GUIDELINES ON THE ADOPTION OF PHILIPPINE FINANCIAL REPORTING STANDARDS 9 (PFRS 9) FINANCIAL INSTRUMENTS – IMPAIRMENT

Section 1. Expected Credit Loss Model

BSFIs shall adopt the expected credit loss (ECL) model in measuring credit impairment, in accordance with the provisions of PFRS 9. In this respect, BSFIs shall recognize credit impairment/allowance for credit losses even before an objective evidence of impairment becomes apparent. BSFIs shall consider past events, current conditions, and forecasts of future economic conditions in assessing impairment.

a) BSFIs shall apply the ECL model on credit exposures covered by PFRS 9, which include the following:

- Loans and receivables that are measured at amortized cost;
- Investments in debt instruments that are measured at amortized cost or at fair value through other comprehensive income (FVOCI); and
- Credit commitments and financial guarantee contracts that are not measured at fair value through profit or loss (FVTPL)

b) Credit exposures shall classify into three (3) stages using the following time horizons in measuring ECL:

Stage of credit impairment	Characteristics	Time horizon in measuring ECL
Stage 1	– Credit exposures that are considered “performing” and with no significant increase in credit risk since initial recognition or with low credit risk	Twelve (12) months
Stage 2	– Credit exposures that are considered “under-performing” or not yet non-performing but with significant increase in credit risk since initial recognition	Lifetime
Stage 3	– Credit exposures that are considered “under-performing” or not yet non-performing but with significant increase in credit risk since initial recognition	Lifetime

c) BSFIs shall promptly recognize and maintain adequate allowance for credit losses at all times. It shall adopt the principles provided under the Enhanced Standards on Credit Risk Management[1] in implementing sound and robust credit risk measurement methodologies that adequately considers ECL. In this respect, the ECL methodology shall not be considered as a separate and distinct process but as an important element of the entire credit risk management process.

Section 2. Twelve (12)-Month ECL

a) BSFIs shall consider reasonable and supportable information, including forward-looking information that affect credit risk in estimating the twelve (12)-month ECL. BSFIs shall exercise experienced credit judgment and consider both qualitative and quantitative information that may affect the assessment.

b) Zero allowance for exposures under Stage 1 shall be rare. It shall be expected only for exposures with zero percent (0%) credit risk-weight under the Risk-Based Capital Adequacy Framework, such as Philippine peso-denominated exposures to the Philippine National Government and the Bangko Sentral.

Section 3. Lifetime ECL

a) BSFIs shall evaluate the change in the risk of default occurring over the expected life of the exposures in assessing whether these shall be moved to a lifetime ECL measure[2]. Although collateral will be used to measure the loss given a default, this should not be primarily used in measuring risk of a default or in transferring to different stages.

b) BSFIs shall measure lifetime ECL of the following:

- exposures that have significantly increased their credit risk from origination (Stage 2); and
- non-performing exposures (Stage 3).

Section 4. Assessment of forward-looking information

BSFIs shall clearly demonstrate how forward-looking information, including macroeconomic factors, have been reflected in the ECL assessment and how these are linked to the credit risk drivers of the exposures. Experienced credit judgment is essential in assessing the soundness of forward-looking information and in ensuring that these are adequately supported.

Section 5. Transfer from Stage 1 to Stage 2 – Assessment of significant increase in credit risk

BSFIs shall transfer credit exposures from Stage 1 to Stage 2 if there is significant increase in credit risk from initial recognition.

a) BSFIs shall establish well-defined criteria on what constitutes significant increase in credit risk. BSFIs shall consider a wide range of information, which includes among others, information on macroeconomic conditions, economic sector and the geographical region relevant to the borrower, and other factors that are borrower-specific. The criteria on what constitutes significant increase in credit risk shall consider, at a minimum, the list provided in PFRS 9.

b) BSFIs shall classify exposures to Stage 2 if the exposures have potential weaknesses, based on current and/or forward-looking information, that warrant management's close attention. Said weaknesses, if left uncorrected, may affect the repayment of these exposures. BSFIs shall also classify exposures Stage 2 if there are adverse or foreseen adverse economic or market conditions that may affect the counterparty's ability to meet the scheduled repayments in the future.

c) The Bangko Sentral shall apply the following indicators of significant increase in credit risk in BSFIs noted to have weak credit loss methodologies:

- exposures considered especially mentioned under Sec. 143 (*Credit Classification and Provisioning*);

- exposures with missed payment for more than thirty (30) days; and

- exposures with risk ratings downgraded by at least two (2) grades (e.g., exposure with risk rating of "3" on the origination date was downgraded to risk rating of "5" on the reporting date) for BSFIs with below fifteen (15)-risk rating grades, and three (3) grades for BSFIs with fifteen (15) or above risk rating grades.

Section 6. Transfer from Lifetime ECL to Twelve (12)-month ECL

BSFIs shall transfer the exposures from Stage 3 (non-performing) to Stage 1 (performing) when there is sufficient evidence to support their full collection. Exposures should exhibit both the quantitative and qualitative indicators of probable collection prior their transfer. The quantitative indicator is characterized by payments made within an observation period (e.g., regularly pays during the minimum observation period). The qualitative indicator pertains to the results of assessment of the borrower's financial capacity (e.g., improvement in counterparty's situation).

As a general rule, full collection is probable when payments of interest and/or principal are received for at least six (6) months.

BSFIs shall observe the following guidelines for exposures that were restructured:

a) Non-performing restructured exposures that have exhibited improvement in creditworthiness of the counterparty may only be transferred from stage 3 to Stage 1 after a total of one (1) year probation period [i.e., six (6) months in Stage 3 before transferring to Stage 2, and another six (6) months in Stage 2 before transferring to Stage 1; or directly from Stage 3 to Stage 1, without passing through Stage 2, after twelve (12) months]; and

b) Restructured accounts classified as "performing" prior to restructuring shall be initially classified under Stage 2. The transfer from Stage 2 to Stage 1 will follow the six (6)-month rule mentioned in Item *"a"* of this Section.

Section 7. Multiple exposures to specific counterparties

In measuring the ECL to multiple exposures to a single counterparty or multiple exposures to counterparties belonging to a group of related entities, the following shall apply:

a) *Exposures to non-retail counterparties.* BSFIs with multiple exposures to a non-retail counterparty shall measure ECL at the counterparty level. In particular, the BSFI shall consider all exposures to a counterparty as subject to lifetime ECL when any of its material exposure is subjected to lifetime ECL;

b) *Exposures to a retail counterparty.* BSFIs with multiple exposures to a retail counterparty shall measure ECL at the transaction level. In particular, the BSFI may classify one transaction under Stage 1 and another transaction under Stage 3. However, BSFIs are not precluded from taking into account the potential of cross default, such that if one exposure is classified under Stage 3 all the other exposures may be classified under Stage 3; and

c) Exposures to counterparties belonging to a group f related entities. BSFIs with multiple exposures to counterparties that belong to the same group of related entities shall measure ECL at the counterparty level (per entity). BSFIs shall likewise consider the status of the other counterparties belonging to the same group in determining the stage under which the exposures shall be classified.

Section 8. Recognition of Income

For purposes of preparing the prudential reports (e.g., Financial Reporting Package and Capital Adequacy Ratio report), BSFIs shall not recognize interest income on non-performing exposures, except when payment is received.

On the other hand, interest income recognized on non-performing exposures (Stage 3 accounts) for purposes of preparing the audited financial statements (AFS) shall be disclosed in the AFS. This shall likewise be included in the list of reconciling items between the prudential reports and the AFS that is being submitted to the Bangko Sentral.

Section 9. Off-balance sheet financial items

As a general rule, BSFIs shall recognize the ECLs on off-balance sheet exposures as a liability and booked as “Provisions-Others”.

On credit facilities with partial drawdown (e.g., with loan balance and an undrawn commitment), BSFIs shall observe the following rules in accordance with PFRS 7 (Financial Instruments: Disclosures):

a) If the BSFI cannot separately identify the ECL attributable to the drawn and undrawn commitment, the provision for ECL on the off-balance sheet accounts shall be presented together with the allowance for the financial asset (contra-asset); and

b) If the combined ECL exceeds the gross carrying amount of the financial asset, the ECL should be recognized as “Provisions-Others” (liability).

BSFIs shall look beyond the contractual date when estimating the expected losses of facilities with both loan and undrawn commitment components such as the credit card portfolio.

Section 10. Application to simple BSFIs

BSFIs with simple operations shall adopt simple loan loss methodologies fundamentally anchored on the principle of recognizing ECL. In this respect, BSFIs shall look beyond the past due/missed amortizations in classifying exposures and in providing allowance for credit losses. On the other hand, BSFIs with credit operations that may not economically justify adoption of said simple loan loss estimation methodology that is compliant with PFRS 9 shall, at a minimum, be subject to the regulatory guidelines in setting up allowance for credit losses prescribed under the Appendix 15.

Section 11. General and Specific Provisions for Loan Accounts

a) BSFIs shall treat Stage 1 provisions for loan accounts as General Provision (GP), while Stages 2 and 3 provisions shall be treated as Specific Provisions (SP).

b) BSFIs shall set up general loan loss provision (GLLP) equivalent to 1 percent (1%) of all outstanding Stage 1 on-balance sheet loans, except for accounts considered as credit risk-free under existing regulations. BSFIs are not required to provide a 1 percent (1%) GP on other credit exposures covered by PFRS 9 such as off-balance sheet accounts and investments.

c) Allowance for credit losses for Stages 1, 2 and 3 accounts shall be recognized in the profit or loss statement. In cases when the computed allowance for credit losses on Stage 1 accounts is less than the 1 percent GP required, the deficiency shall be recognized by appropriating the Retained Earnings (RE)[3] account. GP recognized in profit or loss as allowance for credit losses for Stage 1 accounts and the amount appropriated in RE shall be considered as Tier 2 capital subject to the limit provided under the Capital Adequacy Ratio (CAR) framework[4].

d) BSFIs that use the guidelines provided under Appendix 15 in determining allowance for credit losses shall book the entire amount of GP in profit or loss.

e) BSFIs shall charge against RE the increase in ECL – SP as of 01 January 2018 as a result of the change in accounting policy.

Section 12. Expectations from Trust Entities

Consistent with the expectations from BSFIs on the adoption of PFRS 9, as provided under Item *"d"* of the Sec. 172 (*Philippine Accounting Standards*), the board of directors of a trust entity (TE) shall ensure that the TE appropriately and consistently adopts PFRS 9 as part of its reporting governance process.

In this respect, the board of directors shall approve policies and guidelines relative to the impairment of financial assets under management of the TE.

The TE shall adhere to the requirements of PFRS 9 on impairment and the guidelines provided herein, to the extent applicable to the trust operations. Pursuant to Item *"c"* of Section 1 of *Appendix 100* (*Expected Credit Loss Model*), a TE shall promptly recognize and maintain adequate allowance for credit losses at all times.

Consistent with the provisions under Section 10 of Appendix 100 (*Application to simple BSFIs*), the following provisions shall apply to TEs:

a) A TE with simple operations shall adopt simple loan loss methodologies fundamentally anchored on the principle of recognizing ECL. In this respect, the TE shall look beyond the past due/missed amortizations in classifying exposures and in providing allowance for credit losses.

b) A TE with credit operations that may not economically justify adoption of said simple loan loss estimation methodology that is compliant with PFRS 9 shall, at a minimum, be subject to the regulatory guidelines in setting up allowance for credit losses prescribed under *Appendix 15*.

(Circular Nos. 1023 dated 04 December 2018 and 1011 dated 14 August 2018)

Footnotes

1. Sec. 143
2. PFRS 9 paragraph 5.5.9 provides that the assessment should be made in terms of the risk of a default and not on the expected credit loss (i.e., before consideration of the effects of credit risk mitigants such as collaterals or guarantees).
3. BSFIs shall use Retained Earnings Reserve – Others as temporary account of Retained Earnings – General Provisions (RE-GP)
4. As temporary presentation in CAR reports, the Retained Earnings (RE) included in Common Equity Tier (CET/Core Tier 1 shall be net of RE-GP. In computing Tier 2 Capital, the General Loan Loss Provision (GLLP) shall include the RE-GP. However, the GLLP added back to on-balance sheet assets subject to risk-weight shall not include the RE-GP since when appropriating the RE, total assets is not affected.