

# The Basel Committee Guidance on credit risk and accounting for expected credit losses

January 2016

## What you need to know

- ▶ The G-CRAECL applies to ECLs calculated under both US GAAP and IFRS. However, as the US GAAP model is still being completed, the G-CRAECL has only one appendix, which addresses the application of IFRS 9.
- ▶ The main messages are not significantly different from those in the consultation document and most of the amendments have been to structure and language.
- ▶ As with the consultation document, the G-CRAECL limits the use of the simplifications available in IFRS 9 by internationally active banks, including the 'low risk exception' and reliance on delinquency to determine whether assets should be measured using lifetime ECLs.
- ▶ The G-CRAECL states that any bank that complies with the Guidance should not reduce its level of allowances by using the simplifications, as to do so would introduce 'bias'.
- ▶ As with the consultation document, the G-CRAECL does not address regulatory capital requirements.

The final guidance has now been published.

## Introduction

In February 2015, the Basel Committee on Banking Supervision (the Committee) issued a *Consultative Document: Guidance on accounting for expected credit losses* (the CD) that outlined supervisory expectations regarding sound credit risk practices associated with implementing and applying an expected credit loss (ECL) accounting framework. The CD largely retained the Committee's previous principles on sound credit risk assessment and valuation of loans (SCRAVL) that were issued in 2006, but was revised to reflect the move from an incurred loss to an ECL accounting model. This followed the publication of IFRS 9 *Financial Instruments* by the International Accounting Standards Board (IASB), application of which is mandatory for financial years beginning on or after 1 January 2018. Please refer to our [\*IFRS Developments Issue 100, Basel Committee proposes guidance on accounting for expected credit losses\*](#). The final version, titled *Guidance on credit risk and accounting for expected credit losses* (G-CRAECL or Guidance) was issued in December 2015. Its main messages do not differ significantly from the CD and most of the amendments have been to structure and language.

Representatives of the IASB have been provided with the opportunity to comment on the Guidance and have not identified any aspects of it that would prevent compliance with IFRS 9.

## Objective and scope

The G-CRAECL aims to set out supervisory guidance on sound credit risk practices associated with the implementation of ECL accounting models for banks' lending exposures that include loans, loan commitments and financial guarantee contracts, but exclude debt securities. The Guidance does not address regulatory capital requirements, although supervisors are advised to reflect significant deficiencies in the application of an ECL model through supervisory ratings or a higher 'Pillar 2' capital requirement.<sup>1</sup> The G-CRAECL does not intend to drive convergence between different ECL accounting frameworks, but rather it aims to drive consistent interpretations and practices where there are commonalities across accounting frameworks and when the same accounting framework is applied.

The change in title from that used in the CD emphasises that the G-CRAECL not only guides ECL accounting, but also guides credit risk practices affecting the assessment and measurement of ECLs, since involvement of the risk management function is essential for the accounting. However, compared to the CD, there is less emphasis on aspects of credit risk management that do not directly affect the assessment and measurement of ECLs, such as loan pricing.

The main section of the Guidance is applicable to all ECL accounting frameworks. For jurisdictions in which ECL accounting is not required, the Committee expects that all relevant aspects of the Guidance will be applied as far as is appropriate.

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<sup>1</sup> Paragraph 91 of the G-CRAECL.

If a bank adopts an approach that is an approximation to the 'ideal', the method must be designed to avoid bias.

In contrast to the CD, the G-CRAECL does not say that it is addressed only to internationally active banks – although the Guidance states that “... the Committee has significantly heightened supervisory expectations that internationally active banks will have a high quality implementation of an ECL accounting framework ...” The extent to which less sophisticated banks are required to follow the Guidance will depend on the local regulatory requirements. Banking supervisors are guided to adopt a proportionate approach, which will be relevant, not just for the less sophisticated banks but also for the less significant activities of those that are internationally active. As an amendment to the requirements in the CD, materiality must also be given due consideration. However, the Guidance does state, “when because of considerations relating to proportionality or materiality, a bank chooses to adopt an approach to ECL estimation that would generally be regarded as an approximation to ‘ideal’ measures, it is important that such approximation methods are designed and implemented so as to avoid bias.”<sup>2</sup> ‘Bias’ is not defined in the G-CRAECL.

This new principle of avoiding bias is illustrated by paragraphs A39 and A55 of the appendix, The first tells us that, “the use of a 30 days-past-due criterion introduces bias” while, in the second, it is written that, if an entity must (in limited instances) rely on past-due information to determine whether exposures should move to lifetime ECL measurement, “banks should pay particular attention to their measurement of the 12-month ECL allowance”. This would appear to mean that, if a bank relies on triggers such as delinquency to assess the transfer of exposures to Stage 2, the Stage 1 allowance must be increased to compensate.

### Reasonable and supportable information

IFRS 9 requires entities to apply the standard using ‘reasonable and supportable information’; the G-CRAECL interprets this very broadly. For instance, the G-CRAECL states that, “The Committee does not view the unbiased consideration of forward-looking information as speculative”<sup>3</sup> and, “information should not be excluded ... simply because an event has low likelihood of occurring or the effect of that event on the credit risk or on the amount of expected credit losses is uncertain.”<sup>4</sup> The same paragraph acknowledges that there may be instances when relevant information may not be reasonable and supportable, but the circumstances in which such information should be excluded ‘would be exceptional in nature’.

## Supervisory requirements for sound credit risk practices using an ECL measurement

As with the CD, the Guidance is structured around eight principles that apply to banks and three to supervisors. The principles are the same as those in the CD, with only minor amendments. Some of the key messages include:

- ▶ The Committee emphasises the responsibilities of the board of directors and senior management, and the need for an effective internal control system for credit risk assessment and ECL measurement. This must include appropriate written policies and independent evaluation by an internal audit function.

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<sup>2</sup> Paragraph 17 of the G-CRAECL.

<sup>3</sup> Paragraph 21 of the G-CRAECL.

<sup>4</sup> Paragraph 22 of the G-CRAECL.

- ▶ Processes for assessing credit risk and measuring ECLs should, where possible, leverage and integrate processes (i.e., systems, tools and data) used for other risk management functions. A common dictionary of terms should be applied across the bank.
- ▶ Compared to the CD, there is even more focus on the need to make use of appropriate forward-looking information, including macroeconomic factors that are relevant for credit risk assessment and ECL measurement. The reasons that particular methods have been adopted should be documented, along with inputs, data and assumptions, plus any adjustments made to historical loss experience, which must be independently validated and back-tested. Different potential scenarios should be considered to calculate ECLs, and the bank should assess and document how ECLs would vary with changes in those scenarios.
- ▶ To the extent that they could affect its ability to recover amounts due, the bank must consider factors such as competition and legal requirements, the bank's overall volume of credit, its risk profile and credit concentrations, and the quality of its systems.
- ▶ Banks must have an effective credit risk rating system to track changes in credit risk, with clear definitions, assigned responsibilities and an independent review function. Subsequent to initial assignment, risk grades will need to be reviewed whenever new information is received and at least annually, and may need to be adjusted on a portfolio or individual basis due to factors such as changes in economic forecast or weaknesses identified in the initial underwriting.
- ▶ When forward-looking information and macroeconomic factors cannot be applied at the individual exposure level, exposures should be placed in a group with shared credit risk characteristics and assessed collectively. The G-CRAECL states that, "use of individual versus collective assessments should not result in materially different allowance measurements."<sup>5</sup> However, the Guidance does not say how compliance with this requirement would be demonstrated if information cannot be applied at an individual exposure level: "The ECL estimation technique used should be the most appropriate in the particular circumstances."<sup>6</sup>
- ▶ Groupings of exposures into portfolios with shared credit risk characteristics should be sufficiently granular to ensure that changes in a part of the portfolio are not masked by the performance of the portfolio as a whole. Groups must be re-evaluated regularly.
- ▶ If a bank cannot re-segment on a timely basis, or it is evident that relevant risk factors, events or circumstances have not been considered in the credit rating and modelling process, an adjustment may be used. However, such adjustments should be temporary, as processes should be updated in the near term and judgemental adjustments create the potential for bias. Temporary adjustments should be subject to appropriate corporate governance.
- ▶ Models must be robustly validated when they are initially developed and at regular intervals thereafter (e.g., annually) by staff with appropriate experience and expertise who are independent of model development. Validation methods, and the procedures performed, must be documented comprehensively.

Any adjustments to reflect shortcomings in processes should be temporary and subject to appropriate corporate governance.

<sup>5</sup> Paragraph 54 of the G-CRAECL.

<sup>6</sup> Paragraph 55 of the G-CRAECL.

The Committee recognises that incorporating forward-looking information and macroeconomic factors is challenging, costly and will require significant judgement, and that ECLs will not predict actual outcomes. However, the consideration of forward-looking information is considered “essential to the proper implementation of an ECL accounting model, and should not be avoided on the basis that a bank considers the costs ... to be excessive or unnecessary, or because of the uncertainty in formulating forward looking scenarios.”<sup>7</sup> A bank’s experienced credit judgement will also be crucial.

The guidance sets out disclosure requirements, although not in detail.

The Committee encourages banks to improve their disclosures in order to fairly depict their exposures to credit risk and risk management practices and to facilitate peer comparison. The G-CRAECL does not specify the required disclosures in detail, given that the Enhanced Disclosure Task Force issued its own guidance on this topic in December 2015. However, it requires quantitative and qualitative disclosures, taken together, to communicate the main assumptions and inputs used for ECL estimates. It also requires disclosure of policies and definitions, factors that cause changes in ECL estimates and an explanation of significant changes to those estimates, plus how management judgement and forward-looking information have been incorporated in the estimation process.

## Supervisory requirements specific to jurisdictions applying IFRS

The appendix to the Guidance provides additional supervisory requirements on three key areas that are specific to banks reporting under IFRS.

### Loss allowance at an amount equal to 12-month ECL

The Committee recommends that a bank’s definition of default adopted for accounting will be guided by that used for regulatory purposes. This includes both a qualitative ‘unlikelihood to pay’ criterion and a quantitative ‘90-days-past-due’ criterion, described as a backstop. Measurement should make use of all relevant information that is reasonably available, including forward-looking information and macroeconomic factors, along with experienced judgement.

### Assessment of significant increases in credit risk

Compared to the CD, the language used in the Guidance on when exposures should be measured using lifetime ECLs is a little more lenient, but not much. References to a ‘single notch’ downgrade have been removed, but paragraph A30 says that “thorough consideration and full weight must be given” to a decision such as “to intensify the monitoring of a borrower or class of borrowers” as “it is unlikely that such action would have been taken if the increase in credit risk has not been perceived as significant”.

The G-CRAECL states that lifetime ECLs are generally expected to be recognised before a financial instrument becomes past due or other lagging borrower-specific factors are observed. Credit risk often begins to deteriorate a considerable time (months or even years) before an actual delinquency occurs. Banks are required to make forward projections of the key drivers of credit risk, and be able to judge whether, based on these projections, particular exposures have increased significantly in credit risk.<sup>8</sup> An example is

<sup>7</sup> Paragraph 64 of the G-CRAECL.

<sup>8</sup> Paragraph A18 of the G-CRAECL.

given of commercial property loans, for which banks should consider information such as levels of interest rates and occupancy rates.<sup>9</sup> The Committee believes that IFRS 9 “is demanding in its requirements for data, analysis and use of experienced credit judgement”<sup>10</sup> for making this assessment and will require strong governance, systems and controls.

As with the CD, internationally active banks are expected to make limited use of the low risk simplification and the 30 days past due presumption to assess credit risk.

### **Use of practical expedients**

IFRS 9 includes a number of practical expedients to ease its implementation, such as the low risk simplification and a more than 30 days past due rebuttable presumption, to assess whether exposures should be measured using lifetime ECLs. However, the Committee expects that the use by internationally active banks will be limited.<sup>11</sup> Also, any bank that chooses to rebut the 30-day presumption is expected to carry out a thorough analysis to evidence clearly that 30 days past due is not correlated with a significant increase in credit risk and this analysis will need to consider both current and forward-looking information.

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<sup>9</sup> Paragraph A21 of the G-CRAECL.

<sup>10</sup> Paragraph A15 of the G-CRAECL.

<sup>11</sup> Paragraph A45 of the G-CRAECL.

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