The Coordination of Dynamic Provisioning System and Financial Assets Impairment Accounting Standards

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Abstract. In order to effectively deal with the pro-cyclical provision, the China Banking Regulatory Commission and the Ministry of Finance have issued a counter-cyclical dynamic provisioning system. However, the dynamic provisioning system and China's financial assets impairment criteria have some differences, resulting in the implementation process some problems, therefore there is a need to coordinate this.

Introduction

After the outbreak of the financial crisis in 2008, the issue of pro-cyclical bank provisioning began to be exposed. Due to the implementation of a dynamic provisioning system in Spain and other countries, the banking industry was relatively less affected by the financial crisis. The formal adoption of Basel III in 2010 provided a benchmark for the development of China's dynamic provisioning system. Subsequently, the China Banking Regulatory Commission and the Ministry of Finance have successively issued a dynamic provisioning system that has a counter-cyclical effect. However, this system is in conflict with the current devaluation of financial assets. Therefore, it is necessary to coordinate this system.

Traditional Provisioning System and Dynamic Provisioning System

The traditional provisioning system is based on the "lost model" and only recognizes actual credit losses and ignores the future risks of bank credits. It has strong periodicity. During the economic upturn, there were fewer default events. Banks expanded the scale of credit and the credit risk in the future increased. During the economic downturn, the increase in actual losses caused an increase in provisioning provision, further worsening the bank’s financial status. The dynamic provisioning system is based on the "expected loss model" and requires banks to identify future risks in advance. In the economic upturn period, the bank considers the potential risks arising from credit expansion in advance and provides more provision; during the economic downturn, it plays a buffer role in the provision, compensates for loan losses, and reduces provisions for provision.

The Practice of China's Dynamic Provisioning System

Regulatory Practices - "Guiding Opinions on the Implementation of New Regulatory Standards for China's Banking Industry by the China Banking Regulatory Commission"

The "Guidance on the Implementation of New Supervision Standards in China's Banking Industry" issued by the China Banking Regulatory Commission in 2011 (Yinjianfa [2011] No. 44) proposed the establishment of "dual-indicator" supervision over the ratio of loan to loan ratios and provision coverage. The ratio of required loan to loan ratio is not less than 2.5%, and the provision coverage ratio is not less than 150%. The supervisory department will adjust the supervisory standards according to the actual situation and adjust the supervisory standards according to the specific conditions of the single bank. For the first time, the China Banking Regulatory Commission included the loan to loan ratio as a regulatory indicator, taking into account the risk of
increased loans becoming non-performing loans in the future, reflecting the concept of dynamic provisioning.

**Accounting Practices - "Administrative Measures for Provision of Financial Companies for Reserves" of the Ministry of Finance**

The “Measures for the Provision of Provisions for Financial Enterprises Provisions” promulgated by the Ministry of Finance in 2012 introduced a dynamic provisioning mechanism. Provisions are divided into loan loss preparations and general preparations. Loan losses are prepared using the cash flow method to measure actual credit impairments in the current period; general provisions are used to make up for unrecognized losses, and are extracted using credit risk estimates (calculated in accordance with the internal model method or standard method) minus the actual impairment of loans. When the risk estimate is lower than the actual impairment, the general reserve may not be withdrawn but the general reserve must not be less than 1.5% of the risky asset. The provision for general reserves is based on a comparison between risk estimates and actual impairments, taking into account the potential risks of credit assets and having dynamic characteristics. General preparations as post-tax profit distribution can only be used to make up for losses.

**Differences and Impacts of the Current accounting Standards and Regulatory Policies**

Although China has introduced the concept of dynamic provisioning on the supervision and accounting treatment of bank provisioning, due to the different goals of policy formulation, there are many differences between the two. The accounting treatment of bank provisioning mainly reflects the past situation and aims to provide true and fair accounting information. The regulatory policy is more concerned with the future and aims to maintain the stable development of the financial system through forward-looking supervisory methods.

**The main performance of the difference**

**Dynamic Provisioning has different accounts.** The dynamic provision required in the accounting standards is accrued in the general reserve account through the distribution of after-tax profits, and the dynamic provision mentioned in the regulatory policy of the CBRC is recorded in the loan loss allowance account, which is the future cash flow of credit assets required by the accounting standards. The difference between present value and book value. In the accounting treatment, the estimation of the future cash flow of credit assets will not take into account the credit risk that has not yet occurred. This leads to the fact that the loan loss preparation actually records the credit impairment that has occurred, rather than the estimation of future risks, making the two policies The dynamic provisioning in the two are completely different concepts.

**Dynamic provisioning method is different.** Accounting standards require banks to calculate credit risk estimates through internal model methods or standard methods, and to recognize the provision amount of dynamic provision by comparing the difference between the risk estimate and loan impairment provision. Except for the feasibility of risk assessment, this method is theoretically reasonable; and the Banking Regulatory Commission, by setting adjustable regulatory indicators, sets the minimum requirements for provisioning based on the loan to loan ratio and provision coverage ratio. The operation is simple and easy for regulators to perform effectively. Although the China Banking Regulatory Commission emphasized that it would adjust the supervision indicators for the specific circumstances of individual banks, whether such adjustments can effectively consider the difference in loan risks between commercial banks also requires practical tests.

**Dynamic provisioning has different effects on the financial statements.** The dynamic provisions required by the China Banking Regulatory Commission are often excessive loan losses, which are listed in cost items through the loan loss preparation subject, which in turn affects the current profit and loss. The dynamic provision required by the accounting standards is an after-tax profit distribution item. The general preparation of the account directly affects the owner's equity. The two have different effects on the financial statements of commercial banks.
The adverse effects of the difference

**Provide space for earnings management.** Earnings management refers to the behavior of the enterprise to maximize its own interests by controlling or adjusting the accounting income information externally reported by the company on the basis of following the accounting standards. Differences in regulatory policies and accounting standards have led companies to have the flexibility to choose ways to prepare for loan losses. When accounting provision is greater than or equal to the regulatory minimum requirements, the results of the two sets of standards are the same. However, in the course of practice, such a situation may not be achieved. Therefore, the company will select the provisioning standards that are favorable to itself for earnings management according to the actual situation.

**Failed to meet the quality requirements of accounting information.** When the accrued provision fails to meet regulatory requirements, commercial banks are under pressure from supervision to avoid penalties resulting from non-compliance of supervision, and provision may be made based on the minimum supervision standards of the China Banking Regulatory Commission. The general commercial bank will calculate the loan loss provision that needs to be made according to the minimum supervision standard, and then use that amount to reverse the amount that should be withheld according to the accounting standards, instead of making provisions strictly in accordance with the requirements of the accounting standards. This will lead commercial banks to fail to effectively implement current accounting standards and fail to meet accounting quality information requirements.

**Coordination of Accounting Standards and Regulatory Policies**

The Ministry of Finance and the China Banking Regulatory Commission have different considerations on the formulation of policies. Therefore, the differences between the two are inevitable, and differences should be effectively coordinated. The author proposes the following suggestions in combination with foreign practice and domestic realities:

**Improve provisioning supervision indicators**

Regulators can use the “total loan provision ratio” instead of the loan to loan ratio as a regulatory indicator. The total loan provision ratio is the ratio of loan loss preparation and general preparation to the balance of the loan. Using it as a supervisory indicator can take account of both the implementation of accounting standards and the effectiveness of supervision. At the same time, the China Banking Regulatory Commission and the Ministry of Finance should establish a coordination mechanism to make dynamic adjustments to the regulatory standards for total loan provision ratios based on factors such as economic cycles, macroeconomic policies, industrial policies, overall loan classification deviations of commercial banks, and changes in loan losses.

**Regulating banking report disclosure**

At present, the difference between the provision and supervision of banks in China is ambiguous, resulting in information asymmetry. Therefore, it is necessary to strengthen the standardization of banking accounting information disclosure, unify the reporting format of the profit statements of the banking industry, and separately list the “Loan Loss Allowance Shortfall” and the “General Reserve Shortage” items, as well as the aforementioned gaps and their accounting standards and regulatory policies. The differences reflected between them are fully explained to improve the transparency and comparability of accounting information.

**Ensure effective communication between functional departments**

The China Banking Regulatory Commission and the Ministry of Finance must strengthen communication when formulating policies. In formulating regulatory measures, the CBRC shall fully consider the adverse effects of this measure on the accounting business, and try to adopt some regulatory indicators that are in line with current accounting standards. Only in this way can we
effectively improve the effectiveness of supervision, weaken the negative effects of supervision, and ensure the smooth implementation of regulatory measures.

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References