NÁRODNÁ BANKA SLOVENSKA

DISCUSSION FORUM

PROVISIONS ACCORDING TO IFRS AND BASEL II HELD ON 3 NOVEMBER 2005

Juraj Lörinc, Claudia Ružičková
National Bank of Slovakia

Among the issues currently faced by professionals in the Slovak banking sector, one is causing a particular stir: as of 1 January 2006, under international accounting standards, adjustment to the valuation of banks' assets by the creation of provisions will also apply to individual financial statements. How are the provisions to be correctly created? Do international accounting standards (IAS/IFRS) allow for elements of the New Basel Capital Accord (Basel II)[1] to be used in the valuation of assets? An attempt to more precisely define and possibly answer these questions was made at a recent discussion forum organised by the National Bank of Slovakia.

The forum was attended by around 150 people from across the banking sector, bearing witness to the theme's topicality. The presenters included representatives of audit companies (Deloitte Audit, s. r. o., and PricewaterhouseCoopers Audit, s. r. o., Prague), the National Bank of Slovakia, and the commercial banking sector (VÚB, a. s., and Slovenská sporiteľňa, a. s.). The forum presentations were divided into two parts. The first were given by representatives of the NBS and the audit companies, and the second by representatives of the above-mentioned banks. This contribution brings a summary of the main points of the presentations[2].

The opening presentation by J. Šefčík, of the National Bank of Slovakia, focused on describing in general terms the creation of provisions in accordance with international accounting standards. Content of the presentation may be summed in the following points:

• The basis for using international accounting standards is the EU regulation on the application of international accounting standards[3], which stipulates that companies whose securities are admitted on the regulated markets within the EU will, from 1 January 2005, prepare consolidated financial statements in accordance with international accounting standards. Since 2003, the European Commission has issued some ten other regulations in order to effect changes in accounting standards. In Slovakia, these regulations have been transposed into the Act on Accounting[4], under which all banks in Slovakia prepare their individual financial statements in accordance with international accounting standards.

• The first step in the algorithm for provisioning in accordance with international accounting standards results in the following groups of financial assets: 1) individually significant and individually insignificant financial assets, for which a provision is created on an individual basis, and 2) significant and insignificant financial assets, for which a provision is not created on an individual basis, indicating that these assets show no sign of impairment.

• A financial asset for which a specific provision is created is assessed on an individual basis until the reason for the impairment of the financial asset has passed.

• Significant and insignificant financial assets for which provisions are not created on an individual basis are treated as a group, in other words it is ascertained whether there are reasons for creating provisions for these financial assets as a group – the creation of provisions on a portfolio basis. A reason for the portfolio creation of provisions may be, for example, a significant decline in expected cash flows for the group of assets, which is not evident within individual items of the group. The provisions are created for events that have already occurred and not for those that are likely to occur in the future, while the amount of the provisions is based on both the past event and the current conditions. Based on the stated facts and using examples and prepared questions, two problematic areas were presented: first, what according to the IAS/IFRS constitutes an impairment of a group of assets; second, the reporting of classification of assets and the actual quality of the customer and individual assets.

Z. Letková, of Deloitte Audit, s. r. o., focused her pre-

[1] http://www.bis.org/publ/bcbs107.htm: International Convergence of Capital Measurement and Capital Standards, A Revised Framework, Bank for International Settlements, Basel Committee on Banking Supervisiaon, June 2004.

[2] The aim of this contribution is not to present the opinions of the presenters, or to explain the issue of provisioning in terms of accountancy, but rather to inform the professional public about what took place at the discussion forum.

[3] Regulation No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards.

[4] Act No. 431/2002 Coll. on Accounting as amended by Act No. 562/2003 Coll. and Act No. 561/2004 Coll.

sentation particularly on the differences between IAS 39 and Basel II. The fundamental difference between the creation of provisions according to IAS 39 and expected loss in the meaning of Basel II is that under IAS 39 there are considered incurred losses and under Basel II expected losses.

It is understandable that banks are attempting to calculate provisions in accordance with the rules of Basel II given their investments in technology enabling the calculation of expected loss. There remains, however, the question of how this approach should be dealt with by the auditor of the bank's financial statements, whose task is to verify that the financial statements have been prepared in compliance with international financial standards.

It is precisely this point that could become problematic, not least because of certain differences between the two frameworks. Listed below, these differences become apparent upon detailed comparison of the incurred loss (serving as a basis for provision creation) according to IAS 39 and the expected loss according to Basel II:

- the actual concepts of incurred and expected loss differ,
- Basel II specifies for regulatory purposes a minimum number of credit risk categories, and IAS/IFRS do not,
- default has different time horizons,
- Basel II, unlike the IAS/IFRS, defines default,
- a loss upon the first reporting of a loan is handled differently,
- the individual and group approach taken by the two standards is different,
- the definitions of existing security values differ and they also follow different methods,
- the reporting requirements differ,
- the definitions of capital from the accounting and regulatory viewpoint are different,
- whereas accountancy reflects the current economic situation, Basel II takes the view of cyclical economic losses,
- the exposure upon impairment differs between Basel II and the IAS/IFRS;
- and, finally, loss amount is calculated using different methods.

From this it is clear that the interaction between the two frameworks is not so great as would at first sight seem. If a bank keeps to the Basel II framework when creating provisions, the auditor may, for example, examine whether requirements under IAS 39 have been fulfilled with regard to the three Basel parameters: EAD (Exposure At Default), LGD (Loss Given Default) and PD (Probability of Default). There remains, moreover, the open question of how a bank should proceed to create provisions if it plans to use the standardised approach for the calculation of capital requirements, given that the three mentioned parameters are only used when calculating credit risk capital requirements with advanced methods (IRB approach).

A view on this issue was also presented by **P. Kříž,** of PricewaterhouseCoopers Audit, s. r. o., Prague. As a first solution for banks, he mentioned the possible creation of two models: one for measuring credit risk according to Basel II, and the other for the calculation of provisions according to IAS 39. Such a solution would, however, be to a large extent impractical and expensive for banks. So the question is whether and where these theoretical models can be interlinked so that the synergic effect resulting from the similarity of the standards is utilised.

The differences between the models for Basel II and IAS 39 result from, first of all, the distinct purposes of the two standards and their different roles. Basel II is a product of regulators which first task is to protect a bank's creditors. The model based on Basel II is a model of expected losses. The objective of Basel II is to ensure that a bank has sufficient reserves/provisions or capital to cover expected losses over the next 12 months. By contrast, the model based on IFRS is a model of incurred losses. The objective of IFRS is to ensure that financial statements as at a given date properly present in the balance sheet the incurred loss for the given period.

The main theoretical problems of implementing IAS 39 by such a method are (besides what has already been mentioned) as follows: the transition from the expected-loss model to the incurred-loss model, the reporting of interest income on impaired loans, and the discounting of provisions for loans. In addition, the models must include a significance criterion and banks must have objective evidence of the impairment of the financial asset or the portfolio of financial assets, for which they are creating a provision. It is also important to use back testing, in other words the regular re-examination of results in comparison with estimations in order to eliminate differences between the estimated reduction in value and actual losses; this applies to both the model used for the Basel II and the model used for accounting in accordance with IAS 39. A key detail which results from this purpose but which is often neglected is the definition of Probability of Default (PD) under Basel II, according to which the probability is estimated for a period of 12 months and not for the lifespan of the financial asset.

Along with implementation of the models there are a great many practical problems, for example:

- determination of portfolios that have the same risk characteristics,
- handling undrawn credit facilities,
- handling financial assets with variable interest rate,
- setting and taking account of the fair value for securing financial assets,
- defining individually significant financial assets,
- identifying objective evidence for the impairment of a portfolio.

It is necessary to distinguish between losses for which the bank must and must not create provisions.

The second part of the discussion was opened by **M. Augustín,** of VÚB, a. s., who is at present chairman of the Bank Accountancy Committee of the Slovak Association of Banks. IAS 39 is an accounting, not a management, standard and it does not define which model is good and which one bad. What is more, from the terminological aspect, this standard does not draw any distinction between financial assets and group financial assets. On the issue of selecting an item from a portfolio of items assessed on a group basis, the presenter opposed the view of the previous speaker in regard to cases where individual impairment is identified – it is not necessary to select such a financial asset from the portfolio and create an individual provision for it; on the contrary, it should be possible to leave it in the portfolio and cover the requirement of provisioning with the portfolio's provision.

M. Augustín went on in his presentation to present an overview of the financial asset in terms of decision-making according to IAS 39, again using an algorithm for the assessment of the financial asset. This decision-making has four levels: the first is the objective evidence and significance of the financial asset (the materiality mentioned in IAS may vary between banks); the second is the method of evaluating the impairment, and the third and fourth level consist of recording the impairment loss on the financial asset at the individual or group level. An analysis of discounted cash flows is at the same time applied to all future expected cash flows, including the relevant estimates for received collateral, while the original effective interest rate applied to the financial asset is used for the discounting.

The presentation of **K. Krivanská**, of VÚB, a. s., had the more practical focus of how to apply the theory of Markov's chains to measuring portfolio impairment. A basic assumption of this theory is the independence of the impairment estimate from a specific previous development of the portfolio; this estimate is based solely on the current state of the portfolio while taking into account the past statistical parameters. According to the presentation, individually insignificant financial assets will be assessed on a portfolio basis, and individual provisions will only be created for individually significant loans for which evidence of impairment exists.

In developing a specific procedure for the calculation of portfolio provisions, one of the requirements was that the calculation keeps as accurately as possible to the expected or future loss on the assumption that the quality of the specific portfolio in the near future will resemble its quality in the past. The crucial issue was therefore the quality and accessibility of the data on the bank's portfolio. The existing data store was utilised and the model was synchronised with the parent company's model. The results were tested using back testing and bootstrapping, a simulation method used in this case to test the stability of the transition matrix from one theoretical state of the portfolio to the other.

The discussion forum came to a conclusion with a presentation by the representatives from Slovenská sporiteľna, a. s., **M. Schmid and R. Harvánková**. Their presentation focused on information from the conference "IFRS practice in the banking sector", held in Amsterdam on 19 and 20 October 2005.

The presentation mentioned the main differences between and principles of IAS 39 and Basel II, which were substantially the same as those mentioned by the previous speakers, as well the reasons for individual and group evaluation. Portfolio provisions can only be reported if there is objective evidence of the impairment of portfolio financial assets, or if the portfolio includes a loss event that has already occurred; it is not possible, however, to create a provision for a portfolio in which the impairment or loss event is merely expected. Moreover, a portfolio may only be considered impaired where there is a significant probability that the assets will in future be individually impaired. Where a rating system is used that meets the requirements of the advanced Basel II approach to the measuring of credit risk (IRB approach), it should be possible to consider as group-impaired portfolios those portfolios that have the worst rating among portfolios in which a default has not been identified.

A method for the calculation of group provisions was also presented. The main parameters of the calculation would be those used by Basel II except that the probability of default would be cumulated up to maturity. The loss up to maturity would be calculated in the same way as the expected loss in Basel II, with the exception that the probability of default according to Basel II (having a term of only one year) would be replaced by the probability of default up to the maturity of the financial asset. It may also be noted that impairment losses reported on a group basis represent a transitional step towards the identification of impairment losses on individual assets in the group of those financial assets evaluated for impairment as a group.

The discussion forum did not come up with a clear-cut answer to the questions posed in the introduction. It may be said, however, that all participants expressed their view on the issue and that there was to some extent a convergence of opinions. Nevertheless, it was shown that substantial differences exist between Basel II and IAS/IFRS and that it is not possible simply to use the results from one model in the other model. Synergy may be utilised without doubt when gathering the source data used in both areas, and certain numeric characteristics may be transferred having due regard to the descriptive differences. In the end, however, the universality of both standards will to some extent necessitate mutually communication, primarily between banks and their external auditors in regard to the IAS/IFRS, while the regulator will have in this area a secondary role. The most important discovery for most participants was that they are not alone in having a problem to put the new accounting standards into practice.