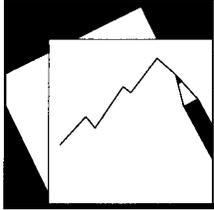


Supervisory Roles in Loan Loss Provisioning in Countries Implementing IFRS



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Monetary and Capital Markets Department

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Abstract

Countries implementing International Financial Reporting Standards (IFRS) for loan loss provisioning by banks have been guided by two different approaches: International Accounting Standards (IAS) 39 and Basel standards. This paper discusses the different accounting and regulatory approaches in loan loss provisioning, and the challenges supervisors face when there are different perspectives and lack of guidance from IFRS. It suggests actions that supervisors can take to help banks meet regulatory and capital requirements and, at the same time, comply with accounting principles.

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I. INTRODUCTION

For countries implementing International Financial Reporting Standards (IFRS), current loan loss provisioning by banks has been influenced by two sets of approaches: International Accounting Standards (IAS) 39² and the Basel Regime.^{3,4} Since the first Basel Capital Accord in 1988, the two regimes have remained different and continue to exert almost equal weights in shaping banks' loan loss provisioning practices. IAS 39 recognizes impairment losses based on an incurred loss based model, which only permits recognition of credit losses supported by "objective evidence." This approach has been viewed as recognizing impairment losses "too little and too late." As a result, provisioning under IAS 39, as practiced,⁵ often does not meet supervisory requirements from the perspective of credit risk review and capital adequacy assessment.⁶

Inherent in the "dual-approach" system are diverging perspectives between accountants and supervisors. The accounting and auditing professionals are charged with ensuring that impairment loss recognition and financial statement preparation are in accordance with IFRS. Bank supervisors, however, who are responsible for assessing credit risk and enforcing capital adequacy, not only make decisions on whether banks' overall provisions are sufficient and timely, but may also have to bridge any gaps between accounting and supervisory requirements where necessary.

While IAS 39 is important in terms of credit loss recognition in countries implementing IFRS, supervisors fulfill their roles of assessing credit risk and enforcing capital adequacy of banks, in part, by ensuring sufficient and timely loan loss provisioning.⁷

² IAS 39 is the current guiding accounting standard on impairment loss recognition. It will be replaced by IFRS 9, which was published by the IASB on July 24, 2014. Following the reorganization of International Accounting Standards Committee (IASC) into the International Accounting Standards Board (IASB) in 2001, new accounting standards issued by the IASB have been designated IFRS. At the same time, the IASB adopted all the existing IAS issued by the IASC.

³ Over 100 countries and jurisdictions worldwide have adopted IFRS. The levels of adoption vary, with the optimal form being the IFRS as issued by the IASB with no modifications. The IASB has a web site (Jurisdiction Profiles: <http://www.ifrs.org/use-around-the-world/Pages/Jurisdiction-profiles.aspx>), which provides detailed information on IFRS adoptions for 130 jurisdictions.

⁴ The Basel Regime in this paper refers to Basel Capital Accord I, II, III, and various guidelines issued by the Basel Committee on Banking Supervision (BCBS). Although Basel Capital Accord I, II and II are not provisioning standards, they include many important elements of loan loss provisioning. Basel III is largely similar to Basel II in terms of provisioning.

⁵ As IFRS is principle-based, banks use judgment in the application of IAS 39. There are various practices in identifying the existence of objective evidence, which may lead some to rely more on lagging indicators, such as past due status or default.

⁶ With the hindsight of the recent global financial crisis, some argue that both IFRS and the Basel Regime proved incapable of ensuring that banks were maintaining sufficient provisioning buffers.

⁷ Creating loan loss provisions reduces the net income of banks and thereby affects their capital positions.

Accounting is not the only element in the universe of loan loss provisioning and credit risk management. In addition to banks, accounting professionals, and external auditors, bank supervisors also have authority over the identification of impaired assets and measurement of provisioning levels. They exercise their judgment on the sufficiency of provisioning based on their overall assessment of banks' credit risk management processes and methodologies. Ultimately and crucially, through ensuring sufficient and timely loan loss provisioning, supervisors fulfill their roles of assessing banks' credit risk and enforcing their capital adequacy.

Even though IFRS 9 has been published, IAS 39 will continue to be the guiding principle until IFRS 9 becomes effective in 2018, and some of the provisioning issues encountered by supervisors under IAS 39 may continue to be relevant under IFRS 9. At the request of the Financial Stability Board (FSB), G-20, and the BCBS, the IASB undertook a very high profile project to replace the incurred loss based accounting model with an expected loss based model for credit loss recognition.⁸ Since IAS 39 was criticized for allowing recognition of impairment losses “too little and too late,” the new model, IFRS 9, is expected to better align supervisory and accounting requirements by recognizing credit losses in a more timely manner and at an accelerated pace. However, whether the new model will be able to meet expectations is yet to be seen. With the slow progress of the development of the new model, IAS 39 has been “alive” for longer than expected, and will continue to be “alive” for the next few years until IFRS 9 becomes effective and replaces IAS 39 in 2018. This signifies the continued importance of bank supervisors' roles in loan loss provisioning under IAS 39, as discussed in this paper. In addition, some of the provisioning issues and challenges experienced currently will likely remain under IFRS 9, as also explored by the paper.

It is critical that bank supervisors possess the powers, willingness, and ability to act, as well as the technical expertise in both prudential supervision and accounting rules. Bank supervisors should play an active role in helping banks to navigate the conceptual and practical differences between the two approaches and resolve specific issues in various situations.^{9,10} Sound and astute supervisory judgments are particularly needed given the

⁸ This IAS 39 replacement project was also supposed to be a convergence project between IFRS and the U.S. Generally Accepted Accounting Principles (GAAP). Unfortunately, however, accounting convergence, at least on credit loss recognition, is unlikely to happen soon. Although the IMF supports a single set of high quality, principle based international financial reporting standards, it is beyond the scope of this paper to discuss issues related to accounting convergence between IFRS and U.S. GAAP.

⁹ The “Sound Credit Risk Assessment and Valuation for Loans,” issued by the BCBS in 2006, provides high level principles guiding banks and supervisors in credit risk assessment and valuation practices. While the guiding principles are consistent with IFRS, the paper explicitly recognizes that it is not intended to bridge provisioning for credit risk assessment for accounting purposes to capital adequacy measures.

¹⁰ In addition, the revised Basel Core Principles for Effective Banking Supervision (BCP) (2012) reinforced essential criteria to establish what is expected of supervisors regarding provisions (for example, CP 18, ECs 4, 10, 11, and 12).

imprecise nature of loan loss provisions assessment. A review of evidence from recent IMF Financial Sector Assessment Programs (FSAPs) shows that bank supervisors have adopted a variety of supervisory approaches to ensure the adequacy of provisions within their jurisdictions (See Annex 1).

Recent developments in banking systems around the world illustrate the continued importance of proper provisioning. Two such examples are the Asset Quality Review (AQR) exercise in the EU and the European Banking Authority (EBA)'s initiative of unifying the definitions of non-performing loan and loans subject to forbearance measures.¹¹ Credit quality inadequacies and their resulting losses have always been one of the primary causes of bank failures. Six years after the global financial crisis, despite ongoing regulatory reforms and rounds of organized stress testing, deleveraging, and balance sheet repair exercises, loan loss provisioning and asset quality remain key issues for banks. Provisioning merits particular attention given its vital role in ensuring the safety and soundness of the banking system. Another important event is that the BCBS has started working on issuing new supervisory guidance on provisioning for banks with an international footprint.¹²

This paper discusses the different accounting and regulatory approaches in loan loss provisioning, and the challenges supervisors face given the diverging perspectives or lack of guidance from IFRS. This ultimately translates into what supervisors should do to help banks meet regulatory and capital requirements and at the same time comply with the accounting principles. The paper aims to serve as a useful reference not only for countries facing these issues, but also for IMF mission work, i.e., FSAPs, TAs (Technical Assistance), and country surveillance.

The paper has five sections. Section II describes and compares the two current different approaches to loan loss provisioning. Section III discusses provisioning rules under the new accounting framework on credit loss recognition. Section IV examines the implications for supervisors: (i) in balancing accounting and regulatory approaches; (ii) in balancing provisioning and capital requirements; and (iii) in dealing with common provisioning issues in countries implementing IFRS. Section V concludes.

¹¹ See EBA's Final Draft Implementing Technical Standards (EBA/ITS/2013/03, February 20, 2014).

¹² This was decided in anticipation of the new IFRS framework on credit loss recognition, as well as a probable lack of convergence between the IFRS and U.S. GAAP on this issue.

II. A WORLD OF DUAL PROVISIONING APPROACHES: IFRS AND THE BASEL REGIME

A. IFRS – IAS 39¹³

IAS 39 prescribes an “incurred loss” approach. This approach was designed to limit management’s ability to create hidden reserves that could lead to earnings management. Before adopting IFRS, some European countries’ accounting regimes allowed entities to accumulate reserves, which served as a buffer against losses in weakening credit conditions and thus minimized earnings volatility. While this incurred loss approach, combined with a restriction on creating reserve buffers, has served to reduce the scope for earnings manipulation, IAS 39, as implemented,¹⁴ has been criticized for recognizing impairment losses “too little and too late.”

As a principle-based standard, IAS 39 leaves substantial room for judgment, which may result in insufficient provisions, especially if misapplied. Though IAS 39 specifies a series of observable data that can serve to support the objective evidence, it leaves room for judgment on a number of critical elements such as what constitutes objective evidence and how best to estimate future cash flows, especially when there is limited data. Banks have wide latitude in selecting relevant objective evidence.¹⁵ IAS 39 recognizes that loss estimates may lie within a range of possible losses and directs entities to select the best estimate within a range of possible losses. While the use of experienced judgment in part reflects the nature of financial reporting,¹⁶ further elaborations and examples from the IASB to clarify the meaning of ‘objective evidence’ would have assisted banks in implementing IAS 39 and may have improved the quantity and timeliness of provisions.

IAS 39 requires the occurrence of a loss event or events (trigger events or objective evidence), with impairment losses being assessed and measured both on an individual and group basis. If no impairment loss is identified on an asset assessed on an individual

¹³ IAS 39, which became effective on January 1, 2001, has four main components: Recognition and Measurement, Impairment, Hedge Accounting, and Derecognition. The discussion of impairment loss recognition measurement in this paper will focus on those financial assets classified by IAS 39 as “Held To Maturity” and “Loans and Receivables,” which are measured at amortized cost.

¹⁴ In some instances, the actual implementation of the IAS 39 approach has not been sufficiently robust or responsive to changing credit quality conditions. This can broadly be attributed to two reasons: (i) the approach does not allow taking into account projections of future credit loss events, and (ii) the discretion afforded to banks in the implementation of the standard has led some banks to focus more on lagging indicators of objective evidence of impairment.

¹⁵ IAS 39 allows management to rely on “experienced judgment” to adjust observable data (IAS 39 paragraph 62) when determining impairment losses. In privately owned banks, management is likely to be driven by the objective to maximize share price and this could often lead to optimistic interpretation of the accounting standards.

¹⁶ The standard explicitly supports the use of experienced judgment to estimate the amount of impairment losses. According to IAS 39, Paragraph 62, the use of estimates is an essential part of the preparation of financial statements and does not undermine their reliability.

basis, the asset is grouped with those that have similar credit characteristics, and impairment loss is estimated collectively for the group. Group assessment is considered an interim step, and once losses can be associated with an individual loan, the loan is removed from the portfolio. Even though formula-based approaches or statistical methods are allowed for group assessment, impairment losses assessed on a collective basis are not supposed to deviate from the incurred loss principle. IAS 39 considers these losses “incurred but not reported,” which should be differentiated from credit losses that are expected to occur in the future under the prudential framework.

The measurement of impairment losses uses the discounted cash flow method. For individual assets, the amount of impairment losses is measured as the difference between the asset's carrying amount and the present value of estimated cash flows discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition). In practice, the measurement of impairment losses on a group basis can use historical loss experience adjusted with current observable data to arrive at present values of future cash flows.

The calculated impairment losses are recognized in the Income Statement. In contrast, credit losses expected as a result of future events, no matter how likely, are not reported in the Income Statement.¹⁷ The carrying amount of the loan on the Balance Sheet is reduced either directly or through the use of an “allowance account.”

B. The Basel Regime

Bank supervisors and regulators favor an “expected loss” approach in provisioning for credit losses.¹⁸ Under the Basel Capital Accord I (Basel I), banks’ provisions include identified losses (specific provisions) and unidentified losses that are expected to occur (general provisions). Specific provisions are those associated with identified loan losses or deterioration, while general provisions pertain to losses that have not arisen yet but expected to emerge based on an evaluation of economic and financial factors and the borrower’s ability to pay. The BCBS (2006) recommends that valuation of loan impairment not be based solely on prescriptive rules or formulae but also be enhanced by judgment from bank management. Under Basel II, loan loss provisioning requirements incorporate the notion of default, past due and other indicative elements.¹⁹ Even though Basel II provides no specific definition of non-performing loan (NPL), the judgment of which is at the discretion of each jurisdiction, the threshold of 90 days overdue is implied. According to Basel II, a default is

¹⁷ The additional amounts set aside by an entity for foreseeable credit losses that cannot be supported by objective evidence are not reported as impairment losses in the Income Statement. See Annex 2.2 for financial reporting treatment of these amounts.

¹⁸ Like IFRS, this framework also permits use of professional judgment.

¹⁹ Some of these elements, e.g., default, can be objective evidence under IFRS, though Basel rules do not emphasize objective evidence, which is used as the only basis for impairment loss recognition under IFRS.

considered to have occurred if the borrower is unlikely to pay its credit obligations to its bank or if a payment is past due more than 90 days.²⁰

General provisions, as defined by Basel II, are for possible or latent losses that are not yet identified. Such provisions are sometimes calculated as a percentage of total loans. Alternatively, they can be calculated by applying progressively higher percentages for lower quality assets, reflecting the increasing probability of losses. Under the Basel II Internal Ratings Based (IRB) approach, the calculation of expected losses relies on the formulation and estimate of Probability of Default (PD) and Loss Given Default (LGD) for credit exposures *not in default*. For credit exposures that *are in default*, banks must use their best estimate of expected losses based on the principle that banks would have to recognize additional unexpected losses during the recovery period.

The measurement of provisions is directly linked to the capital ratio calculation. Under Basel I, general provisions can be included in Tier II capital subject to the limit of 1.25 percent of risk-weighted assets; general provisions are intended to cover possible or latent losses that have not yet been identified. Under Basel II, in the case of the standardized approach to credit risk, general provisions can still be included in Tier II capital subject to the limit of 1.25 percent of risk-weighted assets. In the IRB approach, the option to explicitly include general provisions in Tier II capital does not exist; instead, the excess of eligible provisions (which includes specific and general provisions)²¹ over expected losses can be carried over to Tier II capital subject to a maximum of 0.6 percent of risk-weighted assets. Creating specific provisions reduces income and thus has an adverse impact on capital. Specific provisions are not included in capital because they are established for expected losses that are explicitly tied to the exposures they cover, and banks' capital adequacy ratio should be the mirror of banks' ability to absorb unexpected losses. Under-provisioning is generally the single greatest distortion in the calculation of capital and capital adequacy. Particularly when under stress, banks are likely to have an incentive to underestimate credit risk, misclassify impaired assets, and postpone recognition of losses so as to avoid large provisions which would depress stated performance and limit refinancing opportunities at a critical time.²²

C. Where Do They Meet and Clash?

It is important that supervisors have a clear understanding of the similarities and differences between these two approaches. Given the co-existence of two sets of loan loss provisioning approaches, supervisors should understand where they coincide and how they

²⁰ Refer to Basel II paragraphs 452 and 453.

²¹ Eligible provisions are defined as the sum of all provisions (e.g., specific provisions, partial write-offs, country risk provisions and general provisions).

²² See IMF (2001).

differ, and have the technical expertise, so that they can make correct decisions in performing their functions and help banks to bridge any gaps during the course of implementing the two approaches.²³

There are few similarities between the two approaches,²⁴ though common data may be shared. At a general level, both approaches recognize the existence of credit risk and strive to measure how much resources should be set aside to mitigate and absorb losses stemming from that risk. In addition, experienced and professional judgments are permitted and even relied upon on various occasions under both approaches. The BCBS (2006) and the IASB (2009) expect common data to be shared between the two sides. This data includes common credit risk grades, historical loss rates, characteristics used to group loans for collective assessment, and observable data used to estimate credit losses or to adjust historical loss rates.

The main difference between the two approaches—incurred loss based under IAS 39 and expected loss based under Basel II—arises at both the conceptual and operational levels. Under the IFRS framework, a bank is expected to measure impairment losses based on an assessment of the occurrence of loss events or objective evidence as defined by IAS 39.²⁵ In contrast, under Basel II, in addition to specific provisions, recognition of credit losses is based on a notion of expected loss and requires assessing economic and financial conditions as well as the borrower’s ability to pay.²⁶ The different terminologies used by the two professions, namely “impairment loss” recognition (accounting term) and “credit loss provisioning” (prudential term), are broadly indicative of the underlying differences.

The focus of impairment loss recognition for financial reporting purposes is to ensure that Balance Sheets and Income Statements are fairly stated for the measurement period. To the extent that accounting is largely about reporting the past (updated for current conditions),²⁷ IAS 39 may have fulfilled its financial reporting role,²⁸ and even helped to

²³ Within supervisory teams, a high degree of cooperation between accounting and credit risk/capital experts is needed.

²⁴ In fact, for some of the common factors, there are often different underlying interpretations and treatments due to the different perspectives of the two approaches. For example, both methods consider collateral or credit risk mitigants in determining loan loss provisions. However, how collateral is factored in and treated under the two standards varies significantly. IAS 39 considers collateral in the context of estimating the present value of future cash flows assuming a foreclosure of the collateral. Under the advanced approach of Basel II, discounted cash flows will also be the way collateral is valued, although the discount rate may differ. Under the standardized and IRB foundation approaches, collateral value is determined by pre-set Basel II formulae independent of any discount rate (See Fitch Ratings, 2005, P. 11).

²⁵ See IAS 39, Paragraph 59.

²⁶ Ibid. IAS 39 also considers “significant financial difficulty of the issuer” as observable data in determining objective evidence.

²⁷ Hoogervorst (2012).

reduce earnings management.²⁹ Nonetheless, the accounting philosophy of only recording impairment losses arising from past events and current conditions has been challenged by the supervisory community.³⁰ Partly in response to that, IFRS 9 stipulates that expected credit losses be recognized in Income Statements under IFRS 9.

In contrast, the focus of prudential provisioning requirements under the Basel Regime is to align banks' risk taking with adequate capitalization and thereby ensure their safety and soundness. According to these approaches, banking supervisors should evaluate the effectiveness of a bank's policies and practices for assessing credit risk and be satisfied with the bank's loan loss provisions that need to be produced in an adequate and timely manner. Since risk consideration is at the center of the capital framework, which focuses on banks' going concern and solvency issues, it seems logical for the Basel Regime to advocate a forward-looking approach that hinges on anticipating and estimating risks and losses that have not yet happened but have a high degree of probability to occur. In this vein, Basel II's IRB approach explicitly encompasses the concept of expected losses together with computing methodologies.³¹

The most important consequence of the different approaches, underpinned by different perspectives, is that the prudential loan loss provisioning approach tends to generate provisions that are higher than those allowed under IAS 39. This can be explained by several factors including (i) the different ranges of information allowed under the two approaches, (ii) different judgments used by banks in applying IAS 39, and (iii) lack of due scrutiny by auditors at times. Nonetheless, dealing with two different levels of provisions is one of the most common and important issues faced by countries implementing IFRS (see Section IV.A).

III. THE NEW ACCOUNTING CREDIT LOSS RECOGNITION FRAMEWORK—IFRS 9

The incurred loss-based accounting approach has not been popular with the supervisory community. As noted, the incurred loss model, as implemented under IAS 39, has been viewed as recognizing impairment losses “too little and too late” and promoting

²⁸ While IAS 39's impairment loss model may have come short in satisfying bank supervisors, it is worth noting that financial reporting is designed to serve general investors and creditors rather than special groups such as regulators.

²⁹ Levenitis and Dimitropoulos (2010) used a sample of 91 EU listed commercial banks to examine implementation of IAS 39. They found that implementation of IAS 39 appears to have improved earnings quality by mitigating the tendency of bank managers of listed commercial banks to engage in earnings management using loan loss provisions and reserves.

³⁰ Packer and Zhu (2012) argue that one of the reasons why Asian banks withstood the global financial crisis relatively well is because supervisors required banks to have additional regulatory reserves, and in some cases, on top of IAS 39 provisions.

³¹ Expected losses will be discussed further in Section IV. B.

cyclicality. As a result, after the global financial crisis, and at the urging of the FSB, G-20, and the BCBS, a project was undertaken to replace the incurred loss based model with an expected loss based model.

In 2009, the BCBS affirmed the supervisory expectations of the new credit loss recognition model. The BCBS issued “Guiding Principles for the Replacement of IAS 39” (see Box 1), affirming the supervisory expectations of the new credit loss recognition model, which should “reflect expected losses over the life of the portfolio considering the loss experience over the complete economic cycle, allow early identification and recognition of losses, and incorporate a broader range of available credit information.” The BCBS reiterated this stance in its 2012 letter to the IASB.

Box 1. Guiding Principles for the Replacement of IAS 39

On provisioning and impairment: The new provisioning standard should:

- reflect expected losses over the life of the portfolio, considering the loss experience over the complete economic cycle;
- allow early identification and recognition of losses;
- incorporate a broader range of available credit information;
- allow for the use of professional judgment while using leading economic indicators, changes in underwriting standards and collection practices, and other relevant information; and
- allow for provisions for groups of loans with similar risk characteristics.

Source: Basel Committee on Banking Supervision, August 2009.

According to the IASB’s newly issued IFRS 9 (published in July 2014), credit loss recognition will be forward looking rather than dependent upon the occurrence of objective evidence. The expected loss model will provide users of financial statements with information about expected credit losses and changes in expectations about credit losses. Importantly, in contrast with IAS 39, which only allows information from the past and present to influence banks’ estimate of future cash flows, IFRS 9 will permit a wider range of information, including on expectations of future credit losses.

Under IFRS 9, credit losses are measured at different stages, marked by 12-month and life-time expected credit loss recognitions. In the so called first stage, 12-months’ expected credit losses are recognized. When assets experience “significant increase of credit risk,” they enter the second stage and life-time expected losses are to be assessed and measured.³²

³² The third stage of the approach also calls for recognizing life-time expected credit losses. However, at that stage, assets have deteriorated to the point where credit losses can be identified with specific assets. Interest income accrual at this stage is on the net of the carrying amount and credit allowance, versus on the gross

(continued...)

IFRS 9 does not mandate or recommend a particular measurement methodology. It just stipulates that the measurement of 12-month and life-time expected credit losses should reflect: (i) an unbiased and probability-weighted amount determined by evaluating a range of possible outcomes; (ii) time value of money, and (iii) reasonable and supportable information available without undue cost or effort.³³ Therefore, to the extent that the new approach allows banks to use historical loss rates (adjusted with current and reasonable and supportable forecasts) and probability of default estimates, banks can leverage their existing credit risk management systems and some of the matrices used in calculating prudential provisions.

The new approach also requires significant judgment. In particular, judgment will have to be applied to determining what constitutes “significant increase of credit risk” and when to transfer assets from the first to the second stage. Nonetheless, the IASB has the intention of limiting opportunities for earnings management by requiring disclosures on assumptions used and the source of changes in allowance balances from period to period.³⁴

Although the new approach will be forward looking, it will continue to have drawbacks. For example, the use of a 12-month horizon instead of a longer time span at the first stage may result in insufficient provisioning. Thus, whether or not the approach will bring about the intended increase in provisions remains an open question. Due to the complexity and slow progress of the expected credit loss recognition project, the effective date for IFRS 9 has been postponed from January 1, 2015 to January 1, 2018.³⁵ Until IFRS 9 becomes effective, IAS 39 will continue to be the accounting standard for provisioning. Thus during this period, supervisors will have to continue dealing with the issues posed by the co-existence and differing stances of IAS 39 and the Basel Regime.

IV. IMPLICATIONS FOR SUPERVISORS

A. Balancing Accounting and Regulatory Approaches

Under IAS 39

One of the challenges faced by supervisors owing to the existence of the dual principle system and diverging standpoints is how to make sure that countries implementing IFRS comply with both requirements. Clear supervisory powers, together with the ability and willingness to act, and possible expansion of supervisory roles outside the prudential arena may be necessary to achieve this. Although the responsibility for ensuring that

carrying amount in the first two stages.

³³ IFRS 9, Paragraph 5.5.17.

³⁴ See Hoogervorst (2014).

³⁵ The implementation date had already been postponed from January 1, 2013 to January 1, 2015. The lengthy process can be partly explained by the fact that the project deals with one of the most complex, challenging, and controversial accounting issues.

financial statements comply with IFRS lies with management and external auditors,³⁶ it is in the supervisors' best interest to help enforce consistent implementation of IFRS, because the integrity and transparency of the financial statements directly contribute to the financial stability of the capital market and provide a good starting point for a capital adequacy assessment. At the same time, an important role that supervisors can play in relation to IAS 39 is to ensure that loan loss provisions are adequate in meeting regulatory requirements in the context of sound credit risk review and capital adequacy assessment.

By following IAS 39, banks may not produce sufficient provisions from a supervisor's view point. As noted, banks may be in compliance with IAS 39 without having to ensure that their loan loss provisions are robust and sufficiently sensitive to declining economic conditions.³⁷

For sound credit risk review and capital adequacy assessment purposes, it is advisable that supervisors step in to impose additional provisions when those under IAS 39 are deemed insufficient. Banking supervisors have a natural interest in promoting the use of sound and prudent credit risk assessment based on efficient credit risk models, realistic valuation of collateral, and prudent underwriting policies and practices. While respecting IFRS' jurisdiction, supervisors should have the authority and ability to take steps to strengthen provisioning when impairment loss recognition under IFRS is insufficient for the purpose of prudential regulation; in such cases, additional resources should be set aside for the loan loss reserve (see Annex 2.1 and 2.2). To this end, it would be helpful if the prudential provisioning system can continue to be kept after IFRS has been adopted. At minimum, this system can help to provide a check and reference point for the amount of impairment losses estimated under IFRS.

This active role by supervisors is recommended by the BCBS. The Basel Committee has always been clear and firm in emphasizing the supervisory responsibilities in evaluating banks' processes for credit risk management and asset valuation, as well as in ensuring adequate loan loss provisions, especially in the context of proper assessment of credit risk exposures and capital adequacy. According to Basel Committee's guidelines, which include "Sound Credit Risk Assessment and Valuation for Loans" (2006), "Core Principles for Effective Banking Supervision" (2012), and Basel II Pillar 2 (2006), if supervisors determine

³⁶ Given the critical role played by external auditors, supervisors are encouraged to establish effective working relationships and on-going communications with them. Supervisors should regularly engage with the external auditors and exchange views on cross-cutting risks and the extent to which these are adequately reflected in banks' provisioning practices and credit risk management. The Basel Committee encourages supervisors to have close relationships with internal and external auditors and may make use of their work where appropriate. See BCBS (2006), Paragraph 43, and BCBS (2014), Principle 8.

³⁷ According to Hoogervorst (2014), the incurred loss model could be easily used for a very restrictive attitude towards provisioning. He further pointed out that in many cases during the crisis, the model was applied so that impairment was only recognized just before a loan defaulted.

that provisions are inadequate for prudential purposes, they have the power and responsibility to require banks to re-assess and increase provisioning levels where appropriate.

Loan loss provisioning is another area which proves that rules alone, even complex rules, are not enough, and should be supplemented by good and effective supervision. In fact, as pointed out by Viñals and Fiechter (2010), when rule books become more detailed and complex, the supervisory approaches and skills required to implement the rules become more challenging.

This calls for supervisory powers, as well as the willingness and ability to act against inadequate provisioning. In order for supervision to be effective, and at least in part to compensate for the lack of willingness to act by supervisors, it is important to incorporate supervisory powers regarding provisioning into the national legislation or regulatory reporting rules (if they have enforcement power), so that supervisors can effectively intervene and discipline offending banks when necessary.³⁸

Supervisors should also have operational independence and accountability.³⁹ In addition to being granted the requisite powers, the ability to act can be bolstered by the operational independence of the supervisory authority, adequate resources and proper training, i.e., a good knowledge of IFRS and Basel Regime requirements. These are particularly relevant when loan loss estimates are guided by two different approaches.

Another aspect of the ability to act is supervisory judgment and technical expertise, which are especially important in the ambiguous world of estimating loan loss provisioning. Both accounting and regulatory approaches require use of judgments and assumptions, which are seen as necessary for reliable credit risk and loan loss assessments.⁴⁰ While this partially reflects the nature of loan reviews and loan loss recognition and measurement, supervisors can expect further challenges in forming and implementing consistent loan loss provisioning policies across banks and similar classes of assets, as well as using expert judgments to make case-by-case decisions on various assumptions and estimates.⁴¹

³⁸ After the recent global financial crisis, supervisory intervention on loan loss provisions has become more common, particularly in countries such as Ireland, Portugal and Bulgaria.

³⁹ Although supervisors are formally independent, the government and subsequently the supervisory authority could face strong lobbying forces from the banks.

⁴⁰ This requires adequate allocation of resources in order to bring together experts with accounting knowledge and experts with credit risk/capital knowledge.

⁴¹ Greater involvement of supervisors can also help to ensure a certain level of consistency in terms of classification and provisioning across banks and similar asset classes.

Box 2. Provisioning and Supervisory Practices

It is important that supervisors pay close attention to the adequate level and reasonableness of provisioning. If necessary, supervisors should recommend or require higher levels of provisioning than those required under IFRS so as to withstand expected losses.

This approach is consistent with the BCBS's minimum principles for recognition of credit-risk related impairment (minimum principle),¹ the Basel Core Principles, and Basel III. It is also consistent with sound supervisory practice on the basis that failure to have adequate provisioning leads to a fundamental misstatement of capital adequacy.

According to the BCBS's minimum principle, the provisioning approach should allow for the exercise of professional judgment when estimating provisioning. It should require the consideration of: (i) leading economic and market indicators; (ii) portfolio and borrower-specific characteristics; (iii) lending policies and procedures, including underwriting standards; (iv) the impact of increased risks from loan origination during expansionary economic periods; (v) collection practices; and (vi) all other relevant information.

To the extent that credit risk assessment or provisioning deficiencies are significant and not remedied on a timely basis, the supervisor should act promptly. Supervisors should assess how these deficiencies affect the level of provisions and discuss this with the bank's management. Whenever the deficiencies are affecting provisions, supervisors should recommend and enforce the establishment of higher provisions. In addition, if the deficiencies affecting a bank's capital position and/or are beyond the realm of the provisions, the supervisor should consider whether they should be reflected through higher capital requirements and seek adequate disclosure of the information in the bank's financial reports.

Capital without proper provisioning will be overstated and overstated capital may result in problems down the road. Without proper provisioning, banks' behavioral changes, such as foreclosure of collateral and effective asset workout, would not occur because they do not have any incentive to act. In this context, it is not a trade-off between provisioning and a higher capital ratio. Proper provisioning needs to be a requirement. This view naturally motivates the broader view that accounting standards (and international convergence) should move to an expected loss approach.

Based on IMF FSAP findings, examples of countries among Basel Committee members, where there is evidence that such powers have been put into practice are: Australia, Austria, Canada, France, Italy, South Korea, and Spain, though the level of intrusiveness varies among countries. On the other hand, while Germany, Netherlands and Belgium do not have such powers to demand an increase in the provisioning level, corrections can be required by deducting the deficiency from a bank's own funds (Belgium) or imposing additional capital charges (Germany, Netherlands). (See Annex 1 for details.).

¹ "Minimum Principles for Recognition of Credit Risk Related Impairment," BCBS, December 2012.

² Refer to Section IV B. and Box 3.

Supervisors should be aware of some key issues when trying to reconcile accounting and regulatory provisioning rules. For example, when assets are collectively evaluated for impairment, the criteria used for grouping assets under IAS 39 are similar to those under

Basel II. These include default probabilities or credit grades, type of loan, geographic location, collateral type, maturity, and past due status. In addition, information used for calibration of the historical loss rate for group assessment under IAS 39 can also be used to formulate the LGD rate used under Basel II. These can all potentially create efficiencies and synergies in configuring implementation of the two sets of approaches. As mentioned earlier, supervisors should also be mindful that provisions assessed on a group or portfolio basis under IFRS are still incurred loss based and are different from provisions based on expected losses under Basel II.

When IFRS 9 Replaces IAS 39

IFRS 9 may bring much closer alignment with the prudential standards than IAS 39, and could potentially result in higher and earlier credit loss recognition. The new approach has clear advantages. From the supervisors' perspective, recognizing upfront expected losses will reduce the possibility of distributing overstated profits in the form of dividends and bonuses during the upswing and as a result will facilitate the capital adequacy assessment. From the financial reporting perspective, the new approach, coupled with the enhanced disclosure requirements, will provide investors with more transparent, timely, and relevant information about a bank's expected credit losses. However, IFRS 9 still does not include unexpected credit losses, which will continue to be covered by capital. As noted earlier, in the event that provisions are deemed insufficient as a result of implementing IFRS 9, supervisors will still need to step in and impose additional where necessary.

The adoption of IFRS 9 may also bring about operational efficiencies. Because of the closer alignment of the two models, one of the operational efficiencies that supervisors should take note of is that the infrastructure and data collected for complying with regulatory measures can be used as a basis for expected credit loss calculation as prescribed by the new accounting framework.⁴² In light of the finalization of IFRS 9, in addition to helping banks to properly implement IAS 39, supervisors should take note of these and start looking into preparing banks for transitioning to IFRS 9.

However, IFRS 9 has not been designed to meet the needs of both supervisors and investors. IFRS 9 aims to present neutral information that reflects the economic characteristics of the financial instrument at the reporting date. While the IASB expects provisioning balances to increase under IFRS 9, it defers to the supervisors to decide if the loss allowances are sufficient in the context of capital assessment. This affirms the supervisory roles in provisioning in the new accounting era.

With the onset of the expected loss based accounting framework, the BCBS is working on a new supervisory guidance. Supervisors may need to reassess the interactions between

⁴² Leveraging existing credit risk management systems is also expected by the IASB. See IFRS 9, Paragraph BC 5.251.

accounting rules and regulatory requirements and revise the corresponding regulatory requirements or issue new ones to capture changes on the accounting side.⁴³

B. Balancing Provisioning and Capital Requirements

Under Basel II, stipulations regarding provisioning aim at ensuring a sufficient level of capital to cover banks' credit risk. In this framework, future loan losses are classified into two groups: expected losses and unexpected losses. The general concept is that capital should provide adequate loss-absorption capacity on a going concern basis and a strong enough incentive for its holders to monitor risk taking at banks. Consistent with this concept, unexpected loan losses due to credit risk need to be covered directly by capital. Expected losses (formulated under the product of the probability of defaults times the loss given defaults), are used as a yard stick for banks to measure how the combination of specific provisions and general provisions compares against expected losses.

The measurement of provisions against expected losses is meaningful for capital assessment purposes. According to Basel III, if the combination of specific and general provisions is less than expected losses, additional capital is potentially needed as the difference must be deducted from Tier I capital.⁴⁴ On the other hand, if the combination exceeds expected losses, the treatment is more conservative—only general provisions subject to a certain threshold⁴⁵ can be added to Tier II capital, as this portion is not linked to any identified losses and can be more readily available.

Supervisors have the two main tools when faced with a shortfall of coverage against loan losses: increasing provisions or increasing capital. Which tool should be used? In general, it is preferable that supervisors ask for higher provisioning rather than the higher capital ratios without provisioning, as the latter would tend to overstate capital. (see Box 3). This is the approach recommended in BCBS (2006)⁴⁶ and is also the approach followed by several Asian countries (such as Korea, Philippines, Singapore, Thailand, Hong Kong SAR, and China),⁴⁷ which imposed regulatory provisions often when accounting provisions were

⁴³ The new guidance, will replace the one issued in 2006 by the BCBS, “Sound Credit Risk Assessment and Valuation for Loans.”

⁴⁴ Under Basel II, this difference must be deducted half from Tier I and half from Tier II, while Basel III requires deducting the entire difference from Common Equity Tier I.

⁴⁵ The additions to capital are subject to 1.25 percent of RWAs under the Standardized Approach, and 0.6 percent of RWAs under the IRB approaches.

⁴⁶ “Increased capital should not be viewed as the only option for addressing increased risks confronting the bank. Other means for addressing risk, such as strengthening risk management, applying internal limits, strengthening the level of provisions reserves, and improving internal controls, must also be considered.” Basel II (2006), Paragraph 723, Part 3.

⁴⁷ China does not implement IFRS. However, its national GAAP substantially converges with IFRS.

deemed to be inadequate following IFRS implementation.⁴⁸ It should be noted, however, that the additional provisions required by supervisors should bypass Income Statements and be reported in reserves (see Annex 2.2 for reporting of accounting and regulatory provisions).

Box 3. Capitalization versus Provisioning

Provisioning and supervisory capital requirements are directly linked because they are based on the level of risk in a bank's financial position. Provisions are intended to cover losses that are "expected" to occur and losses above this level are "unexpected" and covered by capital. Capital should provide adequate loss-absorption capacity on a going concern basis and a strong enough incentive for its holders to monitor risk taking at banks.

Some countries have the practice of using capital to mitigate rising impairment losses, instead of putting in place sufficient provisioning—the so called "capitalization approach." There are pros and cons following this approach.

Because the economic values of loans are not readily observable, estimated provisioning would not reflect exact expected losses. In this regard, some supervisors demand that more risky banks increase their equity instead of increasing provisioning. They argue that a higher CAR level will not create confusion for investors and will avoid an adverse credit rating caused by high provisioning.

On the other hand, the "capitalization approach" overstates the capital level and retained earnings, and conceals the issues associated with rising credit deterioration. It is not transparent and provides uncertainty about the quality of banks' balance sheets as weak banks show higher capital ratios but without disclosing underlying weakness in the loan portfolio. It may also delay supervisors' prompt corrective actions based on predetermined capital adequacy ratios as well as bank management actions on effective asset workout or foreclosure of collateral.

Higher reported provisioning will reduce banks' retained earnings and capital. These reductions may induce a bank to undertake some behavioral changes such as issuing new equity capital, reducing dividends, reducing the growth rate of its risky assets, conducting a workout of NPLs, and taking other conservative actions that it otherwise might not have undertaken.

On balance, requiring higher provisioning seems preferable than requiring higher capital ratios without proper provisioning. The latter would overstate capital and may result in higher dividends, taxes, and a higher risk of insolvency later. Moreover, the higher capital may not bring about the desired change in banks' behavior. There should be no trade-off between sufficient provisioning and capital. Nevertheless, when credit risk assessment or provisioning deficiencies are significant or not remedied on a timely basis, supervisors may consider whether such deficiencies should be reflected through a higher capital requirement.

C. Dealing With Common Provisioning Issues in Countries Implementing IFRS

In countries implementing IFRS, supervisors also face practical provisioning issues.

Most of these issues stem from the absence of, or inadequate guidance in, IFRS, which create a need to adopt supervisory measures and policies to fill the gaps. For example, due to the

⁴⁸ "Loan Loss Provisioning Practices of Asian Banks" (2012), pp. 4-5.

lack of guidance in IAS 39, supervisors should develop a policy to help banks to formulate uncollectible loan write-off rules and criteria. Supervisors may also have to provide guidance on: (i) recognizing and disclosing NPLs and forborne loans properly; (ii) identifying more formal links between NPLs and impairment triggers; (iii) properly recognizing and reporting interest on NPLs; (iv) setting specific requirements for collateral valuations including periodic updates; and (v) treating restructured loans prudently. Table 1 summarizes some common provisioning issues encountered under IAS 39. These issues, together with recommended supervisory approaches, are discussed in detail in Annex 2. In addition, where applicable, the application of these issues under IFRS 9 is also discussed in Annex 2.

Topics	Main Issues
When Transitioning from Local GAAP to IFRS	How should “day one gain” be treated? How should supervisors deal with decrease of provisioning levels as a result of adopting IFRS? Can the existing loan grading systems and matrices continue to be utilized and still comply with IAS 39?
Financial and Regulatory Reporting Implications	How should financial statements comply with IAS 39 rules and properly reflect regulatory provisioning requirements at the same time?
Interest Income on Impaired Loans – to Accrue or not to Accrue	What are the practical implications of IAS 39’s principle of continuing to accrue interest on impaired loans? What should supervisors and banks do to meet both IFRS and regulatory requirements?
Uncollectible Loan Write-off	Does IAS 39 deal with uncollectible loan write-off? Should IAS 39’s derecognition rules be used to guide loan write-off? What are the benefits of timely write-off of uncollectible loans, and what roles should supervisors play to facilitate that?
Valuation and Sale of Collateral in Possession	Can banks keep foreclosed assets on their books for more than one year and still comply with IFRS 5? What are the recommended practices surrounding valuation and sale of collateral in possession? What should supervisors know in safeguarding the quality of appraised values?
Restructured Loans	To what extent does IAS 39 deal with restructured loans? What are the good practices supervisors should be aware of in handling various aspects of restructured loans?

V. SUMMARY AND CONCLUDING REMARKS

A key function of supervisors in assessing credit risk and enforcing the capital adequacy of banks is to ensure sufficient and timely loan loss provisioning. This may entail requiring additional provisioning when provisions under IFRS are deemed insufficient. Under the current “dual approach” system, the incurred loss-based impairment loss recognition model, as applied under IAS 39, often leads to recognizing impairment losses “too little and too late,” and therefore does not always meet supervisory expectations of estimating credit losses within the forward looking capital adequacy assessment framework. This problem may persist when IFRS 9 replaces IAS 39.

It is critical that bank supervisors possess the powers, willingness, and ability to act, as well as the technical expertise in balancing prudential and accounting requirements. Aside from stepping in to impose additional provisioning where necessary, supervisors should also reinforce prudent provisioning practices, to correct adverse incentives and inappropriate bank behaviors. In doing so, supervisors should recognize the different roles played by provisioning and capital as well as the interactions between the two. Because of the risk that capital without proper provisioning would result in an overstatement of capital, higher provisioning is a better option than high capital as a means to mitigate rising impairment losses.

Implementation of IFRS as the global accounting standard should continue to be encouraged. While both IAS 39 or IFRS 9 have deficiencies, at least in regard to credit loss assessment and measurement, adoption of IFRS as the global financial reporting standard will help to promote greater transparency of the capital market and comparability of financial statements.

IFRS 9 is a step in the right direction. An accounting model based on expected credit losses is a significant improvement from IAS 39, though it falls short of providing for credit losses on a through-the-cycle basis for loans in the higher credit quality categories. Although IFRS 9 is a step in the right direction, the results of its implementation are yet to be seen. The slow progress and repeated delays have made IAS 39 relevant for longer than expected, and will remain so for a few more years until IFRS 9 becomes effective. This affirms the continued significance of the issues and recommended approaches discussed in this paper.

Annex 1. Supervisory Powers in Loan Loss Provisioning in Selected Countries

Countries	Practices
Australia	<p>The Banking Act empowers the Australian Prudential Regulation Authority (APRA) to make legally enforceable prudential standards (including those relating to credit quality, problem asset recognition and provisioning) and to issue formal directions to comply if necessary. APRA also has a general power to issue directions to banking institutions as to the way their business affairs are conducted. In practice, however, authorised banking institutions (ADIs) accept APRA's specific requirements as to appropriate provisioning levels and problem credit categorisation without APRA having to invoke its formal powers.</p> <p>APRA's prudential standard on credit quality (APS 220) specifically provides for an ADI to maintain provisions and reserves adequate to absorb existing and estimated future credit losses in its business given the facts and circumstances applicable at the time. Under paragraph 41, APRA may require an ADI to increase the level of its provisions, reserves or capital or to otherwise change its policies and practices.</p> <p>APRA also may require an ADI to hold additional capital (Prudential Standard APS 110 Capital) and to rectify or make further public disclosures (including relating to provisions) if APRA is of the view that these are inaccurate (Prudential Standard APS 330 Disclosure).</p>
Austria	<p>On-site examinations may result in reclassifications of individual assets as well as additional loan loss provisioning requirements.</p> <p>Within the Pillar II Supervisory Review and Evaluation Process (SREP) framework, based on the overall risk assessment of a credit institution, additional capital may be required. The overall level of provisioning given the portfolio and the risk management processes is also considered in the SREP.</p>
Belgium	<p>The National Bank of Belgium (NBB) is not empowered to modify the level of provisions reported by credit institutions or in their general purpose financial statements (i.e., in their accounts). However, corrections can be required by the NBB for prudential purposes, pursuant to article II.1, §1.b.v of the NBB Regulation of 15/11/2011 on own funds. This article determines the elements that must be deducted from accounting own funds, in order to determine the regulatory own funds. In this connection, the deduction mentioned in element (v) of this article relates to the possible and predictable losses and costs for which, in the opinion of the NBB, the necessary impairment or provisions have not been accounted for.</p> <p>In practice, if the NBB identifies weaknesses in provisioning, it has a number of tools to remedy the problem, such as to apply an adjustment to regulatory own funds.</p>
Brazil	<p>The Supervisor may determine the reclassification of credit operations and demand corrective actions including capital allocation for incorrectly classified operations (Resolution 2682).</p> <p>Similarly, if a classification or disclosure error or inconsistency is identified during an onsite inspection, the Supervisor may direct the necessary corrective actions and</p>

	<p>adjustments to the financial statements. In addition, according to Resolution no. 4019, the Supervisor may require, as a prudential measure, financial institutions to increase capital. This may be necessary when there is deterioration in the condition of the institution (for instance when a high level of classified assets is determined to potentially threaten the soundness of the bank), regardless of compliance with minimum capital requirements.</p>
Canada	<p>As determined through the detailed file review part of a credit risk review, recommendations for risk rating changes/additional provisions are a normal part of supervisory work. The Office of the Superintendent of Financial Institutions (OSFI) expects the bank to make the necessary adjustments and advise OSFI of their actions in their response to OSFI's letter. Any pervasive problems with risk ratings or provisions would be the subject of separate recommendations to the bank to make improvements to their risk rating and/or provisioning policies and procedures.</p>
France	<p>Loan classification and provisioning are reviewed by French Prudential Supervisory Authority (ACP) inspectors in special credit risk targeted reviews or in general on-site reviews.</p> <p>Based on their reports, off-site teams may formulate recommendations for re-classifications and additional provisions. These recommendations are sent to the external auditors of the institution. Auditors that the assessors met confirmed this did happen but that it was infrequent.</p>
Germany	<p>If the processes and procedures for risk classification, intensified loan management, treatment of problem loans and risk provisioning—as well as for all other parts of risk management—are deemed to be inappropriate, Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin), the German supervisory authority, can issue an official order pursuant to Section 25a (1) sentence 8 of the Kreditwesengesetz (KWG), which is the German banking act, to an institution to remove any shortcomings in this area. If the institution does not remove the shortcomings within the timeframe specified, BaFin has several tools at its disposal; it can, inter alia, impose additional capital charges, order risk reducing measures and impose restrictions on the institution's deposit and credit business. Although BaFin lacks the power to demand an increase in provisioning levels, the aforementioned powers effectively allow it to “increase the overall financial strength” of an institution, or seek a risk deduction that is commensurate with the perceived provisioning shortfall.</p>
Italy	<p>Inspectors assess the bank's internal asset classification and provisioning guidelines onsite. In case of credit deterioration, the inspector assesses that the credit policy clearly defines the objectives to be pursued, the actions to be taken, and the time necessary for their implementation. If the inspector finds that classifications are inaccurate or provisions are inadequate, adjustments are required. Assessors, who reviewed instances either through Pillar 2 add-ons or reclassification of the loan, required the bank to correct/offset inadequate provisions/classifications.</p> <p>When the credit risk management process is judged inadequate, the Bank of Italy (BI), on a case by case basis, has set higher minimum capital requirements for individual banks and banking groups or applies higher risk weights to specific</p>

	categories of assets.
Korea	<p>In transitioning from Korean GAAP to KIFRS, the authorities implemented a reserve for credit loss to prevent a decrease in a bank's loss absorbent capacity from the change in accounting treatment. Regulatory reserves for IRB banks are determined based on the larger of either minimum regulatory ratios or expected losses under the IRB approach.</p> <p>Financial Supervisory Service (FSS) examiners conduct off-site monitoring and on-site examination to assess whether asset classifications and provisioning are adequate. In case the classification is not adequate for certain assets, bank supervisors may order the bank to reclassify the assets and make additional provisioning. The Regulations are sufficiently prescriptive for the supervisor to ensure banks fully reflect losses in the amount of provisions.</p>
Netherlands	<p>The actual level of provisions is determined by the external auditor in line with accounting principles. Although the central bank (DNB) has no direct power to require a bank to increase its level of provisions, it will discuss the adequacy of provisions with the management of the bank and the external auditor if it judges that the level of provisions is inadequate based on its own assessment of risks or likely recoveries. In the event that DNB judges that the level of provisions is not adequate it has the power, by virtue of the Decree of Prudential Regulations (DPR) Sections 3:18 and 3:18a to require a bank to increase its financial strength, e.g., by placing restrictions on the payment of dividends or raising new capital.</p>
Spain	<p>Article 47.a of the Banking Law of 1946 assigns responsibility to the Bank of Spain (BdE) to make recommendations to the banks concerning their credit practices and policies. Articles 4(f) and 5(k) makes it a violation of the regulation to have insufficient provisions and enable the BdE to take action to ensure the bank's books accurately reflect the bank's condition.</p> <p>The subject of provision adequacy is addressed in the letters the BdE sends banks at the conclusion of its supervisory activities and may include a requirement to increase provisions. The BdE takes supervisory enforcement actions when corrections are not implemented.</p>
United Kingdom	<p>The Financial Supervisory Agency (FSA) requires that banks and banking groups have adequate information systems for measuring, assessing and reporting on the size, composition and quality of exposures. The FSA handbook places requirements on banks to have effective processes to identify, manage, monitor and report the risks they are (or might be) exposed to (SYSC 4.1.1 R). The handbook also requires that banks should satisfy themselves that their systems are sufficiently sound to support the effective management and, where applicable, the quantification of the risks (GENPRU 1.2.89 G).</p> <p>As part of the Advanced Risk Responsive Operating Framework (ARROW) assessment process, the FSA supervisors check the quality of banks' management information systems and reporting to their Boards and senior management in general. Large banks, however, are affected by the common inadequacies in information technology systems. As market events unfold rapidly and intensely, this makes it difficult to undertake timely aggregation of risk information on broad financial risks. Risk management cannot be effective if risk monitoring is not adequate.</p>

Source: Most recent IMF FSAP BCP assessments and country authorities.

Annex 2. Common Provisioning Issues in Countries Implementing IFRS⁴⁹

2.1. When a Country Transitions from Local GAAP to IFRS⁵⁰

When transitioning to IAS 39, supervisors may face how to handle the so called “day one gain.” In the case that provisioning before IFRS adoption is higher than allowed under IAS 39, upon transitioning to IFRS, instead of having a “windfall” of gains in Profit and Loss, supervisors should advise banks to place the “excess” in a non-distributable reserve in retained earnings (also see Annex 2.2).

Upon transitioning, one of the main issues is that provisions based on IFRS are often lower than those estimated under the previous credit loss system.⁵¹ While this is not a problem in terms of complying with IFRS for financial reporting purposes, the decrease in provisioning levels may violate regulatory requirements and require supervisors to step in.

To supplement the inadequate provisioning as a result of implementing IAS 39, banks can use the so called regulatory provisioning. This may mean applying a percentage to either outstanding loans or assets in accordance with the results of credit risk analysis. This approach has been practiced by certain countries, as mentioned in Section IV. B. In this situation, while the supervisors are enforcing sustainable overall provisioning levels, accounting and auditing staff should provide an assurance that banks’ financial statements appropriately apply IFRS in terms of impairment loss recognition and measurement. That is, only impairment losses recognized under IAS 39 are reflected in Income Statements, while the additional regulatory provisioning is reflected in the non-distributable reserve (see Annex 2. 2).

Another common question is if a country can continue to use the existing prudential provisioning systems and be compliant with IFRS. This includes using the existing methodologies to ensure that provisioning does not drop below the pre-IAS 39 level. Before IFRS adoption, a country could either follow local GAAP or regulatory rules in assessing the amount of the credit loss provisions, and the common practice was to use internal credit grading systems⁵² and a matrix⁵³ to assess and estimate credit losses. The grading systems

⁴⁹ Though issues covered in this Annex pertain to IAS 39, their applications under IFRS 9 are also discussed where applicable.

⁵⁰ It is beyond the scope of this paper to discuss issues related to first time adoption of IFRS, which is guided by IFRS 1, First-Time Adoption of International Financial Reporting Standards.

⁵¹ This can be either prior national GAAP or regulatory rules. According to “ILG Survey on Loan Loss Provisioning” by the BCBS (2009), no respondents had the view that provisioning levels increased post IAS 39 adoption.

⁵² The methodologies used are different from country to country with varied cut-off points at which loans are categorized. The commonly seen categories include “pass,” “watch,” “substandard,” “doubtful,” “loss.”

⁵³ A prescribed range of loss rate is assigned to a loan in a specific category.

classify loans into different categories based on their credit risk profiles, risk characteristics, and past due status. The matrix specifies the percentage or a range of percentages to be applied to each loan category to arrive at the provision amount.

In line with Basel rules, IAS 39 does not preclude using internal credit grading systems for impairment loss assessment for individual or portfolio loans. The grading system has built-in credit evaluation criteria based on asset type, geographic location, economic and financial indicators, risk profiles of loans and borrowers, and past due status, all of which are common factors supported by accounting and regulatory rules. Banks can also take advantage of a legacy loan grading system by using it as an analytical tool to gauge the additional cushion needed if there is a shortfall as a result of implementing IAS 39.

While it may be acceptable to continue to use credit grading systems to categorize loans and decide if there is objective evidence of a loss event occurring, using the matrix to calculate and measure loan loss allowance may pose a problem. For individually assessed loans, the actual measurement of impairment loss should follow the discounted cash flow method, taking into account collateral, as set out in IAS 39. For these loans, the only time that the matrix could continue to be used is if it is calibrated to yield the same loan loss provision amounts as those calculated based on IAS 39's discounted cash flow model. This is not easy to achieve as each loan would have its individual original effective interest rate and estimated cash flows. For collectively assessed loans, IAS 39 allows the use of the historical loss rate adjusted with current information as a proxy for determining the present value of estimated cash flows when calculating impairment losses. While it is possible that prudentially imposed fixed loss rates or ranges of loss rates in a matrix may be commensurate with the estimated loss determined by applying IAS 39, banks will not be able to default to a regulatory approach for their financial reporting without ensuring that the results from both methodologies are materially consistent. When transitioning to IFRS 9, the existing historical loss rate and PD may continue to be used, provided any data based on past events is updated with current and foreseeable future information.

2.2. Financial and Regulatory Reporting Implications

Adopting IFRS encompasses two aspects: adopting IFRS for financial reporting, and incorporating IFRS into the regulatory reporting by banks to supervisory authorities. A country often puts one in place first, which lays the groundwork and infrastructure and enables banks to gain experience for the other one. This does not, however, preclude a country with the resources and capacity from adopting IFRS in both systems at the same time, as there are conceivable efficiencies to be leveraged.

Both financial and regulatory reporting should address any potential shortfalls in provisions before IFRS reporting formally starts. Anticipating the shortfall, supervisors should work together with banks and external auditors to determine how much additional provisioning is needed and the manner in which this should be assessed. For countries that

plan to also incorporate IFRS in their regulatory reporting, they will have the opportunity to formalize the solution in the course of drafting regulatory reporting rules based on IFRS.⁵⁴

IAS 39 does not permit recognition in the Income Statement of any impairment losses that are not based on objective evidence. This means that, strictly speaking, the additional provisions set aside to satisfy regulatory requirements are not taken into account in arriving at current year net profits, though this does not prevent the excess of “regulatory” over “accounting” credit losses being deducted from capital and equity and reported transparently. On the Balance Sheet, cumulative impairment losses measured per IAS 39 are reflected in the “allowance account,” which is a contra asset account (or a liability account) to net against the gross loan amount.

The proper treatment would be to create a non-distributable capital reserve, or regulatory reserve, for any shortfall between accounting and regulatory provisions. Specifically, a regulatory expected loss buffer, which is built based on regulatory requirements, is earmarked and reported transparently in the Retained Earnings instead of current year net income.⁵⁵ Regulatory provisions are not reflected in the “allowance account” on the Balance Sheet, but rather a reclassification within Retained Earnings. This treatment ensures compliance with IAS 39, while satisfying regulatory requirements. Additionally, financial statement transparency is upheld while presentations and disclosures provide investors with critical information to assess bank performance based on both accounting and prudential measures.

Many countries have incorporated IFRS (or accounting rules) into their regulatory reporting requirements, on top of which prudential rules are promulgated. For example, in the EU, the European Banking Authority has constructed a regulatory reporting template called FINREP (financial reporting), which is compliant with IFRS. Whether a country follows a standardized template or customizes their regulatory reporting rules, the same reporting methodology described above should be adopted to ensure their consistency with IFRS.⁵⁶

Unlike IAS 39, under IFRS 9, the Income Statement will reflect expected credit losses, as defined by the IASB. In the event that provisions under IFRS 9 are deemed insufficient

⁵⁴ It is encouraged that countries adopting IFRS in their financial reporting also incorporate IFRS in their regulatory reporting. This would help to reduce potential reporting burden and mitigate possible confusion for users of both financial and prudential reporting information.

⁵⁵ In Hong Kong SAR, financial institutions are expected to maintain a “regulatory reserve” to cover losses that may occur in the future. This regulatory reserve is earmarked in retained earnings and is distinct from loan loss reserves reported under IAS 39 (Packer and Zhu, 2012).

⁵⁶ While incorporating IFRS in regulatory reporting is encouraged, especially for countries using IFRS to guide their financial reporting, regulatory reporting is not officially governed by IFRS, and hence deviation from it is permitted.

by supervisors, whether the additional provisions imposed should be taken to the expense account or in the reserve, as discussed above, is yet to be determined. In addition, it is only after IFRS 9 has been implemented for a period of time that the frequency and scale of this event occurring can be observed.

2.3. Interest Income on Impaired Loans – to Accrue or not to Accrue

Prudential regulations in some countries require that the accrual of interest on NPLs not be recognized as interest income. From the prudential supervision perspective, interest income on NPLs is recognized only when it is actually received (cash accounting), and in cases where full collection of the principal balance is not assured, cash received is commonly applied to the outstanding principal balance. A move from an accrual basis to cash accounting appropriately reduces a bank's income flow (as well as tax and dividend obligations). When accrued but uncollectible interest on NPLs is recorded as income, the bank's interest income will be overstated.⁵⁷

On the other hand, it is widely recognized that IAS 39 requires interest on all loans, including those that are impaired, to be accrued.⁵⁸ According to IAS 39, interest income is recognized on impaired loans by applying the original effective interest rate to the difference between the carrying amount of the loan and impairment loss.

In practice, this IAS 39 requirement could run into issues. When substantial collection of a loan's principal and/or interest is in doubt, then continuation of interest accrual would not seem to be a good practice, as a bank would be recording interest income and increasing an asset that is not likely to be recoverable. Indeed, in some countries implementing IFRS, banks continue to recognize interest income on impaired loans even though it is not probable that the borrower will repay either the principal or the interest or both, resulting in overstated interest income. In other words, in a situation in which impairment losses can be identified with the loan, the borrower has stopped paying principal and/or interest for a certain period of time, and there is no predictability as to when any payment will be received and the amount, it would not seem justifiable to continue to recognize interest income. However, if at any point cash is received, the bank should record it on a cash basis or reduce the principal balance if the full collection of the principal balance is in doubt.

IFRS 9 has retained the interest income recognition clause under IAS 39. However, the U.S. FASB's version of the credit loss model specifically included a non-accrual principle,⁵⁹

⁵⁷ Provision expense would also be overstated under the accrual method. Thus, everything else being equal, the net income stays the same.

⁵⁸ The accrual is effectively an unwinding of the discount applied in calculating the NPV. Thus the accrual method under IAS 39 reflects the passage of time or time value of money. Nonetheless, the accrued amount is recorded as "interest income" in the Income Statement.

⁵⁹ Exposure Draft, Financial Instruments: Credit Losses (2012), U.S. FASB, Paragraph 825-15-25-10.

which formally recognizes the non-accrual practice that has been carried out by the U.S. banking system for years as an expedient provided by the U.S. federal banking supervisors in the absence of guidance from U.S. GAAP.⁶⁰ It is worth mentioning that, in its comment letter on the IASB's Exposure Draft on credit loss recognition, the BCBS called for a revision of the rules on interest income recognition and its replacement with a non-accrual clause for stage 3 assets.

Given that neither IAS 39 nor IFRS 9 adopts the non-accrual principle, banks would run the risk of violating IFRS by implementing a non-accrual policy in their financial reporting. Therefore, it may be helpful for banks to disclose results of both accrual (IFRS) and non-accrual (prudential rules) practices, so that users can compare the impact. This assumes that banks continue to keep the prudential provisioning systems after adopting IFRS (see Section IV. A). In a situation where a bank continues to receive interest payments at regular intervals as specified by the contract or based on an agreement, but at a reduced amount, the bank should continue to accrue interest income at the reduced level and recognize revenue. In the event that substantial collection of all principal and/or interest is in doubt, cash payments should reduce the principal balance first.

2.4. Uncollectible Loan Write-off

On the accounting side, the recording of a loan write-off entails removing some or all of an uncollectible loan from the books of the bank. This is generally done by reducing the loan balance (an asset) and reducing an allowance account for loan losses, which is a contra asset account that reflects cumulative impairment losses recognized. Therefore, when a loan is fully provisioned, the value of the loan is reduced to zero on the Balance Sheet by netting the carrying amount and the cumulative impairment losses in the allowance account.

IAS 39 is silent about the write-off of uncollectible loans.⁶¹ However, the importance of write-offs is implied in IAS 39 and IFRS 7. IAS 39 allows the use of historical loss experience in assessing impairment losses on a group basis and IFRS 7 requires disclosure of write-off criteria.⁶² The accounting community considers specifying when to write off uncollectible loans as too prescriptive and should be left to local regulators to provide jurisdiction specific guidance.

The BCBS indicated that timely charge-off of uncollectible loans is necessary to understand the pattern of historic losses specific to loan types and classifications. In its

⁶⁰ The expedient is for a U.S. entity to cease interest income accrual when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest.

⁶¹ "Financial Instruments: Impairment, Definition of 'write-off'" (2011), IASB/FASB Board Meeting Staff Paper for Week beginning February 14, 2011, Paragraph 14.

⁶² IFRS 7 (2011), Paragraph B5 (d).

“Sound Credit Risk Assessment and Valuation” (2006) paper, the BCBS stated that banking supervisors should be satisfied that the methods employed by a bank to calculate loan loss provisions produce a reasonable and prudent measurement of estimated credit losses in the loan portfolio that are recognized in a timely manner. An accurate historical loss rate, taking into account timely write-offs, is important not only for IAS 39 compliance, but also for LGD calculation under Basel II.

Banking supervisors should have a general policy requiring timely write-off of uncollectible loans and assist banks in formulating sound write-off criteria. The benefits of timely write-offs of uncollectible loans are numerous (see Box A1). A bank should write off a loan or portion of a loan when it is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. This does not have to be preceded by exhausting all legal means and giving up contractual rights on cash flows.⁶³ This also does not mean that the loan has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this essentially worthless asset even though partial recovery may be realized in the future. In fact, the rate of repayment of charged-off loans should be factored into the historical loss rate. Supervisors should also require banks to back test their loss rates and compare actual losses with the loss estimates that are applied to ensure that historical loss rates are not distorted.

⁶³ It is advisable for banks to have safeguards over loan documents and collection ledgers for loans that are written off but still have legal rights and potential for recovery.

Annex Box 1. Benefits of Timely Write-off of Uncollectible Loans

Stronger transparency in financial reporting – NPL figures that include legacy loans deemed uncollectible and the collection of which is not being actively pursued by the bank can disguise the level of loans that are newly problematic and actively being collected. Additionally, large quantities of fully provisioned loans that are deemed uncollectible can hinder the ability to understand the NPL coverage ratio.

Cross-country comparability of aggregate banking sector information – it is considered good practice to write off loans when the lender deems these loans to be uncollectible or of such little value that the loans are no longer considered bankable assets. Consistent application of these principles by banks in all countries applying IFRS would increase transparency and comparability of NPL levels and coverage for users of reported NPL information, including potential investors, banking supervisors, and supervisory oversight bodies.

Greater accuracy in calibration of historic loan loss rates – Historic loss rates, which are used for determining collective loan loss provisions under IFRS and the LGD for the Basel capital framework, require accurate and timely loss information. When banks delay writing off loans, these loss rates may not include the most recent and relevant loss information. On the other hand, loss rates should be adjusted by subsequent recoveries.

Potential for a more future-focused business environment for banks – The markets take a dim view of banks with high levels of NPLs. When these NPLs represent legacy loans that are fully provisioned and are not currently being pursued for collection, banks can stagnate under the cloud of these loans. When banks employ timely write-off practices, the balance sheet is cleansed and bank leadership can focus efforts on seeking new business and recovering from the effects of their resolved weak position.

One of the concerns over uncollectible loan write-offs is that while write-offs will result in a lower NPL ratio, the NPL coverage ratio will also likely decline. However, this decline should present a truer view of the provision coverage for loans for which collection efforts are currently active, and a clearer picture of the shortfalls measured against an assessment of inherent credit risk.

There are impediments to loan write-offs. These include court order dependence, a prolonged foreclosure process, tax disadvantages,⁶⁴ and supervisory rules that may require exhaustion of all possibilities for the collection of claims and giving up contractual rights to the cash flows on the loans. All these will hinder banks' ability to accurately calculate the historical loss rate. As stated above, the expectations from accounting and regulatory standard setters is for supervisors to intervene and put policies in place that require banks to write off uncollectible loans on a timely basis, and hence fill the void left by the current accounting standards.

⁶⁴ Detailed discussions of legal and tax aspects in this context are out of the scope of this paper.

In the absence of clearly defined write-off rules under IAS 39, supervisors and banks should not attempt to use IAS 39’s derecognition rules to guide the write-off of uncollectible loans.⁶⁵ The derecognition guidance within IAS 39 was designed to be applied to events such as the sale or transfer of financial instruments (e.g., repos, securities lending, and receivable factoring transactions) or when the financial rights to cash flows from a financial instrument expire, and not to the write-off of uncollectible loans. While these rules are applicable in determining if an asset should be derecognized, they do not apply to uncollectible loan write-offs.

IFRS 9 only has high level guidance on loan write-offs. Recognizing the importance of a definition of “write-off,” the new credit loss framework under IFRS 9 added language on timely loan write-offs that deal with both the entire loan and a portion of it.⁶⁶ However, there is still no specific guidance on write-off criteria, which would need to be determined by banks and supervisors.

2.5. Valuation and Sale of Collateral in Possession

Broadly speaking, there are two key aspects regarding the treatment of collateral: (i) its role in loan classification and provisioning, and (ii) valuing and divesting it as a foreclosed asset. An earlier IMF working paper researched the first aspect—best practices in terms of how to value collateral and incorporate collateral in loan classification and provisioning.⁶⁷ This subsection does not duplicate that working paper; rather, it focuses on the second aspect by exploring supervisory views and roles in dealing with issues associated with the valuation and sale of collateral seized upon foreclosure, especially real estate properties.

Valuation

Collateral is taken into account in impairment loss recognition and measurement under IAS 39,⁶⁸ though neither accounting nor regulatory rules have detailed guidance on its measurement. IAS 39 requires entities to estimate impairment losses based on the difference between the loans’ carrying amount and the present value of estimated cash flows, discounted at the loan’s original effective interest rate. These cash flows may come directly from the borrower or may result from liquidation of the loan’s collateral.⁶⁹ Thus the estimate

⁶⁵ This does not mean derecognition rules should not be followed on other applicable occasions as defined by IAS 39.

⁶⁶ IFRS 9, Paragraphs 5.4.4 and B5.4.9.

⁶⁷ “Collateral in Loan Classification and Provisioning” (2002), In Won Song.

⁶⁸ There is hardly any change in this regard in the new credit loss recognition model under IFRS 9.

⁶⁹ “...the calculation of the present value of the estimated future cash flows of a collateralized financial asset reflects the cash flows that may result from foreclosure less costs for obtaining and selling the collateral, whether or not foreclosure is probable.” – Paragraph AG 84, IAS 39. This remains the same in IFRS 9. –

(continued...)

of cash flows from liquidating foreclosed collateral would need to assume, among others, the remaining life of the asset, the timing of the sale of collateral, and the discount rate. Without detailed rules, supervisors would need to ensure banks make consistent and reliable judgments and assumptions, which will serve to support both financial and regulatory reporting, especially if the latter is based on IFRS.

Upon foreclosure, collateral in possession is classified as held for sale under IFRS 5, as these are non-current assets to be disposed of. In other words, unless a bank intends to hold the foreclosed collateral as investment property, which means using the property to earn rentals or for capital appreciation or both,⁷⁰ collateral in possession is classified as held for sale under IFRS 5, and re-measured at the lower of its carrying amount and fair value less costs to sell.⁷¹ These assets are not subject to depreciation, although an impairment test is required and loss is recognized as the write-down to its fair value less costs to sell.⁷²

Fair value measurement of collateral in possession should be supported by an independently qualified third party on a periodic basis. Even though IFRS 13, Fair Value Measurement (2011), defines fair value and establishes a framework for fair value measurement, it does not specify measurement methodologies. Therefore, by improving the quality of the independent third party and their work, supervisors would be able to help banks to obtain more reliable valuations. At the same time, instead of solely relying on third party valuation results, banks have the ultimate responsibility to determine if appraised values are sustainable and consistent with IFRS requirements.

Specifically, supervisors should make sure appraisals for collateral in possession follow International Valuation Standards (IVS),⁷³ as issued by the International Valuation Standards Council (IVSC). IVS valuation methodology is market value or fair value based, and provides a good proxy of fair value. However, fair value definition under IVS is not identical with IFRS 13, which emphasizes exit price and market participants' perspective.⁷⁴

Fair value measurement under IVS and accounting rules requires significant judgment. Therefore, supervisors should be properly trained and prepared to be intrusive and challenge the appraised values by evaluating a bank's appraisal evaluation process, appraisal

Paragraph B5.5.55.

⁷⁰ IAS 40, Investment Property (2003), Paragraph 5.

⁷¹ IFRS 5, Non-current Assets Held for Sale and Discontinued Operations (2004), Paragraph 15.

⁷² Ibid. Paragraph 20.

⁷³ IVS are internationally accepted valuation standards.

⁷⁴ While IFRS 13 sets out principles for measuring fair value, the IVS, among other things, provides standards and guidelines on how to measure fair values. In 2014, the IASB and IVSC have formally agreed to cooperate and exchange information, to service their common interest of ensuring that the IVS on how to measure fair value is consistent with IFRS and enhances financial reporting in accordance with IFRS.

assumptions, inputs, conclusions, independence, and the capacity of the appraisal firms. If there is non-compliance, supervisors should have the power to take corresponding disciplinary actions against either the appraiser or the bank.

Supervisors' support of the establishment of a professional valuation industry would enhance the quality of valuations over time. Supervisors should also ensure that a central registry (or equivalent) is established for real estate and other property sales prices in order to promote fair value measurement by appraisers so that appraisals can more closely reflect proper market values.

Supervisors should ensure proper mark down of property values. Supervisors and banks should come to realize that foreclosed properties have a high probability of incurring losses upon liquidation, and the value is not likely to increase as time goes by. Therefore, supervisors should make sure by means of issuing rules, for example, that banks write down the values of the collateral in possession based on reliable periodic appraised values. This will not only avoid overstating asset values on the Balance Sheet, ensuring adequate provisioning, but will also rid banks of the burden of continuing to carry the foreclosed properties, which are often poor investments and non-earning assets.⁷⁵

This is especially important in countries where the real estate market is illiquid and/or the appraisal system is not fully developed to produce reliable market values.

Supervisors should encourage banks to work with appraisers to come up with the best estimates possible from the available information and mark down the values of the properties given the illiquidity of the market. If the loss has been taken, banks are more likely to be willing to sell at a lower price. Allowing banks to continue to carry collateral in possession on their books at overstated values until they can sell it at a desired price is a form of forbearance, which hides losses and does not address the underlying issues. In line with strengthening supervision, forbearance should be avoided during stable periods.⁷⁶

Sale

Assets classified in the held-for-sale category must be sold within one year, as required by IFRS.⁷⁷ Most of the time, banks do not have either the interest or the means to turn a foreclosed property, which may be in dire condition and/or an unpopular location, into a profit generating investment. Instead, banks are more interested in selling the collateral in possession at a desired price within a reasonably short period of time.

Therefore, to ensure compliance with IFRS 5, auditors and supervisors should ensure that the bank is committed to selling the property by having a plan to sell and actively

⁷⁵ For further discussion on collateral valuation problems, see European Banking Coordination (2012).

⁷⁶ Erbenova and Song (2010).

⁷⁷ IFRS 5 (2004), Paragraph 8.

marketing the property. This includes checking to make sure the bank’s listed property prices are reasonable in comparison to fair values and reflect the bank’s commitment to sell. If the listed price is too high, the commitment to sell would need to be discounted. On the other hand, supervisors should be aware that IFRS 5 does make exceptions to events and circumstances⁷⁸ under which banks can exceed the sale of the property to beyond the one year limit. If supervisors decide that the situation of a particular bank warrants a period longer than one year for the sale of the foreclosed property, the property can continue to be classified as held for sale. However, supervisors must ensure that the bank marks down the property values as appropriate, based on periodic appraisals, and recognize impairment losses against fair value less costs to sell. This would also incentivize banks to dispose of foreclosed properties in a timely manner.

Supervisors should encourage banks to divest foreclosed assets. Sometimes, when banks claim that there are no buyers largely due to foreseeable losses from the sale, they simply hold these properties as held for sale for years and in some cases, without recognizing any impairment losses. External auditors sometimes find themselves “powerless” in this situation as they do not feel they are in a position to enforce selling and impairment loss recognition, especially if the real estate market is shallow and the appraisal quality in the banking system is not up to par. Thus, it falls upon the supervisors to exercise their power and judgment to make sure that (i) the appraisal system is robust enough to support fair value measurement per IFRS, and (ii) banks take the necessary and required steps to actively market and sell the foreclosed properties. These steps will not only help banks to avoid opportunity costs and devote their resources to core businesses, but also safeguard the integrity of the balance sheet and facilitate proper provisioning for collateralized loans.

2.6. Restructured Loans⁷⁹

The appropriate treatment of restructured loans⁸⁰ is an important component of maintaining bank soundness, not only under normal circumstances but also in the event of a systemic crisis. This is another area where IFRS offers very little specific guidance, which does not go beyond acknowledging that “renegotiated or otherwise modified” loans

⁷⁸ Ibid. Paragraph 9 and Appendix B.

⁷⁹ Refer to Basel II paragraph 458 regarding “re-ageing.” In addition, refer to EBA’s final draft implementing technical standards (EBA/ITS/2013/03, October 21, 2013) and In Won Song (2006).

⁸⁰ The restructuring of a loan or other debt may include: (i) the transfer from the borrower to the bank of real estate, receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan; (ii) a modification of the terms of the loan such as a combination of the following factors: a reduction in an agreed-upon interest rate; an extension of the final maturity; a reduction of principal; or a reduction of accrued interest; or (iii) acceptance by the bank of the conversion of the borrower’s debt into equity to be held by the bank, in full or partial settlement of a debt. Restructuring should be designed to be in the best interests of both the bank and the borrower (i.e., the restructured loan should maximize collection of the bank and be on terms that will benefit the borrower and be consistent with their ability to repay the debt).

are impaired and should be subject to the same impairment loss measurement criteria.⁸¹ Thus, bank supervisors should provide prudential guidelines on the treatment of restructured loans and monitor the extent of these loans carefully; and banks should develop a policy regarding restructured loans to ensure that such loans are clearly designated as such, monitored and properly handled from both accounting and loan review standpoints.

When loans are classified and heavy provisions are required by accounting standards or supervisors, some banks may engage in extensive troubled loan restructuring if this treatment minimizes the impact of NPLs on their net income. However, such treatment can often be interpreted as only “cosmetic” by supervisors in the context of postponing recognition of the true extent of their portfolio losses.

At the time of their restructuring, all restructured loans should be subject to an assessment of risk according to certain specific criteria to determine their collectability. They should, thereafter, be identified in the bank’s internal credit review systems and regularly monitored by bank management. When analyzing restructured loans, the credit reviewer should focus on the ability of the borrower to repay the loan in accordance with its modified terms, both under normal circumstances and in the event of a systemic crisis.

Many supervisors provide specific criteria for banks to classify loans as restructured, and give more detailed guidance. Definitions of a restructured loan involve extending the loan’s maturity or lowering its interest rate or both. Although published international best practices do not exist on this issue, the following elements could be regarded as good practices:

- **Classification of a restructured loan.** A restructured loan should generally be classified as “substandard” or no better than its category prior to restructuring, such as “doubtful.” Otherwise, banks can exaggerate their credit quality by granting terms to borrowers that are considerably easier than normal commercial terms. A borrower’s compliance with the terms and conditions of the restructured loan for a certain specified period of time gives a fair indication of the improvement in the borrower’s debt repayment capacity, and warrants the restoration of the loan to a regular category.
- **Performance before upgrading.**⁸² After a reasonable period of demonstrated payment performance, banks could upgrade a restructured loan. Clearly, a period of sustained performance is a very important factor in determining whether there is a reasonable assurance of repayment and performance according to the loan’s modified terms.

⁸¹ IAS 39 (2009), Paragraph AG84. IFRS 7 (2011), Paragraph B5 (g) requires disclosures of accounting policy for renegotiated assets.

⁸² Banks should have systems to track restructured loans – to ensure they do not mask problem loans, repeatedly restructure loans, so that restructured loans are subject to higher levels of credit review scrutiny.

- **Relationship of additional debtor.** If the substitute or additional debtor is related or affiliated to the original debtor, then the original loan classification cannot be changed unless subsequent debt servicing by the borrower improves sufficiently to warrant a fresh review of the classification. If the substitute or additional debtor is totally unrelated to the original debtor, then the subjective loan classification criteria can be applied to the substitute or additional debtor. This should be done in accordance with the general principle of the borrower's ability to repay his/her debt in the normal course of business. If the new debtor is able to clear all interest arrears, then the loan classification can be upgraded accordingly.
- **Time period before upgrading.** Regarding the minimum time period before restructured loans are upgraded, country practices vary widely. In some countries, restructured loans may be upgraded if they comply with their new restructured terms for at least one year. In other countries, the period may be shorter or it may require meeting the upgrading conditions specified in terms of the number of repayments rather than a minimum period. In any case, the time period should encompass demonstrated payments by the borrower and not simply a passage of time.
- **Dealing with more favorable conditions.** When troubled loan restructuring is arranged under more favorable conditions compared with market conditions or the original terms of the loan, a cost should be assigned to this difference and provisioned in its full amount.
- **Dealing with uncollectible restructured loans.** When available information confirms that a specific restructured loan or a portion thereof, is uncollectible, this amount should be written off against the provisions for loan losses at the time of restructuring. Thereafter, the bank should regularly evaluate the collectability of the restructured loan as a part of the impairment assessment process. This will help determine whether existing provisioning is adequate and whether any additional amounts should be charged to provisions.
- **Treatment in a systemic crisis.** Arguments could arise regarding the different treatment of restructured loans and associated provisions in a crisis situation as opposed to normal circumstances. Although there are no published international best practices on this issue, it is suggested that prudential norms and practices for the classification and provisioning for restructured loans be the same under normal circumstances as in the event of a systemic crisis, i.e., the supervisor does not exercise forbearance on classification and provisioning during depressed economic conditions. In classifying restructured loans even in a systemic crisis, the emphasis should be placed on the quality of the restructured troubled loan and the prospects for repayment. Problem loans have to restore first their track record of payments to be upgraded, even under a systemic crisis.

The best practices described above should continue to apply under IFRS 9. IFRS 9 increased guidance on modified loans in the context of assessing and measuring 12-month

and lifetime expected losses.⁸³ In setting out the general principles for expected credit losses recognition for modified loans under the new framework, the IASB believes that:(i) a modified asset does not automatically have lower credit risk; and (ii) a debtor needs to have consistent good payment record for a period of time before the credit risk can be considered to have decreased.

⁸³ IFRS 9, Paragraphs 5.5.12, B5.5.25 – B5.5.27.

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