Continuous communication with entities that have the capacity to comply with the standard in the short term is essential, to inform the supervisor about the structure and suitability of these additional requirements.

The development of proprietary metrics for verification and the ability to execute methodological approval protocols will continue to be a challenge for authorities in the Americas. The development of metrics to verify and contrast results, as well as the authorities' review of the internal models and methodologies utilized by supervised entities are challenges that, for the time being, may be beyond the scope of supervisory activities. In several small economies in the region, the availability of historical data on macroeconomic variables, necessary for the proper implementation of the standard, does not exist or is limited (for example, in Suriname there is no official real estate price index). In this scenario, it is advisable to strengthen the supervision of corporate governance and internal controls in the short term, and gradually build the necessary capacities for the review and validation of internal models, in case the authority considers it convenient and possible.

Banks that operate regionally may encounter difficulties and have disadvantages by complying with different accounting standards. For example, since 2018 some foreign banks with subsidiaries in the region report accounting calculations to their parent companies based on IFRS 9 since 2018. Some of these banks only send the data and the parent company is responsible for carrying out the calculations, while others have had to hire consultants to prepare the report for their parent company, which has additional costs.

III. ASSET VALUATION, DATA AND CONCERNS IN MODELING RISKS

The implementation of IFRS 9 implies a paradigm shift in the use of internal models by supervised institutions in the region. In general, jurisdictions in the region base their credit risk management regulation on the criteria established by the Basel framework (I, II, and III) related to the standardized approach. In various jurisdictions, the regulations do not allow the use of internal models and in others, although it is allowed under certain prudential conditions, there are no banks that develop these models. The introduction of the full version of IFRS 9 would require jurisdictions to review these restrictions and develop criteria and monitoring strategies for the use of internal models.

A significant number of jurisdictions seek to converge on the adoption of IFRS 9. However, the main frictions with current accounting standards are concentrated in the provisioning practices of credit instruments. Prudential authorities, as in the case of Chile, have indicated that the sections of the standard related to measurement and classification of financial assets may not represent a significant impact when introduced. However, the change in the provisioning approach could have a greater impact and repercussions because the accounting standards for provisioning in the region are more aligned with the prudential vision of credit risk management, which focuses more on capital and not on provisions.

In the region, four different positions have been identified on how to address the frictions arising from the paradigm shift in provisioning practices. On the one hand, two extreme positions: a limited number of countries have mentioned that their accounting standards will remain in force and will not be revised; while another group of countries, also limited, will seek to implement the standard in its entirety for the financial system. On the other hand, two more flexible positions were mentioned: the first, to partially implement the content of the standard and the second, to use a proportional approach in the standards.

One of the options to address the frictions between current accounting standards and the adoption of IFRS 9, is to partially adopt the standard. This means generally complying with the standard, omitting some components and some specific cases. In the case of Chile, for example, the criterion will be to maintain a series of accounting standards aligned to IFRS, such as financial assets measurement and classification, with certain exceptions, such as the treatment of impairment and provisioning for credit instruments. As for instrument types other than credit, such as fixed income instruments, the provisioning models established by IFRS 9 will be applied.

Another option mentioned during the meeting is to adopt IFRS 9 through a proportional approach in the regulation. For some years, the topic of a differentiated financial regulation has been the center of the debate among authorities at a global level. In the case of Brazil, the standard would be introduced based on the size and complexity of institutions, according to the current segmentation criteria. In this case, smaller institutions will be subject to standardized rules to calculate provisions established and calibrated by the Central Bank of Brazil, while larger and more complex institutions will use internal models under IFRS 9 with prudential backstops, which refers to a minimum level of provisions that serve as a security mechanism. It is important to mention that this approach is still under study and can be modified.

The proportional model in Brazil will establish minimum provision levels for large and complex institutions, while utilizing a standardized framework based on average expected losses for smaller institutions. In the case of large and complex institutions, the Brazilian regulation will define minimum provisions for Non-Performing Exposures (NPEs). That is, regulation focuses on exposures classified as stage 3. A matrix will be defined with minimum provisions for each type of credit instrument (grouped according to the type of collateral) and then according to the days past due, this will translate into non-static minimum provisions, which will increase over time. Loss Given Default (LGDs) associated with this matrix will be calculated and calibrated by the Central Bank of Brazil. For smaller and less complex institutions, a standardized framework with a similar level of granularity will be established, but calculations will be calibrated based on average expected losses for each type of credit instrument and provisions will also be established for performing exposures (performing - stage 1 or 2).[2]

Considering the limitations of resources faced by supervisory authorities, it is advisable to strengthen the inspection activities in topics covering corporate governance and internal controls, in addition to establishing prudential protection mechanisms. In any of the aforementioned approaches, the process of validating methodologies and internal models for each supervised institution is a task that consumes time, resources, and demands a high degree of specialization by the authority. These resources are usually insufficient in supervisory agencies in the region; thus, it is advisable to strengthen and focus supervision on credit risk management features at a higher level. That is, to verify the corporate governance structure, to assess the suitability of senior management, as well as the validation mechanisms and internal controls. A complementary option is to establish prudential backstops, such as highly detailed minimum provisioning levels.

2 The approach proposed by the Central Bank of Brazil is still under study and has not been published, thus it may have modifications in the future.

IV. CONCERNS OVER ASSETS CLASSIFICATION

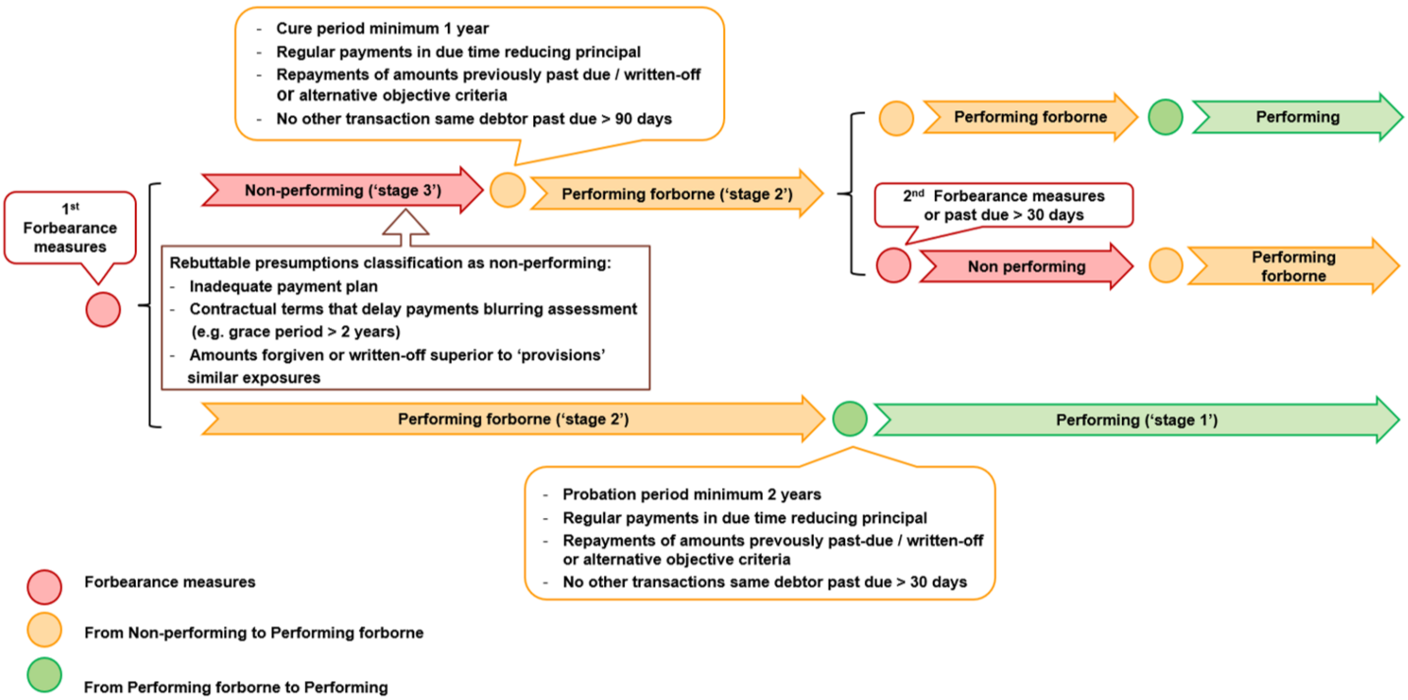
The lack of uniformity and clarity in the concepts of NPEs and asset forbearance, is a key issue for the adequate classification of assets at a regional and global level. Although international standards provide a starting point, no consensus has been reached at the regional level on these definitions, in contrast to the European framework. An adequate classification is necessary for cross-border supervision, designing models, stress testing, and to improve understanding between authorities.

The definitions of NPEs in LAC jurisdictions consider both quantitative and qualitative criteria that significantly differ among jurisdictions. Although, in general, the usual '90 days past due' criterion is used and the concept is related to the notion of "impairment" and "default," there are important variations in other criteria. Moreover, the adaptation of international standards to Spanish-speaking jurisdictions have generated a variety of translations in which, on many occasions, we can find the same word in Spanish, but with different conceptualizations. For example, the following translations of NPEs have been identified: doubtful, non-profitable, unproductive, non-compliant exposures, among others.

There is no global or regional consensus on the definition of the concept of forbearance. In practice, financial authorities understand the concept of forbearance. However, this classification label often depends on the supervisor's criteria and not on clear and more homogeneous guidelines. The definition is reasonably uniform in Europe, where an asset is recorded as restructured in cases where: the asset could have been classified as non-performing before any modifications to the contract or when the forbearance clauses in the original contract are applied by the debtor; when the repayment of a non-performing contract is made shortly before granting additional loans; when the modifications leads to a total or partial cancellation of the contract through a write-off; or when the restructured contract is or has been 30 days past due (refutable).

The criteria for classifying restructured or refinanced exposures in any of the three stages of impairment (stage 1, 2 or 3) established in the framework of IFRS 9 are even less homogeneous. Although IFRS does not establish detailed criteria for the treatment and modification of restructured exposures, it is necessary that these be established by the authority to avoid an increase in credit risk through practices that delay the recognition of impairment or losses (extend and pretend). In the European case, regulation establishes that restructured exposures can be performing or non-performing, although they must necessarily be classified in stages 2 or 3. It also establishes detailed conditions to "cure" and reclassify this type of exposures (See Figure 3). In contrast, it should be taken into account that establishing highly severe conditions could encourage banks to avoid restructuring measures and, therefore, affect borrowers with a good credit rating, but with temporary problems.

FIGURE 3. AVOIDING EXTEND AND PRETENT APPROACHES



Source: Bank of Spain, *Asset Classification Concerns*. Presented by Carlos José Rodríguez García in the Technical Implementation Meeting on IFRS 9 in July 2019.

As for the classification of NPEs, the most advanced jurisdictions in the implementation of IFRS 9 are focused on establishing minimum provisioning levels for exposures classified as non-performing (stage 3) and not on imposing minimum requirements for Probability of Default (PDs). In countries like Spain and Brazil, there are no minimum requirements for PDs, in contrast to the Basel framework that establishes a minimum PD of 0.05 for IRB banks. However, the approach is to impose minimum provisioning levels for NPEs. That is, exposures in stage 3 of impairment. In Brazil through minimum provisioning levels differentiated by size and complexity of the institution[3], and in Spain through minimum prudential levels, whose difference with accounting provisions are considered as additional requirements of Pillar 2 or deductions related to Pillar 1.

3 The approach proposed by the Central Bank of Brazil is still under study and has not been published, thus it may have modifications in the future.

V. OTHER PRUDENTIAL CONCERNS

At the international level, various issues related to frictions between the parameters of the Expected Loss (EL) models of the IRB framework and the Expected Credit Loss (ECL) model of IFRS are discussed. The IRB framework focuses on capital, thus expected losses represent long-term averages over economic cycles, while IFRS 9 focuses on short-term economic conditions. In this regard, authorities must ensure consistency in the estimates. The parameters of the IRB approach may have to be adjusted to meet the requirements of IFRS 9.

An important difference between the IRB approach and IFRS 9 is the type of interest rate used to discount cash flows in the calculation of LGDs. This difference is not actively discussed internationally. While under IRB, the risk-free rate can be properly used as the discount rate for cash flows in the calculation of LGD, IFRS states that the coupon rate or nominal rate is the one that should be used. This could have an important impact in jurisdictions where rate differentials are very high and volatile (this is the case in various LAC countries). On the other hand, using nominal rates would imply a high cost in computing resources in order to be able to monitor them continuously. It may be advisable that during the transition period for the adoption of IFRS 9, risk-free rates be used for the calculation of LGD, but this will require further internal discussion by supervisory authorities.

There are concerns on the part of authorities about the criteria for the calculation of PDs at 1 year and over the Lifetime of the asset (LT). There is still no clear convergence in the literature on the type of theoretical models that FIs intend to implement, the minimum historical data that will be required, nor the maximum time horizon that should be established for the calculation of the Lifetime PD. A frequently explored approach is the use of survival models.

It is reasonable to think that for the calculation of PDs, banks use the 5-year minimum requirement for historical data established in the Basel framework. However, given that IFRS 9 takes into account the current economic conditions and short-term changes, it requires supervisors to pay attention on how to modify regulation to introduce this requirement in PD calculations.

Financial authorities should work to ensure the standardization in the treatment of NPEs among financial institutions within their jurisdictions. In order to ensure comparability among financial institutions in the recognition, classification, and cure of NPEs, Brazilian authorities have decided to make public some sections of their supervision manual to standardize the understanding of the supervisor's expectations among the entities under surveillance. In addition, workshops and presentations have been carried out with regulatory drafts for their socialization among financial institutions.

The financial authority should strengthen the supervision of risk management, corporate governance, and internal control functions. Supervisors should require and ensure that entities have solid validation processes, *a priori* strategy tests (back testing), and that their results are adequately used. As previously mentioned, reviewing each model utilized by financial institutions is inefficient and requires numerous resources from the supervisor. A well-established early warning system will help focus on specific institutions and specific models that would require more detailed validation by the supervisor. In addition, supervisors should require financial institutions to present an Action Plan for the adoption of IFRS 9. Supervisory activities will closely monitor the implementation of action plans.

TERMS AND ABBREVIATIONS

Association of Supervisors of Banks of the Americas	**ASBA or Association**
International Financial Reporting Standards	**IFRS**
International Accounting Standards	**IAS**
Latin America and the Caribbean	**LAC**
Expected Loss	**ECL**
Expected Credit Loss	**EL**
Internal Rating-Based	**IRB**
Prudential Security Mechanisms	**Backstops**
Minimum Provision for Non-Performing and Doubtful Exposures	**NPEs o NPLs**
Loss Given Default	**LGD**
Asset Restructuring	**Forbearance**
Probability of Default	**PDs**
Lifetime	**LT**

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