CENTRAL BANK OF TRINIDAD & TOBAGO

Guideline for the Treatment of IFRS 9 (Estimated Credit Loss Provisions) for Regulatory Capital Reporting Purposes

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1. Introduction

1.1. The International Financial Reporting Standard for Financial Instruments (IFRS 9) became effective January 1, 2018. IFRS 9 replaces IAS 39 which addresses the recognition and measurement, impairment, de-recognition and general hedge accounting of financial instruments. IFRS 9 introduces an Estimated Credit Loss (ECL) accounting model that incorporates earlier and larger impairment allowances.

1.2. On 29 March 2017, the Basel Committee on Banking Supervision (BCBS) issued an interim standard on the regulatory treatment of accounting provisions (BCBS interim treatment), under which the current classification of banks' provisions into general provisions and specific provisions and their respective capital treatment will remain.

1.3. Basel I allows for a limited amount of general provisions to be included in total Tier 2 capital to reflect that they are freely available to meet future losses that currently are not identified. In accordance with the Financial Institutions (Prudential Criteria) Regulations, 1994 licensed institutions are currently allowed to include general provisions in Tier 2 capital up to a 1.25% limit of credit risk-weighted assets. Specific provisions and general provisions in excess of the 1.25% limit are required to be deducted from risk adjusted assets.[1]

1.4. The BCBS decided that given the diversity of accounting and supervisory policies in respect of provisioning and capital across jurisdictions, and the uncertainty about the capital effects of the change to an Estimated Credit Loss (ECL) accounting model, it will retain the current regulatory treatment of provisions.

1.5. Accordingly, the BCBS recommended that regulatory authorities provide guidance, as appropriate, on how they intend to categorize ECL provisions as either general or specific for regulatory capital purposes to ensure consistency of treatment by the financial institutions within their jurisdictions.

2. Purpose, Application and Scope

2.1. The IFRS 9 standard is divided into three (3) areas:
- Classification and measurement;
- Impairment; and

[1] See Regulations 6(h) ,7(d) and 10(a) and (b) of the Financial Institutions (Prudential Criteria) Regulations 1994.

- Hedge accounting.

However, this Guideline for the Treatment of Estimated Credit Losses in Determining Regulatory Capital ("ECL Guideline") will focus only on the Impairment component of IFRS 9.

2.2. The purpose of this ECL Guideline is to provide financial institutions[2] specifically with guidance on the categorization of provisions under the ECL model as either general or specific provisions for regulatory capital reporting purposes.

2.3. The ECL Guideline applies to all financial institutions.

2.4. Based on a review of the current Guideline for the Measurement, Monitoring and Control of Impaired Assets dated July 2007 ('Impaired Assets Guideline') which provides guidance on the classification of impaired assets, the Central Bank has determined that financial institutions **for the purpose of regulatory capital reporting, are now required to align their general and specific provisions in accordance with this new ECL Guideline.** This guidance supplements the requirements outlined in the Impaired Assets Guideline and the Central Bank's prudential requirements.

2.5. Financial institutions should note that classification of the general and specific provisions for regulatory reporting purposes set out in this Guideline will be for a maximum transitionary period of three (3) years. Thereafter, the Central Bank will determine the continued applicability of regulatory provisions.

3. Impairment

3.1. IFRS 9 replaces the existing incurred loss model with a forward-looking ECL model. Entities will now be required to consider historic, current and forward-looking information, including macro-economic data.

3.2. All instruments within the scope of the new impairment requirements will be subject to the same single ECL model. It is noted that there are different approaches to applying the new model including:

- General Approach – applies to all loans and receivables, which are not eligible for the other approaches. It includes three (3) stages of an asset to recognize impairment loss depending on the stage of the asset.

[2] For the purposes of this Guideline, a "financial institution" refers to an institution licensed under the Financial Institutions Act 2008 (FIA) and financial holding companies granted a permit under the FIA.

- Simplified Approach – applies to certain trade receivables and so called "IFRS 15 contract assets" and otherwise optional for these assets and lease receivables. Loss is measured at lifetime ECL for all assets.

Table 1 below illustrates the key differences between the General and Simplified approaches for measuring and recognizing expected credit losses.

Table 1 – Approaches for measurement and recognition of ECLs

	General Approach	**Simplified Approach**
Applies to	All other loans and receivables not covered by another approach	Qualifying trade receivables, IFRS 15 contract assets and lease receivables
Timing of Initial Recognition	Same period as asset is recognized	Same as General Approach
Measurement basis of loss allowance	12 month ECLs unless a significant increase in credit risk occurs, then Lifetime ECL applies unless the increase in credit risk reverses	Lifetime ECLs

3.3. It is noted that all financial institutions have adopted the General Approach. The General Approach outlines a general model (three-stage approach) for impairment based on changes in credit quality from initial recognition (refer to Table 2).

Table 2: Estimating ECL using the Three Stage Approach under IFRS 9

Stage	**Stage One (1)**	**Stage Two (2)**	**Stage Three (3)**
Recognition of expected credit losses	12-month expected credit losses	Lifetime expected credit losses	Lifetime expected credit losses
Guidance under IFRS 9	**Performing Assets** Includes financial assets that may possibly default within 12 months after the reporting date. Credit risk has not increased significantly since initial recognition.	**Underperforming Assets** Includes financial assets that have experienced a significant increase in credit risk since initial recognition.	**Impaired Assets** Includes financial assets that have objective evidence of impairment at reporting date. (Stage 3 is similar to the approach used to estimate impairment loss under IAS 39.)
Interest Calculation	Effective interest on gross carrying amount (gross).	Effective interest on gross carrying amount (gross).	Effective interest on amortised cost (net).

3.4. In determining whether the credit risk on a financial instrument has increased significantly, Management must consider reasonable and supportable information available, in order to compare the risk of a default occurring at the reporting date with the risk of a default occurring at initial recognition of the financial instrument.

3.5. Financial institutions are reminded that section 4.1 of the Impaired Assets Guideline states that a financial institution must implement an effective credit risk management policy, which incorporates an effective impairment recognition and measurement process. Further, the credit risk management policy must be supported by appropriate accounting and documentation procedures and information systems to ensure its integrity. This condition must also apply to criteria used to determine any significant increase in credit risk on a financial instrument.

4. Asset Classification

4.1 According to the Impaired Assets Guideline, all credit exposures must be assessed from the standpoint of the degree of risk presented by individual items, and the likelihood of orderly payments by the borrower. **While the payment status is normally the first reference point in establishing classification, other criteria established by a financial institution's credit policies should be considered on an equal basis in determining ultimate credit classification.** Assets are currently classified into the following categories:

- **Standard/Pass** – The credit is current and its original source of repayment is adequate. It has adequate collateral support and does not carry more than a normal risk of loss. Such credit is not classified for the purposes of making a specific provision.

- **Special Mention** – The credit is of acceptable quality. However, due to particular weaknesses, it requires more than usual management attention to prevent deterioration (e.g. the credit may be past due for 1-89 days). It is not mandatory that such credits be classified for the purposes of making a specific provision.

- For the purposes of this guideline, the Central Bank has distinguished past due exposures in this category 1 – 30 days and 31 – 89 days specifically to indicate which exposures should be classified as Stage 1 and Stage 2 respectively for regulatory reporting purposes (see Appendix 1).

- Some institutions may have assets, which are classified as Special Mention (1 – 30 days) where there has been a significant increase in credit risk and may want to apply specific provisions to those loans. In such circumstances, those loans should be considered as Stage 2 loans and should be deducted from any calculations of general provisions for Tier 2 capital reporting purposes. See Appendix II for further guidance.

- **Sub-Standard** – The credit is in arrears 90-179 days and displays weaknesses that jeopardize the full liquidation of the debt and there is a distinct possibility that the financial institution will sustain some loss, if deficiencies are not corrected. A credit that is currently performing but has weaknesses that throw doubt on the customer's ability to comply with the terms and conditions of the credit, may be classified as sub-standard.

- **Doubtful** – The credit is in arrears 180-359 days and exhibits the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection in full, on the basis of currently known facts, conditions and values, highly improbable. There is a high risk of default. A credit that is not in arrears 180 days, but has weaknesses that make collection in full highly improbable, may warrant to be classified as doubtful.

- **Loss** – The credit is in arrears 360 days and over. A credit classified as loss is considered uncollectible. A loss credit should not be kept on the books of a financial institution in the hope that there may be some eventual recovery.

4.2 Institutions are required to adhere to the classifications of ECL as general and specific provisions for regulatory capital reporting purposes as shown in Appendix I.

5. Loan Loss Provisions and Regulatory Capital

5.1 Stage 1 ECL should be treated as General provisions and would only be allowed in Tier 2 Capital up to the limit of 1.25 per cent of credit risk weighted assets.

5.2 Stage 2 and Stage 3 ECLs should be treated as Specific provisions and deducted from the credit risk exposure amount.

5.3 In determining the treatment of Stage 1, 2, or 3 ECLs, financial institutions should be guided by Appendices I and II of this Guideline.

6. Effective Date

6.1 This Guideline is effective from the date of issuance and would apply to all relevant submissions to the Central Bank from **March 2020**.

6.2 Financial institutions are required to review this ECL Guideline and institute appropriate measures to ensure compliance by the aforesaid reporting date.

Appendix I

Classification of ECL for Determining Regulatory Capital Adequacy Requirements

Classification	Stage	Provision	Comments
Standard/Pass Current	**Stage 1 ECL**	**General**	A Standard/Pass asset should be classified as Stage 1 ECL – credit risk has not increased significantly since initial recognition.
Special Mention 1 – 30 days	**Stage 1 ECL***	**General**	A Special Mention asset in this category may be classified as Stage 1 ECL where it is determined that the credit is still of acceptable quality with few weaknesses. . However, some financial institutions may opt to apply specific provisions for these credits where although classified as Special Mention (1 – 30 days) the institution has determined that there has been a significant increase in credit risk. See Appendix II.
Special Mention 31 – 89 days	**Stage 2 ECL**	**Specific**	A Special Mention asset in this category should be classified as Stage 2 ECL – credit risk has increased significantly and showing signs or evidence of factors that could result in further deterioration. See Appendix II.
Sub Standard 90-179 days	**Stage 3 ECL**	**Specific**	A Substandard asset should be classified as Stage 3 ECL – credit risk has increased significantly since initial recognition and it displays weaknesses that may jeopardize the full liquidation of the debt.
Doubtful 180-359 days	**Stage 3 ECL**	**Specific**	A Doubtful asset should be classified as Stage 3 ECL – there is a high risk of default and/or the loan is impaired.
Loss >360 days	**Stage 3 ECL**	**Specific**	A Loss asset should be classified as Stage 3 ECL – it is considered in default and uncollectible. The treatment is similar to the approach used to estimate impairment loss under IAS 39

Appendix II
Presumptions to apply in determining a significant increase in credit risk

In identifying whether the credit risk of a loan or receivable has increased significantly relative to the credit risk at the date of initial recognition, the institution must clearly determine the triggers, which cause it to change the basis of its calculation of the loss allowance from 12 month ECLs to Lifetime ECLs. To determine whether such an increase has occurred, the institution must consider reasonable and supportable information that is available without undue cost or effort, including information about the past and forward-looking information. Certain key presumptions apply in performing this test:

- An institution may assume that credit risk has not increased significantly if a loan or receivable is determined to have "low credit risk" at the reporting date; e.g., the risk of default is low, the borrower has a strong capacity to meet its contractual cash flow obligations in the near term and adverse changes in economic and business conditions in the longer term may, but will not necessarily, reduce the ability of the borrower to fulfil its contractual cash flow obligations. An example of a loan that has a low credit risk is one that has an external "investment grade" rating. An entity may use internal credit ratings or other methodologies to identify whether an instrument has a low credit risk, subject to criteria outlined in its credit policies.

- If reasonable and supportable forward-looking information is available without undue cost or effort, an entity cannot rely solely on past due information.

- There is a rebuttable presumption that the credit risk has increased significantly when contractual payments are more than 30 days past due.