Consultation paper | CP 17.02

March 2017

Regulatory Treatment of Provisions under HKFRS 9

HONG KONG MONETARY AUTHORITY
香港金融管理局

Contents

I INTRODUCTION

1 Overview

1 The "expected loss" provisioning model under the new Hong Kong Financial Reporting Standard 9[1] (HKFRS 9) will come into effect from 1 January 2018. The move to expected loss is a response to the lessons learned from the global financial crisis where the existing "incurred loss" provisioning model was considered to have resulted in loan loss provisions that were "too little, too late".

2 The new accounting standard is expected to result in an increase in accounting provisions, and the regulatory treatment of these provisions will in turn have an impact on banks' regulatory capital positions. The Basel Committee on Banking Supervision (BCBS) issued on 29 March 2017, an interim standard on the regulatory treatment of accounting provisions[2] (BCBS interim treatment), under which the current classification of banks' provisions into general provisions (GP) and specific provisions (SP) and their respective capital treatment will remain. The individual jurisdictions have the discretion to determine how accounting provisions should be classified as GP or SP and whether to apply transitional arrangements to smoothen the impact on banks' capital positions.

3 Accordingly in Hong Kong we need to consider how HKFRS 9 provisions should be allocated, for capital adequacy purposes, between GP and SP, bearing in mind that these two categories of provisions are currently subject to different treatments under the standardised approach for credit risk within the BCBS capital framework.

4 Furthermore we need to decide how the regulatory reserve (RR) should henceforth be determined, given that by original design it covers unidentified expected future losses and therefore will (to some degree) overlap with HKFRS 9 provisions. This leads to the question of whether (and, if so, to what extent) the RR currently maintained by AIs should be allowed to "absorb" HKFRS 9 provisions.

5 The HKMA invites comments on its proposals on these aspects (as set out below) by 2 May 2017.

---

[1] Hong Kong Financial Reporting Standard 9 is the equivalent of the International Financial Reporting Standard 9.

[2] http://www.bis.org/bcbs/publ/d401.pdf. Following issuance of the interim standard, the BCBS continues to work on the development of a final standard to reflect expected loss provisioning within the regulatory capital framework.

2 Structure of this Consultation Paper

6 This consultation paper is organised as follows:

- Section II outlines a proposed mechanism for the interaction between RR and HKFRS 9 provisions;
- Section III proposes a broad approach for classifying HKFRS 9 provisions as GP or SP as an interim treatment and discusses the need for any transitional arrangements locally; and
- Section IV describes the proposed approach to, and the timeline for, implementing the interim treatment of HKFRS 9 provisions under the capital framework.

II INTERACTION BETWEEN REGULATORY RESERVE AND HKFRS 9 PROVISIONS

7 The HKMA currently requires authorized institutions (AIs) to maintain an RR on top of the collective impairment allowance (CIA) under HKAS 39 to proxy the amount of GP they were previously required to maintain to cover unidentified expected future losses prior to the advent of HKAS 39.

8 In 2011, particularly strong credit growth in Hong Kong (with the consequent likelihood of increased levels of non-performing loans), prompted the HKMA to ask AIs to review and in many cases increase their RR levels. Subsequently, following the introduction of the Basel 3 countercyclical capital buffer (CCyB) in 2016, the HKMA agreed with AIs to gradually release (over 4 years) that part of the "increased RR" focused on risks arising from excessive credit growth which are now considered to be addressed by the countercyclical capital buffer.

9 The implementation of HKFRS 9 means accounting provisions will henceforth cater for expected future losses in addition to incurred losses. Designed to be forward looking in the recognition of credit losses, HKFRS 9 categorises financial assets into three Stages in the determination of credit impairment as follows:

Stage of credit impairment	**Characteristics of financial assets**	**Time horizon for expected credit losses**
Stage 1	Not credit-impaired (credit risk has not increased significantly since initial recognition)	12 months
Stage 2	Not credit-impaired (credit risk has increased significantly since initial recognition)	Lifetime
Stage 3	Credit-impaired	Lifetime

10 Given the original design of the RR to cover a measure of unidentified expected future loss and the move under HKFRS 9 to include expected loss within the provisioning framework, there is now a case for the HKMA to review its policy and approach to the RR, and the extent to which an AI should be required to maintain any RR on top of the provisions made under the new accounting standard and, if so, what the amount of that RR should be. The HKMA is inclined to adopt a two-step approach for the purpose of making such determination:

- **Step 1** – calculating (as at present with the existing RR) a benchmark regulatory provision for unidentified expected loss (benchmark) for each AI as the <u>product</u> of (i) a predetermined bank-specific "target rate" (as defined in para. 11(a) below) and (ii) "relevant exposures" (as defined and explained in para. 11(b) below);
- **Step 2** – comparing the benchmark with a "relevant portion of HKFRS 9 provisions" (as defined in para. 11(c) below); and

  (i) where the benchmark is greater than the relevant portion of HKFRS 9 provisions, the "shortfall" will continue to be earmarked from retained earnings and maintained as RR;

  (ii) where, on the other hand, the benchmark is smaller than relevant portion of HKFRS 9 provisions so that there is an "excess" of accounting provisions, no RR will be required.

11 For the purposes of the two-step approach:

(a) The "target rate" will be the prevailing target rate (for CIA + RR) net of (where applicable) the enhanced level of RR introduced in 2011 which AIs are releasing over the 4 years from 2016 to 2019 following implementation of the CCyB. So in 2018, when HKFRS 9 takes effect, the target rate will be that corresponding to the third year of release. For example, where the pre-release target rate was 1.4% which included 0.5% "enhancement" from 2011 and where the amount of RR to be released from 2016 to 2019 is 0.4% (i.e. 80% of the 0.5%), the "target rate" will be 1.1% in 2018 and 1.0% from 2019 onwards:

Year	**2005 - 10**	**2011 - 15**	**2016**	**2017**	**2018**	**2019 onwards**
Target rate	0.9%	1.4%	1.3%	1.2%	1.1%	1%

(b) The existing target ratio is calculated on the basis of total loans and advances (to non-banks). It is proposed that "relevant exposures" for the purposes of the two-step approach described above will adopt the same measure of "total loans and advances" (to non-banks). This presumes that the HKMA will retain the existing policy of requiring RR only to cover general expected future loss for these on-balance sheet exposures (as opposed to a potentially much wider coverage under HKFRS 9, which includes other on-balance sheet exposures such as debt securities and loans and advances to banks, as well as off-balance sheet exposures in the form of guarantees and loan commitments). To expand "relevant exposures" to match the coverage of HKFRS 9, with the application of an unchanged target rate, would result in a significant increase in, and change of the existing purpose and scope of, the RR with a potentially significant impact. On the other hand, the recalibration of the target rate to accommodate exposures other than total loans and advances (to non-banks) would be practically difficult and, since the existing incurred loss approach under HKAS 39 also covers loans and advances to banks it likewise has a wider coverage than the RR. HKFRS 9 implementation does not itself therefore provide a necessary justification for a change in coverage of the RR.

(c) The "relevant portion of HKFRS 9 provisions" will be the portion of HKFRS 9 provisions made for total loans and advances to non-banks categorised into Stage 1 and Stage 2 under HKFRS 9 which, by definition, are not impaired (i.e. they are provisions for unidentified expected loss).

12 Given that both the RR and the new accounting provisions under HKFRS 9 both address identified expected loss, the question arises as to why any measure of RR should remain following the introduction of HKFRS 9. The main considerations for requiring AIs to maintain RR in the situation described under (i) of Step 2 in paragraph 10 above are that:

- depending on the stage of the economic cycle, there are times that the "point-in-time" 12-month probability of default used for determining provisions required for Stage 1 exposures under HKFRS 9 may not be sufficient for the "through-the-cycle" provisioning normally required for prudential regulatory purposes;
- some potential gaps may still exist, at least initially, regarding the significant data, systems and controls required for the implementation of HKFRS 9; and
- a greater extent of management judgement is expected to be involved in the calculation of the accounting provisions under HKFRS 9.

13 As noted in footnote 2 above, the BCBS will continue the work on a long term standard for the interaction of IFRS 9 expected loss provisioning and the regulatory capital framework. Depending on future developments in the relevant standards and practices internationally on the regulatory treatment of expected loss provisioning, the HKMA may review and reconsider the two step approach proposed above in consultation with the industry.

Q1. Do you agree with the proposed approach and mechanism for determining the amount of RR that an AI should maintain under HKFRS 9?

III CAPITAL TREATMENT OF HKFRS 9 PROVISIONS

1 Classification as General Provisions and Specific Provisions

14 The need to classify HKFRS 9 provisions into GP and SP is relevant only to the basic and the standardised approaches for credit risk under the Banking (Capital) Rules (BCR) where GP and SP are subject to different treatments (i.e. GP can be counted as Tier 2 capital up to 1.25% of credit RWAs while SP are netted off from risk-weighted exposures). Under the IRB approach, the total eligible provisions (EP) (which include all accounting provisions and RR) are compared with the regulatory measure of expected loss (EL) calculated based on predetermined parameters. Any shortfall of EP vis-a-vis EL is deducted from CET1 capital, and any excess of EP over EL is counted as Tier 2 capital up to 0.6% of credit RWAs. The issue is then how HKFRS 9 provisions should be categorised into GP and SP under the basic and the standardised approaches.

15 Given that the first two Stages (i.e. Stage 1 and Stage 2) of HKFRS 9 are concerned with exposures to assets that are not considered "credit-impaired", it appears not unreasonable for the impairment provisions pertaining to the exposures classified under these two Stages to be treated as GP, and for the impairment provisions pertaining to exposures classified under Stage 3 to be treated as SP, for capital adequacy purposes. The HKMA therefore proposes to adopt this approach as an interim measure pending the design and development of a longer-term solution by the BCBS.

Q2. Do you agree with the proposed classification of HKFRS 9 provisions as GP or SP as an interim treatment for the basic and the standardised approaches for credit risk under the BCR?

2 Transitional arrangement

16 The BCBS interim treatment allows jurisdictions the discretion to make available certain forms of "transitional arrangement" to reduce the impact of the introduction

of expected loss provisioning on banks' capital positions (e.g., by spreading out the impact arising from the increase in accounting provisions over three years). The HKMA is not inclined to provide such an arrangement in Hong Kong as this will arguably make the regulatory standard less prudent than the accounting standard, and the existing RR (under the proposed two step mechanism described in Section II of this paper) should be able to absorb the impact of the introduction of new accounting standard to some extent. The results of a preliminary survey conducted recently on a sample of locally incorporated AIs also appears to lend support to this approach, indicating that the sum of the existing accounting provisions (under HKAS 39) and the RR predicted by the participants institutions should exceed (in most cases fairly substantially) the anticipated new HKFRS 9 provisions.

Q3. With the proposed approach to RR and classification of HKFRS 9 provisions as GP or SP, do you agree that there is no pressing case for any transitional arrangement in Hong Kong?

IV APPROACH AND TIMELINE FOR IMPLEMENTATION

17 The HKMA proposes to adopt the new regulatory treatment of provisions on 1 January 2018, in line with the effective date of HKFRS 9.

18 Limited consequential amendments to the BCR relating to existing definitions (such as the definition of “collective provisions”) to align with the demarcation of HKFRS 9 provisions into GP or SP[3] will be required. Some alignment changes to the existing Return of Capital Adequacy Ratio (Form MA(BS)3) (CAR Return) and its accompanying completion instructions will also be required. The industry will be consulted on these at a later stage.

19 Following the current consultation, the HKMA currently intends to conduct a follow-up impact study, most likely in the third quarter of this year, to update our assessment of the expected impact of HKFRS 9 provisions on AIs’ capital positions at a time when the industry is at a relatively more advanced stage of preparation for implementation of the new accounting standard. The outcome will be taken into account as the HKMA finalizes the policy proposals.

20 The proposed implementation timeline is summarized as follows:

Date	**Event**
March / April 2017	Consultation on policy proposals
July / August 2017	Follow-up impact study
August / September 2017	Statutory consultation on amendments to BCR
Q3 2017	Consultation on the amendments to CAR return and completion instructions[4]
October 2017	Gazettal and submission to LegCo of amended Rules

---

[3] Subject to the final approach adopted for mapping the hierarchy of approaches in the BCBS revised securitization framework to the binary divide between STC(S) approach and IRB(S) approach under Basel II (see paragraph 45 under section 5.2 of HKMA’s consultation paper on “Revised Securitisation Framework” (CP17.01) issued on 20 January 2017), consequential amendments to section 42 of the BCR may also be necessary.

[4] Some additional banking returns may also be subject to change to cater for HKFRS 9 implementation.

1 January 2018	Amended Rules coming into effect
Q1 2018	Launch the revised CAR return

Q4. Do you have any specific views on the proposed approach and timeline for implementing the interim capital treatment of HKFRS 9 provisions?