Superintendencia
de Bancos de Panamá

April 21, 2017
Circular N° SBP-DR-0051-2017

General Manager

Reference: International Financial Reporting Standard
No. 9 and Dynamic Provision

Dear General Manager:

As you know, Rule 6-2012 establishes that the International Financial Reporting Standards (IFRS) are the technical standards banks and banking groups must use for their accounting records and in preparing individual and consolidated financial statements.

These technical rules are amended or modified from time to time as business activities evolve or financial problems affecting the global economy arise. In connection with the above, the last modification made by the IFRS Foundation to IFRS 9 (page B827, paragraph FCIN.11) recognized there were weaknesses arising from a delay in recognizing credit losses on loans and other financial instruments.

In that sense, among the various modifications introduced in IFRS 9 for Financial Instruments that will replace International Accounting Standard (IAS) 39 on January 1, 2018, is the measurement of a bank's expected credit losses for certain financial instruments, introducing the expected loss concept. The deterioration model will require, as a minimum, the creation of provisions covering the expected losses over the next 12 months and over the lifetime of loans and other financial instruments that have experienced significant increases in credit risk.

Provisions and capital are different concepts, as they refer to different phenomena.

Provisions try to face impairment that is inevitable due to the fact that banks grant loans and respond to "regular" losses, not for the occurrence of extraordinary phenomena; that is, for actual loan activity and based on the identified risk profile. In fact, provisions are accounting adjustments, value corrections that will appear on the income statement.

Capital has a dual function in financial entities. On the one hand, it is a source of internal funding and sets limits on leveraging. On the other, it is an instrument capable of absorbing the extraordinary losses that can be incurred from both the exposure to risks taken by the entity and the effects of systemic shocks.

The Basel Committee for Banking Supervision's financial regulation tries to assess how much minimum capital banks should have. As you should know, Basel III has determined new standards for determining both capital quantity and quality.

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Determining minimum regulatory capital is the exclusive purview of the Superintendency of Banks and it is out of IFRS reach.

In that sense, Rule 4-2013, which sets the provisions on *credit risk management inherent in credit portfolio and off-balance sheet operations*, a prudential regulation issued by the Superintendency, established dynamic provisions as a capital reserve that is not affected by any correction of the accounting value of financial assets due to deterioration. IFRS 9 is not applicable.

The fact that IFRS 9 introduces the possibility that certain financial assets currently classified as "normal" may be subject to impairment provisions under the concept of non-significant increases in risk and the 12-month expected loss estimation, should not be confused with the dynamic provision, since it is based on the calculation of the outstanding amount in the normal portfolio and its quarterly variation in determining the dynamic provision. The main difference is that the dynamic provision does not try to estimate the accounting value correction in estimating an expected loss. It increases the required reserves to face large unexpected losses, i.e. extraordinary losses.

Extraordinary losses, very uncommon but of a high amount, may result from serious mistakes in the bank's loan policies, loan bubbles or securities market's policies, among others.

Due to the above, we wish to clarify that the results obtained for the expected loss provision according to IFRS 9 should not be deducted from the balances of the dynamic provision established in Article 33 of Rule 4-2013.

We would greatly appreciate your providing the necessary instructions to your staff for compliance with these provisions.

Best regards,

Ricardo G. Fernandez D.
Superintendent

ARV/RA