Convergence Romania Financial Sector Modernization

Special Projects Initiative Public-Private Steering Committee

SPI Project SPI Project on Loan loss provisioning in view of IFRS application
Project Working Group Meeting
April 12th, 2007
10:00– 17:00
National Bank of Romania

Participants:

Project Management Group
Veronica Raducanescu, Director, Regulation and Licensing Department, National Bank of Romania, Project Owner (PO) and Hosting Chairperson
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Project Working Group
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SPI Project Technical Anchor
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Other Participants
Angela Manolache, KPMG
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Irina Lupa, National Bank of Romania
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SPI Secretariat (Oana Nedelescu, SPI Director for Analytics and Policy)

MINUTES

I. Follow up discussions on the workshop on the International Experience with Provisioning in View of IFRS and Basel II Implementation

The project working group appreciated that the presentations made at the workshop on the International Experience with Provisioning in View of IFRS and Basel II Implementation had a great relevance for its activities and improved its understanding of the international experience on the matter.

Following the workshop, the project working group members clarified the outstanding issues with the speakers present at the meeting, as follows:

Experience of Slovakia
In Slovakia, IFRS are applied at individual banks level. Likewise, the IFRS based provisions are also used for supervisory purposes, thus banks keeping one set of books. The models used by banks in applying the IAS 39 are reviewed by auditors, but supervisors can also have a say.

Experience of Italy
Similarly, 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, and the extent to which it differs from Basel II rules (Bank of Italy applies "prudential" filters to IFRS based accounts).

Experience of Spain
Spain has developed a unique approach in regulating loan loss provisions. While in the early 80's the regulation was prescribing only the set up of "specific provisions" taking into consideration objective events (time) and subjective events (financial condition), this approach has evolved over time.

In the late 80's, taking advantage of a period of high profits of banks, the regulator imposed a new category of "generic provisions" to offer a buffer for possible extreme losses. These provisions were calculated as stocks. In the late 90's, in order to have a more accurate evaluation of the credit risk, the regulator prescribed a new category of "statistical" provisions, determined based on historical experience and credit risk internal models, aimed at acting as well as cyclical stabilizers. These provisions are calculated as flows.

At present, after the adaptation to IFRS, 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).

The specific provisions are calculated by applying designated percentages per asset type and time elapsed since maturity to the amount of loans (adjusted for collateral and guarantees). The coefficients for the specific provisions have been determined based on the positive and negative information available at the Central Credit Register (CCR), which cover more than twenty years and allows the calculation of PDs.

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. One of the preconditions stated for the application of this approach is the availability of information to cover a whole economic cycle.

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. This method divides the credit portfolio into six categories, based on their risk. According to the standard method, the provisions calculated by banks may be higher than those that would result from internal models, providing thus an incentive for banks to develop their own internal models.

The Spanish experience shows that priorities have to be set to strike a balance and address the challenges that arise around the credit risk control and management modernisation processes.

II. Outlining a possible approach for the new regulations

The project technical anchor stressed that it is important that the regulator sets the priority, i.e. whether the amendment of the prudential regulations will target only an alignment to the IFRS principles or will entail a comprehensive revamping of the prudential principles in order to ensure an adequate coverage of risks.

The NBR's view is that the ***IFRS-based provisions, which cover only for the incurred losses, are not satisfactory from a prudential point of view***. Therefore, the NBR would like to design a regulation that, similarly to the Spanish experience, would require banks to calculate provisions that would embed:

a) specific provisions (IFRS based and therefore covering for incurred loss) and
b) statistical/dynamic provisions (to cover for expected losses and estimated on the basis of statistical analysis of similar portfolios).

This approach will eliminate the double reporting of provisions by banks as it will be in line with the IFRS standards and will also satisfy the supervisor that banks have adequate safeguards for covering incurred <u>and</u> expected losses.

This approach will face some challenges, as follows:

a) its implementation heavily relies on data availability for both banks and regulator (i.e. the NBR outlined that it has information only for the upturn side of the economic cycle). In this regard, the technical anchor suggested that the NBR could design a simplified form of the statistical provisions, based on sound and prudent judgement and the best estimations that can be made;
b) while the non-accrual principle is not accepted under IFRS, NBR may still need to set out prudential filters for allowing the application of the non-accrual accounting in special cases (i.e. for "bad" sales, etc.). The technical anchor outlined that the Spanish regulation has special derogatory provisions for such cases, approach that could be also considered by the NBR;
c) banks may encounter some difficulties in applying the IFRS in full as major changes have to be brought to their IT systems for computing effective interest rates for individual loans (currently applied on a linear basis);
d) enable the application of the credit risk mitigation practices under Basel II for collateral in the case of provisions.

III. Further steps

The project working group agreed that, given the complexity of the task of designing a set of principles for the new regulation in line with the approach outlined above, it would be necessary to split the task into the six following major themes:

I. Specific provisions

I.1. establishing the general methodology
I.2. performing individual assessment of loans
I.3. performing collective assessment of loans

* to be developed by the NBR accounting experts, banks' representatives and reviewed by the peer reviewer

II. Statistical/dynamic provisions

II.1. developing a simplified (standardized) approach for banks whose models are not going to be approved by the NBR or who are not going to have internal models
II.2. decide on the output needed
II.3. decide on how to gather the data

* to be developed by the NBR prudential and financial stability experts, under close supervision of the technical anchor

III. Collateral

III.1. establish considerations on the eligibility - how to make applicable Basel II credit risk mitigation practices for collateral
III.2. establishing considerations for the part of the collateral that can be taken into consideration

* to be developed by the NBR prudential and accounting experts plus Big Four experts

IV. Non-accrual basis considerations

IV.1. establish a prudential filter regarding accrual of doubtful assets

* to be developed by NBR prudential and accounting experts, under close supervision of the technical anchor

V. Accounting issues

V.1. decide on the accounting treatment of the "extra" provisions
V.2. decide on a generic rule to avoid artificial transactions having real effects in terms of provisions

* to be developed by NBR prudential and accounting experts and reviewed by the peer reviewer

VI. Tax issues

VI.1. decide on the tax treatment of the provisions calculating according to the new methodology

* to be developed by MOPF and NBR experts.

Also, the project working group decided that:

a) The first five issues will be treated in parallel. The issue of taxation will be raised with MOPF once the prudential regime has been defined;
b) The NBR will involve banks in reviewing work-in-progress as deemed necessary;
c) The NBR aims at drafting the set of principles for the new regulations by end of June, which should allow it to issue the new regulation by the end of 2007;

d) The project will be undertaken under the general guidance of the project technical anchor and reviewed, whenever necessary, by the peer reviewer.

IV. Next project working group meeting

The next project working group meeting will be held on April 13, 2007, with the participation of the technical anchor.