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Dear CFO

Transition disclosures for IFRS 9 'Financial Instruments'

In November 2016 and August 2017, Sam Woods wrote to the CEOs of the larger UK-headquartered 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. Both those letters, but particularly the second, referred to the importance of good market disclosure, both on transition to IFRS 9 and at subsequent period-ends.

It is not our role to set, interpret or enforce accounting standards. However, where the application of those accounting standards has an impact on our statutory objectives we have an interest in how the standards are implemented. The ECL requirements in IFRS 9 are fundamental to the financial statements of credit institutions with large (relative to balance sheet) credit portfolios. We regard it as important for our statutory objectives that investors and investment analysts ('market participants') understand the implications for credit institutions of the move from IAS 39's incurred loss provisioning model to ECL.

As a consequence, the second letter explained that the PRA expected the larger UK-headquartered credit institutions to provide good disclosures at the point of transition to IFRS 9. It went on to note that those firms had agreed to work together through UK Finance and with the PRA to develop a list of core disclosures that should as a minimum be provided to the market at the point of transition. Since then the PRA and those firms have been discussing the content of that list of core transition disclosures. The purpose of this letter is to set out the expectations the PRA has as a result of those discussions. Those expectations are set out in the annex.

Thank you for your input through UK Finance to help us develop these expectations.

Yours sincerely

Victoria Saporta
Executive Director, Prudential Policy

cc James Proudman, Executive Director for UK Deposit Takers Supervision, Prudential Regulation Authority
Stephen Jones, Chief Executive Officer, UK Finance

Annex
The PRA's expectations as to the minimum transition disclosures about ECL that will be provided

The objective of transition disclosures

1 The objective of the transition disclosures is to help market participants understand how ECL works, what its implications are, and what the implications are of the choices the firm has made in implementing ECL.

- ECL has implications for, amongst other things, provisioning levels, governance, risk management and potentially regulatory capital (including capital planning)[1]. Transition disclosures that meet the objective set out above cover all those implications.
- ECL's impact on the matters mentioned in the previous bullet will vary depending on where the reporting period is in the credit cycle. Transition disclosures that meet the objective set out above look beyond ECL's transition date impact.
- Transition disclosures provide a bridge from IAS 39 incurred loss to ECL. An important role of the transition disclosures is therefore to help market participants to understand the implications of the differences between the two provisioning models and to understand how concepts familiar to them from the IAS 39 incurred loss world map onto new ECL-related concepts.
- In order to understand the implications of the choices the firm has made in implementing ECL and indeed some of the implications of ECL, the transition disclosures provide sensitivity and measurement uncertainty information.

2 ECL's implications can differ from product to product, meaning that balance sheet-level disclosures can be significantly affected by product mix. Where major products or portfolios are involved, the transition disclosures will draw out the differences.

General comments about the transition disclosures

Scope

3 This letter is addressed to the larger UK-headquartered credit institutions.[2] The expectations it sets out are likely to be of some relevance to other credit institutions, particularly those that manage their investor-base actively but, as the PRA has not discussed transition disclosure with those firms, it is not addressing the expectations to them.

When and where the transition disclosures will be published

4 We understand that at least some firms are planning to publish a separate 'transition disclosure pack' after their 2017 (or 2017/2018) annual report and accounts have been published but before their Q1 statement is issued. The PRA is expressing no view on whether the minimum transition disclosures are all published in the annual report and accounts, all published in a separate transition disclosure pack or some are published in one publication and the rest in the other.

5 The PRA expects a firm to use its best endeavours to publish all the minimum transition disclosures in or by the later of the date on which any separate transition disclosure pack is published and the date on which the Quarter 1 statement is published. If one or more of the disclosures are not published by the later of those two dates, the PRA regards it as very important that the omitted information be disclosed as soon as practicable thereafter and in any event no later than the 2018 (or 2018/2019) annual report and accounts.

[1] The FPC has stated that it will take steps to ensure that the interaction of IFRS 9 accounting with its annual stress test does not result in a de facto increase in capital requirements.

[2] Barclays Bank, HSBC, Lloyds Banking Group, Nationwide Building Society, Royal Bank of Scotland, Santander UK and Standard Chartered Bank. Henceforth referred to in this letter as 'the firms'.

Audit

6 Although we see advantages in the minimum transition disclosures being the subject of some form of external assurance work, we are not setting out any expectations on the matter.

Materiality

7 Materiality is of course an important factor to take into account when preparing transition disclosures. The PRA encourages firms to apply materiality to their transition disclosures in a way that enables market participants to understand the full implications of ECL and judgments and choices made in implementing it regardless of the day one implementation impact.

Consistency

8 We have chosen to describe the expected disclosures in some detail. That is because we attach considerable importance to there being as much consistency as possible from firm-to-firm in the content – and ideally the form - of the transition disclosures. Such consistency helps market participants to familiarise themselves more easily with the implications of ECL. Avoidable differences in content and form are unhelpful.

The content of the minimum transition disclosures

9 A quantitative reconciliation of the closing IAS 39 provision number to the ECL provision as at the effective date of IFRS 9, showing separately the impact of each of the main differences between IAS 39 and ECL provisioning models.

(a) For example, those differences could be grouped together as follows:

- the need to make a 12-month provision against exposures that did not carry a provision under IAS 39 and have not suffered a significant increase in credit risk since origination or acquisition,
- the need to make lifetime provisions against exposures that did not carry a provision under IAS 39 but have suffered a significant increase in credit risk since origination or acquisition,
- the differences in the way an ECL provision and an incurred loss provision are calculated on assets treated as impaired under IAS 39,
- the impact of taking into account multiple economic scenarios; and
- the difference in the scope of ECL provisioning model compared to the incurred loss model.

This is intended only as an illustration of the sort of reconciling items that could be provided. (Firms would for example need to decide how to deal with collective IAS 39 provisions not allocated to individual exposures if the above bullets were to be the reconciling items.) We note the helpful development in this respect of firms agreeing to work together on a set of reconciling items that will focus on the main differences between ECL and incurred loss and to agree on an order for estimating the quantitative impact of those reconciling items.

(b) The reconciliation will be supplemented by explanations of the main reconciling items and from which products and portfolios they mainly arise.

(c) The reconciliation will usually be provided at the balance sheet level but, where the relative size of the reconciling items would be very different for a major product or portfolio, more detail will be provided to help market participants understand the implications of ECL for those products or portfolios.

(d) In exceptional cases it might be difficult for a firm to provide a balance sheet-level reconciliation in the form agreed because it does not have all the data it needs for one or more products or portfolios. Where that is the case, we encourage the firm to consider the possibility of omitting that product or portfolio (or those products or portfolios) from the reconciliation. Firms would need to ensure that they comply with the disclosure requirements of IFRS, but providing a partial reconciliation on a broadly standardised basis (rather than a comprehensive reconciliation on a substantively different basis to other firms) might be the most helpful for market participants overall.

10 Disclosures that enable market participants to understand how key existing impairment concepts are compared to and/or are reflected in the ECL methodology, the ECL estimate and the amounts allocated to each of the three ECL stages.

(a) This will include quantitative mapping disclosures that show how the IAS 39 impairment provision, IAS 39 impaired loans, (where significant) non-performing loans (or something broadly similar like loans that are 30 days past due) and (where significant) forborne loans have been allocated between the three ECL stages.

(b) The reconciliation will usually be provided at the balance sheet level but, where the mapping would be very different for a major product or portfolio, information will be provided to help market participants understand the implications of ECL for those products or portfolios.

11 A description of the main judgments made and their impact on the ECL estimate, the exposure amounts allocated to each of the three ECL stages and the other ECL-related numbers disclosed.

12 Information about measurement uncertainty inherent in the staging and provisioning levels and information about the sensitivity of those levels to changes in credit conditions, and the implications of that measurement uncertainty and sensitivity for regulatory capital. This should include the quantitative disclosures described under the next heading.

13 Information that enables market participants to understand the potential volatility of the ECL estimate, both in terms of the extent of the volatility size and its sources. Quantified disclosures are not expected.

14 Information that enables market participants to understand any implications for the firms' capital position and capital planning of the ECL estimate often being bigger and more volatile than the IAS 39 incurred loss estimate and ECL responding differently (both in terms of cyclicality and procyclicality) to the credit cycle compared to IAS 39 incurred loss.

15 Explanations of any changes to governance and risk management organisation, processes and key functions made as a result of ECL coming into force, including:

(a) an explanation of the link between ECL and credit risk management,

(b) disclosures that enable market participants to navigate between key ECL-related numbers (including ECL estimates and the amounts allocated to each of the 3 ECL-related stages) and the firm's risk metrics.

Quantitative measurement uncertainty and sensitivity disclosures

16 Implementing ECL requires firms to make a series of choices, judgments, assumptions and forecasts (together referred to here as 'subjective elements and inputs'). The staging and provisioning levels are more sensitive to some of those subjective elements and inputs than to others. The focus of any quantitative measurement uncertainty and sensitivity disclosures should be on the subjective elements and inputs that are or could become more fundamental to the staging and provisioning levels ('the key drivers').

17 The PRA believes that from the effective date of IFRS 9 firms should understand the sensitivity of their ECL-related estimates to those key drivers and to do that they need to have quantitative information about that sensitivity available internally. The PRA also believes it is also reasonable for market participants to expect to be put in a position where they too can understand the sensitivity of their ECL-related estimates to those key drivers. This will involve quantitative measurement uncertainty and sensitivity information being provided, not only as part of the normal period-end reporting but also as part of the transition disclosures.

(a) The PRA encourages those firms that are able to provide some useful quantitative sensitivity information as part of their transition disclosures to do so.

(b) The PRA expects all the firms to be providing useful quantitative sensitivity information no later than their 2018 (or 2018/2019) annual reports and accounts.

18 The form of quantitative sensitivity disclosure that is most useful for market participants is still a matter of debate and this will be a key issue for the Taskforce on Disclosures about ECL (DECL Taskforce) to consider. We do not wish to prejudge the Taskforce's discussion. It might nevertheless be useful for firms to think of quantitative sensitivity information in the following way:

(a) Measurement uncertainty and sensitivity to changes in credit conditions are different things so the disclosures should probably acknowledge that and deal with them separately.

(b) To avoid clutter, the disclosure needs to focus on the key drivers. There will generally only be a few of those, but they will often differ from product-to-product and from portfolio to portfolio, so firms will need a robust way of narrowing the focus and avoiding too much detail.

(c) Some of the measurement uncertainty will arise from decisions taken when designing and building the ECL methodology, and some will arise from decisions taken as the methodology is being applied. Some of the decisions taken when designing and building the ECL methodology will be being kept under regular view – so data about their implications might be available on a regular basis – but some will not and it is difficult to estimate the impact of a different design/build decision where that is the case because a methodology incorporating that different decision has not been built so data cannot be generated. It is important that the measurement uncertainty disclosures provided are clear as to which subjective elements and inputs have been considered for inclusion as a key driver and which have not (because there is insufficient data available).