



Please note: This letter has been prepared for the website and text in square brackets shows where it may differ slightly from versions prepared for different types of PRA-regulated firm.

Sam Woods
Deputy Governor, Prudential Regulation
CEO, Prudential Regulation Authority

[25 September 2017]

Dear CEO

TRANSITIONAL ARRANGEMENTS FOR CAPITAL IMPACT OF IFRS 9 EXPECTED CREDIT LOSS ACCOUNTING

As you are probably aware, the Basel Committee and European legislative bodies have examined the case for transitional arrangements to be applied to the impact of IFRS 9 expected credit loss accounting on credit institutions' regulatory capital. It is likely that the Capital Requirements Regulation (CRR) will be amended to establish such arrangements in the European Union. Based on the currently extant draft legislative texts for amending the CRR, it appears probable that the use of these arrangements will be at the option of the individual firm.

Against that background, the purpose of this letter is to: summarise the rationale for transitional arrangements; outline the main features of the transitional arrangements which have been considered within Europe thus far; set out the PRA's views on UK firms using the arrangements; note the tight timeframes within which UK firms will probably need to make a final decision; and request a response by [date] on whether your firm intends to use the transitional arrangements.

Rationale for transitional arrangements

The Basel Committee has identified two main reasons why transitional arrangements may be appropriate. Expected credit loss (ECL) provisioning will be sensitive to expectations of future economic conditions. If, following transition to IFRS 9, firms give significant weight to adverse economic scenarios, there could be unanticipated large increases in provisions. Second, ECL provisioning is a completely 'new' technology. How it works in practice, including its volatility, pro-cyclicality and effect on banks' behaviours, can be gauged only in the light of experience.

European proposals

The European Commission published a proposal to amend the CRR to establish IFRS 9-related transitional arrangements in November 2016, and around mid-2017 the European Council and European Parliament adopted their draft legislative texts. A final amendment to the CRR is expected to emerge following dialogue between Council, Parliament and Commission in the autumn.

The draft texts share a number of features. They envisage a five year transition period. During that time, specified percentages of 'new' provisions due to adoption of IFRS 9 are added back to CET1 capital. 'New' provisions include those arising at the point of transition to IFRS 9 and also – broadly speaking – 'new' provisions which are raised subsequently (though the Council text stipulates capital relief for post-transition new provisions only if they exceed a specified threshold). The add-back percentages under consideration start as high as 90 – 100% in 2018, falling to 20 – 25% in 2022, the final year of the transition period.

The PRA's views

Provided that the final CRR amendment establishes transitional arrangements broadly similar to those currently being considered, the PRA encourages UK firms to use them from the first day of IFRS 9 application (1 January 2018 for December year-end firms). The PRA supports the following arguments in favour of transitional arrangements:

- i. ECL provisioning introduced by IFRS 9 is completely new, and there is currently little insight into how sensitive ECL will be to changes in economic conditions.

- ii. It is therefore possible that in the early years of use of IFRS 9 the impact of ECL provisioning on banks' capital ratios will be significantly more volatile than currently anticipated – in normal times and in the context of actual stress / stress testing.
- iii. If this were to be the case, transitional arrangements would provide time for firms and the PRA to consider through the capital planning process how to maintain sufficient resilience during, and at the end of, the transition period.

Subject to the need for sufficient resilience at the end of the transitional period, the PRA's intention is that all aspects of supervision of a firm using the transitional arrangements would be carried out using 'transitional' data on capital resources and not 'fully loaded' figures. In particular, since stress tests should reflect how stress would be experienced in reality, such tests will fully take account of transitional arrangements.

The PRA is aware that the Council text includes a 'one time' option for a firm to opt into transitional arrangements subsequent to the adoption of IFRS 9. This option may not appear in the final CRR amendment. If it does, the PRA is unlikely to give credit in stress testing for a management action of subsequent adoption of IFRS 9 transitional arrangements. It is improbable that the market would be content with a firm adopting transitional arrangements only when they really needed the benefit to their capital position.

I should stress that there is no question of IFRS 9 transitional arrangements leading to relevant information being obscured from the market, because, under the proposals, firms will be required to disclose fully-loaded numbers. The EBA is consulting on Guidelines for the appropriate disclosures, based on prior work by the BCBS.¹

The PRA notes that there is no cost to firms in using the transitional arrangements, apart from performing the calculations. It is not anticipated that supervisory consent will be required to use the arrangements: rather, firms should inform their supervisor of their final decision as to whether they will use the arrangements.


Timeline

The final amendment to the CRR may not become available until end 2017. The PRA advises firms to arrange for their boards to be in a position, if necessary, to make a final decision on the use of transitional arrangements in a compressed timescale across the year-end.

Follow up

Given this issue, and based on the current state of play in European discussions, please submit to your supervisor by [date] a statement of whether your firm plans to use the IFRS 9 transitional arrangements. Should your firm plan not to do so, please include a full explanation of how your firm's board has satisfied itself that the firm will have adequate financial resources, including in stressed scenarios. Your supervisor would discuss such an explanation with you in the context of supervision of your firm's resilience and capital adequacy.

Yours sincerely



¹ The draft EU Regulation for IFRS 9 transitionals includes a requirement to disclose the effect of the transitionals on own funds and capital and leverage ratios. The EBA published draft Guidelines for this disclosure on 13 July 2017: www.eba.europa.eu/documents/10180/1906197/Consultation+Paper+on+Guidelines+on+disclosure+requirements+on+IFRS+9+transitional+arrangements+%28EBA-CP-2017-11%29.pdf/a870981e-94dd-4538-922a-7045e8d90d03 The Guidelines are aligned to Basel's 'Key Metrics' template, recently updated for this purpose. That template includes disclosure of the main capital figures and ratios, on both a transitional and fully-loaded basis.