World Council

September 12, 2018

<u>Sent via Email</u>

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Co-operative Development Division
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Re: International Financial Standard 9 and Credit Union Regulatory Capital

Dear Commissioner McKenna:

World Council of Credit Unions (World Council) appreciates the opportunity to provide the Co-operative Development Division with World Council's official position on the implementation of International Financial Reporting Standard 9 (IFRS 9) and the Basel Committee on Banking Supervision's transitional regulatory capital add-back for the new loan loss reserves established by the IFRS 9 expected credit loss accounting standard. World Council is the leading trade association and development organization for the international credit union movement. Worldwide, there are over 60,000 credit unions in 109 countries with USD 1.8 trillion in total assets serving 223 million physical person members.[1]

World Council's official position concerning IFRS 9 is that credit unions systems should <u>not</u> be required to adopt IFRS 9 at this time unless the applicable credit union regulatory capital rulebook has itself been adapted to implement IFRS 9 in a proportional manner that does not increase overall credit union capital requirements. World Council has worked extensively with the Co-operative Credit Union League of Trinidad and Tobago this year to help credit unions in Trinidad and Tobago prepare for IFRS 9 implementation. World Council fully endorses the League's work as consistent with our official position, including that:

(1) Credit unions following IFRS 9 should be able to use the IFRS 9 standard's "practical expedient," which has been endorsed by the International Credit Union Regulators' Network (ICURN) and allows credit unions and other entities to omit the use of rate of discount when calculating the value of loans;[2] and

(2) The Basel Committee on Banking Supervision's transitional IFRS 9 capital add-

[1] World Council of Credit Unions, *2016 Statistical Report* (2017), *available at* http://www.woccu.org/publications/statreport.

[2] International Accounting Standards Board, *IFRS 9: Financial Instruments*, ¶ B5.5.35 (July 2014) ("An entity may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph 5.5.17."), *available at* http://www.ifrs.org/current-projects/iasb-projects/financial-instruments-a-replacement-of-ias-39-financial-instruments-recognitio/Pages/Financial-Instruments-Replacement-of-IAS-39.aspx.

back international standard should be implemented in Trinidad and Tobago in order to allow credit unions and banks to phase in IFRS 9 in over up to 5 years while the Basel Committee and other international standard setting bodies further adjust regulatory capital rules to harmonize them with the expected credit loss approach taken by IFRS 9.[3]

As a threshold matter, IFRS 9 is an accounting standard that is independent from regulatory capital rules per se. The Basel Committee on Banking Supervision is the main standard setting body for international regulatory capital rules whereas the International Accounting Standards Board is the main standard setting body for international accounting rules. Supervisory agencies establish regulatory capital standards by rule or guidance and, while regulatory capital rules often incorporate International Financial Regulatory Standards, some regulatory capital items that do not qualify as equity on an accounting basis, such as reserves that are not allocated to specific losses and subordinated debt, are typically included in regulatory capital.[4]

World Council strongly urges the Co-operative Development Division, if it chooses to implement IFRS 9 for credit unions at this time, also to implement the Basel Committee's transitional IFRS 9 regulatory capital add-back as well. Implementing the IFRS 9 practical expedient and the Basel Committee's transitional IFRS 9 capital add-back are necessary to ensure a proportional implementation of IFRS 9 for credit unions in Trinidad and Tobago that does not impose unreasonable compliance burdens.

Implementing the IFRS 9 practical expedient and the Basel Committee's transitional IFRS 9 capital add-back will also promote safety and soundness by avoiding the appearance of a decapitalization of the credit union system on paper—which could reduce public confidence in credit unions and potentially precipitate runs—even though no new losses will have occurred as an economic manner because of IFRS 9 implementation. World Council strongly urges the Co-operative Development Division to implement the IFRS 9 practical expedient and the Basel Committee's transitional IFRS 9 capital add-back so that credit unions' accounting positions accurately reflect the credit unions' true economic strength in a manner consistent with IFRS 9 and Basel Committee international standards.

1. ***Credit Unions in Trinidad and Tobago Should Use the IFRS 9 Practical Expedient Endorsed by the International Accounting Standards Board and the International Credit Union Regulators' Network***

World Council's white paper *IFRS 9 Loan Loss Accounting for Cooperative Financial Institutions* (Dec. 2016),[5] which is included in this letter as Annex A, below, sets forth the details of World Council's official position concerning how to credit unions and their

[3] Basel Committee on Banking Supervision, *Regulatory treatment of accounting provisions – interim approach and transitional arrangements* (Mar. 2017), *available at* https://www.bis.org/bcbs/publ/d401.pdf.
[4] *See, e.g.*, Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems*, ¶¶ 57-61 ("Tier 2 Capital"), *available at* https://www.bis.org/publ/bcbs189.pdf.
[5] World Council of Credit Unions, *IFRS 9 Loan Loss Accounting for Cooperative Financial Institutions* (Dec. 2016), *available at* https://www.woccu.org/documents/WOCCU_-_IFRS_9_for_Coop_Financial_Institutions_Dec_2016.

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supervisors should implement IFRS 9 in a proportional manner utilizing the IFRS 9 practical expedient. The practical expedient allows credit unions and other users of the standard to omit rate of discount in their IFRS 9 calculations, which greatly reduced the compliance burdens associated with calculating IFRS 9 loan loss reserves.[6]

In addition to World Council, the International Credit Union Regulators' Network (ICURN) has also endorsed and advocated for credit unions to use the IFRS 9 practical expedient in their loan loss calculations. A copy of ICURN's letter to the International Accounting Standards Board endorsing using the IFRS 9 practical expedient for credit unions is included with the email transmitting this letter and is also available online.[7] According to ICURN:

> "To accommodate the resource constraints faced by smaller institutions, such as credit unions and other financial cooperatives, the proposed [IFRS 9] standard could be modified to include additional practical expedients that satisfy the intended measurement objective. This should include providing prudential regulators and national accounting authorities with flexibility regarding small and medium financial institution expected credit loss accounting such as:
>
> - "Not requiring the discounting of expected future cash flows at the credit-adjusted effective interest rate, in order to reduce the standard's compliance burden on smaller institutions.
> - "Permitting a long transitional period for phase-in of the new standard pursuant to IFRS 9 so that credit unions and other financial cooperative organizations have sufficient time to build up additional loan loss reserves and adjust their back office systems in anticipation of the new standard.
> - "Permitting the use of alternative forward-looking loan loss provision methods set by regulatory authorities, such as is currently the practice with credit unions in the United Kingdom and other jurisdictions."[8]

The International Accounting Standards Board adopted ICURN's recommendation to allow credit unions and other financial cooperatives to utilize the IFRS 9 practical expedient,[9] which are explained in greater detail in World Council's *IFRS 9 Loan Loss Accounting for Cooperative Financial Institutions* include in Annex A of this letter, below.

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[6] International Accounting Standards Board, *IFRS 9: Financial Instruments*, ¶ B5.5.35 (July 2014) ("An entity may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph 5.5.17."), *available at* http://www.ifrs.org/current-projects/iasb-projects/financial-instruments-a-replacement-of-ias-39-financial-instruments-recognitio/Pages/Financial-Instruments-Replacement-of-IAS-39.aspx.

[7] Letter of Andy Poprawa, Chairman, & Martin Stewart, Vice Chairman, International Credit Union Regulators' Network, to the International Accounting Standards Board, *Financial Instruments: Expected Credit Losses* Exposure Draft (ED/2013/3) (July 5, 2013), *available at* http://eifrs.ifrs.org/eifrs/comment_letters/20/20_2032_AndyPoprawaInternationalCreditUnionRegulatorsNetwork_0_ICURNIASBCommentonExpectedCreditLossED.pdf.

[8] *Id.*

[9] *See* International Accounting Standards Board, *IFRS 9: Financial Instruments*, ¶ B5.5.35 (July 2014) ("An entity may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph 5.5.17."), *available at* http://www.ifrs.org/current-projects/iasb-projects/financial-instruments-a-replacement-of-ias-39-financial-instruments-recognitio/Pages/Financial-Instruments-Replacement-of-IAS-39.aspx

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We urge the Co-operative Development Division to help Trinidad and Tobago credit unions implement IFRS 9 in the proportional manner authorized by the International Accounting Standards Board that is also endorsed by ICURN and World Council whereby credit unions can utilize the IFRS 9 practical expedient to limit unreasonable compliance burdens.

2. ***Credit Unions in Trinidad and Tobago Should Use the Basel Committee on Banking Supervision's "Interim Approach and Transitional Arrangements" IFRS 9 Capital Add-Back Standard***

World Council strongly urges the Co-operative Development Division to implement the Basel Committee on Banking Supervision's March 2017 standard *Regulatory treatment of accounting provisions – interim approach and transitional arrangements*[10] regulatory capital rules, which allows banks and credit unions to add back to their regulatory capital the new loan loss reserves required by IFRS 9, in order to achieve a proportional implementation of IFRS 9.

As you may know, IFRS 9 differs significantly from its predecessor, IAS 39, by requiring credit unions and banks to reserve for expected credit losses under IFRS 9 whereas IAS 39 only required credit unions to reserve for incurred losses, i.e. those that had already occurred as an economic manner. The Basel Committee's transitional IFRS 9 capital add-back standard allows credit unions and banks to add back the new IFRS 9 "Phase 1/Bucket 1" and "Phase 2/Bucket 2" reserves to their regulatory capital ratios as an interim measure, with this transitional capital item being amortized over a period of up to 5 years. "Phase 3/Bucket 3" reserves—which are equivalent to IAS 39 incurred loan loss reserves—are not included in the add-back.

In other words, all that occurs with IFRS 9 implementation is that funds are moved from the credit union's general reserve (i.e. retained earnings) and expensed to its loan loss reserve. While IFRS 9 places these (formerly) retained earnings into a different type of accounting reserve, the total reserves of the credit union are not changed by IFRS 9. Instead, the credit union's general reserve is decreased, and institution's loan loss reserve is increased by a corresponding amount that is not allocated to any incurred loss. Since IFRS 9 merely shifts general reserves to loan loss reserves that are not allocated to incurred losses, the credit unions or bank has just as much economic capital to absorb losses after IFRS 9 implementation as it was before IFRS 9, despite the increased (but unallocated) loan loss reserves required by IFRS 9.

The Basel Committee established its IFRS 9 transitional capital add-back standard—which allows credit unions and banks to add back their new "Phase 1/Bucket 1" and "Phase 2/Bucket 2" IFRS 9 reserves to their regulatory capital—in order to keep the phase-in of IFRS 9 from having a negative capital impact on banks and credit unions on paper. Such paper losses from IFRS 9 would not be justified by the underlying economic positions of the banks and credit unions because phase-in of IFRS 9 does not change the underlying economics of the institution or its total economic capital available to absorb losses. Rather, IFRS 9 simply transfers some of the credit union's or bank's general reserve to the part of its loan loss reserve that is not allocated to any incurred loss.

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[10] Basel Committee on Banking Supervision, *Regulatory treatment of accounting provisions – interim approach and transitional arrangements* (Mar. 2017), *available at* https://www.bis.org/bcbs/publ/d401.pdf.

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The Basel Committee issued its transitional IFRS 9 capital add-back standard to respond to directives from the Group of 20 (G20) Leaders to solve this problem of IFRS 9 not aligning with pre-IFRS 9 regulatory capital rules issued by the Basel Committee and other regulatory agencies, including credit union supervisors. The G20 Leaders' Communique from the September 2016 G20 Hangzhou Summit instructed the Basel Committee to implement Basel III in conjunction with IFRS 9 "without further significantly increasing overall capital requirements across the banking sector . . . ."[11] The G20 Leaders' Statement at the G20 Hamburg Summit in July 2017 reaffirmed the requirement for the Basel Committee's post-IFRS 9 international capital standards to be finalized "without further significantly increasing overall capital requirements across the banking sector . . . ."[12]

In response, the Basel Committee on Banking Supervision in March 2017 issued its *Regulatory treatment of accounting provisions – interim approach and transitional arrangements*[13] that allows banks and credit unions to add back to their regulatory capital the new loan loss reserves required by IFRS 9 for up to five years.

In practice, this means that the credit union would add back 100% of the new "Phase 1/Bucket 1" and "Phase 2/Bucket 2" loan loss provisions required by IFRS 9 to its regulatory capital in Year 1, and this transitional capital item would be amortized on a straight-line basis over five years (i.e. 80% of this transitional IFRS 9 capital item would count as regulatory capital in Year 2, 60% of this transitional IFRS 9 capital item would count as regulatory capital in Year 3, and so forth until the transitional capital item is fully amortized after five years). The Basel Committee has also issued a consultative discussion paper on how further to adjust their regulatory capital rules in the long-term so that the full phase-in of IFRS 9 does not result in significantly increased capital standards for credit unions or banks.[14]

The Bank for International Settlements' Financial Stability Institute in July 2018 also endorsed the Basel Committee's transitional capital add-back and the need for further revisions to credit unions and bank regulatory capital rules in the future so that IFRS 9 does not increase overall capital requirements for credit unions and banks.[15] According to the Financial Stability Institute:

> "There is a possibility that the impact of [Expected Credit Loss] ECL accounting [e.g., IFRS 9] might be significantly higher than under the incurred loss accounting frameworks, leading to an unexpected decline in capital ratios. Due to these

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[11] Group of 20 (G20) Leaders, *Hangzhou Summit G20 Leaders' Communique*, at ¶ 18 (Sep. 4-5, 2016), *available at* https://www.g20.org/profiles/g20/modules/custom/g20_beverly/img/timeline/China/2016-09-04-g20-comunique-en.pdf.

[12] Group of 20 (G20) Leaders, *Hamburg Summit G20 Leaders' Declaration: Shaping an Interconnected World*, at ¶ 18 (July 7-8, 2017), *available at* https://www.g20.org/profiles/g20/modules/custom/g20_beverly/img/timeline/Germany/2017-g20-hamburg-action-plan-en.pdf.

[13] Basel Committee on Banking Supervision, *Regulatory treatment of accounting provisions – interim approach and transitional arrangements* (Mar. 2017), *available at* https://www.bis.org/bcbs/publ/d401.pdf.

[14] *See* Basel Committee on Banking Supervision, *Regulatory treatment of accounting provisions – Discussion Paper* (Oct. 2016), *available at* http://www.bis.org/bcbs/publ/d385.htm.

[15] *See* Financial Stability Institute*, Accounting provisions and capital requirements - Executive Summary* (July 2018), *available at* https://www.bis.org/fsi/fsisummaries/acprov.htm

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> uncertainties, jurisdictions may choose to introduce a transitional arrangement to mitigate the impact of ECL accounting on regulatory capital. The transitional arrangements should only apply to new provisions arising from changes to the ECL accounting methods and not to provisions that existed prior to the implementation of ECL accounting. The transition period can be no longer than five years."[16]

While the timeline for finalization of the long-term solution to integrating IFRS 9 into regulatory capital rules is not clear, it is certain that the Basel Committee is planning to lower its regulatory capital requirements so that, post-IFRS 9, banks and credit unions are not required to hold more economic capital than they did prior to IFRS 9.

In the meantime, the Basel Committee's March 2017 *Regulatory treatment of accounting provisions – interim approach and transitional arrangements* capital add-back is a final standard that should be implemented for Trinidad and Tobago credit unions in order to limit the compliance burden of IFRS 9 consistently with international standards.

Conclusion: Proportional Application of IFRS 9 for Credit unions Necessitates the IFRS 9 Practical Expedient and the Basel Committee's Transitional IFRS 9 Capital Add-Back

World Council's official position concerning IFRS 9 is that credit unions systems should not be required to adopt IFRS 9 at this time unless the applicable credit union regulatory capital rulebook has itself been adapted to implement IFRS 9 in a proportional manner with:

> (1) Credit unions using the IFRS 9 standard's "practical expedient," which is part of the IFRS 9 standard itself and has been endorsed by the International Credit Union Regulators' Network; and
>
> (2) Credit unions utilizing the Basel Committee on Banking Supervision's transitional IFRS 9 capital add-back international standard.

World Council does not believe that it would be possible to achieve a proportional implementation of IFRS 9 for credit unions in Trinidad and Tobago or in most other jurisdictions without the use of the: (1) IFRS 9 practical expedient; and the (2) Basel Committee's transitional IFRS 9 capital add-back. If it is not possible to implement the IFRS 9 practical expedient and the Basel Committee's transitional IFRS 9 capital add-back at this time, World Council believes that implementation of IFRS 9 for Trinidad and Tobago credit unions should be postponed indefinitely.

We do not, however, believe that such a delay is necessary if the IFRS 9 practical expedient and the Basel Committee's transitional IFRS 9 capital add-back are implemented in Trinidad and Tobago. World Council has worked extensively with the Co-operative Credit Union League of Trinidad and Tobago to help credit unions in Trinidad and Tobago prepare for IFRS 9 implementation in a proportional manner.

World Council fully endorses the League's work in this area as consistent with IFRS 9 itself as well as with Basel Committee standards on IFRS 9 implementation, the two most recent G20 Leaders' communiques, the position of the Bank for International Settlement's Financial

[16] *Id.*

Stability Institute's position on IFRS 9 implementation, and World Council's official positions on IFRS 9 and credit union regulatory capital.

World Council strongly urges Co-operative Development Division to implement the IFRS 9 practical expedient and the Basel Committee's transitional IFRS 9 capital add-back so that credit unions' accounting positions accurately reflect the credit unions' true economic strength in a manner consistent with IFRS 9 and the Basel Committee's international standard.

Trinidad and Tobago credit unions utilizing the IFRS 9 practical expedient and the Basel Committee's transitional IFRS 9 capital add-back will also help promote safety and soundness by ensuring continued, justified public confidence in credit unions. Credit unions in Trinidad and Tobago will be just as strong economically after IFRS 9 implementation as they are currently. The credit unions' post-IFRS 9 regulatory capital ratios should reflect the Trinidad and Tobago credit unions system's unaltered economic strength.

World Council appreciates the opportunity to provide the Co-operative Development Division with World Council's official position on the implementation of IFRS 9 and the Basel Committee on Banking Supervision's transitional regulatory capital add-back for the new loan loss reserves established by the IFRS 9 expected credit loss accounting standard. If you have questions about our comments, please feel free to contact me at medwards@woccu.org or +1-215-668-5240.

Sincerely,

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ANNEX A

IFRS 9 Loan Loss Accounting for Cooperative Financial Institutions

Updated December 2016

The International Accounting Standards Board's International Financial Reporting Standard (IFRS) 9 *Financial Instruments* sets the international accounting standard applicable to impaired financial assets, including loans made by cooperative financial institutions—such as credit unions, cooperative banks, savings and loan cooperatives, caisses populaires, etc.—to their members. IFRS 9 is scheduled to take effect starting January 1, 2018. Early phase-in of IFRS 9 is also permitted.

IFRS 9 is an "expected loss" methodology, and will replace the currently applicable "incurred loss" IAS 39 *Financial Instruments: Recognition and Measurement* standard. Expected credit loss methodologies seek to estimate lifetime credit losses that are likely to occur, whereas incurred loss methodologies focus on what credit losses have occurred already. Expected credit loss methodologies create larger loan loss reserves because they include estimates of future losses that have not yet been incurred as an economic matter.

IFRS 9 uses what is frequently called the "Three Bucket Approach" where the institution's loan book is reserved for using three phases of credit deterioration:

1. **Bucket 1:** For loans without signs of credit impairment, i.e. loans never in arrears ≥30 days. Bucket 1 recognizes expected losses within the next 12 months.
2. **Bucket 2:** For loans that have signs of credit impairment—i.e. the loan has been in arrears for ≥30 days at least once (even if later cured)—but have not met the criteria for Bucket 3. Bucket 2 recognizes lifetime expected losses.
3. **Bucket 3:** For loans with serious credit impairment as well as large exposures with a history of arrearage. Bucket 3 recognizes lifetime expected losses.

This guide provides a mathematical representation of IFRS 9's application to Allowance for Loan Loss (ALL) accounting in the context of a non-complex cooperative financial institution. In Buckets 1 and 2, loans of a similar purpose and collateral—such as unsecured signature loans to consumers, credit cards, new or used auto loans, residential mortgages, business loans, and so forth—are grouped into "Sub-Buckets" and reserved for collectively. In Bucket 3, each problem loan and its collateral are assessed individually. Institutions using the IFRS 9 standard would establish as many Sub-Buckets (or assessments of individual loans) as necessary within each Bucket to represent accurately the types of loans it holds.

IFRS 9 also allows institutions to use a practical expedient and omit discounting the value of future cash flows to determine their present value.[17] Omitting rate of discount (i.e. the time value of money) significantly reduces IFRS 9 calculations' compliance burdens.

[17] International Accounting Standards Board, *IFRS 9: Financial Instruments*, ¶ B5.5.35 (July 2014) ("An entity may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph 5.5.17."), *available at* http://www.ifrs.org/current-projects/iasb-projects/financial-instruments-a-replacement-of-ias-39-financial-instruments-recognitio/Pages/Financial-Instruments-Replacement-of-IAS-39.aspx

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If you have questions about this guide, please contact VP & General Counsel Michael Edwards at medwards@woccu.org or +1.202.508.6755.

Bucket 1—for loans without signs of credit impairment, i.e. loans never in arrears ≥30 days:

As noted above, Bucket 1 loans are broken into particular Sub-buckets based on collateral type and loan purpose (e.g., unsecured closed-end consumer credit, unsecured open-end consumer credit, residential real estate mortgages, chattel mortgages such as new or used auto loans, business loans, etc.) and a collective reserve amount is determined on a Sub-bucket-wide basis.

Bucket 1 uses a 12-month lookout period for expected losses, which is calculated by multiplying: (a) the percentage chance of a loan going from fully-performing to written-off within the next 12 months, by (b) the expected lifetime losses on similar loans, also expressed as a percentage. This means multiplying a fraction by a fraction.

IFRS 9 has a rebuttable presumption that a loan in arrears for 30 days or more has experienced credit deterioration.[18] Unless this presumption is rebutted, loans in Bucket 1 that are in arrears by ≥30 days are moved to: (i) Bucket 2 or (ii) to Bucket 3 if the loan is one of the institution's largest exposures (such as, for example, any of its 10 largest loans and/or loans with a face value greater than 5% of the institution's total unimpaired regulatory capital). Once moved out of Bucket 1, the loan can never return to Bucket 1 even if the arrearage is cured.

An institution's Bucket 1 ALL reserve can be represented by the following equation:

$$R_1 = \sum_{j=1}^{n} d_j\,(e_j(B_j))$$

Where:

R_1 = reserve amount for Bucket 1 in the current reporting period.
d_j = % of loans in Sub-bucket "j" of Bucket 1 expected to be subject to write-off within 365 days of the reporting date, based on historical losses.
e_j = % expected lifetime loss on loans in Sub-bucket "j" of Bucket 1.
B_j = total face value of loans in Sub-bucket "j" of Bucket 1.

[18] *Id.* at ¶¶ 5.5.11, B5.5.19-B5.5.21.

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Bucket 2—Loans with Signs of Credit Impairment But Have Not Met the Criteria for Bucket 3:

In Bucket 2, loans are broken into particular Sub-buckets based on collateral type and loan purpose (e.g., unsecured open-end consumer credit, real estate mortgages, new or used auto loans, business loans, etc.) and a collective reserve amount is determined on a Sub-bucket-wide basis.

An institution's Bucket 2 ALL reserve can be represented by the following equation:

$$R_2 = \sum_{h=1}^{n} e_h(B_h)$$

Where:

R_2 = reserve for Bucket 2 in the current reporting period
e_h = % expected lifetime loss on loans in Sub-bucket "h" of Bucket 2
B_h = total face value of loans in Sub-bucket "h" of Bucket 2

IFRS 9 does not address specific time limits for moving a loan from Bucket 2 to Bucket 3 per se; rather, IFRS 9 requires a loan be moved to Bucket 3 once it becomes seriously impaired. All available material information about the borrower's creditworthiness should be considered, including the number of days the loan has been in arrears.

IFRS 9 does include a rebuttable presumption of "default" after 90 days in arrears,[19] and the Basel Committee on Banking Supervision proposed in April 2016 to set a limit of a maximum 90 days in arrears before a loan is considered "non-performing."[20]

In the IFRS 9 framework, if the Basel Committee's proposed approach to "non-performing" loans is finalized, this would mean that the maximum number of days of arrearage before it is mandatory to move loan from Bucket 2 to Bucket 3 is:

- When the loan is in arrears by ≥90 days.

A loan from Bucket 2 that is moved to Bucket 3 can return to Bucket 2 if it is cured.

[19] *Id.* at ¶ B5.5.37.
[20] Basel Committee on Banking Supervision, *Prudential treatment of problem assets – definitions of non-performing exposures and forbearance – Consultative Document* (2016), *available at* http://www.bis.org/bcbs/publ/d367.pdf.

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Bucket 3—Loans with Serious Credit Impairment and Impaired Large Exposures:

Bucket 3 is for any loan that becomes seriously impaired, such as in the case of long-term arrearage, as well as for the institution's largest exposures that are in arrears. Each problem loan in Bucket 3 is analyzed individually.

The value of any collateral should also be assessed on a case-by-case basis, as well as the legal and practical aspects of safekeeping, repossession, or foreclosure.

While the IFRS 9 standard does not address the details of how an institution should determine its large exposures per se, a reasonable approach would be for an institution to place a loan in arrears in Bucket 3 if that loan is one of the institution's largest loans overall and/or if the loan amount represents a face value of more than a specified percentage of the institution's total regulatory capital.

For this guide, as explained above, the illustrative parameters selected based on similar regulatory standards now in existence are the institution's 10 largest loans (if they are in arrears more than 30 days) as well as any loan in arrears with a face value that is more than 5% of the institution's regulatory capital.

If a loan in Bucket 3 has its arrearage cured, it can return to Bucket 2 unless it is a large exposure. Large exposures with a history of credit impairment remain in Bucket 3 even if the arrearage is cured.

An institution's Bucket 3 ALL reserve can be represented by the following equation:

$$R_3 = \sum_{k=1}^{n} e_k(B_k)$$

Where:

R_3 = reserve for Bucket 3 in the current reporting period
e_k = % expected lifetime loss on loans Loan "k" of Bucket 3
B_k = total face value of Loan "k" of Bucket 3

Any loan that is seriously impaired or is an impaired large exposure should be included in Bucket 3.

As noted above, cooperative financial institution regulators typically establish guidance setting a maximum number of days in arrears after which it is mandatory to adjust the treatment of the loan for accounting purposes.

The criteria for Bucket 3 inclusion based on the Basel Committee's proposed definition of "non-

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performing exposure”[21] and the “rebuttable presumptions” of IFRS 9[22] would be:

I. Loans that are ≥90 days in arrears (unless later cured); and

II. Any loan in arrears ≥30 days if it is one of the institution’s largest 10 loans and/or the loan is ≥5% of the institution’s total unimpaired regulatory capital (these loans stay in Bucket 3 even if cured).

<u>Establishing Expected Loss Percentages:</u>

The reserve equations, above, anticipate the institution calculating expected lifetime loss percentages on its loans based on historical losses as well as potentially other factors such as any macroeconomic events that would be likely to have a material effect on the repayment of the loans in question.

IFRS 9 does not address how an institution should make these calculations per se. Many institutions assess their likely expected losses based on a weighted analysis of their historical losses expressed as a percentage of written-off loans’ face values for a particular loan’s purpose/collateral type with a similar level of arrearage over the previous 12 months, 2 years, or 3 years.

As noted earlier, IFRS 9 allows a practical expedient whereby institutions are not required to factor in rate of discount into these calculations.[23] The below weighted-average loss equations are intended to be illustrations of possible approaches to a 12-month approach, a 2-year weighted historical approach. and a 3-year weighted historical approach.

<u>a. 12-Month Approach:</u>

$e_x = L_0$

Where:

e_x = the expected loss percentage for a particular Sub-bucket loan type in Buckets 1 or 2, or to inform the expected recovery on an individual loan in Bucket 3.
L_0 = losses as a percentage of face value incurred on similar loans over the previous 12 months.

[21] *See id.*
[22] International Accounting Standards Board, *IFRS 9: Financial Instruments*, ¶¶ 5.5.11, B5.5.19-B5.5.21, B5.5.37 (July 2014).
[23] *Id.* at ¶ B5.5.35 (“An entity may use practical expedients when measuring expected credit losses if they are consistent with the principles in paragraph 5.5.17.”).

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b. 2-Year Weighted Average Approach:

$e_x = (2L_0 + L_1)/3$

Where:

e_x = the expected loss percentage for a particular Sub-bucket loan type in Buckets 1 or 2, or to inform the expected recovery on an individual loan in Bucket 3.
L_0 = losses as a percentage of face value incurred on similar loans over the previous 12 months.
L_1 = losses as a percentage of face value incurred on similar loans 12-24 months ago.

c. 3-Year Weighted Average Approach:

$e_x = (3L_0 + 2L_1 + L_2)/6$

Where:

e_x = the expected loss percentage for a particular Sub-bucket loan type in Buckets 1 or 2, or to inform the expected recovery on an individual loan in Bucket 3.
L_0 = losses as a percentage of face value incurred on similar loans over the previous 12 months.
L_1 = losses as a percentage of face value incurred on similar loans 12-24 months ago.
L_2 = losses as a percentage of face value incurred on similar loans 25-36 months ago.

d Calculating Bucket 1's 12-Month Lookout for Loans Without Credit Problems

The above 12 month approach as well as the 2-year and 3-year weighted-average historical loss data equations can also be used to establish the percentage for Bucket 1's 12-month expected loss lookout factor (i.e. factor "d_j" in the Bucket 1 reserve equation, above).

The 12-month lookout factor is Bucket 1's percentage chance for loans without credit problems going from fully performing to fully written-off within the next 12 months.

This factor is typically a low figure since only loans without a history of significant arrearage are included in Bucket 1.

ALL Reserve Equation:

$ALL_1 = R_1 + R_2 + R_3$

Where:

R_1 = reserve amount for Bucket 1 for the current reporting period
R_2 = reserve amount for Bucket 2 for the current reporting period
R_3 = reserve amount for Bucket 3 for the current reporting period
ALL_1 = ALL for the current reporting period

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Loan Loss Expense (Gain) Equation:

Loan Loss Expense(Gain) = $ALL_1 - ALL_0$

Where:

ALL_1 = ALL for the current reporting period
ALL_0 = ALL for the prior reporting period

Definition of "Write-Off":

IFRS 9 does not specify the timing of a loan write-off per se. Rather, the standard bases the timing of write-off on the likelihood of recovery on the loan, i.e. that a loan should be written off as soon as possible once collection efforts have been exhausted and no further recovery is likely. Loan losses resulting from write-offs are satisfied out of the ALL.

Cooperative financial institution regulators typically establish a maximum number of days in arrearage after which write-off is mandatory.

The following, based on an analysis of regulators' write-off requirements under IAS 39, should be considered an illustrative example of the types of maximum periods of arrearage after which a cooperative financial institution regulator would likely require a loan to be written off under IFRS 9:

i. Maximum 365 days in arrears for loans that are fully secured;

ii. Maximum 180 days in arrears for loans that are not fully secured; and

iii. In the case of loans guaranteed by the full faith and credit of a sovereign government, write-off should occur in connection with the definition of "default" upon which the guarantee becomes payable to the institution (these loans are not included in Bucket 1, Bucket 2, or Bucket 3 unless a full recovery becomes questionable based on the creditworthiness of the sovereign guarantee and/or other material information, in which case they are classified in Bucket 2 or 3 based on how long they have been in arrears and whether or not the loan is fully secured).

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