

Financial Stability Institute



Prudential treatment of asset quality amidst Covid 19 – risk management and supervisory challenges

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* Views expressed are my own and do not necessarily represent those of the BIS, BCBS or FSI

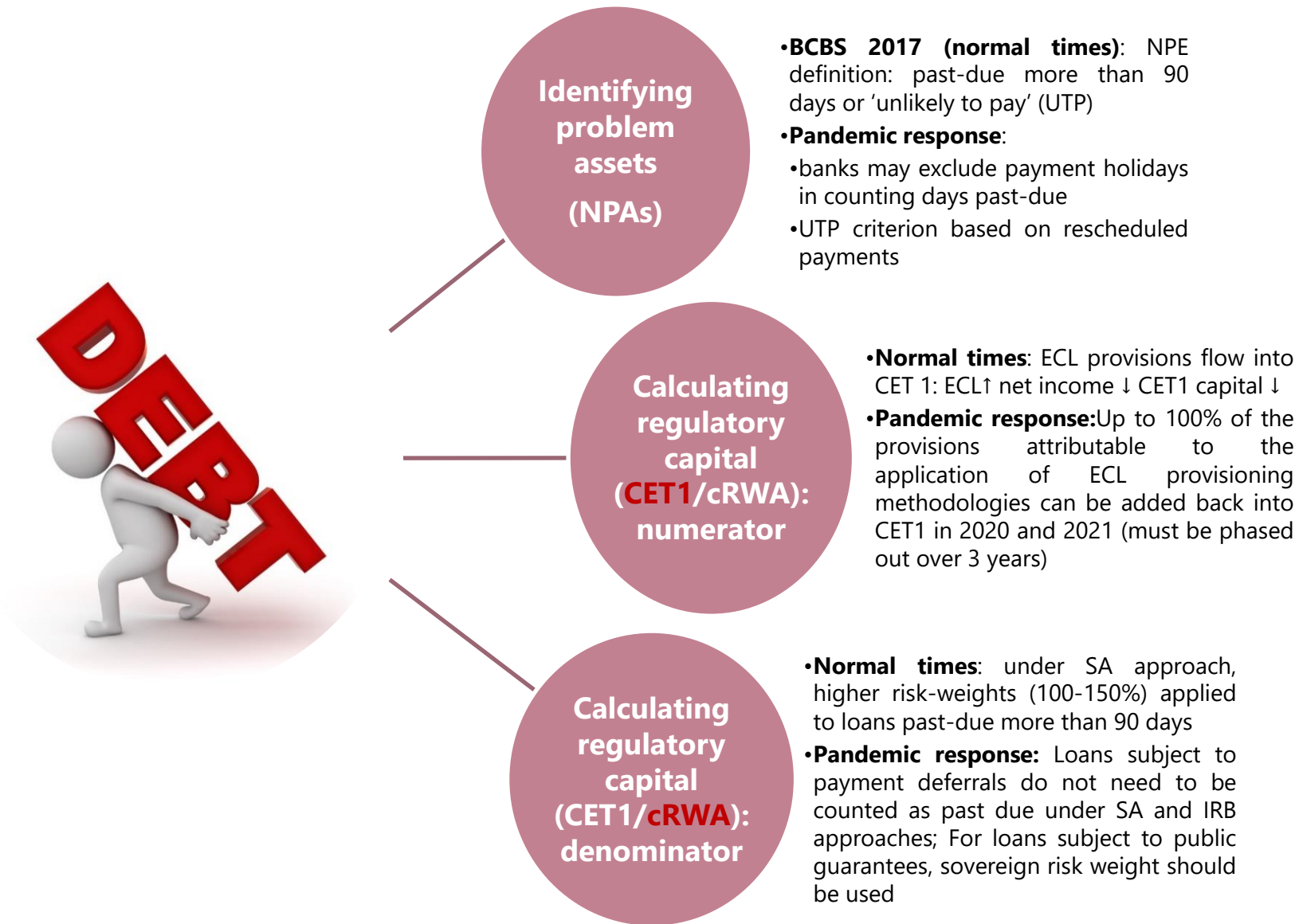
Prudential treatment of extraordinary support measures – BCBS guidance

- Many jurisdictions have introduced extraordinary support measures to alleviate impact of Covid-19:
 - Government guarantee programmes for bank loans
 - Payment holidays / moratoria
- Technical clarifications of prudential treatment to reflect risk-reducing effect of these measures:
 - Apply relevant sovereign risk weight for loans subject to sovereign guarantees
 - Exclude payment moratorium periods from definition from 'past due' / 'default' calculations and 'non-performing asset' definition
 - No automatic categorisation of loans as 'forborne'

Expected credit loss accounting provisions

- Importance of ECL accounting frameworks as forward-looking measure of credit losses
 - Banks expected to continue to apply relevant frameworks for accounting purposes
 - But modelling Covid-19 outlook subject to high degree of uncertainty
- ECL frameworks not designed to be applied mechanistically
 - Use flexibility inherent in framework to take account of mitigating effect of extraordinary support measures – many authorities issued 'statements' to avoid automatic credit downgrade
- Amended transitional arrangements for regulatory capital treatment of ECL accounting
 - Option to add-back up to 100% of transitional adjustment to CET1 capital in 2020 and 2021; subsequently phased out over three years

Regulatory relief medicine – much needed but have side effects



Implications of relief measures on key supervisory ratios

Supervisory metric	Purpose	Relief measures taken	Potential impact on supervisory metric
Stock of NPEs	Key asset quality measure	<ul style="list-style-type: none"> Payment deferrals do not need to be counted in determining over 90 days past due and in and of itself does not signal 'unlikely to pay' 	May reduce (understate) reported level of NPEs
Size of loan loss provisions	Reflection of credit risk in earnings	<u>IFRS 9</u> <ul style="list-style-type: none"> payment deferrals may delay migration to stage 2 Interest accrues on missed payments (net or gross basis) Restructured debt may not trigger NPV loss calculation Public guarantees of debt (if provided) could lower LGD's 	<ul style="list-style-type: none"> Provisions could be understated Interest income could be overstated Earnings could be overstated
CET 1 RBC ratio	Key barometer of financial health	<ul style="list-style-type: none"> Sterilization of ECL provisions (numerator) Loans subject to payment deferrals not counted as past due under SA and IRB approaches (denominator) Loans subject to public guarantees, risk-weight of sovereign replaces obligor risk-weight (denominator) 	May increase (overstate) reported CET 1 ratios

Practical considerations

- What can risk managers and supervisors do to enhance risk assessments?
 - Ensure use of UTP criterion – independent of public guarantees – to determine the stock of reported NPEs
 - Assess under Pillar 2, whether the minimum Pillar 1 credit risk capital requirements are sufficient in relation to a bank's stock of NPEs and other low-quality assets
 - Determine reasonableness/collectability of deferred interest payments recognised in P&L. Unpaid interest recognised in interest income via:
 - Capitalisation of interest
 - Increase in balance sheet line item, "interest accrued but not collected"
 - Encourage using other forms of credit modifications, such as principal haircuts – rather than relying solely on payment deferrals that must be repaid - if circumstances warrant

Concluding remarks

- Credit risk-related regulatory relief measures much needed but have side effects
 - provides banks with flexibility in supporting the real economy
 - raises risk management and supervisory challenges that become more pronounced the longer relief measures remain in place
- Challenge for authorities will be *how* and *when* to exit from relief measures
 - Acting too early may remove much needed credit to support economic growth
 - Waiting too long could undermine confidence in the post-crisis regulatory regime and heighten systemic risks
- Challenge for banks
 - Support viable borrowers but preserve integrity of published financial metrics to promote market confidence

Thank you!

Further reading

- FSI Brief 10: "Prudential response to debt under Covid-19: the supervisory challenges"
<https://www.bis.org/fsi/fsibriefs10.pdf>
- FSI Brief 8: "Payment holidays in the age of covid" <https://www.bis.org/fsi/fsibriefs8.pdf>
- FSI Brief 3: " Expected loss provisioning under a global pandemic"
<https://www.bis.org/fsi/fsibriefs3.pdf>
- FSI insights #7: [The identification and measurement of non-performing assets: a cross-country comparison \(bis.org\)](https://www.bis.org/fsi/fsibriefs7.pdf)