CONSULTATION PAPER

P009 - 2017

12 May 2017

Proposed Amendments to Regulatory Requirements in relation to Credit Loss Provisioning

Monetary Authority of Singapore

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1 Preface

1.1 The Singapore Accounting Standards Council ("ASC") has adopted the International Financial Reporting Standard ("IFRS") 9 *Financial Instruments* and issued the standard as Singapore Financial Reporting Standard ("SFRS") 109 *Financial Instruments*. SFRS 109 will replace SFRS 39 *Financial Instruments: Recognition and Measurement* and will be effective for annual periods beginning on or after 1 January 2018[1]. Banks in Singapore are therefore required to apply SFRS 109, or IFRS 9 for locally-incorporated banks that are listed on the Singapore Exchange, in the preparation of their financial statements for reporting periods beginning on or after 1 January 2018 in accordance with sections 201 or 373 of the Companies Act (Cap. 50).

1.2 SFRS 109 introduces a new approach for the estimation of allowance for credit losses based on the Expected Credit Loss ("ECL") model, which includes more forward-looking information and addresses the issue of delayed recognition of credit losses on loans and other financial instruments under the incurred loss model. As the accounting estimates of allowance for credit losses closely interact with a bank's prudential provisioning and regulatory capital computation, there is a need to review the relevant regulatory requirements.

1.3 MAS is consulting on the proposed amendments to MAS Notices 612, 1005, 637 and 1111 in relation to the changes in the recognition and measurement of allowance for credit losses introduced in IFRS 9 and SFRS 109. The proposals are set out in Section 3 to 5 of this consultation paper.

1.4 Interested parties are invited to provide their views and comments on the proposals in this paper.

Please note that all submissions received will be published and attributed to the respective respondents unless they expressly request MAS not to do so. As such, if respondents would like (i) their whole submission or part of it, or (ii) their identity, or both, to be kept confidential, please expressly state so in the submission to MAS. In addition, MAS reserves the right not to publish any submission received where MAS considers it not in the public interest to do so, such as where the submission appears to be libellous or offensive.

[1] http://www.asc.gov.sg/press_release_11122014

1.6 Please submit written comments by 12 June 2017 to –

Banking Department
Monetary Authority of Singapore
10 Shenton Way, MAS Building
Singapore 079117
Fax: (65) 62203973
Email: MAS612_consultation@mas.gov.sg

1.7 Electronic submission is encouraged. We would appreciate that you use this suggested format (http://www.mas.gov.sg/~/media/MAS/News%20and%20Publications/Consultation%20Papers/P0092017%20Template%20for%20Feedback.docx) for your submission to ease our collation efforts.

2 MAS' Observations and Considerations for the Expected Credit Loss Accounting Model

Overview of the impairment requirements under SFRS 109

2.1 SFRS 109 requires entities to account for expected credit losses when financial assets are first recognised and to recognise full lifetime expected losses if there is significant deterioration in the credit quality of the underlying financial assets. At each reporting date, banks will be required to assess and categorise their financial assets into the three stages as set out in the table below, which reflect the general pattern of credit deterioration of financial assets till their default.

Stage of credit impairment	Characteristics of the financial asset	Time horizon for the measurement of expected credit losses
Stage 1	• No significant deterioration in credit quality since initial recognition; or • Of low credit risk at the reporting date	12 months
Stage 2	• Significant deterioration in credit quality since initial recognition but there is no objective evidence of impairment	Lifetime
Stage 3	• Exposures with objective evidence of impairment at the reporting date	Lifetime

MAS' observations and considerations

2.2 MAS has been engaging various stakeholders such as banks, external auditors and other industry practitioners to understand and assess the impact of the application of the ECL model. Quantitative surveys and questionnaires were conducted to study the estimated financial impact on major banks in Singapore, and more generally, the banking industry's readiness to apply the ECL model for the estimation of allowance for credit losses. The policy proposals on credit provisioning as set out in this consultation paper have taken into account the observations and feedback gathered from these engagements.

2.3 MAS recognises that the ECL model under SFRS 109 is, an improvement to the incurred loss model under SFRS 39 for the early recognition and measurement of impairment loss allowance because:

(i) It requires banks to recognise expected credit losses and to update them at each reporting date to reflect significant changes in the credit quality of the underlying exposures since their initial recognition.

(ii) The ECL model incorporates a larger set of information relevant for identifying credit losses, including for the first time, forward-looking information. This allows the effects of possible future credit loss events to be considered in assessing the level of impairment loss allowance required and represents a key improvement from the current incurred loss model where impairment loss allowance is calibrated based only on objective evidence of the occurrence of specific credit loss events. If implemented properly, the ECL model will address, to some extent, prudential concerns over the timeliness and adequacy of banks' impairment loss allowance.

2.4 On the other hand, the need to incorporate forward-looking information including macroeconomic factors also means that the extent of judgement required in the ECL model is substantially more than that under the incurred loss model. Varying approaches adopted by banks such as the types and range of reasonable and supportable forward-looking information to be used and the number of forward-looking scenarios could affect the comparability of the expected credit losses across banks with similar credit risk exposures[2]. Furthermore, data quality, particularly the availability of the lifetime probability of default as at the date of initial recognition, was the biggest data concern highlighted in a survey of international banks[3]. This could potentially have an impact on the reliability of the estimated expected credit losses, at least for the initial period of implementation.

2.5 As a principles-based standard, SFRS 109 also contains a number of requirements which are subject to interpretation. As an example, banks will have to determine what constitutes a significant increase in credit risk. This is not trivial, while credit loss

[2] In a recent survey conducted by Moody's: *Capital Impact of IFRS 9 Adoption Will Be Modest For Most Banks* (15 March 2017), developing multiple, forward-looking, probability-weighted scenarios was found to be a main implementation challenge cited by banks.

[3] Deloitte's Sixth Global IFRS Banking Survey dated May 2016.

allowance is expected to increase during an economic downturn as a true and fair reflection of the deterioration in borrowers' repayment ability, the movement of exposures from Stage 1 to Stage 2 or Stage 3 could result in unintended cliff effects if significant increases in credit risk are not identified and credit loss allowance not recognised early enough in an economic cycle. Such cliff effects could adversely impact the financial stability of a bank and the industry, especially in an economic downturn when banks' earnings and reserves could already be stressed.

International guidance and practices

2.6 The Basel Committee on Banking Supervision ("BCBS") issued supervisory guidance in December 2015 to address how the ECL model should interact with a bank's overall credit risk management practices[4]. It contains eight principles for banks on robust governance, methodologies, credit risk rating processes, experienced credit judgement and adequacy of allowance, ECL model validation, common data and risk disclosures. The guidance sets out sound credit risk practices associated with the implementation and application of the ECL model, and is intended to complement the applicable accounting standards. MAS expects banks in Singapore to adopt a high quality application of the ECL model consistent with this guidance.

2.7 MAS also recognises the importance of providing users of financial statements with timely, relevant and useful information. The range of possible approaches and judgements when applying the ECL model as mentioned earlier underscore the importance of clear and transparent disclosures in facilitating comparisons between banks, and in maintaining the confidence of external stakeholders in the banks' financial statements. In this regard, in addition to the impairment disclosure requirements under the relevant accounting standard, banks should take into consideration the guidance on public disclosures as set out in Principle 8 of BCBS' supervisory guidance mentioned above. Banks should regularly review their disclosure policies to ensure that the information disclosed is useful and relevant to readers.

[4] This refers to BCBS' "Guidance on Credit Risk and Accounting for Expected Credit Losses" ("GCRAECL") available at www.bis.org/bcbs/publ/d350.htm

3 MAS' Approach

3.1 MAS encourages the use of sound credit risk and provisioning practices by banks and supports a well-thought out and robust implementation of the ECL model which allows timely recognition of credit losses. At the same time, MAS remains cognisant of areas where the ECL model may not fully address prudential concerns, at least in the initial period of implementation. Accordingly, the policy proposals as set out in this section are calibrated to meet MAS' prudential objectives while reducing unnecessary burden on banks, particularly for smaller institutions. Proposed amendments to MAS Notice 612 and MAS Notice 1005 are as follows:

<u>Removal of regulatory requirements on minimum impairment provisions for loans graded "substandard", "doubtful" and "loss"</u>

3.2 Paragraph 6.5.2 of MAS Notice 612 prescribes minimum individual impairment provisions. Specifically, banks that do not meet the requirements set out in paragraphs 6.2.1 to 6.2.6 of the abovementioned Notice shall maintain individual impairment provisions of not less than 10%, 50% and 100% for loans graded "substandard", "doubtful" and "loss", respectively, on the portion not covered by amounts realisable from collateral. Banks need not comply with these minimum provisioning requirements if they have in place a systematic, comprehensive and consistent process to identify on a timely basis, all loans that are impaired, and sound loan loss estimation methodologies that will yield timely and prudent estimates of the amount of loss allowances required for each loan assessed to be impaired.

3.3 The current accounting approach for the estimation of loss allowances for credit impaired exposures is well established under SFRS. Specifically, it is based on discounted cash flows analysis, with loss allowance for a credit impaired exposure being measured as the difference between its carrying amount and the present value of estimated future cash flows[5]. This approach is not expected to differ significantly under the ECL model[6]. Credit exposures in Stage 3 under IFRS 9 are similar to those deemed under IAS 39 to have

[5] Based on requirements under SFRS 39 and SFRS 109.

[6] Based on quantitative surveys performed by MAS as mentioned in paragraph 2.2, banks do not expect the ECLs for credit impaired exposures to be materially different from the individual impairment provisions currently maintained for these exposures.

suffered individual incurred losses i.e. exposures where there is objective evidence of impairment[7].

3.4 The adequacy of a bank's provision for loans and advances are subject to external auditor's review and assessment not only as part of its annual financial statements audit, but also specifically required under MAS Notices 609 for banks and MAS Notice 1002 for merchant banks. Given the considerations above, MAS proposes to remove the regulatory requirements on minimum impairment provisions for credit impaired exposures. Accordingly, the minimum provisioning requirements as set out in paragraph 6.5.2 of MAS Notice 612 and MAS Notice 1005 will be removed, and banks are to recognise loss allowance for credit impaired exposures based on the accounting requirements under SFRS 109.

Question 1.	MAS seeks comments on the proposed removal of regulatory requirements on minimum impairment provisions for credit impaired exposures.

<u>Regulatory requirements on minimum loss allowance for non-credit-impaired exposures</u>

3.5 Under paragraph 6.4.2 of MAS Notice 612 and MAS Notice 1005, a bank or a merchant bank shall maintain collective impairment allowances of not less than 1% of its loans and receivables net of collaterals after deducting individual impairment provisions made, if it does not have a loss estimation process that is sufficiently robust, or sufficient quality historical loan loss data over a full credit cycle, relevant to current circumstances. Hence in practice, banks with sufficiently robust historical loan loss data may maintain provisions based on requirements under the current accounting standard SFRS 39 (which has generally been lower than 1% of loans and receivables), or continue to hold collective impairment provisions of 1% or more on the basis of prudence.

3.6 While the SFRS 109 ECL model represents an improvement to the existing incurred loss model, there remain challenges and uncertainties globally in the implementation and application of the standard. Given the observations and

[7] This is noted by Ernst & Young in its paper on the *Impairment of financial instruments under IFRS 9* (December 2014) and by Grant Thornton in its publication entitled "*Get ready for IFRS 9, The impairment requirements*" (March 2016).

considerations set out in paragraphs 2.4 and 2.5 earlier, MAS considers it prudent to continue to subject domestic systemically important banks ("D-SIBs")[8] to supervisory measures which ensure that a minimum level of loss allowances is maintained to absorb expected credit losses. This is consistent with MAS' existing approach of applying higher supervisory intensity and additional supervisory measures on banks designated as D-SIBs[9]. MAS' proposals are outlined in paragraphs 3.7 and 3.8 below.

Locally-incorporated D-SIBs (including subsidiaries of foreign banks)

3.7 While all banks are required to comply with the impairment recognition, measurement and disclosure requirements of the relevant accounting standards, locally-incorporated D-SIBs will be subject to a minimum level of loss allowances for its non-credit impaired-exposures, of 1% of the exposures[10] net of collaterals ("minimum regulatory loss allowances"). For transparency, notwithstanding the requirement for a minimum regulatory loss allowance, locally-incorporated D-SIBs will be required to make relevant disclosures of its expected credit losses estimation in its financial statements. This will apply even where it is lower than MAS' minimum regulatory loss allowance.

Foreign bank branches and merchant banks

3.8 Foreign bank branches and merchant banks are in varying degrees of readiness in implementing the ECL requirements under SFRS 109. Many are implementing the requirements under the guidance from their head offices while there are a few whose head offices may not be adopting IFRS 9 on 1 January 2018. There are also banks with small and simple operations in Singapore that may not warrant a sophisticated models-based approach and are working towards implementing SFRS 109 in a simplified manner.

3.9 All banks are required to comply with the impairment requirements for the recognition, measurement and disclosure of loss allowance in accordance with the relevant accounting standards. In this regard, MAS is supportive of a proportionate approach towards ECL implementation that would enable banks to adopt sound ECL methodologies commensurate with their size, complexity and risk profile. In addition,

[8] D-SIBs are banks assessed to have a significant impact on the stability of the financial system and proper functioning of the broader economy.

[9] MAS has designated the following banking groups as D-SIBs – (i) DBS Bank; (ii) Overseas-Chinese Banking Corporation; (iii) United Overseas Bank; (iv) Citibank; (v) Malayan Banking Berhad; (vi) Standard Chartered Bank; (vii) The Hongkong and Shanghai Banking Corporation.

[10] Exposures refers to the total of (i) loans and receivables to non-banks customers; and (ii) all other credit exposures, including debt securities held and off-balance sheet exposures as determined by the bank's credit measurement framework and expert judgement.

MAS will permit foreign bank branches and merchant banks maintaining a minimum level of credit loss allowances for non-credit-impaired exposures of 1% of the exposures net of collaterals, if it results in higher loss allowances than the expected credit losses estimated under SFRS 109.

Question 2. MAS seeks comments on the proposal for:

(i) Locally-incorporated D-SIBs to maintain minimum loss allowances for non-credit impaired exposures of 1% of exposures, net of collaterals ("minimum regulatory loss allowances") and to disclose the expected credit losses estimated under SFRS 109 in its financial statements; and

(ii) Foreign bank branches and merchant banks to be permitted to maintain loss allowances of 1% of non-credit-impaired exposures, net of collaterals, if it results in higher loss allowances than the expected credit losses estimated under SFRS 109.

Role of External Auditors of Banks

3.10 MAS expects external auditors of banks to, as part of its audit of the banks' financial statements, assess the adequacy of a banks' provisions for its loans and advances[11]. Depending on the level of complexity, estimation uncertainty and materiality of banks' provisions, this should include a review of the bank's internal controls, including the bank's risk governance, the relevant control processes and information systems, in relation to the measurement, recognition, financial reporting and disclosure related to expected credit losses[12]. MAS may as part of banking supervision, make use of the work performed by external auditors in reviewing a bank's credit risk assessment and credit loss provisioning functions[13].

[11] This should be in line with ISA 540, *Auditing Accounting Estimates, Including Fair value Accounting Estimates and Related Disclosures* under review by the International Auditing and Assurance Standards Board.

[12] These should be in line with ISA 315 (revised), *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*.

[13] The BCBS' guidance on *External audits on banks* (March 2014) includes guidance on supervisory cooperation with external auditors.

Treatment of the minimum regulatory loss allowance

3.11 The requirement to maintain a minimum regulatory loss allowance for non-credit impaired exposures is intended to meet MAS' prudential objectives. There are two alternative approaches towards complying with this requirement, as set out below.

Approach 1 *– Banks to comply with the minimum regulatory loss allowance requirement by establishing a **non-distributable regulatory loss allowance reserves ("RLAR")** through appropriation of retained earnings.*

3.12 Under this approach, when a bank's expected credit losses for non-credit impaired exposures measured in accordance with SFRS 109 is below the 1% minimum regulatory loss allowance, the bank is required to recognise the additional loss allowance[14] by establishing a RLAR on 1 January 2018 (or the first day of the reporting period where a bank in Singapore adopts SFRS 109) via an appropriation of retained earnings. Banks are allowed to transfer its existing excess collective impairment provisions[15] into the RLAR. The additional loss allowance will be measured at each subsequent reporting date and maintained in the RLAR. At times when the expected credit losses under SFRS 109 rises above 1%, the bank can utilise the RLAR and reverse the amount back into its retained earnings. The profit and loss statement of the bank therefore reflects credit loss allowance based on ECL requirements of SFRS 109.

Approach 2 *– Banks to comply with the minimum regulatory loss allowance requirement via its **profit and loss account**.*

3.13 Under this approach, the bank is required to recognise the additional loss allowance through its profit and loss statement. The profit and loss statement of the bank therefore reflects impairment charges based on ECL requirements of SFSR 109 and the effects of compliance with the minimum level of regulatory loss allowance. Under this approach, the bank's total credit loss allowance as presented in its financial statements reflects the loss allowance based on SFRS 109 and regulatory requirement.

[14] Additional loss allowance refers to the amount of the excess of the minimum regulatory loss allowance over the expected credit losses measured under SFRS 109.

[15] These refer to collective impairment provisions held under the current MAS Notice 612 or SFRS 39 accounting standard which are carried over on 1 January 2018, and are in excess of the expected credit losses measured under SFRS 109.

3.14 Both approaches support MAS' prudential objective as banks accumulate a minimum level of provisions at all times, especially in the upturn phase of an economic cycle.

Question 3.	MAS seeks comments on the two alternative approaches that banks may be required to adopt to comply with the minimum regulatory loss allowance. MAS will determine the required approach, taking into consideration the consultation feedback received.

Loss allowances for non-credit-impaired exposures determined and carried at Head Office

3.15 Under Paragraph 6.6.1 of MAS Notice 612 and MAS Notice 1005, in the case of a bank or merchant bank whose head office is incorporated outside Singapore, its collective impairment provisions may be determined and carried at its head office. In such cases, banks are required to submit a semi-annual report to MAS indicating the level of collective impairment provisions maintained at head office to cover the estimated losses inherent in loans booked in Singapore.

3.16 MAS proposes to retain the option for banks incorporated outside Singapore to record their loss allowances for non-credit impaired exposures at head office. To ensure proper authority and accountability, the semi-annual report submitted to MAS shall be signed off by an authorised person of the bank's head office. Please also refer to **Annex B** for the proposed reporting template. The semi-annual report shall be based on balances as at the close of business on 30 June and 31 December of each calendar year ("reporting month"). Banks will be required to submit the returns to MAS not later than 15 days after the last day of each reporting month.

3.17 For avoidance of doubt, MAS continues to maintain the discretion to require the establishment of loss allowances for non-credit impaired exposures on the books of a bank's Singapore branch to address specific concerns or issues, as part of MAS' supervisory process.

Question 4.	MAS seeks comments on the proposal to retain the option for banks incorporated outside Singapore to record their loss allowances for non-credit impaired exposures at head office.
Question 5.	MAS seeks comments on the proposed reporting template.

4 Transitional Arrangements

4.1 Banks in Singapore that currently do not maintain the 1% minimum collective impairment provisions under MAS Notice 612 or MAS Notice 1005, and which are required to comply with the minimum regulatory loss allowances from 1 January 2018 onwards, will be given a period of up to two years to build up the required minimum regulatory loss allowances.

Question 6.	MAS seeks comments on the proposed transitional arrangement of up to two years.

5 Regulatory Capital Treatment of Loan Loss Allowances

5.1 The BCBS published its standard on the *Regulatory treatment of accounting provisions – interim approach and transitional arrangement* on 29 March 2017[16].

5.2 Consistent with the BCBS standard, MAS proposes to retain the current regulatory treatment of accounting provisions for an interim period following the introduction of the ECL accounting model. Specifically, for application under the standardised approach (SA) to credit risk, MAS proposes for loan loss allowances held for non-credit impaired exposures measured under SFRS 109 and additional loan loss allowances[17] recognised to meet the minimum regulatory loss allowance, to be included as Tier 2 capital up to the prescribed thresholds under MAS Notice 637 and MAS Notice 1111, as applicable.

5.3 MAS intends for these proposals to fully take effect from 1 January 2018.

Question 7.	MAS seeks comments on the proposed interim regulatory capital treatment of loan loss allowances under the ECL model.

[16] Available at https://www.bis.org/bcbs/publ/d401.htm

[17] Additional loss allowance refers to the amount of the excess of the minimum regulatory loss allowance over the expected credit losses measured under SFRS 109.

ANNEX A

LIST OF QUESTIONS

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Question 2. MAS seeks comments on the proposal for: 11

(i) Locally-incorporated D-SIBs to maintain minimum loss allowances for non-credit impaired exposures of 1% of exposures, net of collaterals ("minimum regulatory loss allowances") and to disclose the expected credit losses estimated under SFRS 109 in its financial statements; and 11

(ii) Foreign bank branches and merchant banks to be permitted to maintain loss allowances of 1% of non-credit-impaired exposures, net of collaterals, if it results in higher loss allowances than the expected credit losses estimated under SFRS 109. 11

Question 3. MAS seeks comments on the two alternative approaches that banks may be required to adopt to comply with the minimum regulatory loss allowance. MAS will determine the required approach, taking into consideration the consultation feedback received. 13

Question 4. MAS seeks comments on the proposal to retain the option for banks incorporated outside Singapore to record their loss allowances for non-credit impaired exposures at head office. 13

Question 5. MAS seeks comments on the proposed reporting template. 13

Question 6. MAS seeks comments on the proposed transitional arrangement of up to two years. 14

Question 7. MAS seeks comments on the proposed interim regulatory capital treatment of loan loss allowances under the ECL model. 15

ANNEX B

Semi-annual Report on Credit Loss Allowances for Non-credit Impaired Exposures of [Bank xxxx, Singapore Branch] carried at Head Office

As at the close of business on: [31 December xxxx or 30 June xxxx]

	Amount (S$'000)
Total non-credit impaired exposures	xx
of which:	
- Stage 1	xx
- Stage 2	xx
Credit loss allowances for non-credit impaired exposures	xx
of which:	
- Stage 1	xx
- Stage 2	xx

Signature of authorised person:

____
Designation, [Bank xxxx]

Monetary Authority of Singapore