BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

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Dear CEO

Implementation of IFRS 9 Financial Instruments

I am writing to the CEOs of the larger UK credit institutions to set out the PRA's expectations as regards the implementation of International Financial Reporting Standard 9's (IFRS 9's) expected credit loss accounting (ECL) requirements and the approach we will follow in the light of those expectations. The letter follows the brief discussion of this matter that we had at our meeting on 17 October. I will be writing on the same subject to a wider population of credit institutions in early December.

Firms are required by the PRA's Threshold Conditions to be fit and proper and to have adequate financial resources.[1] Although it is not our role to set, interpret or enforce accounting standards, where the application of those accounting standards has an impact on our statutory objectives (for example, on our assessment of 'fit and proper' or our regulatory capital regime) we have an interest in how they are implemented.

The PRA considers the effective implementation of ECL to be important in ensuring the safety and soundness of PRA-authorised firms, so we will continue to work with firms to share concerns, facilitate cross-industry solutions and promote high quality implementation. As discussed at our recent meeting, we are currently focussing on the level of consistency in the resulting ECL accounting numbers and on the quality, complexity and proportionality of ECL implementation. In accordance with our Fundamental Rules and as with our other interactions with firms, we expect firms to engage with us openly and cooperatively as they implement this major accounting change.

Firms' ability to implement IFRS 9 appropriately will be part of our supervisory assessments of firms but, in keeping with our overall approach to supervision, we will take a proportionate approach and use transitional arrangements where appropriate. Our approach for 2017 to ICAAPs and the concurrent stress test (CST) is an illustration of that. On proportionality for example, although the objective is a demonstrably unbiased estimate of ECL, we recognise that proportionate approaches can be applied to smaller portfolios and to bigger portfolios in territories where the data or expertise availability makes more sophisticated approaches to ECL either not realistic or likely to result in lower quality outcomes.

Consistency of implementation and disclosures about inconsistency

It is of fundamental importance to our regulatory capital regime that banks and building societies with similar types and levels of resources, liabilities and risk exposures have broadly similar regulatory capital positions. Where there is a risk that this might not be the case, we take action to mitigate that risk.

[1] The full Threshold Conditions Order can be found at www.legislation.gov.uk/uksi/2013/555/article/2/made.

We know from our monitoring of firms' ECL implementation plans that there are differences in the way firms are planning to adopt ECL and many of those differences are unrelated to the underlying risks. This means that firms that are similar could have significantly different accounting numbers—and therefore significantly different regulatory capital positions. The PRA and firms we supervise have a shared interest in addressing this 'outcome inconsistency' so that it does not undermine the regulatory capital regime or investors' confidence in your statutory financial statements.

In our view, there needs to be more focus on achieving greater consistency more quickly than currently seems likely to be the case. In addition, firms need to provide public disclosures and regulatory data that enable market participants and the PRA to work with the ECL numbers. The PRA expects your firm to work proactively and constructively with other firms to achieve these objectives, and to accept that this may involve your firm incurring some additional cost.

To assist the industry in this work, the PRA intends to participate actively. We will facilitate discussion within the industry and with auditors and will provide insights based on our ability to see across the sector. We will expect to see real progress being made quickly towards greater consistency and we will want to see an appropriately focused set of disclosures. However, we do not intend to tell firms how to implement IFRS 9; the preparation of financial statements that provide a true and fair view of profit or loss and of financial position must and will remain the responsibility of firms.

- We envisage that, as a first step, the PRA will hold a roundtable meeting as soon as possible to discuss how best to proceed. At the meeting the PRA will suggest identifying separately issues to be addressed before implementation and issues to be addressed post-2018, and that prioritisation will be needed within those broad categories. The PRA will make some initial suggestions as to categories and priority but this is a joint effort so better suggestions that command greater support will be welcomed.

- The PRA's expectation is that priority should be given to changes that make a significant difference to outcome consistency or to the ability of market participants and others to understand and work with existing inconsistency. We would like to discuss with you and other firms the possibility of developing a benchmarking tool that could be used to help focus the work on achieving greater consistency of outcomes and might possibly be of use in developing appropriate financial statement note disclosures.

- We envisage that as a result of that first meeting there will be an agreed programme of work, showing what is to be achieved by when. If consistency has already been achieved on an issue by the time we focus on it, we will regard the issue as having been addressed as long as the quality of implementation has not been compromised to achieve that greater consistency.

The disclosures and regulatory data will be needed for the first year of implementation. However, firms' plans for ECL implementation are well advanced and we do not want to put the timetable for and quality of that implementation at risk. For that reason, although we hope that material progress can be made on consistency prior to 2018, we recognise that greater consistency will be achieved through work after 1 January 2018. We expect firms to make the resources and budgets available for several years after 2018 to enable such work to continue.

<u>Complexity</u>

Implementing ECL well does not necessarily mean having to choose the most complex approach. We encourage firms to weigh the benefits of adopting approaches that are more complex than are necessary to comply with IFRS 9 and meet regulatory expectations against the risk that additional complexity will make it difficult to put effective governance and controls in place and will result in numbers that will prove difficult to understand.

<u>Impact data</u>

In October the BCBS issued a consultative document that considers the possibility of transitional arrangements being put in place to phase in the impact of ECL on Common Equity Tier 1 capital resources. The European Commission has since published a proposal to amend the Capital Requirements Regulation text that includes such transitional arrangements. We are concerned that the EU legislative timetable means that a final decision on whether to introduce transitional arrangements might need to be taken before useful data on the impact of ECL is available. We therefore ask you to consider ways of developing better impact assessments early in 2017 so that they can be used to inform the decision on whether to implement the proposed transitional arrangements.

Capital planning and stress testing

We have already held a number of useful discussions on ECL with firms participating in the CST and supervisors will be communicating guidance to firms shortly for the 2017 CST. We plan to include an ECL information-gathering exercise in addition to the 2017 CST to explore how ECL models might behave under stress given the different design choices institutions have made. Before the end of the year, we plan to publish guidance for all firms that apply IFRS on incorporating ECL in their Internal Capital Adequacy Assessment Process stress testing and capital planning for 2017 and to provide additional guidance to firms in scope of structural reform.

These approaches aim to recognise that firms will be implementing ECL processes and practices during 2017 and that the quality of information will improve with time, while reinforcing the need for firms and the PRA to be prepared for the estimated impact of ECL on capital resources from 1 January 2018. On that last point, we are encouraging firms to be prudent and not factor possible transitional arrangements into their capital estimates while such arrangements remain under negotiation.

If you have any questions concerning this letter, please contact either me or your supervision team.

Yours sincerely

Sam Woods
Deputy Governor and CEO, Prudential Regulation Authority