BANK OF ENGLAND
PRUDENTIAL REGULATION
AUTHORITY

Sam Woods
Deputy Governor, Prudential Regulation
CEO, Prudential Regulation Authority
T 020 3461 8293
sam.woods@bankofengland.co.uk

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Dear CEO

IFRS 9 Financial Instruments

In November 2016 I wrote 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 purpose of this second letter is to update you and to ask you to ensure that your firms engage constructively and energetically in the work ahead. 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 we have an interest in how the standards are implemented.

We expect firms to work together and with the PRA to achieve greater consistency more quickly in their ECL estimates than would otherwise be the case. An important first step in the process is to agree a work plan through to the end of 2018. Our expectation is that your firm will work to help achieve this well before the 2017 reporting season and will then participate constructively in its delivery and in extending the work plan beyond 2018.

We expect the larger UK credit institutions to provide—either in their 2017 (or 2017/2018) annual reports or in transition packs issued shortly thereafter—disclosures that will enable investors to transition effectively from IAS 39 numbers to IFRS 9 numbers. We note that those firms have 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 at the point of transition, and expect that the firms will work productively to achieve that objective. Further details of what we envisage those core disclosures to be are set out in the annex to this letter. We are also pleased that the larger UK credit institutions have decided to participate in the taskforce of preparers and market participants that we, the FCA and the FRC are sponsoring to develop best practices for ECL-disclosures post-transition.

We expect firms' ECL-related priorities for 2018 and beyond to include, in addition to the work already mentioned on consistency and disclosure:

- embedding business-as-usual processes around the newly-developed ECL methodologies and their data sources;
- understanding the linkages between ECL and other aspects of the business and the implications of the way ECL estimates behave, and ensuring that those linkages and implications are approached appropriately; and
- developing and implementing on a timely basis a plan to replace the 'tactical solutions' used to implement ECL so that at all times their ECL methodology is fit for purpose.

We expect stress testing and capital planning carried out as part of firm's Internal Capital Adequacy Assessment Process (ICAAP) during 2018 to incorporate IFRS 9 if a firm prepares IFRS-based financial statements.

Further details on all these expectations are set out in the annex to this letter.

Finally, for your information, work is continuing in the Basel Committee on whether there needs to be a permanent change to the regulatory regime in the light of ECL, although it is not possible at this stage to predict whether any change will be made as a result of this work. The PRA and FPC are considering the UK's regime and will be communicating their decisions in due course. In the meantime, although negotiations continue, it seems more likely than not that EU law will be amended prior to IFRS 9 coming into effect to allow firms some ability to phase in the impact of ECL on capital resources.

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

Yours sincerely

S. Woods

Sam Woods

Deputy Governor and CEO, Prudential Regulation Authority

Annex

Further details on PRA expectations mentioned in the Dear CEO letter of 7 August 2017

Consistency of implementation between firms

In my earlier letter I explained that 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 and that, where there is a risk that this might not be the case, we take action to mitigate that risk. We continue to believe there is a risk that the differences in the way firms are planning to implement ECL will result in significant differences in the ECL estimate—and therefore significant differences in the inputs to the regulatory capital regime—that are unrelated to the underlying risks. I pointed out that 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. I explained that:

- we expected your firm to work proactively and constructively with other firms and with us to manage down the risk that could arise from outcome inconsistency, and to accept that this may involve your firm incurring some additional cost;
- although we hoped material progress could be made on consistency prior to 2018, we recognised that firms' plans for ECL implementation were well advanced and that it would be important not to put the timetable for and quality of that implementation at risk. For that reason, we noted that more progress on consistency would be achieved through post 1 January 2018 work; and
- we expected the work on greater consistency to continue for several years after 2018.

There has been no change in those expectations. Indeed, all that we have learnt since November about firms' implementation plans and the views of investors has reinforced our view that it is important to achieve greater consistency quickly. Please therefore continue to ensure that you will have the necessary resources available to do this work.

<u>Steps taken to date</u>

Following a technical meeting hosted by the BBA in December, the PRA hosted a roundtable meeting on consistency with the firms in March. At that meeting we discussed how we might develop a work plan. Firms were clear that they wanted the work to focus on the methodological differences and assumptions that are the biggest source of outcome inconsistency. On the other hand, firms also made it clear that, although some of the biggest sources would be obvious and some might be identified as a result of already planned work, there would be little time prior to 2018 for them to identify all the biggest sources. Since then, the PRA has been analysing what we know of firms' implementation plans so as to develop an initial list of issues that could form the basis of the work firms initially carry out to bring about greater consistency. This analysis has taken into account the information gathered by our risk specialists and accounting experts as part of the (now largely completed) thematic work evaluating and comparing ECL implementation approaches of each of the larger UK credit institutions.

<u>What will happen next?</u>

Our intention is to convene a second roundtable meeting in September. At that meeting we will discuss the initial list the PRA has developed with the expectation that those discussions will result in a work plan being developed. We continue to remain open to alternative ways of approaching this work, but we regard it as essential that a work plan that will run through to the end of 2018 is developed well before we go into the 2017 reporting season. A work plan for 2019 and thereafter can be developed later.

Disclosure about ECL

Although the quality of the assumptions, judgements and methodologies used to arrive at the ECL estimate is very important, the disclosures provided to support that ECL estimate are also important. For that reason, in my earlier Dear CEO letter I explained that the PRA expected firms to provide an appropriately focused set of ECL-related disclosures. Those disclosures need to be complete, correctly focused, accurate and presented in a way that is as harmonised as possible so that those using them can navigate easily from firm-to-firm. For as long as there is significant outcome inconsistency, one objective of the disclosures will be to enable investors and other users of the financial statements to cope with that inconsistency. However, disclosure plays a key role even if outcome inconsistency is not significant.

Day one disclosures/transition disclosures about ECL

Firms are required by accounting standards to provide some disclosures about the impact of IFRS 9 on their opening ECL balance sheet in their 2017 (or 2017/2018) audited financial statements. Our expectation is that the larger UK credit institutions will seek to ensure that investors are able to transition effectively from their IAS 39 numbers to their IFRS 9 numbers by providing the disclosures necessary to achieve that either in the 2017 (or 2017/18) annual report and accounts or in a separate transition report.

At a meeting of CFOs hosted by the Executive Director of Prudential Policy, Vicky Saporta, on 19 June, the larger UK credit institutions agreed to work together through UK Finance and with us in order to ensure these transition disclosures are harmonised as much as possible. The expectation is that the output of this work will be a list of core disclosures that represent the minimum ECL-related transition disclosures to be provided and that firms will work productively with that end in mind. We envisage that those core disclosures would probably cover at least the following:

- Reconciliations, together with explanations, of the IAS 39 incurred loss provision to the ECL estimate, supported by analyses of the types of product mainly responsible for each type of difference.

- Disclosures that enable market participants to understand how key IAS 39 impairment concepts have been incorporated into the ECL methodology, the ECL estimate and the amounts allocated to each of the 3 ECL-related stages. These disclosures should include quantitative disclosures showing how IAS 39 impairment concepts such as 'impaired', 'provisions' and 'forborne') map across to ECL, and should be at a sufficient level of granularity to enable market participants to understand how the main products and product lines map across to IFRS 9.

- A description of the main judgments made in arriving at the ECL estimate and a description and estimated quantification of the impact those judgements have for the ECL estimate, the amounts allocated to each of the three ECL stages and for the other ECL-related numbers disclosed.

- An explanation of the implications arising for the firm's capital position and capital planning from the ECL estimate often being bigger, more volatile and differently cyclical compared to the IAS 39 incurred loss number.

- Information about the measurement uncertainty inherent in the ECL estimate and the amounts allocated to each of the three ECL-related stages and their sensitivity to key drivers. This disclosure should explain the implications of this for the capital position and for capital planning.

- Information that enables market participants to understand the volatility of the ECL estimate, including information that makes it possible for market participants to make their assessments of future ECL provisions that reflect their own view of future economic conditions.

- An explanation of any changes to governance and risk management organisation, processes and key functions made in the light of the move to ECL, including disclosures that enable market participants to navigate between key ECL-related numbers and the firm's key risk metrics.

We understand that this will next be discussed at a meeting at UK Finance on 8 August.

Year-end 2018 and beyond ECL disclosures

The PRA and other UK regulators are facilitating the setting up a taskforce comprising a partnership of preparers and investors. That taskforce will be asked to develop first a disclosure framework (or set of granular disclosure objectives) that describe what a complete set of correctly focused ECL disclosures should look like, and then a set of recommendations as to how those disclosure objectives could be met in a broadly harmonised way. The intention is that the disclosure framework would be ready in time to influence interim and year-end 2018 disclosures and the harmonisation recommendations would be ready in time to influence disclosures in subsequent periods. The PRA is pleased that all the larger UK credit institutions have agreed to participate in this initiative, and expects that participation to be constructive and energetic.

Other implementation matters

On 12 May the EBA published its *Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses.* These guidelines substantially replicate the Basel Committee's *Guidance on credit risk and accounting for expected credit losses* and address both sound credit risk management practice and the implementation of ECL. In accordance with Article 16(3) of Regulation (EU) No 1093/2010, competent authorities and financial institutions must make every effort to comply with the guidelines.

Furthermore, competent authorities must notify the EBA as to whether they comply or intend to comply with these guidelines. We will be notifying EBA that we intend to comply.

As already mentioned, we do not regard the date on which IFRS 9 comes into effect as the date on which firms' work developing their ECL methodologies ends, and we know from conversations we have had with firms that they too regard it merely as the end of the beginning. In addition to the work already mentioned in this letter on consistency and disclosure, we expect the priorities for 2018 and beyond to include:

- embedding business-as-usual governance, control, forecasting and management information processes around the newly-developed ECL methodologies and their data sources;
- understanding the linkages between ECL and other aspects of the business and the implications of the way ECL estimates behave for the business more generally, and ensuring that those linkages and implications are approached appropriately; and
- identifying the 'tactical solutions' adopted to enable ECL to be implemented on time but which are unduly approximate or are based on assumptions that might not hold in less benign economic conditions than those relevant to the day one ECL estimate; developing a plan to replace those tactical solutions on a timely basis so that at all times the ECL is fit for purpose; and implementing the first year of that plan.

As part of the risk management and asset quality reviews we undertake, PRA supervisors will assess whether firms have managed the introduction of IFRS 9 effectively and also whether appropriate steps are being taken to embed appropriate oversight processes, reaction responses and strategic solutions to ECL implementation.

We would also encourage firms with a presence in more than one jurisdiction to expect an increased level of scrutiny from all their regulators and to have a plan to engage with those enquiries effectively at an appropriate level within the organisation.

ICAAP Capital planning and stress testing

We expect stress testing and capital planning carried out as part of firms Internal Capital Adequacy Assessment Process (ICAAP) during 2018 to incorporate IFRS 9 if a firm prepares IFRS-based financial statements. This is likely to be a significant change from previous years which have been on an IAS 39 basis.

- Later in the year we plan to publish guidance for all firms that apply IFRS on incorporating IFRS 9 in their ICAAP for 2018. Our approach will continue to recognise that firms will still be refining their ECL processes and practices during 2018 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.
- In preparation for the 2018 and future Concurrent Stress Tests (CSTs), we are engaging with participating banks and building societies to consider how best to include IFRS 9. We have had a number of useful discussions with firms participating in the CST and we are looking forward to receiving data from firms as part of the IFRS 9 exercise running alongside this year's CST. Firms can expect this engagement to continue.