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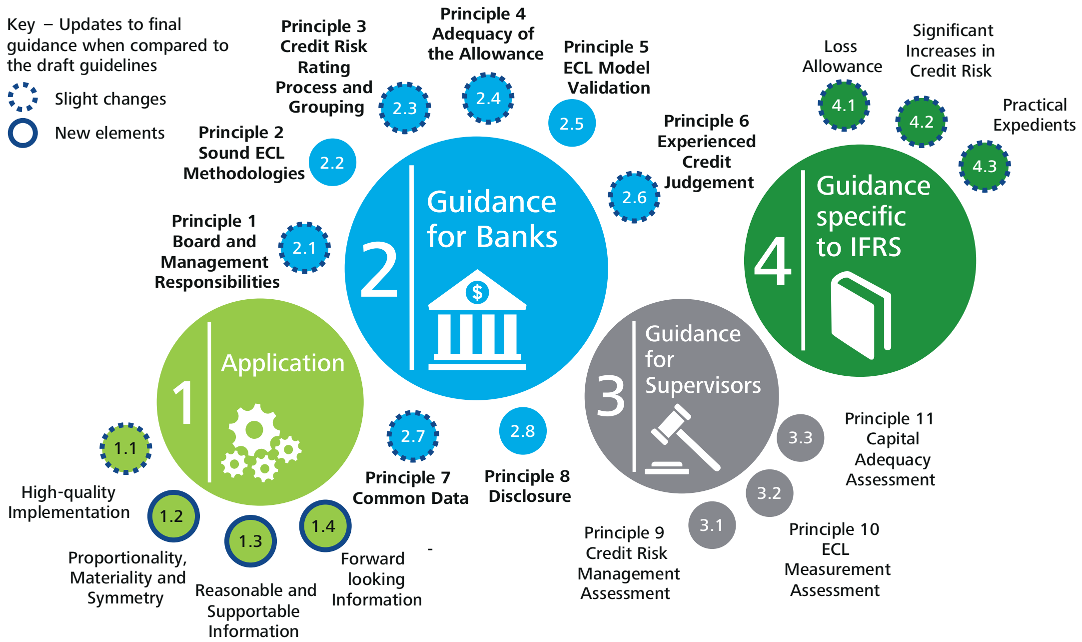
Addressing the Basel Committee's Guidance on Expected Credit Losses

Much awaited by the industry, the Basel Committee issued its final Guidance on Credit Risk and Accounting for Expected Credit Losses in December 2015. What is clear is that the Committee's expectations are high, but there is still a significant degree of interpretation required when it comes to the implementation of the new Expected Credit Loss (ECL) accounting standards issued by the IASB and shortly expected from the FASB. As the implementation deadline approaches there is strong demand for establishing a consensual industry view across banks, regulators, external auditors and other key stakeholders on a number of hot topics, such as proportionality, materiality, symmetry, incorporation of forward looking information, significant increases in credit risk and practical expedients.

Background

On 18 December 2015, the Basel Committee published its final Guidance on Credit Risk and Accounting for Expected Credit Losses, which is intended to be viewed as complementary to the IASB's and FASB's accounting standards. Following a prolonged consultation period, this final guidance supersedes the consultative document issued by the Committee in February 2015 bringing clarification, but no major change, to the 11 fundamental principles applicable to Banks (eight) and Supervisors (three) and the three IFRS 9-specific requirements outlined earlier in 2015.



What are your focus areas?

Embedding these principles will result in substantial changes to existing practices, policies, data, systems and governance.

For many years, we have been working together with standard setters, prudential regulators and banks on shaping views and preparing the industry for IFRS 9 compliance. In this document we provide a snapshot of what we think are the most challenging elements for banks and those charged with governance, either because they are interesting and new, or because the emphasis on some of the existing regulatory requirements will be far greater than before.

1 Application	**There is still a significant degree of interpretation left open on topics such as high quality implementation, proportionality, materiality and symmetry but the banking industry is under increasing pressure to move now. There is a heightened supervisory expectation regarding timely and quality implementation of the Guidance for internationally active banks.**
2 Guidance for Banks	**Boards, and those charged with governance, will be expected to embed eight principles when implementing their ECL solution. This solution should be consistently applied across the bank's accounting and capital management frameworks. Embedding these principles will result in substantial changes to existing practices, policies, data, systems and governance.**
Principle 1 Board and Management Responsibilities	The Committee places the Board as ultimately responsible for implementing a high quality and compliant ECL framework. Roles and responsibilities of the Board (those charged with governance) and senior management must be clearly defined and documented as part of the ECL framework.
Principle 2 Sound ECL Methodologies	ECL methodology should be in line with the bank's accounting and capital management frameworks and be applied consistently. Management will now also have to consider and explain *multiple* forward looking and economic scenarios as part of their chosen ECL framework.
Principle 3 Credit Risk Rating Process and Grouping	There will be a greater focus on management demonstrating the ongoing appropriateness of credit risk rating processes including how businesses group assets based on shared risk characteristics to identify significant changes in credit risk.
Principle 4 Adequacy of the Allowance	Individual and collective estimation techniques will need to be appropriately governed to demonstrate that adequate allowances are provided and that all reasonable and supportable information has been incorporated. Boards should apply temporary adjustments where ECL methodology does not fully consider all relevant credit risk drivers.
Principle 5 ECL Model Validation	All elements of the ECL framework must be subject to independent review including models, application of experienced credit judgement (ECJ), temporary adjustments and triggers for credit deterioration.
Principle 6 Experienced Credit Judgement (ECJ)	The Committee recognises that judgement must play an essential role in a bank's ECL framework due to the complexity of the new ECL requirements. Boards will need to embed a robust ECJ framework and ensure ECJ is appropriately governed on a continuous basis.
Principle 7 Common Data	Embedding common credit risk processes, systems, tools and data across the bank's ECL methodology, its credit management framework, and its capital adequacy framework will be required.
Principle 8 Disclosure	Disclosure requirements are detailed, extensive and involve judgement. Those charged with governance must decide how to deliver appropriate and transparent public disclosures.
3 Guidance for Supervisors	**The final three principles relate to the expected assessments that regulatory supervisors will perform. Banks should understand these assessments to ensure they are appropriately prepared. The credit risk management, ECL measurement and capital adequacy of the bank will be subject to supervisory assessment.**
4 Guidance specific to IFRS	**The Committee also provides specific guidance on particular areas of the ECL requirements in the impairment section of IFRS 9 to help banks implement a high quality IFRS 9 programme.**
Loss Allowance	Final guidance brings clarification on linkages with Basel default definition.
Significant Increases in Credit Risk	There is additional guidance but the onus is on banks to define their own framework for significant increases in credit risk.
Practical Expedients	Not expected to be adopted by internationally active banks.

How are you addressing this challenge?

The implementation date is approaching fast, and whilst the industry discussions continue, it is clear that neither the IASB, nor the Basel Committee, is looking to publish further substantial interpretative guidance on IFRS 9. This may have come as a disappointment for many, but it also highlights that the most important question to ask right now – whether a Board member in a bank, a prudential supervisor, an external auditor or an investment analyst – is how are you going to address this challenge? As external auditors and advisors, we have been working with many banks on articulating this response and in this document we share our view on some of the most important milestones leading up to 2018.

It is clear that neither the IASB nor the Basel Committee is looking to publish further substantial interpretative guidance on IFRS 9.

Where banks should be...	Now	By the end of 2016	Before go-live in 2018
1 Application	**Defining what 'high quality implementation' looks like and defining what proportionality, materiality, symmetry and undue cost and effort mean for your organisation.**	**Interpretation of these terms discussed and agreed by the bank, and outside with regulators, auditors, and as appropriate communicated through public disclosures.**	**Bank's approach has been benchmarked to peers, interpretation reviewed and implementation approach refined where necessary.**
2 Guidance for Banks	**Gaps in existing credit risk management, accounting and capital management frameworks identified and remediation plans defined.**	**Data, practices and systems enhanced. Remediation plans substantially delivered and auditors engaged.**	**Board has approved credit risk management framework and management is embedding and refining framework.**
Principle 1 Board and Management Responsibilities	Gaps in responsibilities, credit risk strategy, credit risk policies identified. Remediation plan established.	ECL framework and internal control system drafted and discussed with auditor. Management delivering remediation plan.	ECL framework approved by Board. Management is embedding sound underwriting and credit risk practices and related internal control processes.
Principle 2 Sound ECL Methodologies	Gaps in responsibilities and existing ECL methodology (and data) identified. Remediation plan established.	ECL methodology drafted. Approach to multiple scenarios and applying ECJs in ECL methodology agreed.	Common credit risk assessment and ECL methodology embedding across accounting and capital frameworks.
Principle 3 Credit Risk Rating Process and Grouping	Credit risk rating system weaknesses and data gaps identified. Remediation plan established.	Rating system enhanced and data gaps filled; external system vendor selection agreed. Asset grouping framework drafted and discussed with auditor.	Rating system used, and asset grouping framework refined and approved by Board.
Principle 4 Adequacy of the Allowance	Missing historical, current and forward looking information identified across individual and collective estimation techniques. Remediation plan defined.	Consistent estimation technique documented. Temporary adjustment framework drafted and discussed with auditor.	Estimation documentation approved by Board. Temporary adjustment framework embedded.
Principle 5 ECL Model Validation	Gaps in existing model validation approach and documentation identified. Remediation plan established.	Model validation framework drafted and discussed with auditor. Independent credit validation (ICV) defined, resourced and upskilled.	Model validation framework approved by Board. ICV embedded and material findings escalated to Board.
Principle 6 Experienced Credit Judgement (ECJ)	Reasonable and supportable information defined (including forward looking information and economic drivers) and gaps in existing ECJ approach identified.	ECJ framework enhanced and discussed with auditor. Economic forecast approach agreed including approach to selecting and executing multiple scenarios.	ECJ framework refined and Board approved; roles and responsibilities within ECJ defined. Economic forecast approach embedded and material findings escalated to Board.
Principle 7 Common Data	ECL data, system and policy requirements defined. Inconsistencies and gaps between accounting and capital frameworks identified.	New data requirements identified and sourced; external data vendor selection agreed where necessary.	Common credit risk data and processes rolled out across accounting and capital frameworks and refined throughout parallel run.
Principle 8 Disclosure	Disclosure delivery plan defined with consideration to EDTF recommendations.[1] Basic qualitative disclosures presented. Gaps identified and remediation plan defined.	Level of data aggregation agreed and quantitative/qualitative disclosures rolled-out throughout 2016.	Disclosures refined during parallel run and following peer benchmarking and wider stakeholder feedback.

Where banks should be...	Now	By the end of 2016	Before go-live in 2018
3 Guidance for Supervisors	**Boards should engage with auditors and regulators throughout to manage assessment expectations. Boards should consider communicating credit risk management, ECL and capital adequacy frameworks to auditor and regulator to facilitate assessment.**		
4 Guidance specific to IFRS	**Impact assessment of significant increases in credit risk and practical expedients performed and default definition reviewed.**	**Accounting and ECL frameworks enhanced and approved by Board. Auditor and regulator engaged.**	**Frameworks and supporting policies embedded and monitored by management.**
Loss Allowance	Default definition benchmarked against regulatory definition. Areas of change identified (models and reporting) and remediation plans defined.	Application of 12 month and lifetime ECL defined in accounting and ECL frameworks and approved by Board. Auditor and regulator engaged throughout.	Approach to 12 month and lifetime ECL recognition embedded and monitored by management; reported to Board.
Significant Increases in Credit Risk	Impact of credit risk drivers performed and impact on data, analysis and use of ECJ assessed.	Framework (and policies) for significant increases in credit risk approved by Board.	Framework (and policies) for significant increases in credit risk embedded and agreed by auditor and regulator.
Practical Expedients	Impact of practical expedients established and selection of practical expedients defined.	Auditor and regulator engaged and qualitative and quantitative justifications defined and monitored.	Practical expedients embedded and discussed with and agreed by auditor and regulator.

Our recommendation in light of the Committee's guidance

Review existing credit risk management practices and impairment and capital frameworks as a priority to identify key data, process, policy, system and governance gaps. Remediation plans should be established and approved by those charged with governance in 2016. Engagement with internal audit, external auditors and regulators will be critical throughout to demonstrate progress in implementing a high quality IFRS 9 solution.

By the end of 2016, credit risk management, accounting and capital adequacy frameworks should be enhanced and supported by developments in data capture, modelling, system capability and reporting. 2017 should see the embedding of Board approved accounting and capital frameworks, credit risk management enhancements, and external disclosures. Boards should focus on benchmarking and refining practices against peers throughout 2017 together with effective communication with external auditor and regulator to manage assessment expectations.

To close, there are two key questions that Boards will need to answer:

1. Do we understand our credit risk processes and outcome better?

2. Are we now communicating our expectations of likely credit losses more clearly to our stakeholders (investors, regulators, counterparties)?

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1 Deloitte publication, December 2015: "Enhanced Disclosure Task Force (EDTF) – What does this report mean for banks?"

Please download the full report and related topics from our **IAS Plus website**.