Convergence Romania Financial Sector Modernization

Special Projects Initiative Public-Private Steering Committee

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National Bank of Romania, Romanian Banking Association, Convergence Program with the support of Romanian Banking Institute

Workshop on

International Experience with Provisioning

in View of IFRS and Basel II Implementation

Bucharest, April 11, 2007

Romanian Banking Institute

3 Aleea Negru Voda

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Foreword

The workshop aims at helping the local stakeholders and, in particular, the SPI project working group that works on amending the current NBR provisioning rules, deepen their understanding of both international supervisory practices and market solutions (methodologies and practical tools, including IT) for provisioning in view of IFRS and Basel II implementation.

The workshop is addressed to the project team, members of the relevant technical commissions of the Romanian Banking Association, representatives of individual banks, as well as to delegates from the National Bank of Romania Supervision, Regulation and Licensing, and Financial Stability Departments.

The Special Projects Initiative (SPI) represents a public-private partnership that has been set up by the National Bank of Romania, the Romanian Banking Association, the Ministry of Public Finance, the National Authority for Consumer Protection and the Convergence Program (administered by the World Bank) to provide focus and coordination and to accelerate the modernization of the Romanian financial sector, with a specific emphasis on banking issues.

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Program

8:45	Registration
9:00	Welcome Address *Mr. Radu Gratian Ghetea, President of the Romanian Banking Association*
9:05	Opening Remarks The relevance of the international experience on supervisory and industry practices regarding IFRS and Basel II implementation for Romanian banks and bank regulator *Ms. Veronica Raducanescu, NBR Director of the Regulation and Licensing Department and SPI Project Owner*

Part I – Supervisory experience with aligning prudential regulations on provisioning to IFRS and Basel II requirements

Moderator: Ms. Veronica Raducanescu, NBR Director of the Regulation and Licensing Department and SPI Project Owner

9:15	Different approaches for credit risk control and loan loss provisioning. The Spanish experience. *Mr. Javier de la Cruz, Independent Advisor (former Bank of Spain supervisor and regulator)*
10:15	The Italian experience with implementing IFRS and Basel II regulations *Mr. Luca Giannini, Senior IAS Expert, Italian Banking Association*

11:15	Coffee Break

Part II – Industry solutions for implementing IFRS and Basel II standards

Moderators: Mr. Javier de la Cruz (SPI Project Technical Anchor)
and Mr. Luca Giannini, Project Peer Reviewer)

11:30	Impairment and provisioning under IFRS. Methodology and solution implementation - practical experience *Mr. Adam Kołaczyk, Director, Deloitte, Poland* *Ms. Natalia Cierna, Deloitte, Romania*
13:00	Lunch Break
13:30	Loan Impairment according to IFRS - Solution approaches - *Mr. Alexander Beck, Manager, Bearing Point, Germany*
14:30	Loan Impairment Modeling According to IAS 39 by Using Basel II Parameters *Ms. Angela Manolache, Manager, KPMG, Romania*
15:30	Coffee Break
15:45	Industry-wide credit data solutions for Basel II implementation *Mr. Andrew Fishman, Managing Director, Algorithmics, UK*
16:45	Questions and Answers Session *Panel of the day's presenters*
17:15	Concluding Remarks *SPI Project Management Group*
17:30	End of the Workshop

Opening Remarks

Veronica Raducanescu, Director, NBR Regulation and Licensing Dept.

I would begin my opening remarks recognizing how old fashioned the current provisioning framework is. Its single merit is that of being a rather simple tool servicing for two purposes – fiscal and prudential.

NBR acknowledges its shortcomings in an environment where risk management becomes more and more sophisticated.

Changing from the scratch the methodology is rather difficult with so many challenges and expectations we have:

-to create a tool for setting up provisions at a level reflecting the real risk incurred;

-to set up a framework that serve for prudential purposes without diverging a lot from the international accounting standards;

-to design a set of best practices applicable to all kind of credit institutions irrespective of the degree of risk management sophistication;

-to develop a methodology without duplicating work for Romanian subsidiary of foreign credit institutions; and

-to have in force a methodology which eventually responds to the needs of the fiscal authority for recognizing tax deductibility.

I know that it is impossible to have a methodology that addresses equally the above mentioned needs.

The odds are rather against us if we scrutinize the degree of convergence of internationally accepted standards in the field of provisioning.

It is amazing how much effort has been dedicated to predict the need for capital buffer covering unexpected losses while very little work has been committed for creating a framework capable to design protection against expected losses.

At the European Union level it is acknowledged that once IFRS are applicable the level of provisions are sharply declining – trend that worries supervisory authorities. In fact at the European Union it has been reached the lowest level of provisions. Of course not only the IFRS application is responsible for it – there is a mix of factors out of which at least one has great impact on the matter under discussion: the business cycle. This leads to the so debated issue of introducing dynamic provisioning as a more viable alternative to "one point in time" provisioning principle.

If for European countries this is maybe something to think about, for Romania in the current stage this is only an unattainable dream. We haven't experienced a whole business cycle and the lack of statistical data makes the search in this field impossible.

European Commission has planned to touch in the future the area of provisioning.

Until then we try to identify the best answers to the above mentioned issues by examining, with the help of today's speakers the current best practices applicable in the area.

Last but not least, I would like to take this opportunity to thank all of our guests for being here to share with us their experience. With this little comment I'll stop here just to begin the real work.

Thank you once again.

Minutes

I. Presentations

The workshop was structured into two parts. The first part outlined the supervisory experience with aligning prudential regulations on provisioning to IFRS and Basel II requirements and included presentations regarding the Spanish (*Mr. Javier de la Cruz, Independent Advisor, former Bank of Spain regulator and supervisor*) and Italian (*Mr. Luca Giannini, Senior IFRS Expert, Italian Banking Association*) experience on the matter. The second part outlined the industry solutions for implementing IFRS and Basel II standards and included presentations from Deloitte, Bearing Point, KPMG, and Algorithmics.

Part I – Supervisory experience with aligning prudential regulations on provisioning to IFRS and Basel II requirements

1. Different approaches for credit risk control and loan loss provisioning. The Spanish experience (*Mr. Javier de la Cruz, Independent Advisor (former Bank of Spain supervisor and regulator)*

The presentation outlined a general perspective on credit risk and what are the main types of prudential tools for preventing and mitigating credit risk (specific provisions – achieving an ex post estimation, generic provisions – embedded in capital, and statistical provisions – providing and ex ante estimation).

The presentation outlined how accounting and supervisory approaches are evolving and converging on an international basis in a parallel way, although there is still a clear need for mutual understanding, on an international basis and under modern risk control and management frameworks.

The presentation offered a detailed explanation of the Spanish approach to regulating loan loss provisions, which has evolved over time. At present, after IFRS implementation, the regulator imposes two set of provisions: specific provisions (based on individual and collective analysis) and generic provisions (cumulating the old “generic” provisions and the old “statistical” provisions).

For the calculation of the generic provisions, the Spanish regulation provides two options. The first option allows banks to calculate themselves the provisions based on their own experience of default and their own expectations of losses from similar categories of credit risk. The second option is the “standard” (“default”) method, which is applicable to those banks whose models fail to comply with the requirements of the supervisor or are unable to develop their own models.

2. The Italian experience with implementing IFRS and Basel II regulations (*Mr. Luca Giannini, Senior IAS Expert, Italian Banking Association)*

The presentation outlined the IAS/IFRS and Basel II general context, stressing their different objectives and approaches. Likewise, the presentation showed the specific Italian Banking Association activities and preparations pertaining to the implementation of the two standards, in line with the general guidance offered by the authorities.

The presentation outlined that the main drivers for IFRS adoption were: the technical forms of the accounts of banks and companies in the financial sector, the limits to the earnings distribution, the income taxes based on reported accounting profit also for companies applying IAS/IFRS, and the principle of neutrality.

Italian banks apply IAS 39/IFRS at individual bank level. The supervisory rules are drawn from Basel II provisions. Banks disclose in the notes to the financial statements the methodology used for loan loss provisioning under IFRS, and the extent to which it differs from Basel II rules (Bank of Italy applies "prudential" filters to IFRS based accounts).

The presentation outlined that in the implementation of the IFRS, the starting point should be the accounting data determined using the IAS/IFRS, on solo and consolidated level. Then, a bank should be able to fulfill all the obligation related to the supervisory rules (COREP and FINREP) using the accounting data corrected using the prudential filter set out by the supervisory authority on the basis of the work done at CEBS. Finally, the accounting data should be the basis for the computation of the taxable income.

Part II – Industry solutions for implementing IFRS and Basel II standards

3. Impairment and provisioning under IFRS. Methodology and solution implementation - practical experience (*Mr. Adam Kołaczyk, Director, Deloitte, Poland and Ms. Natalia Cierna, Deloitte, Romania)*

Deloitte made a comprehensive presentation of the impairment methodology and the experience from implementation projects. Apart from meeting reporting requirements relating to IFRS introduction, implementing provisioning according to IAS 39 and IAS 37 will result in convergence of provisioning methodology with the approach used in credit risk management and Basel 2 (e.g. use of PD, LGD, recovery rates, EAD), better collateral management and a more accurate estimation of loan provisions.

The presentation outlined the IAS provisioning terminology and the major topics of the approach: a) individual versus portfolio assessment, b) client segmentation into homogeneous credit risk groups, c) impairment identification, d) provisions' calculation (estimating cash flows from payments made by debtor and collateral realizations and calculate provision and discounting using effective interest rate and finally e) recognition of interest income on impaired loans, so called „impairment interest".

Deloitte has also made a presentation of its own methodology and IT streams for impairment projects. In this regard, the methodology stream includes an analysis of currently used methodologies for provisioning in view of IFRS requirements, a verification of data availability, an advice on developing impairment IFRS compliant methodologies. The IT stream entails the implementation of the Impairment Tool and the support for internal or external development, implementation and acceptance tests.

Deloitte has also outlined the Polish experience in developing the National Bank of Poland impairment recommendations. In this regard, the Polish Banking Supervision Commission has supported the setting up of a public-private working group aimed at developing recommendations that would present the best practices in implementing impairment requirements under IFRS. This experience represents a useful benchmark for the public-private Romanian working group dealing with the redesign of the provisioning regulations.

4. Loan Impairment according to IFRS - Solution approaches (*Mr. Alexander Beck, Manager, Bearing Point, Germany)*

The presentation outlined that when compared with local GAAPs, IFRS impairment rules have enhanced requirements for calculation methods, posting rules and reporting. Therefore, banks have to cope with additional issues such are the determination of the optimal strategy for the segmentation of the loan portfolio, general guidelines for estimation of future cash flows, preparation of required data, documentation of the calculation parameters and implementation of the new processes within the organization.

The presentation showed that an essential influence on the solution approach and the expected effort is determined by the selected Basel II methodology. In this regard, impairment according to IFRS applies the incurred loss method where Basel II operates with the expected loss method. A translation between these two methods and thereby a use of Basel II parameters is given by using the LIP-factor (loss identification period).

The presentation also showed that the implementation of the appropriate impairment application depends on the existing IT-architecture and the IT-strategy. In this regard, while the implementation of a standard impairment application causes at least redundant data, the enhancement of existing systems reduces complexity but needs a flexible data structure and architecture.

Likewise, the presentation outlined that an integrated risk solution facilitates the use of common data for impairment and Basel II business requirements. At the same time, the implementation of an impairment application requires the management of additional business data (effective interest rates, triggering events, future expected cash flows, calculation results and documentation for auditors).

5. Loan Impairment Modeling According to IAS 39 by Using Basel II Parameters
(Ms. Angela Manolache, Manager, KPMG, Romania)

The presentation by KPMG started by outlining the differences between the Basel II and IFRS approaches with the aim of answering the question whether banks can use Basel II models for the purpose of performing their provisioning calculations. In this regard, while both Basel II and IFRS use the concept of credit loss, there are differences in the purposes of the two methodologies, the loss-related definitions, and the methods used.

The presentation has outlined how historical loss experience can be used for both capital and provision calculations. Likewise, the presentation showed the coverage of the Basel II "expected" and "unexpected" losses versus the IFRS "incurred" losses. The presentation indicated how each of the determinants of the expected loss are estimated depending on the approach endorsed by banks (standardized, IRB foundation, IRB advanced).

Although Basel II default criteria are different from IAS, they could be used as minimum trigger events for IFRS purposes. The advantage of this approach is that many banks have started to develop credit loss databases based on these criteria. In addition, as IAS demands banks to demands banks to provision against impaired loans, those loans would automatically fulfill the Basel criteria.

In order to take advantage of the synergies between the IFRS and Basel II, the presentation proposes that a) a Basel II and IFRS convergence assessment is performed; b) a reconciliation is being made between the Basel II and IFRS definitions and methodologies; c) a unified risk reporting strategy and format is set up and d) data requirements are synchronized.

6. Industry-wide credit data solutions for Basel II implementation (*Mr. Andrew Fishman, Managing Director, Algorithmics, UK)*

The presentation by Algorithmics outlined the issues and the solutions for the practical implementation of Basel II requirements and the issues pertaining to the setting up of industry databases for loss given default (LGD) and mortgage loan servicing. In this regard, the presentation showed the Algo Capital solution and its products for credit risk management in view of Basel II implementation.

The presentation also outlined the data consortium challenges in collecting, normalizing and aggregating data from many different institutions. The inter-bank data pooling, although logistically complex, is the market best practice approach to creation of empirical data sets required to estimate Basel II components.

A solution for data consortiums must meet the following key requirements: established standards (definitions, terminology, data models and methodologies), proven technology (automated data validation, submission and load tools with complete audit trail) and has to be managed by banks (entailing program planning and logistics, member consultation, industry expertise and leading credit risk practitioners).

The inter-bank data pooling has the advantage of being the most reliable, accurate and cost effective way to create the empirical data sets required to estimate Basel II risk components. Algorithmics has proven experience in setting up data consortiums for LGD and mortgage loan servicing databases.

II. Conclusions

Participants have appreciated the presentations made at the workshop as being very relevant for the implementation of the IFRS and Basel II standards. The participants addressed questions aimed at clarifying the methodologies for calculating the provisions in line with IFRS and Basel II implementation. Likewise, the project working group members have clarified with the speakers some issues pertaining to the design of the new regulations for loan loss provisioning.

The workshop was followed by project working group meetings held on April 12 and 13, 2007, at the National Bank of Romania, with the participation of the project technical anchor (Mr. Javier de la Cruz), the project technical anchor (Mr. Luca Giannini) and the representatives of Deloitte and KPMG.

List of Participants

Alpha Bank
Mariana Bara
Cristian Hodarnau
Antonela Rozolimo

Bancpost
Cristian Chetran
Dan Marian
Mihai Stoica
Florin Stroe

BLOM BANK EGYPT SAE Sucursala Romania
Emilia Craciun
Cornelia Erceanu

Banca Comerciala Romana
Marilena Eparu
Popescu Niculina
Dana Zachi

Banca C.R. Firenze Romania SA
Nicoleta Butoi
Daniela Stanciu

Banca Italo Romena SpA Italia – Treviso
Gabriel Ispas
Luminita Vlad

Banca Romana pentru Dezvoltare - GSG
Tudor Bors
Gelu Gherghescu

Banca Romaneasca
Lidia Stan
Marius Zamfirescu

Banca Transilvania
Gabriela Radut

Carpatica
Amalia Iorga

CEC
Eugenia Stan

Citibank Romania
Duras Frantescu
Mihai Prisecaru

Egnatia Bank
Simona Bolovan

Finansbank
Ovidiu Bordeut

HVB TIRIAC
Andrei Faust
Iulian Zaharia

HVB Locuinte
Alexandru Ciubotariu

Leumi Bank
Alin Alupei

Librabank
Doina Andrei
Svetlana David

Millennium Bank Romania
Sorin Serban

Piraeus Bank
Maria Anton
Ioana Ionita

ProCreditBank
Ovidiu Dan
Horatiu Duteanu

Raiffeisen Banca pentru Locuinte
Carmen Cosar

Romanian International Bank
Nitu Alin
Iliescu Radu

SanPaolo Imi
Adela Ivanescu

Volksbank
Daniel Dumitraciuc
Sanda Ghinea
Sorin Teodoriu

National Bank of Romania
Arpad Andrassy
Sandu Anton
Oana Balanescu
Viorica Buchidau
Alexandrina Ciobanu
Florin Dananau
Veronica Danu
Catalin Davidescu
Mirela Dima
Gabriela Dobre
Florina Duta
M. Filiomon
Nicolae Grigore
Mihaela Hughelegiu
Maria Iliciu
Dana Ilie
Irina Lupa
Iuliana Marinescu
Oana Mesea
Maranciu Paula
George Popescu
Veronica Raducanescu
Cristian Ştefan
Valentina Vlad

Ministry of Public Finance
Teodora Grigori
Marilena Gughea
Georgeta Toma

AML Office
Alexandru Codescu

Romanian Banking Institute
Emil Dinga
Marian Dobrila
Ion Mihalteanu
Petru Rares

Romanian Banking Association
Stefan Dina
Radu Negrea

Speakers, special guests and organizers
Alfonso Asaro, Deloitte
Alexander Beck, Bearing Point
Natalia Cierna, Deloitte
Javier de la Cruz, Independent Advisor
Andrew Fishman, Algorithmics
Luca Giannini, Italian Banking Association
Adam Kolaczyk, Deloitte
Angela Manolache, KPMG
George Mucibabici, Deloitte
Bart Piron, Algorithmics
Herwig Rauch, Bearing Point
Roland Schoebel, Bearing Point
Alexander Sirotin, Algorithmics

Organizers:
Oana Nedelescu, Special Projects Initiative
Ramona Bratu, Special Projects Initiative

SPI Committee Secretariat:
Ms. Oana Nedelescu, SPI Committee Secretary and SPI Director of Analytics and Policy
Ms. Ramona Bratu, SPI Director of Bank Products and Services
Tel: 021- 323.66.10
oana.nedelescu@convergence-see.eu ramona.bratu@convergence-see.eu