EUROPEAN BANKING AUTHORITY

Public hearing
EBA draft guidelines on
Credit institutions' credit risk management practices and accounting for expected credit losses

London, 3 October 2016

Disclaimer

This presentation has been prepared for the purposes of the EBA public hearing on the EBA draft guidelines on Credit institutions' credit risk management practices and accounting for expected credit losses.

The slides may include references to some paragraphs on the EBA draft guidelines. However, constituents should only consider the full text of the EBA draft guidelines which has been published in the EBA website for providing their comments during the consultation period.

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Background

Background: basis for policy making

- **EBA welcomes the new IFRS 9** *Financial Instruments* ('IFRS 9') replacing IAS 39 *Financial Instruments: Recognition and Measurement* ('IAS 39')
  - expected to address some prudential concerns and contribute to financial stability by
    - addressing the issue of 'too little, too late' on the recognition of credit losses
    - incorporating a broader range of credit information
- Measurement of impairment loss allowances to be based on an **expected credit loss ('ECL') accounting model rather than incurred loss accounting model**
- Significant number of credit institutions **apply IFRS in EU**
- **Use of judgement** in the ECL assessment and measurement process need to ensure:
  - consistent application of IFRS 9 across credit institutions
  - comparability of credit institutions' financial statements
- **Basel Committee on Banking Supervision ('BCBS') issued supervisory guidance on credit risk and accounting for expected credit losses** (December 2015)

Background: legal basis

Own initiative guidelines

- Article 16(1) of EBA's Regulation on the basis of CRD IV/ CRR on:

Effective risk management by credit institutions including…

- adequate internal control mechanisms
- integrity of accounting and financial reporting systems
- sound accounting procedures
- compliance with the law and relevant standards …

Competent authorities supervision on the adequacy of…

- internal methodologies for the assessment of credit risk of exposures (individual and portfolio)
- ongoing administration and monitoring of the various risk-bearing portfolios
- effectiveness of systems for making adequate value adjustments and provisions
- minimum powers to require specific provisioning policy or treatment of assets for own funds requirements

Background: objectives

EBA's role on financial stability, safety and soundness of the EU banking sector:

- Ensure common, uniform and consistent application of Union law
- Establish consistent, efficient and effective supervisory practices within the EU System of Financial Supervision (ESFS)

High quality and consistent application of the **accounting standards:**

Basis for the effective and consistent application of **regulatory capital requirements**

Sound credit risk management practices relevant to application of ECL

Alignment with BCBS Guidance: level playing field

Consistent application of expected loss accounting framework for **comparable financial information**

High-quality application of expected loss accounting framework for estimation of **adequate amount of expected credit losses**

Background: scope

- Sound credit risk management practices associated with the **implementation and on-going application of ECL**
- **Evaluation of effectiveness of credit risk management** (practices, policies, processes, procedures) affecting allowance levels

In scope...

- **Lending exposures** (not debt securities)
- Allowances under the **accounting framework** (not regulatory EL)
- **Section 4.3** (Annex) of guidelines applies when credit institutions use IFRS
- Competent authorities may **apply the relevant parts** of the guidelines when **incurred losses models are used**
- **Supporting and specifying the SREP process**

Background: addressees

- **Credit institutions (sections 4.1, 4.2, 4.3 of guidelines)**
    - Articles 4(1)(1) of CRR

- **Competent authorities supervising credit institutions (also section 4.4 of guidelines)**
    - Articles 4(2)(i) of EBA Regulation

- **Competent authorities and credit institutions must make every effort to comply with the guidelines (Article 16(3) of EBA Regulation)**

Background: Comparison with BCBS Guidance

- **Consistency with BCBS Guidance, with changes only when necessary:**
  - EU legal terminology and references to EU legal texts
  - EBA legal drafting criteria for guidelines (use of ‘should’, removed some explanatory text)
  - Inclusion of BCBS Annex in main part of guidelines: some paragraphs have been deleted to avoid repetitions.
  - References to IFRS 9 (instead of text)
  - Changes for consistency across text
  - Explanation on how to apply the EBA guidelines considering the principle of proportionality

EBA draft guidelines

EBA draft guidelines: structure

General considerations (4.1)	Main elements of credit risk management and accounting for ECL (4.2)	Guidelines on specific aspects of IFRS (4.3)	Supervisory evaluation of credit risk management practices, accounting for ECL and the overall capital adequacy (4.4)
Principles of proportionality and materiality, use of reasonable, supportable and forward looking information	8 principles, detailed guidance for the application of each principle	On aspects of IFRS 9 not common to other ECL accounting frameworks	Addressed to competent authorities only

EBA draft guidelines: key main elements (1/2)

Principles 1-8 (section 4.2)	
Principle 1	• Management body and senior management of a credit institution are responsible for ensuring that the credit institution has appropriate credit risk management practices
Principle 2	• Adopt, document and adhere to policies which include sound methodologies, procedures and controls for assessing and measuring credit risk on all lending exposures. • Appropriate and timely recognition of ECL in accordance with the applicable accounting framework
Principle 3	• Credit risk rating process in place to appropriately group lending exposures on the basis of shared credit risk characteristics
Principle 4	• Aggregate amount of allowances, should be adequate and consistent with the objectives of the applicable accounting framework
Principle 5	• Policies and procedures to appropriately validate models used to measure ECL
Principle 6	• Use of experienced credit judgment is essential to the assessment of credit risk and measurement of ECL • Especially reasonable and supportable forward-looking information, including macroeconomic factors
Principle 7	• Sound credit risk assessment and measurement process: common systems, tools and data to assess credit risk and to account for expected credit losses
Principle 8	• Public disclosures should promote transparency and comparability • Timely, relevant and decision-useful information

EBA draft guidelines: key main elements (2/2)

Guidelines specific to ECL impairment requirements under IFRS 9 (section 4.3)	
• Measurement of an 12-month ECL (stage 1 of IFRS 9) • Assessment of significant increases of credit risk to transfer credit exposures from stage 1 to stage 2 or 3 of IFRS 9 • Use of practical expedients: credit institutions - considering their business – ***to make a limited use of the practical expedients of IFRS 9 in accordance with the proportionality principle of the guidelines.*** *Reference to: the information set to be considered; the 'low credit risk' exemption; and the 30 days past due rebuttable presumption.*	
Supervisory evaluation of credit risk management practices, accounting for ECL and the overall capital adequacy (section 4.4)	
Principle 1	• Competent authorities to periodically evaluate the effectiveness of a credit institution's credit risk practices
Principle 2	• Competent authorities satisfied on the methods to determine accounting allowances leading to an appropriate measurement of ECL in accordance with the applicable accounting framework
Principle 3	• Competent authorities to consider appropriateness of the level of allowances within the context of assessing a credit institution's overall capital adequacy (SREP)

EBA draft guidelines: Proportionality

Principle of proportionality

- **All credit institutions applying IFRS 9 to ensure that they meet the objectives of IFRS 9 but**

  …the way of meeting these objectives may differ across credit institutions (different techniques, models…)

- Therefore, **credit institutions should comply** with these guidelines **in a proportionate manner** considering different criteria:

  - size
  - internal organisation
  - nature, scope and complexity of their activities

- **Credit institutions should make limited use of practical expedients covered by the guidelines. However, both smaller and less complex credit institutions may reasonably rely more on the use of practical expedients** . Credit institutions should consider the need to make adjustments to **avoid any bias** as the objective of IFRS 9 is to estimate ECL to reflect an unbiased and probability-weighted amount that is determined by evaluating a range of possible outcomes (IFRS 9, paragraph 5.5.17)

Next steps

Next steps: Timeline

Public Consultation:

3 months - ends

26 October 2016

→

Analysis of feedback and finalisation of guidelines

Q4 2016 – Q1 2017

→

Publication of final guidelines

1H 2017

→

Implementation of guidelines

1 January 2018

Next steps: Key Questions

Input on appropriateness and clarity of provisions	**Scope of application**	**Is it appropriate and sufficiently clear?**
	Date of application	**1 January 2018?**
	Proportionality approach	**Is it appropriate and sufficiently clear (criteria)?**
	Main elements of guidelines	**Besides BCBS elements, are there additional issues for EBA guidelines to be amended?**
	Impact assessment	**Additional information on costs and benefits?**

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