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Basel IV: IFRS9 implications

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Introductions

Today's speakers

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Agenda

1	Update on Basel IV
2	IFRS9: Impairment Recap
3	Where IFRS9 intersects with Basel IV • Credit Risk • Hedging
4	Learn more and upcoming events

Update on Basel IV

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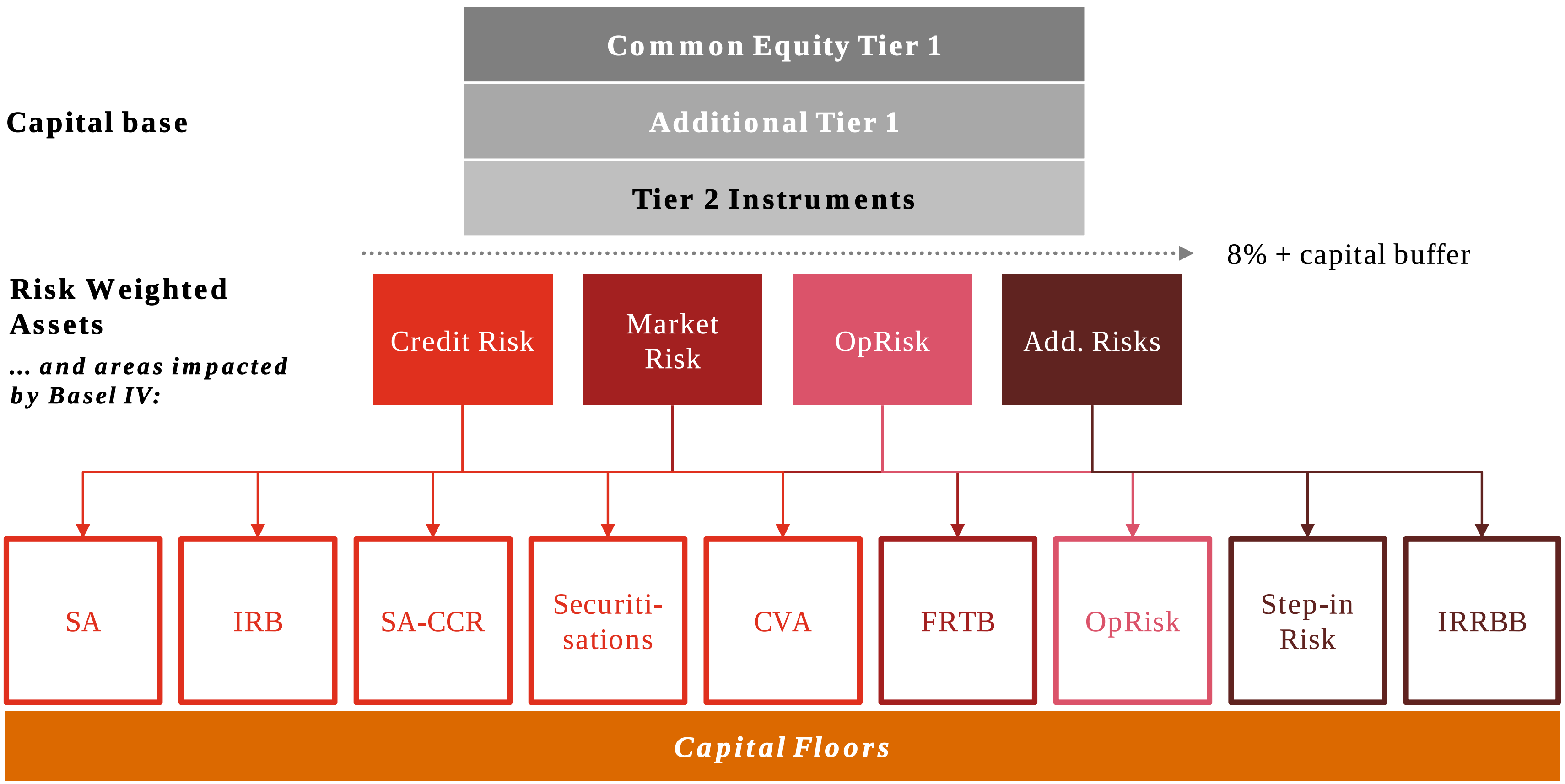
Basel IV overview

Calculation of the capital ratios according to Basel III/APRA



Latest developments – Basel Committee

June 13-14 Meeting of Basel Committee

- Widely expected to come up with a ‘compromise’ package, but no agreement was reached
- Next meeting is in September
- Still concerns about US willingness to engage with regulatory reform.

Some areas which have been rumoured to be under discussion:

- Capital Floor level, and implementation timeline.
- Residential Risk Weights – increased national discretion in countries with high LTV’s. Cap on risk weights.

IFRS 9 Transitional arrangements to mitigate the effect of the IFRS 9 provisions.

Latest developments – APRA seizes the day

"In thinking how to put the [FSI] recommendation into practice, we have been mindful that the international bank capital regime is still undergoing further fine-tuning. We therefore chose to hold off implementing the 'unquestionably strong' recommendation until the work in Basel was completed. We thought it made sense to tackle both issues together, on the basis that implementing one set of changes rather than two was likely to be more efficient and provide greater certainty for everyone.

However, without clarity as to a deadline for an agreement in Basel, we have decided it does not make sense to wait any longer to deal with the question of 'unquestionably strong'."

W. Byres, 5 April 2017

20 July: APRA sets 'unquestionably strong' capital targets

Core Requirements

- APRA has proposed to raise minimum regulatory CET1 requirements for:
  - IRB accredited ADI's from 8% to 9.5% (including buffer of 1% the target CET1 ratio is 10.5%)
  - ADI's using standardised approach to credit risk from 7% to 7.5%
- APRA considers that banks should initiate strategies to be able to meet the above capital benchmarks by 1 January 2020. A more detailed phased approach will be proposed later this year.

Motivations

- Position the four major Australian banks in the top quartile (75th percentile) of Basel Committee's Quantitative Impact Study (QIS) Group 1 banks on an internationally comparable CET1 basis
- Achieve S&P Risk Adjusted Capital (RAC) ratio of 10% (strong) from an existing 9.3% (adequate) for four major banks
- Maintain sufficient capital to stay comfortably above loss absorption trigger point (LARP) in stressed conditions.

IFRS9: Impairment and Hedging Summary

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IFRS9: Impairment Recap
Introduction

Financial crisis raised questions of recognition of losses – timing and completeness.

IAS39 – relied on backward looking data forecasting 12 months ahead. Scope for management overlays to deal with known risks.

This was more pronounced in Europe and USA – where saw large write downs of assets with limited provision cover.

Experience in Australia was less so, with APRA requiring General Reserve for Credit Loss which is more forward looking and prudential in nature. Large banks in particular are holding higher provision reserves than international counterparts.

The IASB's response was to adopt a principle based approach to:

- Earlier recognition of losses
- Incorporate a forward perspective of portfolio risk
- Increase transparency through enhanced disclosures

IFRS9: Impairment

Introduction

To deliver insights in the IFRS9 world we will need to understand measurement drivers* and *stage drivers

Change in credit quality since initial recognition

Stage 1	**Stage 2**	**Stage 3**
Performing (Initial recognition*)	*Underperforming* (Assets with significant increase in credit risk since initial recognition*)	*Non-performing* (Credit impaired assets)

Recognition of ECL

12 month ECL	Lifetime ECL	Lifetime ECL

*Except for purchased or originated credit impaired assets

IFRS9: Impairment
Operational and Project challenges

Observe that projects have focused intensely on technical models, but may be behind in parallel runs, system development and operating model decisions.

Challenges with IFRS9

- Significantly more technical approach to impairment loss estimates
- Enhanced governance framework required due to reliance on models and forecasts
- Outside Australia – there could be significant capital impost where provisions expected to increase well above 20%
- Data availability and quality – both for models and for SICR requirements
- Systems and granularity of data for reporting.

Challenges facing IFRS9 Project teams

- Implementation timetable is getting tighter
- Capability and resources
- Engagement with the broader business is complicated by ongoing refinement of the approach
- Systems capability and development
- Limited focus on target operating model post implementation.

IFRS9: Impairment

What we see that organizations need to consider for IFRS9

Making headway but not resolved

Messaging at transition

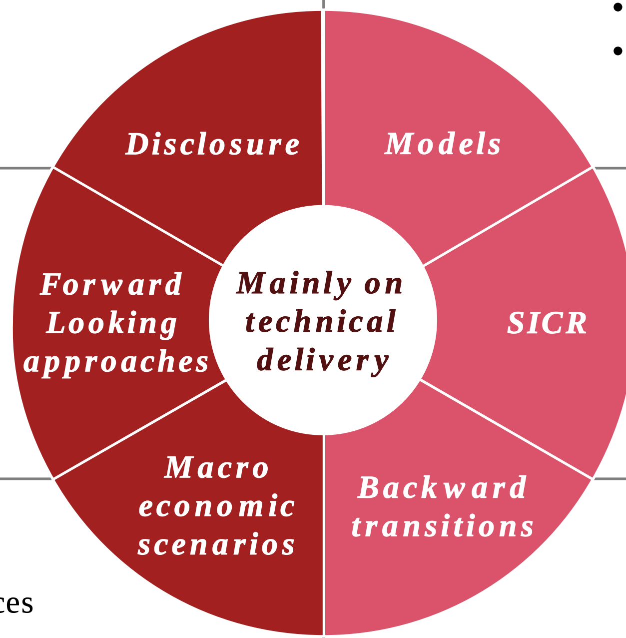
- Quantitative/qualitative
- Outlook commentary
- Market message/update
- Complexity of staging disclosure.

Forward provisions

- Application level – account, portfolio or group?
- Application stage/measurement
- Governance/consistency.

Developing macroeconomic factors

- Internal models or external sources
- Independence of internal experts
- Application PD/LGD/EAD and SICR rules.



Substantially resolved

How granular? How complex?

- PD focus/macro factors
- Leverage or rebuild?
- Leverage regulatory EAD and LGD.

Aligning business and credit model

- Definition
- Forward scenarios
- Simplifications
- Ratings system.

Assessing improvement

- Recognising improvement/cures
- Modified loans
- Spurious volatility.

IFRS9: Impairment

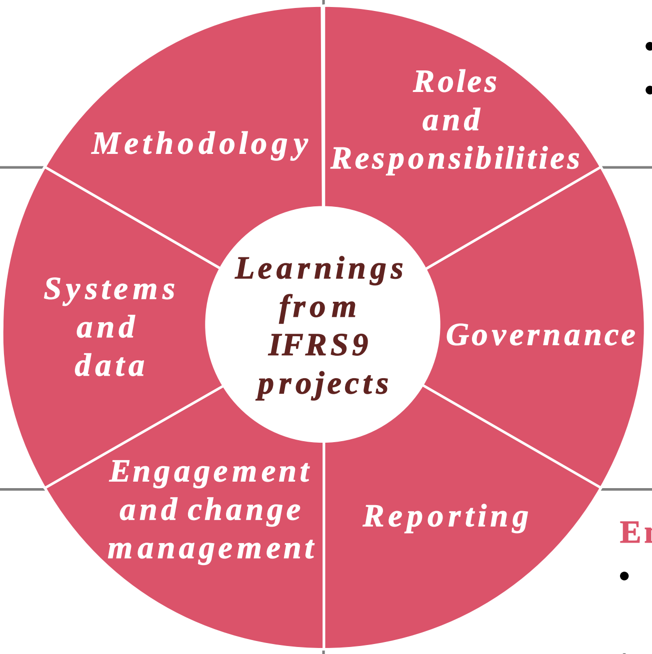
Where do we see project effort today?

Technical decisions

- Risk management alignment
- Multiple approaches to the forward looking requirements.

Risk and Finance synergy

- Clarify roles and responsibility
- Opportunity to enhance Risk and Finance dialogue
- Process ownership
- Accounting Day 1 impact.



Alignment opportunity

- Regulatory and finance data
- Streamline reporting process
- Data design influences the ability to drill for insights
- Consider data granularity required for management information.

More models means more governance

- Educating executives and board about IFRS9 implications
- Implications of more models
- Forward looking scenario governance
- Validations of models.

Educate, educate, educate

- Principles are easy, implications may be more challenging
- Best practice is to have more engagement early
- All levels, across all functions.

Enhanced credit risk reporting

- Management information and insights using IFRS9 data
- External disclosures can be difficult
- Data and system design impact the insights available.

Where IFRS9 intersects with Basel IV

- Credit Risk
- Hedging

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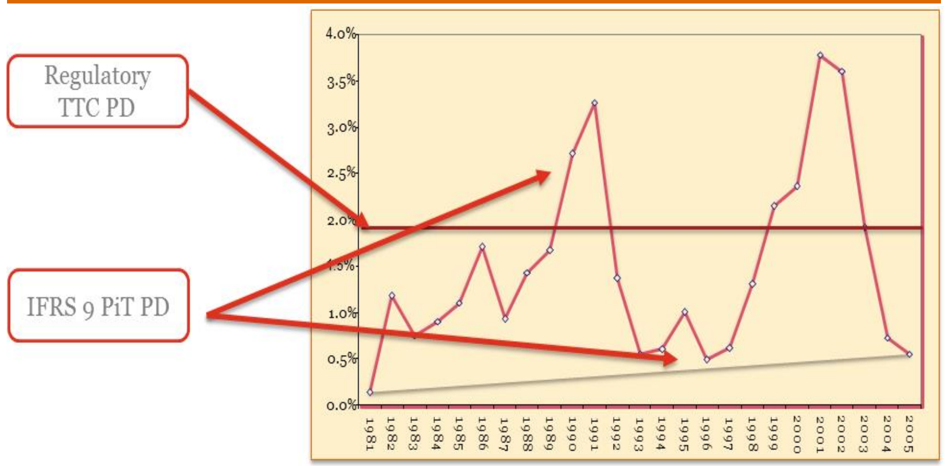
Where IFRS9 intersects with Basel IV

Impairments – Credit Risk

Regulatory PD	Hard to reconcile both!	IFRS 9 PD
Through the cycle (‘TTC’)		Point in time (‘PiT’)



	Basel IV	IFRS
PD	Point-in-time for impairments Through-the-cycle for capital determination	Point-in-time
	Floor regulations 0,03% Art. 163 Abs. 1 CRR (with Basel IV 0,05%)	No floor is available
LGD	Dependent on economic cycle Art. 181 Abs. 1b C	Workout LGD
	Direct & indirect costs Art. 5 Abs. 2 CRR	Only direct costs
	Risk free (interest) rate plus markup	Effective rate

Where IFRS9 intersects with Basel IV

Capital impacts

- There is increasing focus on capital impacts as we move to IFRS 9 transition, with an expectation that for many institutions an increase in the balance sheet provision will result in a depletion of Tier 1 capital.

- The Basel Committee are consulting on the long term implications for treatment of provisions and have consulted on transitional arrangements. The European Union have issued draft regulations on a 5-year transitional arrangement.

- Where transitional arrangements are being put in place there is an expectation that disclosures will be required before and after the application of the transitional arrangement.

- As such, there is a need to understand the likely IFRS 9 ECL estimate to ascertain the potential capital impacts. This will allow institutions to engage with regulators on the impacts and local transitional arrangements.

- Locally we would expect to see a reduction in the APS 220 GRCL lifetime EL top-up, as lifetime losses will be held for Stage 2 assets under IFRS 9.

Where IFRS9 intersects with Basel IV (cont'd)

PRA Discussion paper

www.pwc.co.uk/fsrr
March 2017

Stand out for the right reasons
Financial Services Risk and Regulation

Hot topic

PRA proposes to refine the Pillar 2A capital framework

Highlights

The Prudential Regulation Authority (PRA) proposed the following changes to the Pillar 2A capital framework, with an implementation date of 1 January 2018:

- *Adjustments to the PRA's Pillar 2A approach for firms using the standardised approach for credit risk (SA)*
- *Revisions to the internal rating based (IRB) benchmark*
- *Consideration, as part of the supervisory review and evaluation process (SREP), of the extent to which expected credit losses (ECL) in IFRS 9 may already be covered by the SA Pillar 1 capital charge.*

The PRA published the *consultation paper CP3/17 refining the PRA's Pillar 2A capital framework* on 24 February 2017. This paper sets out three key proposed changes to the existing Pillar 2A capital framework, that has been in effect since 1 January 2016. The revisions would apply to all banks, building societies and the PRA-designated investment firms.

The primary aim of these proposed revisions is to reduce the variability in capital requirements as a result of differing risk weights used under the SA and IRB approaches. Although there are already measures in place, such as the leverage ratio and the systemic risk buffer that also aim to reduce the variance between the two approaches, the PRA recognises the current SA approach can create incentives for smaller firms to take on "excessive" risk, and wants therefore to make the capital requirements for SA firms more risk sensitive. This proposal also seeks to improve the ability of SA firms to compete effectively against the large, IRB firms.

The PRA has proposed an implementation date of 1 January 2018 for the revisions outlined in this consultation paper.

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IFRS9: Hedging

Introduction

- Mandatory adoption for AASB 9 Classification & Measurement and Impairment

- Changes to AASB 7 disclosures will apply regardless

- Policy choice over adopting AASB 9 General hedging OR retaining AASB 139
  - AASB 9 Macro hedging remains under development (discussion paper last issued April 2014)
  - AASB 139 ‘Portfolio Fair Value Hedge’ remains available

IFRS9: Hedging (cont'd)

Substantive positive change…

Hedge accounting easier to achieve (and maintain)

- Fewer bright lines or restrictions
- Forward looking qualifying assessment
- Encourages reliance on existing risk management activity

Aligning accounting to risk management strategy

- 'Cost of hedging' rules reduce P&L volatility (now captured separately in OCI)
  - *Cross currency basis risk*, *forward points* and *option time value* explicitly defined
- Applicable to a broader range of risk exposures and hedging approaches:
  - 'Aggregate' or 'synthetic' exposures
  - Hedging net positions (with restrictions)
  - Hedging 'layers' of a risk exposure
  - Rebalancing
- Hedging of risk components for non-financial items

IFRS9: Hedging (cont'd)

…whilst retaining the basic mechanics

Most mechanical elements retained from AASB 139

- Fair Value Hedge, Cash Flow Hedge, Net Investment Hedge
- Upfront documentation of the relationship incl. RM strategy & objective
- Measure ineffectiveness retrospectively

With some restrictions also carried over

- No retrospective application
- No net sold optionality
- Rules on allowable risk exposures (non-interest bearing deposits, profit hedging..)
- New: No voluntary de-designation, unless risk management objective has changed

IFRS9: Hedging (cont'd)

We see the potential to drive significant commercial value…

1 ***Aggregate risk exposures (e.g. Bills/Libor) and manage as a portfolio***

- Particularly applicable to overseas wholesale funding where separate risks are easily identifiable
- Utilise the synthetic rules to look through to true risk exposure
- Could be applicable pre and post hedging activity

2 ***Additional use of purchased optionality, including structured options***

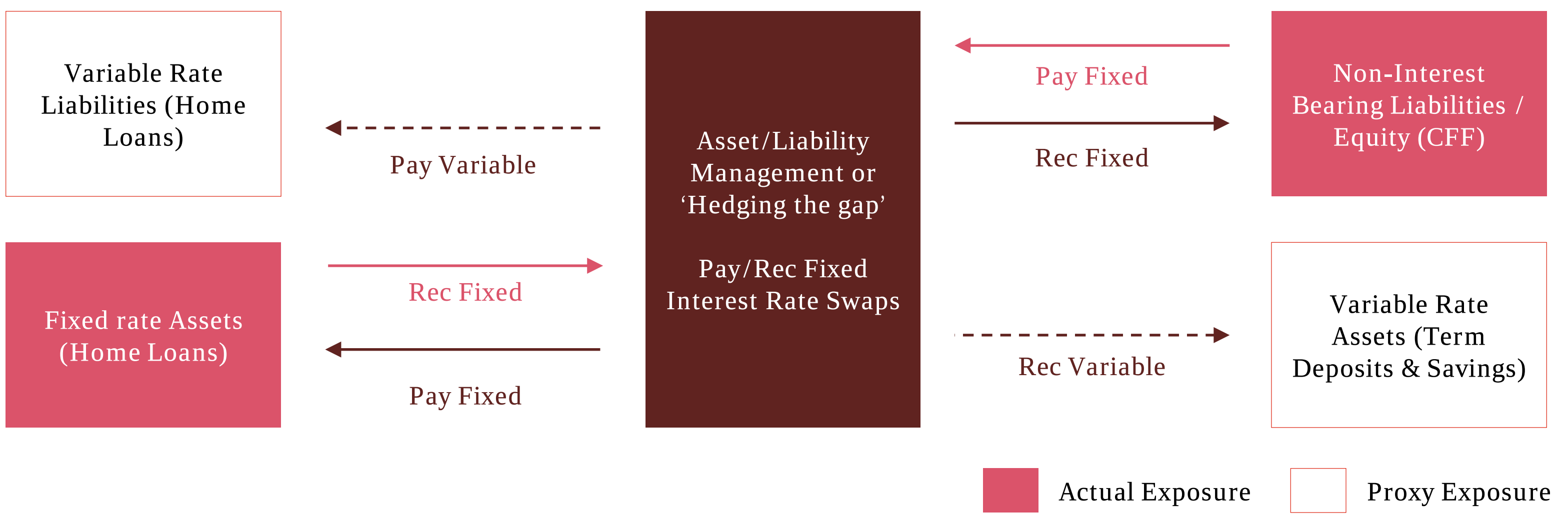
- Cost of hedging rules remove previously unavoidable accounting volatility
- Relaxation in effectiveness assessments could facilitate more structured (purchased) products

IFRS9: Hedging (cont'd)

… and refine the accounting solutions already in place

3 *Utilise synthetics to increase capacity for hedge accounting*

- Existing fixed rate asset or liability hedging can increase variable rate capacity for ALM hedging



Learn more and upcoming events

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Future Webinars

Upcoming Events: Webinar

Webinar Series 2017

October: FRTB: Update on Global approaches and Australian impacts

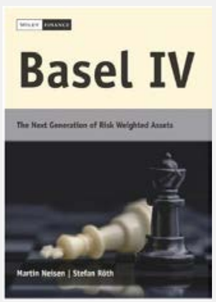
November: Use of internal Models and the impact of a capital floor [Subject to Basel Updates]

Register for interest:

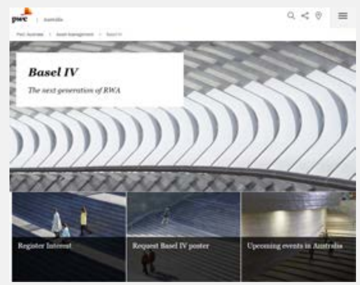
http://www.pwc.com.au/basel-iv.html

Basel IV Knowledge @ PwC

Basel IV Book

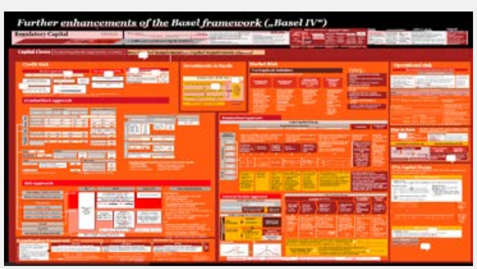


Basel IV Webpage national/international
http://www.pwc.com.au/basel-iv



Publications

Basel IV Poster/Brochure



Basel IV Youtube Channel

Webinars

Upcoming Events: Webinar

Webinar Series 2017

2 June:	Credit risk: Standrad and Advanced Approaches
20 July:	IFRS 9: Focus on Regulatory Reporting and how it reaktes to the Basel Framework
August:	SA-CCR and CVA
October:	FRTB: Update on Global approaches and Australian impacts
November:	Use of internal Models and the impact of a capital floor [Subject to Basel Updates]

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