

Developments in Provisioning Standards and Implications to Banking Institutions

In November 2009, the International Accounting Standards Board (IASB) issued proposals for a fundamental review of International Accounting Standard (IAS) 39 in response to the call by the G20 leaders for both the accounting standard setters and supervisors to work urgently to implement forward-looking provisioning standards as one of the measures to address procyclicality. The proposals by the IASB are broadly in line with the high level principles issued by the Basel Committee on Banking Supervision (BCBS) in August 2009. These proposals reflect lessons learned from the financial crisis, particularly the need for earlier recognition of loan losses based on sound methodologies that capture expected credit losses, including changes in loss expectations as conditions affecting borrowers change.

This article explains the new proposals on impairment by the IASB and discusses its implications for banking institutions in Malaysia.

Problems with incurred loss impairment approach

Under the present incurred loss model applied in IAS 39, loans may be classified as impaired *only* when there is objective evidence that a loan or portfolio of loans will not be repaid in full. Such evidence (known as a trigger event) may be specific to an individual loan (e.g. bankruptcy) or an occurrence of an event that is likely to lead to defaults across a portfolio of loans (e.g. increase in unemployment and a downturn in the property market that may lead to an increase in mortgage defaults).

Expected future credit losses are not recognised until a trigger event has occurred. This approach received criticism during the global financial crisis for failing to account for loss expectations even though such losses are factored in (based on historical experience or judgments made by lenders about likely default experience) when loans are made and priced by banking institutions. As a result, the recognition of expected losses is delayed, while interest revenue is generally overstated before the trigger event occurs. The subsequent recognition of credit losses, in turn, causes abrupt adjustments to income levels of banking institutions when a trigger event occurs, thereby reinforcing the procyclical impact of a financial crisis or general economic downturn. Inconsistencies among banking institutions in defining and assessing trigger events have further reduced the comparability of impairment provisions for similar financial assets across institutions.

Proposals for expected loss impairment approach

The new proposals by the IASB which adopts the impairment method based on expected losses will require entities to:

- (i) determine the expected credit losses on a financial asset when that asset is first obtained;
- (ii) recognise contractual interest revenue, less the initial expected credit losses, over the life of the financial asset;
- (iii) build up a provision over the life of the financial asset for the expected credit losses;
- (iv) reassess the expected credit loss at each period; and
- (v) recognise immediately the effects of any changes in credit loss expectations.

The proposals also include expanded disclosure requirements that compare the development of credit loss provisions and cumulative write-offs by year of origination for each class of financial assets. This will allow users of financial statements to track the development of losses over time and form an opinion on the accuracy of management's estimates.

A comparison¹ of the current incurred loss approach and the proposed expected loss approach is summarised below.

Incurring loss approach	Expected loss approach
<ul style="list-style-type: none"> Interest revenue for financial assets is recognised on the basis of expected cash flows excluding expected credit losses. 	<ul style="list-style-type: none"> Interest revenue for financial assets is recognised on the basis of expected cash flows including expected credit losses.
<ul style="list-style-type: none"> Impairment is recognised only when a loss event occurs (known as an impairment trigger). 	<ul style="list-style-type: none"> Expected credit losses are continuously re-estimated without reference to loss events or impairment triggers.
<ul style="list-style-type: none"> Losses that are expected to arise from future events are not recognised. 	<ul style="list-style-type: none"> Impairment is recognised from an adverse change in credit loss expectations and can be reversed by subsequent favourable changes.
<ul style="list-style-type: none"> Interest revenue can be viewed as 'overstated' in periods before a loss event occurs. 	<ul style="list-style-type: none"> Interest revenue reflects the total net return expected at inception.

The proposed expected loss impairment standard is expected to be finalised by the IASB in the second half of 2010 with an effective date for mandatory adoption not earlier than three years from the finalisation of the standard.

Implications for banking institutions in Malaysia

The move towards more forward-looking provisioning under the expected loss approach aims to better align loan loss reserves with risk management and supervisory approaches which are concerned with loss developments associated with plausible *future* events, as opposed to losses based on *known* events which underpin the current incurred loss model. The gradual build-up of reserves over time will also result in higher reserves held by banking institutions when entering periods of deteriorating credit quality. This in turn will reduce the pressure on bank earnings and capital as loan losses materialise, thus supporting the intermediation activities during periods of stress or economic downturn.

Provisioning based on the expected cash flow model as proposed by the IASB, however, presents several operational challenges for banking institutions. To determine expected losses, a banking institution must forecast expected credit losses and the timing of such losses over the life of financial assets (either on an individual or on a portfolio basis). Depending on the size and complexity of the institution's loan portfolio, this may be an operationally complex undertaking, requiring systems changes to be made and significant lead-time to implement. The incremental effort to implement the new provisioning standards will generally be more significant for banking institutions that are adopting the Standardised Approach for credit risk under Basel II. Such banking institutions will need to develop anew, or substantially recalibrate systems modelled on the incurred loss approach to compute estimates of future cash flows and credit losses.

In contrast, banking institutions, including six domestic banking institutions, that are adopting the Internal Ratings-Based (IRB) Approach for credit risk under Basel II are already required to take into account expected loss considerations in estimating probabilities of default for the purpose of determining regulatory capital. For these banking institutions, the same data collected for capital purposes would also support the estimation of expected loss for provisioning purposes. Common factors should also drive internal credit risk ratings for both capital and provisioning purposes. These

¹ Source: www.ey.com/IFRS

similarities enhance the prospects for IRB banks to leverage on existing infrastructure supporting regulatory capital requirements to meet the proposed provisioning standards. However, some key differences remain, including different assumed time horizons, point-in-time versus through-the-cycle conditions applied for capturing losses and different rates used for discounting cash flows. These differences will require material adjustments to be made to the calibration of IRB models for provisioning purposes.

Under an expected loss approach, changes in expectations of credit losses will have an immediate and direct impact on earnings, potentially resulting in a higher degree of earnings volatility from year to year. The extent of volatility will depend particularly on the time horizon over which estimations are made, economic developments and the effects of changes in portfolio compositions and underwriting practices over time. While longer time horizons will result in more stable parameters, data limitations would be a key constraint. Under these circumstances, it will become more important for banking institutions to integrate the outputs generated from applying an expected loss approach with considerations of business, capital and risk management strategies as well as current measures of performance. This is also important with the more extensive qualitative and quantitative disclosures required under the expected loss approach which will contribute towards greater market discipline as more information is made available about the quality of a banking institution's loan book.

Practical solutions are being pursued at a global level to address these challenges. Specifically, the BCBS has been tasked to develop proposals that would allow banking institutions to draw on their risk management and capital adequacy systems to determine provisions based on expected losses for accounting purposes. Additional proposals are also expected to respond to the interest of ensuring that the provisioning approach is subject to appropriately rigorous and independent internal and external validations.

Additional implementation costs in Malaysia also arise from an earlier announcement made in 2008 by the Malaysian Accounting Standards Board to adopt Financial Reporting Standard (FRS) 139 (Malaysian equivalent of the current IAS 39) for all reporting entities in Malaysia with effect from 1 January 2010 in line with the policy of convergence with international financial reporting standards. The interim implementation of an incurred loss model and subsequent change within a relatively short period to an expected loss model would potentially add further costs to banking operations. Given this and the present fluid nature of international developments that will have important implications on the shape of the expected loss impairment standard, transitional arrangements have been allowed for banking institutions in Malaysia with respect to the implementation of FRS 139. This aims to reduce duplicative system costs and resources associated with implementation of FRS 139, while facilitating the direct migration of systems and processes to support the expected loss approach.

The transitional arrangement, which allows banks to maintain current approaches for establishing general provisions, is accorded to banking institutions for the assessment of collective impairment provisions under FRS 139. Loans that are individually assessed for impairment must comply fully with FRS 139, consistent with the move to incorporate a broader range of credit information, both quantitative and qualitative, in provisioning methodologies for individually significant loans (previously, provisions for such individual loans were established based only on months-in-arrears). Further details on the provisioning standards applicable to banking institutions are discussed in Chapter 3 under 'Financial Reporting Standards'.