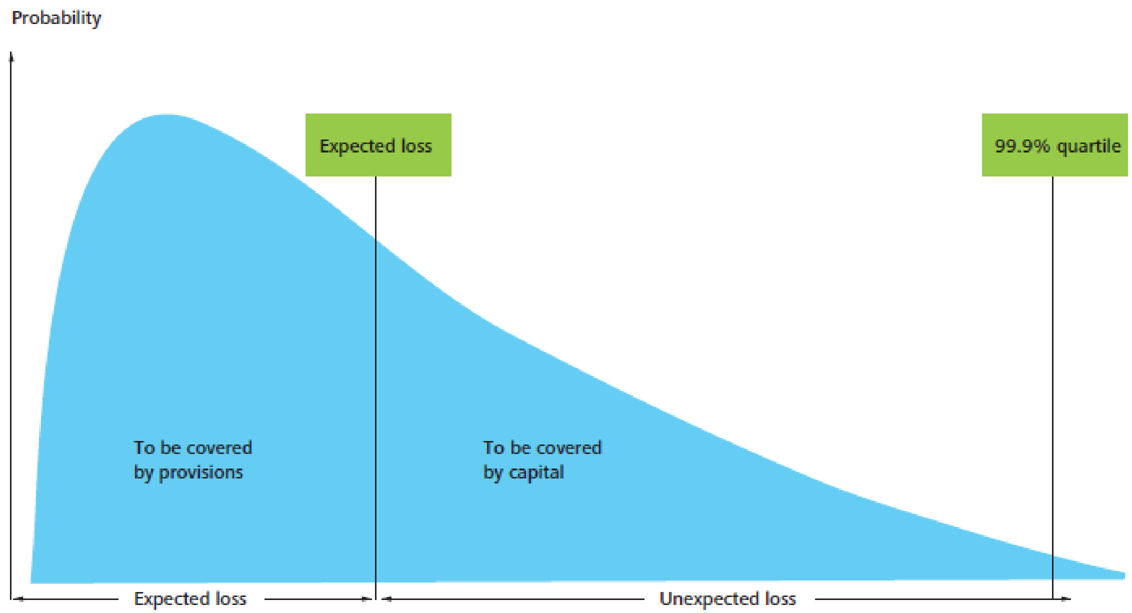
IFRS9 Impact on the Basel Capital Framework

October 2015

Expected Loss vs Unexpected Loss

Capital requirements are calibrated to measure the **unexpected losses** rather than the **expected losses.**



$$RW = \left(LGD \cdot N \left(\frac{1}{\sqrt{1-R}} \cdot G(PD) + \sqrt{\frac{R}{1-R}} \cdot G(0.999) \right) - LGD \cdot PD \right) \cdot \frac{1 + (M - 2{,}5) \cdot b}{1 - 1{,}5 \cdot b} \cdot 12{,}5 \cdot 1{,}06$$

The Formula adjust the Expected Loss

The world before IFRS9

Accounting Provisions based on Incurred Loss Model (Evidence of Impairment)

The Basel Accord adjusts for the difference between accounting provisions and expected losses

Accounting Provisions Less than Expected Losses

One year expected loss amount

Accounting Provisions | *Deduction CET1*

Accounting Provisions More than Expected Losses

One year expected loss amount | *Tier II (Limit)*

Accounting Provisions

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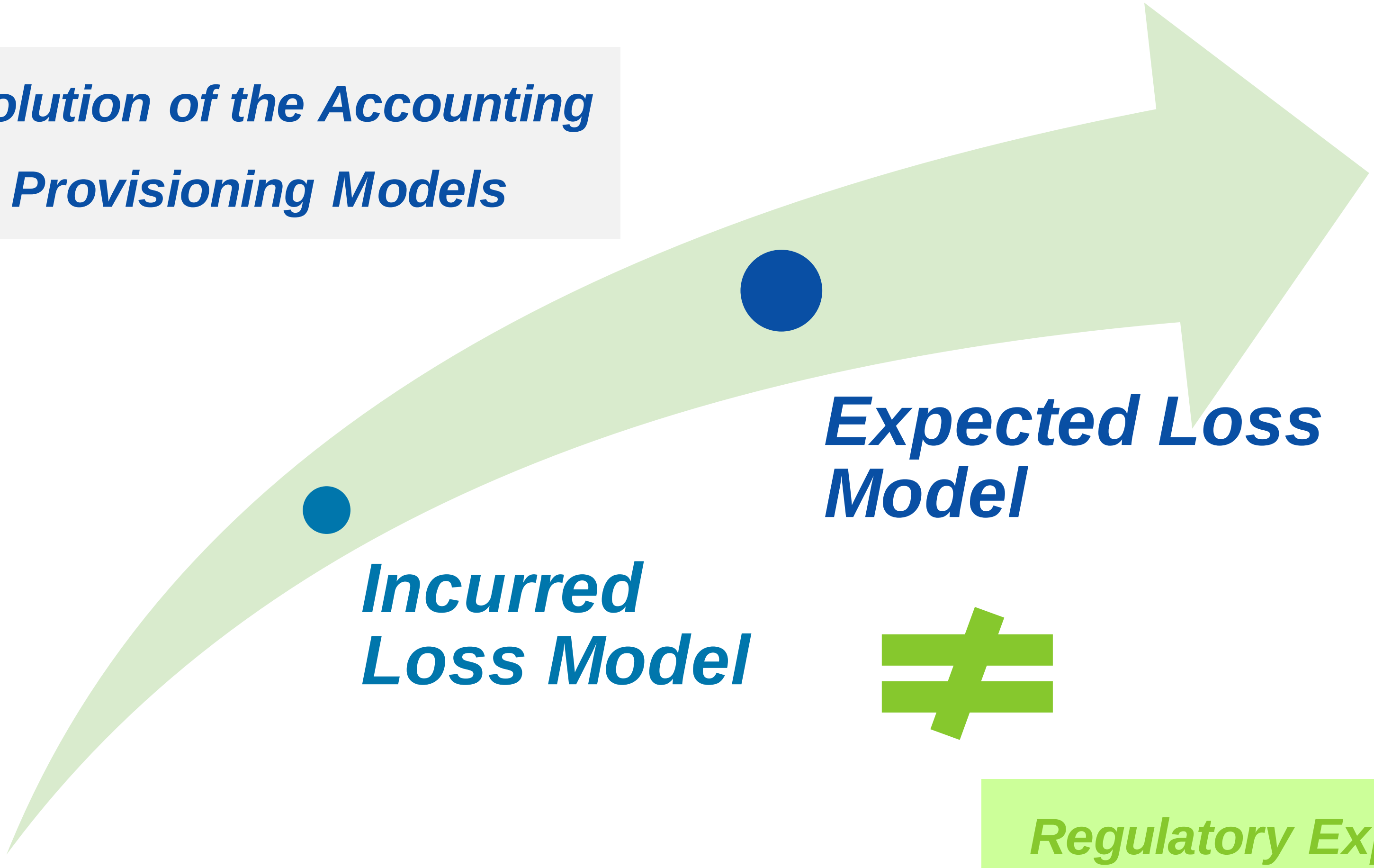
The world before IFRS9

		Standardized Approach	IRB Approach
A	Adjustment of Specific Provisions	Specific provisions are netted from the exposure value.	✗
B	Adjustment of Generic Provisions	Generic Provisions are recognised in TIER II up to 1,25% of credit risk RWAs	✗
C	Comparison of Generic & Specific Provisions to Expected Losses	✗	- Defect netted in Common Equity TIER I. - Excess of Provisions are recognised in TIER II up to 0,6 % of credit risk RWAs.

- Separate Calculation is required for Defaulted and No defaulted Exposures

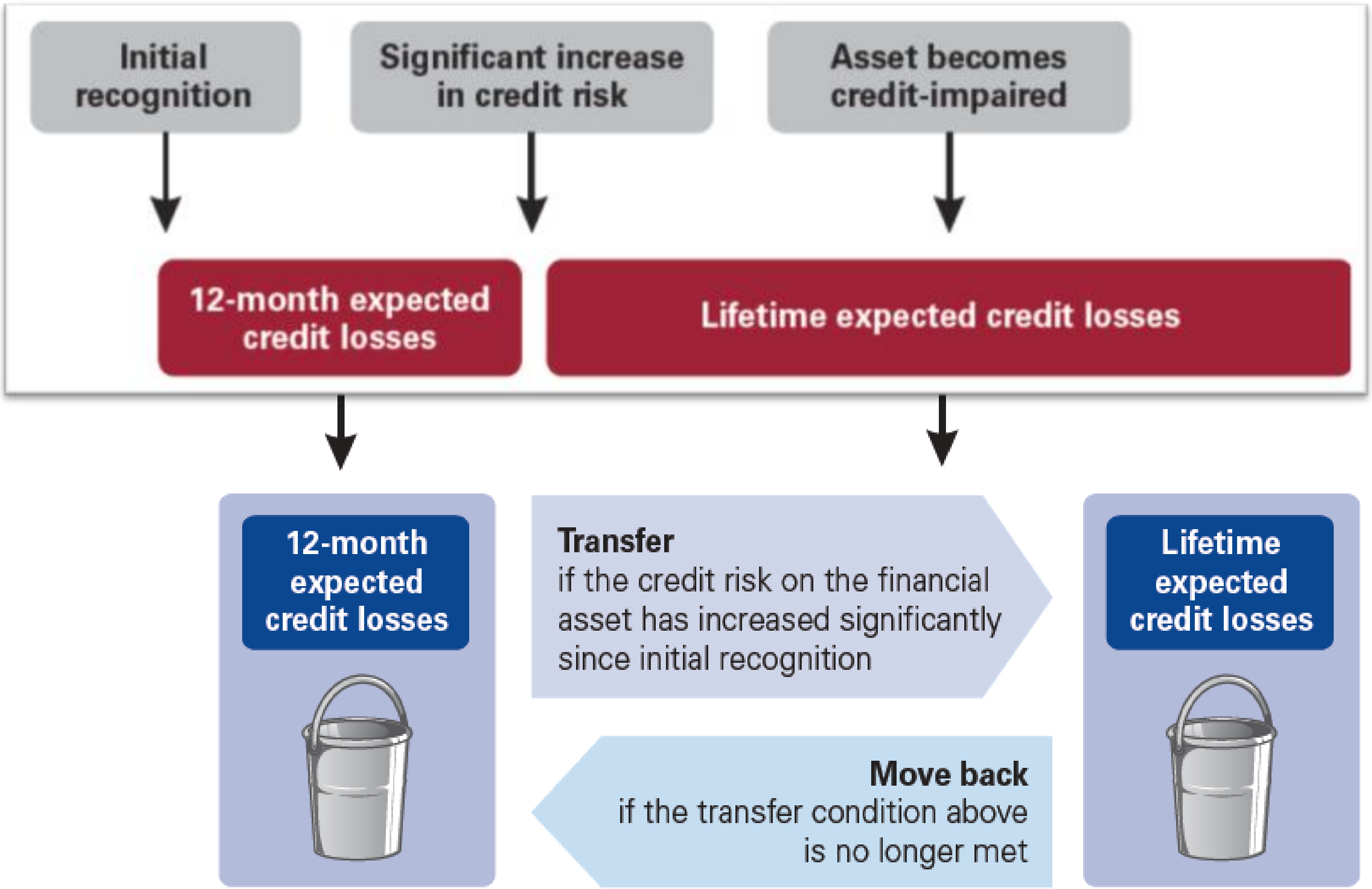
IFRS9: Expected Loss Provisioning

Evolution of the Accounting Provisioning Models

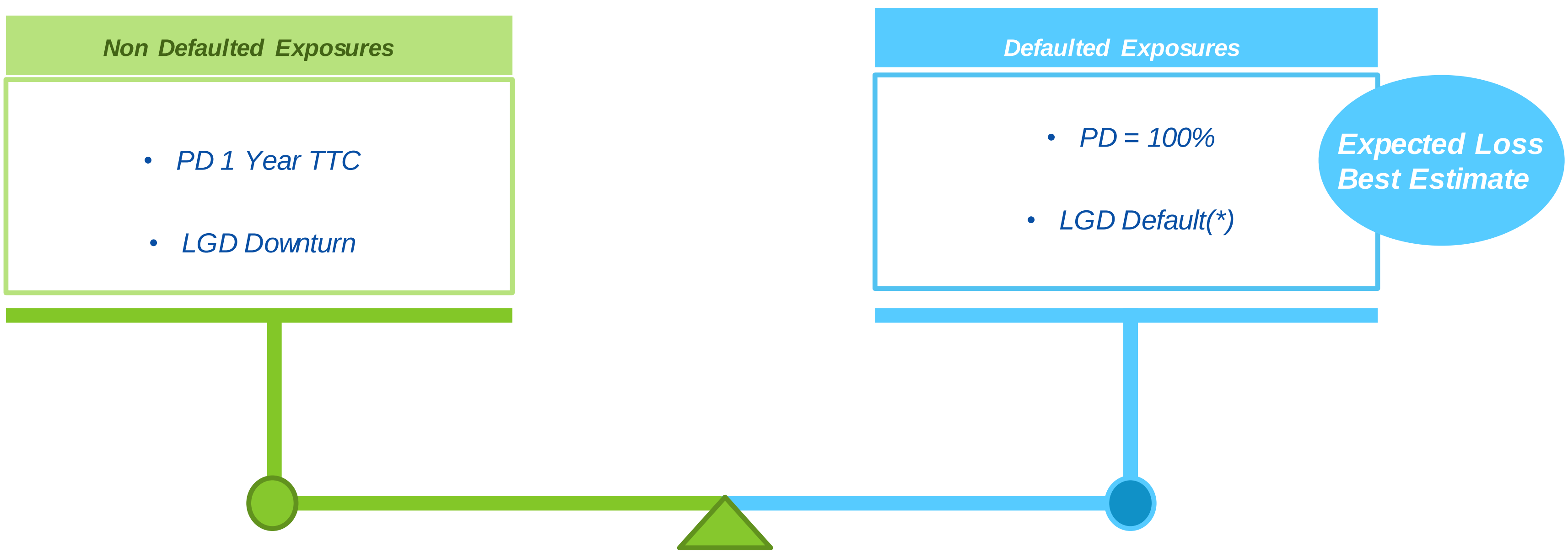


Regulatory Expected Loss Model

IFRS9: Expected Loss Provisioning



Basel III: Expected Loss



Basel Expected Loss

(*) LGD Default: best estimate of expected loss and an add-on that captures the unexpected loss that might occur during the recovery period. In particular the LGD for defaulted exposures should take into account the time the particular exposure has been in defaulted status and recoveries realized so far and consider possible reverse change in economic conditions during the expected length of the recovery process.

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IFRS9 vs Regulatory Expected Loss

Accounting Expected Loss (US GAAP)

Bucket 1	*Lifetime*
Bucket 2	*Lifetime*
Bucket 3	*Lifetime*

Under US GAAP Excess Provisions over Regulatory EL are expected in Bucket 1&2

Accounting Expected Loss (IFRS9)

Bucket 1	*One year*
Bucket 2	*Lifetime*
Bucket 3	*Lifetime*

Under IFRS9 Excess Provisions over Regulatory EL are expected in Bucket 2

Regulatory Expected Loss

Bucket 1	*One year*
Bucket 2	*One year*
Bucket 3	*Lifetime*

IFRS9 vs Regulatory Expected Loss

	IFRS 9	BASEL III

Default Definition	• IFRS9 does not define the term default	• Default occurs if either of the following two events have taken place:
		  • 90 days past due
		  • It's unlike that the obligor will be able to repay

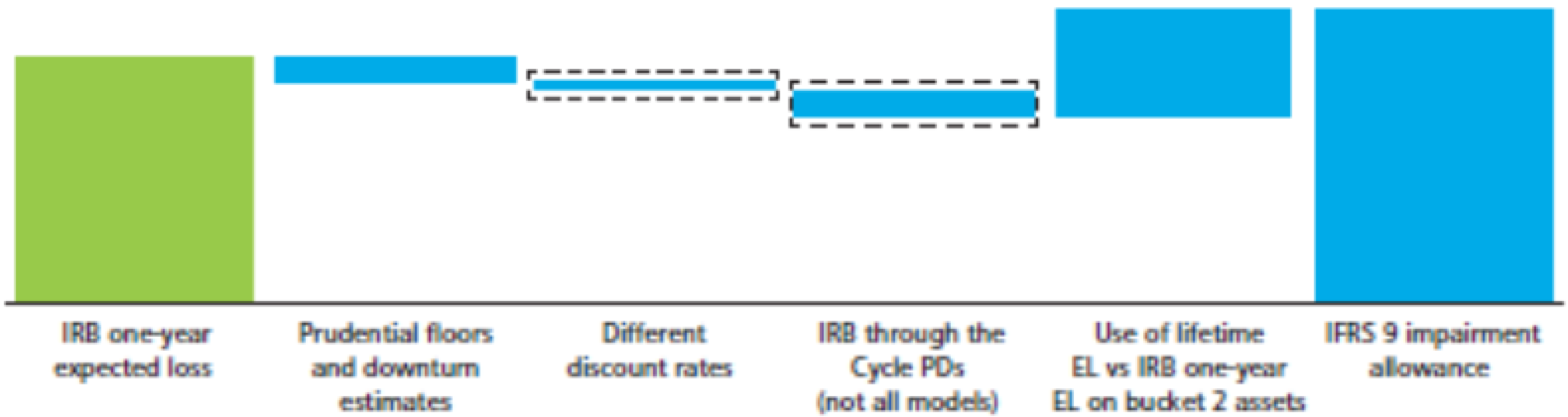
PD Estimation	• Point in Time • For the next 12 months, Lifetime or Pd=100% • No Regulatory Floors	• Through the cycle • For the next 12 months or Pd=100% (lifetime PDs are not applicable) • Regulatory Floors
LGD Estimation	• Current LGD /Default LGD • No Regulatory Floors • There's no specific requirement about the observation period • The interest rate used for the discount depends on the financial instrument • Use of the collateral	• Downturn LGD /Default LGD • Regulatory Floors • Observation Period 5 years for retail and 7 for sovereigns, corporate and banks • The interest rate used for the discount is the average cost of capital • Use of the collateral

IFRS9 vs Regulatory Expected Loss

	IFRS 9	BASEL III
Calculation of Expected Credit Losses	EAD for off balance sheet items includes CCF (could be different from regulatory ones)	EAD for off balance sheet items includes regulatory CCF
Criteria for Estimations	• Individual Basis or Portfolio Basis • Accounting Segmentation • Calibration Standard Period quaterly • Accounting Maturity	• Individual Basis / Pools • Regulatory Segmentation • Calibration Standard Period 1 year • Regulatory Scope • Regulatory Maturity • Haircuts for volatility and currency mistmaches (CRM) • No compensation default / no default in the comparison of EL vs Prov • Generic Provisions and specific Provisions defined by EBA

IFRS9 vs Regulatory Expected Loss

Reconciliation between IRB one-year expected loss and IFRS 9 impairment



(*) The picture above represents an overview of the main adjustments to the Basel Expected Loss. The amount of the adjustments have to be considered an as indication as the analysis is not based on a quantitative analysis.

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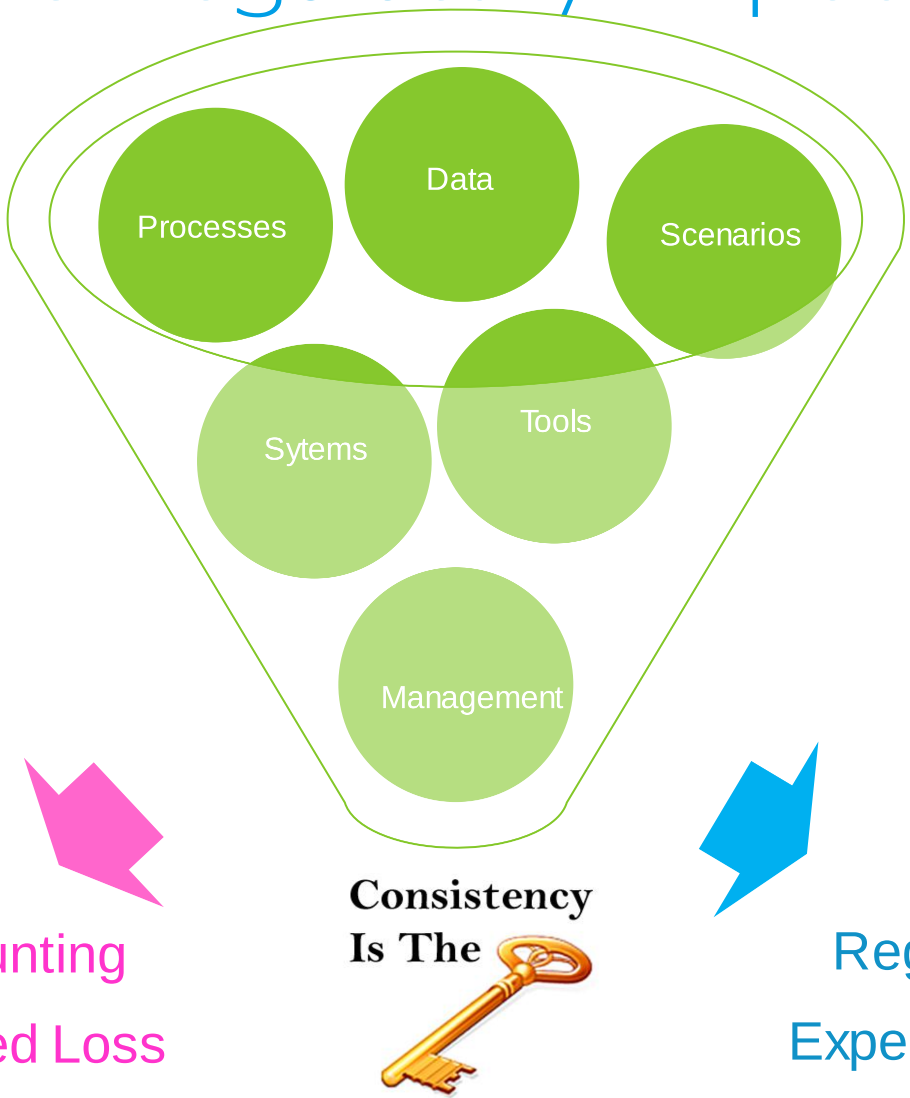
IFRS9 vs Regulatory Expected Loss



Accounting

Expected Loss

Regulatory

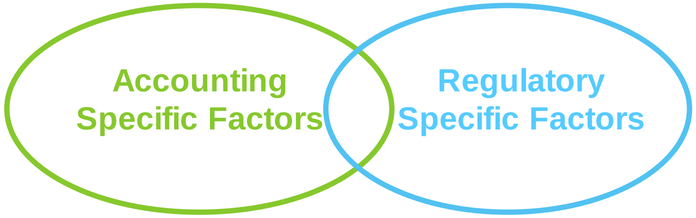
Expected Loss

IFRS9 vs Regulatory Expected Loss

Regulatory Models

Institution	Portfolio
BBVA S.A.*	Financial institutions
	Public institutions
	Specialized finance
	Developers
	Small Corporates
	Medium-sized Corporates
	Large Corporates
	Mortgages
	Consumer finance
	Credit cards
BBVA Ireland	Financial institutions
	Large Corporates
BBVA Bancomer	Retail Revolving (Credit Cards)
	Large Corporates
	Medium-sized Corporates
BBVA Group	Equity

Are these models to be considered the starting point for the accounting expected loss estimation?



The world after IFRS9

IFRS9 implies a fundamental change over the way provisions are registered but some differences remain between regulatory and accounting expected loss models. Is there a need to review the capital treatment of provisions?

MAINTAIN CURRENT TREATMENT

MODIFY CURRENT TREATMENT

Different Options under Discussion

Modify Current Treatment

Standard

- Treatment of Provisions in Exposure Calculation
- Treatment of Provisions in Capital

IRB

- Eliminate the comparison between Accounting and Regulatory Expected Losses
- Symetrical Treatment of Excess / Defects
- Alignment of accounting expected loss time horizon for comparison (non granular / granular approach)
- Alignment of regulatory expected loss time horizon for comparison
- Alignment of accounting & regulatory expected loss scope for comparison

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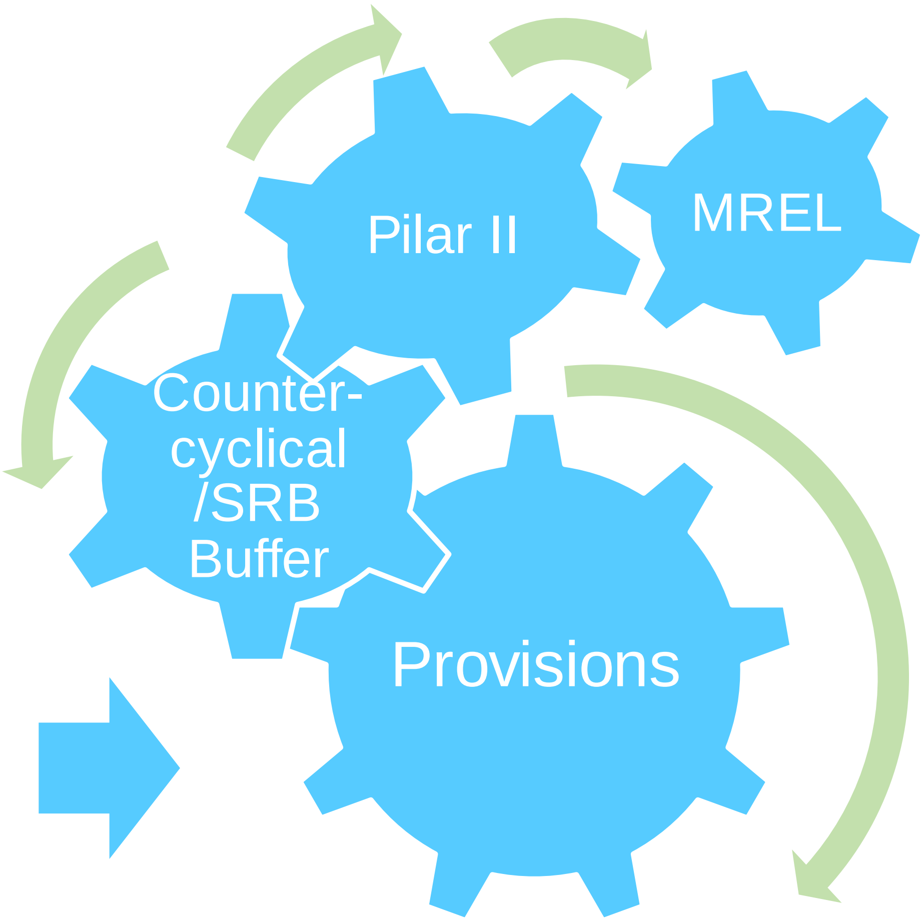
Interactions with other supervisory measures

Interactions with other Supervisory/Regulatory Measures are to be considered in the analysis



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Conclusions

1. Increase of Provisions More Anticipation, More Volatility (increased judgement)

2. Significant Differences vs. Regulatory Expected Loss Remain but Many aspects to be dealt with in a Common Way

3. Possible regulatory changes under revision it’s under discussion if the regulation should be updated to the new provisioning policies

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