Basel Committee issues guidance on credit risk and accounting for expected credit losses

Highlights

− Supervisory requirements for credit risk and accounting for ECLs – Basel Committee sets out 11 fundamental principles
− Committee expects ECL frameworks to be implemented to a high standard
− Guidance specific to IFRS 9 focuses on certain exceptions and areas of significant judgement

Guidance for supervisory requirements

In response to the recent global shift towards using expected credit loss (ECL) accounting models, the Basel Committee on Banking Supervision has issued guidance for supervisory requirements on sound credit risk practices associated with the implementation and ongoing application of ECL accounting models.

The guidance contains 11 principles on credit risk and accounting for ECLs. It also includes guidance specific to banks applying IFRS, and relating to the new ECL model in IFRS 9 Financial Instruments.

The guidance replaces the previous guidance issued in June 2006.

Committee has high expectations

The Committee states that, in its role as a banking supervisor, it expects that internationally active banks will implement ECL accounting frameworks to a high standard. It also discusses how the concepts of proportionality and materiality apply to the guidance.

It emphasises the importance of consistent implementation of the new ECL requirements both within and across jurisdictions. It has noted significant inconsistencies in the way the current incurred loss model was implemented in different jurisdictions, and among banks within the same jurisdiction.

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Guidance specific to IFRS 9
The Committee’s guidance specific to IFRS 9 focuses on:
− the loss allowance equal to 12-month ECLs;
− the assessment of significant increases in credit risk; and
− the use of practical expedients.

Significant increases in credit risk
One of the most difficult judgement areas in implementing IFRS 9’s ECL model is assessing whether credit risk on a financial instrument has increased significantly. The guidance discusses the Committee’s expectations in this area. For example, it:
− strongly endorses the IASB’s view that lifetime ECLs are generally expected to be recognised before a financial asset becomes past due;
− gives specific guidance on how to treat exposures that have been modified; and
− emphasises that, when assessing whether credit risk has increased significantly, banks should consider changes in the risk of default occurring over the expected life of the financial instrument, as it may not always be appropriate to use changes in the 12-month risk of default for this purpose.

The Committee expects that banks will:
− make limited use of the low credit risk exception; and
− not use ‘30 days past due’ as a primary indicator of when it is appropriate to recognise lifetime ECLs.

Supervisors will give increased scrutiny to any such use, to determine whether it is appropriate.

Definition of default
The guidance recommends that the definition of default used for regulatory purposes should serve as the starting point for banks’ definitions.
It notes that for regulatory purposes, in the case of retail and public sector exposures, some supervisors may allow an indicator of 180 days past due – in place of the standard 90 days – to be used when defining default. However, this should not be read as an exemption from the rebuttable presumption in IFRS 9 that default does not occur later than 90 days past due.

Improving measurement of credit losses
The guidance notes that the objective of IFRS 9’s impairment model is to deliver fundamental improvements in the measurement of credit losses. Accordingly, the Committee expects banks to develop appropriate systems and processes. It acknowledges that this may require costly up-front investment, but believes that the long-term benefit of this investment far outweighs the cost.

Next steps
Banks’ IFRS 9 teams should familiarise themselves with the new guidance and consider any possible impact on their implementation plans.
Our latest thinking on this topic can be found in chapter 7A.8 of Insights into IFRS.
And visit our IFRS for Banks hot topics page for the latest on IFRS developments that directly impact banks, and the potential accounting implications of regulatory requirements.

2. Paragraph 5.5.3 of IFRS 9
3. Paragraph B5.5.22-24 of IFRS 9
4. Paragraph B5.5.19-21 of IFRS 9
5. Paragraph B5.5.37 of IFRS 9