The New Era of Expected Credit Loss Provisioning

预期信贷损失拨备的新时代

The Reasons to Provision for Expected Credit Losses

- Historical evidence suggests that loan interest rates were determined in unstable market conditions and, therefore, did not always account for all credit risks. As a result, forward-looking provisions should be made at the same time as loan origination.
- The requirement for banks to set aside funds as capital reserves is unlikely to reduce a banks lending activities during strong economic periods. The result may be excessive lending by banks. Therefore, by provisioning for **expected credit losses** (ECL), *a more accurate cost of lending may be determined (which may ultimately control the amount of lending)*.
- The concept of procyclicality refers to being positively correlated with the overall state of the economy. *Reducing the procyclicality of bank lending* is likely to occur with earlier provisioning for loan losses. Increased (decreased) regulatory requirements pertaining to provisions tend to reduce (increase) the level of bank lending.
- The use of forward-looking provisions essentially results in the earlier recording of loan losses, which *may be beneficial to financial statement users* from the perspective of conservatism in a bank's reporting of earnings.

Example

1. Forward-looking provisions for credit losses should be made:
   A. before loan origination.
   B. at the same time as loan origination.
   C. 3 months after loan origination.
   D. 12 months after loan origination.

B: The nature of forward looking provisions is that they should be made in the current period in anticipation of losses to occur in the future. Therefore, they should be made at the same time as loan origination. Provisions cannot be made before loan origination because there is no information available about the likelihood of default until the loan is actually originated.

Compare and contrast the key aspects of the IASB and FASB standards

- The IASB and FASB standards are similar in that ECL must be initially recorded at the outset of all loans and updated at the end of each reporting period, taking into account any changes in credit risks of their loan assets. In addition, the standards do not require any specific catalyst to occur in order to report a credit loss. Finally, the standards mandate the use of reliable historical, current, and forecast information (including macroeconomic factors) in computing ECL. For example, both standards measure probability of default (PD) at a point in time (rather than in context of the economic cycle) and measure loss given default (LGD) and exposure at default (EAD) as **neutral estimates** (rather than downturn estimates).
- *There are two main differences between the IASB and FASB standards*:

1. FASB requires ECL to be computed over the term of a loan commencing right from the start while IASB requires a series of three stages. This difference will be discussed in more detail shortly.
2. **IASB permits the recording of accrued interest income on delinquent loans**, regardless of whether loan payments are being received. FASB requires the use of the cash basis (no interest income accrual), cost recovery method (payments applied to principal first, and once principal is repaid, the excess is recorded as interest income), or a combination of both in order to provide a more conservative and reliable method for income recognition on delinquent loans.

Example

2. For which measurement basis does IASB (IFRS 9) permit the recording of interest income on delinquent loans?
   A. Accrual.
   B. Cash.
   C. Cost recovery.
   D. A combination of cash and cost recovery.

A: IASB permits the recording of accrued interest income on delinquent loans, regardless of whether loan payments are being received. FASB requires the use of the cash basis (no interest income accrual), cost recovery method (payments applied to principal first, and once principal is repaid, the excess is recorded as interest income), or a combination of both in order to provide a more conservative and reliable method for income recognition on delinquent loans.

Example

3. Both the FASB and IASB standards measure loss given default (LGD) and exposure at default (EAD) as:

   A. backward-looking estimates.

   B. downturn estimates.

   C. forward-looking estimates.

   D. neutral estimates.

***D*:** Both standards measure loss given default and exposure at default as neutral estimates.

International Accounting Standards Board (IASB)

- Under IFRS 9, ECL is reported in three stages to represent the deterioration of assets: *stage* 1 (performing), *stage* 2 (underperforming), and *stage* 3 (impaired).

I. Upon loan purchase or origination, *stage 1* begins and the 12-month ECL is recorded (expense on income statement and contra-asset on balance sheet). However, interest revenue is computed on the original loan amount, not the amount net of the ECL. The 12-month ECL is computed as the expected lifetime credit loss on the loan asset multiplied by the probability of default within the upcoming 12-months after the end of the reporting date.

II. *Stage 2* for a loan asset occurs upon severe deterioration of credit quality to require classification into a high credit risk category. That would be presumed to occur after the loan is 30 days past due according to IFRS 9. The entire lifetime ECL is now recorded (based on the present value of losses due to future defaults), which is likely a large increase in amount from stage 1. The difference in computation of 12-month and lifetime ECL can be explained primarily by the maturity of the loan together with the movement of default risks and recovery values during the term of the loan. Note that the interest revenue computation in stage 2 remains the same as in stage 1.

III. *Stage 3* involves loan assets that are credit-impaired or generating credit losses. The entire lifetime ECL continues to be recorded but the interest revenue is now computed on the original loan amount less the loss allowance.

Assess the progress banks have made in the implementation of the standards

- The IASB standard is effective as of January 1, 2018 (although early adoption is allowed) and the FASB standard as of January 1, 2020 for public companies and January 1, 2021 for all other applicable entities.
- Based on surveys conducted with banks regarding the implementation of IFRS 9, overall it appears that only minimal progress has been made as of 2016. For example, a significant number of banks were unable to quantify the impact of the new standard. For the banks that were able to make estimates, loan loss provision increases were estimated at an average of 20%, with the range typically being between 10% and 30%. A large portion of the increase is due to the recording of lifetime ECL for stage 2 loans. The amounts are not as significant for the related capital decreases [i.e., 50bp to 73bp decrease in Common Equity Tier 1 (CET l) spread and total capital ratio], but the key issue here is that the banks are generally unaware of how regulators will ultimately revise the regulatory capital amounts.

Example

4. For banks that have been able to make estimates of loan loss provision increases, the percentages are, on average, closest to which of the following amounts?

   A. 3%.

   B. 20%.

   C. 33%.

   D. 50%.

***B*:** For banks that have been able to make estimates, the loan loss provision increases are an average of 20%, with the range typically being between 10% and 30%.

Examine the Impact on the Financial System Posed by the Standards

- The impact of the IASB standard would cause a dramatic rise in loss provisions at the start of an economic downturn, specifically the increase in amounts between stage 1 (12-month ECL) and stage 2 (lifetime ECL). One argument for a more proactive stance on recording losses is that it restates the balance sheet assets at more conservative levels to make way for possible future recoveries.
- In one sense, the standards would have no impact for banks that have established sufficiently large capital buffers that could withstand the impact of the increased loan provisions.
- The provisioning requirements of the standards could end up smoothing the issuance of loans throughout the economic cycle (i.e., slowing the growth of loans in a strong economy while preventing the slowing of growth of loans in a weak economy). That is because the prior provisions already taken on loans should prevent the capital cost of lending from increasing when the economy weakens. In a simulation exercise involving the earlier provisioning for loans, it was found that bad debts were lower (higher) in years when loan loss provisions were high (low). With earlier provisioning taken from capital, there would be reduced levels of lending prior to an economic downturn or crisis.

Example

5. Under the IASB standard, in which stage(s) would the impact of the provisioning rules be the greatest on a banks income statement?

   A. Stage 1.

   B. Stage 2.

   C. Stage 3.

   D. Stages 2 and 3.

B: There is a change from the one-year expected loss in stage 1 to a lifetime loss in stage 2, which is a very dramatic change on the income statement. There is not much of a change on the income statement between stages 2 and 3 because lifetime ECL is reported in both stages, but interest revenue is reduced in stage 3 because it is calculated only on the carrying amount less the loss allowance.

Practice Exam

- A risk manager is reviewing accounting rule changes regarding expected credit loss (ECL) provisioning. When comparing and contrasting aspects of the corresponding IASB and FASB standards, which of the following statements is correct?
  A. The FASB standard will result in earlier and larger recognition of losses.
  B. Both standards differ when dealing with loans that have considerable credit deterioration.
  C. The FASB standard only requires the cost recovery method in order to provide a more conservative method for income recognition on delinquent loans.
  D. Under the IASB standard, ECL is reported under stage 3 when there is severe deterioration of credit quality, which requires classification into a high credit risk category.

A: FASB requires the entire lifetime ECL to be recorded as a provision from the outset. As a result, the FASB standard will result in earlier and larger recognition of losses. The two standards are the same when dealing with loans that have considerable credit deterioration. FASB requires the use of either the cash basis, cost recovery method, or a combination of both in order to provide a more conservative and reliable method for income recognition on delinquent loans. Under LASB, stage 2 for a loan asset occurs upon severe deterioration of credit quality to require classification into a high credit risk category.

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