Accounting & Regulatory Challenges of Banks' Troubled Assets

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Level setting

- Covid-19 unprecedented and ongoing shock to the financial system
- Loan loss reserves (allowance for loan and lease losses in the US)
  - Balance sheet valuation account to estimate uncollectible assets
  - Due to impairments, non-performing loans, bankruptcies, etc.
- Loan loss provisions
  - Income statement expense item to maintain loan loss reserves
  - Recent move from incurred loss method to expected credit loss (ECL) approach

Several dimensions to asset quality

- Accounting standards
- Supervisory guidance
- Risk management (arguably most important)

Loan loss accounting: A (very) brief history

- Incurred loss method: “Too little, too late”
- 2008: IASB and FASB note that delayed recognition of credit losses can overstate assets
- 2009: G20 Leaders call for “accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning”
- Concerns over Day One impact of ECL approach overblown
- Cries of “Too much, too soon!”
- Current ALLL levels: more accurately reflect quality of assets

The new ECL frameworks

<u>Global: IFRS 9 Financial Instruments</u>
- Issued 2014
- Effective from 2018

<u>US: Current Expected Credit Loss (CECL)</u>
- Issued 2016
- Effective from 2020

<u>Common attributes</u>

- More useful information about a company’s expected credit loss
- Forward-looking
  - no need for a “trigger event” to have occurred before credit losses are reported
- ECL measurements based on reasonable, supportable information
  - historical, current and – for the first time – forecast information

Covid guidance and the new ECL frameworks

CECL Resource Center

Have a CECL question? Email us at CECL@frb.org

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Data Considerations During a Pandemic

Regardless if your institution has adopted CECL or not, the job of appropriately reflecting COVID-19's effects into your allowance may be a challenge. The key may first be in understanding vital trends in your data. The COVID-19 pandemic has presented many new economic statistics at various extremes. The CARES Act, along with other stimulus efforts, allowed banks to offer deferral programs to offset nonperforming loans and stimulus monies have increased the liquidity on the balance sheet; while regional economic data reflect record high unemployment records and the hospitality industry struggling to remain open. So what is next? What does a long-term estimate look like?

As your institution wrestle with the many complexities associated with current economic conditions, there are a number of forecasting assumptions you may want to keep in mind when assessing COVID-19's impact on your allowance.

- Fiscal and monetary policy
- Job markets – regional and U.S.
- Commodities prices – oil prices are down
- Regulatory changes - election/policy
- Delayed Implication – some bankers express concerns past dues may increase in 2021 and beyond
- Long-term position – change in "how we do business"

Clear documentation is critical and should include support for the processes in the estimates. Institutions must account for historical experience, current conditions, and reasonable and supportable economic forecasts, all of

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27 March 2020

IFRS 9 and covid-19

Accounting for expected credit losses applying IFRS 9 *Financial Instruments* in the light of current uncertainty resulting from the covid-19 pandemic.

This document is intended to support the consistent application of requirements in IFRS® Standards.

IFRS 9 sets out a framework for determining the amount of expected credit losses (ECL) that should be recognised. It requires that lifetime ECLs be recognised when there is a significant increase in credit risk (SICR) on a financial instrument. However, it does not set bright lines or a mechanistic approach to determining when lifetime losses are required to be recognised. Nor does it dictate the exact basis on which entities should determine forward-looking scenarios to consider when estimating ECLs.

IFRS 9 requires the application of judgement and both requires and allows entities to adjust their approach to determining ECLs in different circumstances. A number of assumptions and linkages underlying the way ECLs have been implemented to date may no longer hold in the current environment. Entities should not continue to apply their existing ECL methodology mechanically. For example, the extension of payment holidays to all borrowers in particular classes of financial instruments should not automatically result in all those instruments being considered to have suffered an SICR.

To assess SICR IFRS 9 requires that entities assess changes in the risk of a default occurring over the *expected life* of a financial instrument. Both the assessment of SICRs and the measurement of ECLs are required to be based on reasonable and supportable information that is available to an entity without undue cost or effort.

Entities are required to develop estimates based on the best available information about past events, current conditions and forecasts of economic conditions. In assessing forecast conditions, consideration should be given both to the effects of covid-19 and the significant government support measures being undertaken.

EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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December 2020

FAQs on ECB supervisory measures in reaction to the coronavirus

To be updated depending on developments. Last updated 15 December 2020.

Section 1 – Relief measures regarding asset quality deterioration and non-performing loans

You announced flexibility when implementing the ECB Guid on non-performing loans (NPLs). Are you considering forbearance for NPLs? Are you looking at other ways to miti the deterioration of asset quality, for example with regard t IFRS9?

The ECB Guidance on NPLs already embeds flexibility and case-by-case assess by Joint Supervisory Teams (JSTs).

In exercising flexibility, the right balance should be achieved between helping absorb the impact of the current downturn, on the one hand, and maintaining correct risk identification practices and risk management incentives, on the ot well as ensuring that only sustainable solutions for viable distressed debtors a deployed.

Basel Committee on Banking Supervision

Measures to reflect the impact of Covid-19

April 2020

BANK FOR INTERNATIONAL SETTLEMENTS

Covid-related sup/reg relief measures

- Different national programs
  - Loan accommodations, debt restructurings, loan modification programs, etc.
  - Flexibility in loan classification
  - Permission to avoid using procyclical assumptions in provisioning models
  - Temporary changes to the leverage ratio
- Such measures provide some breathing space but…
  - …do they obscure the true reflection of a firm's asset quality, overall financial soundness?
- During the 2007-09 GFC, crushing uncertainty due to lack of transparency
- A risk that we could we fall into this trap again?

Forbearance: a double-edged sword

- Helps buy much-needed time
- Original purpose and timeframe must be well defined
- Temporary solution but easily abused
- Politics play an important role
- A risk that “temporary” measures becoming permanent

Next steps / policy recommendations?

- Conduct post-implementation review of standards
- Make sure “temporary” relief measures are exactly that
    - Milton Friedman: “Nothing is so permanent as a temporary government program”
- Proceed with extreme caution when it comes to forbearance
- Heightened *supervisory* focus on banks’ Covid-related risks and activities
    - Strategy, credit risk management, compliance, operational risk