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**TO: ALL AUTHORISED DEPOSIT-TAKING INSTITUTIONS**

**PROVISIONS FOR REGULATORY PURPOSES AND AASB 9 FINANCIAL INSTRUMENTS**

All Authorised Deposit-taking Institutions (ADIs) are required to apply *AASB 9 Financial Instruments* (AASB 9) for annual reporting periods beginning on or after 1 January 2018. Under this accounting standard, the move to an expected credit loss impairment approach for loans and other exposures represents an area of significant change.

The Basel Committee on Banking Supervision (BCBS) has recently finalised an interim provisioning approach[1] which retains the current regulatory treatment of accounting Expected Credit Loss (ECL) provisions. This letter sets out APRA's expectations around the regulatory treatment of AASB 9 ECL provisions, and possible transition arrangements. The interim approach set out below applies until further notice.

*Regulatory treatment of accounting provisions*

The regulatory concepts of General Provisions (GP)[2] and Specific Provisions (SP) are important elements in linking the capital and accounting frameworks. Recognising this, the BCBS has recommended regulatory authorities provide guidance, as appropriate, on how they intend to categorise ECL provisions as GP or SP in their jurisdiction.

When applying the *Prudential Standard APS 220 Credit Quality* (APS 220) requirements (paragraphs 39, 42, 43, 46 - 49) APRA expects ADIs to adopt the following approach to the three AASB 9 provisioning stages:

- **Stage 1 (representing 12 months ECL provisions on performing loans)**: allocate to General Reserve for Credit Losses (GRCL) if held against future, presently unidentified losses and therefore freely available to meet losses that subsequently materialise.

- **Stage 2 (representing lifetime ECL provisions on under-performing loans)**: considered SP for regulatory purposes. However, any portion that represents an amount for future, presently unidentified losses would qualify as GRCL.

- **Stage 3 (representing lifetime ECL provisions on non-performing loans)**: considered SP for regulatory purposes.

The GRCL amount that may be included in Tier 2 Capital, gross of tax effects, under *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111) (paragraph 32) remains unchanged. The Attachment includes further details on APRA's expectations.

[1] BCBS paper "Regulatory treatment of accounting provisions - interim approach and transitional arrangements", 29 March 2017: https://www.bis.org/bcbs/publ/d401.htm

[2] In Australia, General Provisions refers to the General Reserve for Credit Losses (GRCL) as defined in APS 220.

*Transition*

APRA already has adopted a GRCL concept in APS 220 that reflects a lifetime ECL concept within its prudential framework. APRA's informal consultation has indicated regulated entities will not need transitional arrangements. However, if entities consider their capital position will be significantly affected, they should approach APRA for discussion on possible transition arrangements.

APRA intends to update APS 220 in due course to reflect the appropriate treatment of provisions under AASB 9.

If you have any questions, please contact your responsible supervisor.

Yours sincerely

Pat Brennan
Executive General Manager
Policy and Advice Division

## ATTACHMENT

## APRA'S PRUDENTIAL EXPECTATIONS FOR REGULATORY PROVISIONS UNDER AASB 9

APRA intends to retain the existing GRCL concept for ECL provisions for an interim period. Accordingly, APRA considers that the categorisation of AASB 9 provisions for regulatory purposes should be as follows:

**ECL accounting provisions for exposures may be treated as GRCL for regulatory purposes provided an ADI can satisfactorily demonstrate that:**

**a) the provision amount is a purely forward looking amount for future, presently unidentified losses, set aside in consideration only of the consequences of potential events or scenarios that could lead to identified losses in the future; and**

**b) there is no evidence the provision relates to the identified deterioration of particular assets or covers exposures on which any impairment or default (individually or collectively) has materialised into identified losses.**

**Accounting provisions for exposures not meeting both of the preceding criteria should be treated as specific provisions for regulatory purposes.**

*Rationale for this approach*

The AASB 9 financial asset, and the associated impairment charge, on initial recognition incorporates the creditworthiness of the counterparty at inception (through the pricing of credit). It follows that a post-origination increase in credit risk may not be fully compensated by the interest rate charged. ADIs should therefore carefully consider whether there has been a significant increase in credit risk. If so, the lending exposure would be subject to lifetime ECL impairment.[3]

A true economic loss arises when ECLs exceed initial expectations (i.e. when the lender is not receiving compensation for the level of credit risk to which it is now exposed). Recognising lifetime ECL after a significant increase in credit risk better reflects that economic loss in the financial statements.

When there is a significant increase in credit risk, the loans would generally fall into Stage 2 or Stage 3 under AASB 9. The provisions associated with such loans should be treated as SP for regulatory purposes unless they meet conditions (a) and (b) above.

Loans associated with an identified (or true economic) loss are credit-impaired and hence the corresponding provisions should not form part of GRCL.

Purchased or originated credit-impaired financial assets would normally fall into Stage 2 under AASB 9. Such loans should be treated as SP under this approach.

*Other matters*

APRA expects that an ADI would be able to satisfactorily demonstrate that an ECL accounting provision meets criteria (a) and (b) above to be classified as part of GRCL. Hence, an ADI should establish and appropriately document its adherence to a well-developed framework for distinguishing between the GRCL and SP subsets of its accounting ECL provisions and

[3] Refer to the BCBS document "Guidance on Credit Risk and Accounting for Expected Credit Losses", December 2015, paragraph A14 available at http://www.bis.org/bcbs/publ/d350.htm

explaining why provisions designated as GRCL should not be treated as SP. The ADI's determinations would be subject to APRA's review and evaluation.

The BCBS has also issued guidance on accounting for ECL.[4] The BCBS guidance complements AASB 9, and emphasises the timely recognition of provisions. APRA expects ADIs to follow this guidance, which will be reflected in the prudential framework in due course.

Certain aspects relating to provisioning, such as the prudential definition of problem assets and the capital treatment of accounting provisions, are evolving internationally. Consequently, APRA intends to update the existing prudential requirements in APS 220 and the regulatory data collections relating to credit quality once these initiatives are further progressed. APRA has also commenced a broader review of APS 220 to update and streamline concepts and guidance. This process will likely extend beyond 1 January 2018, the commencement date for AASB 9.

[4] BCBS document "Guidance on Credit Risk and Accounting for Expected Credit Losses", December 2015.