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Basel Committee on Banking Supervision (BCBS)
Basel, Switzerland

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Basel Committee Consultative Document: Guidance on accounting for expected credit losses

Dear Sir / Madam,

The Association for Financial Markets in Europe (AFME)[1] welcomes the opportunity to comment on the Basel Committee's Consultative Document: Guidance on accounting for expected credit losses (the 'Guidance').

The first part of the Guidance sets out the underlying principles relating to supervisory requirements for sound credit risk practices that interact with expected credit loss measurement. It is stated that the guidance is intended to set forth requirements that do not contradict applicable accounting standards established by standard setters.

The second part of the Guidance in the Appendix outlines supervisory requirements specific to banks reporting under International Financial Reporting Standards (IFRS). It is stated that the guidance in the Appendix is limited to certain aspects of the expected credit loss (ECL) requirements in the impairment sections of IFRS 9 that are not common to other ECL accounting frameworks.

We comment below on the two parts of the Guidance.

<u>First part of Guidance:</u>

<u>Scope:</u>

Paragraph 2 states that "In June 2006, the Basel Committee on Banking Supervision issued supervisory guidance on Sound Credit Risk Assessment and Valuation for Loans to address how common data and processes related to loans may be used for assessing credit risk, accounting for loan impairment and determining regulatory capital

[1] AFME represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society. AFME is registered on the EU Transparency Register, registration number 65110063986-76. www.afme.eu

requirements. This document, once finalised, will replace the Committee's June 2006 guidance".

Our understanding is that the scope of the Guidance is the same as that of the June 2006 guidance, and that the purpose of the update is to reflect the development of ECL accounting frameworks. However, whilst it is stated that the Guidance is intended to set forth requirements that do not contradict applicable accounting standards established by standard setters, we would welcome a more explicit statement that the subject of the guidance is not the accounting treatment itself (as might be inferred from the title of the consultation document), but rather the supervisory requirements for sound credit risk practices.

Similarly, we believe the scope of the Guidance is ambiguous with regard to its application to jurisdictions in which ECL accounting frameworks are not required. In particular, the statement in paragraph 4 that the requirements are applicable under all accounting frameworks is somewhat undermined by paragraph 1, which refers only to "ECL accounting models".

We welcome the clarification of scope in paragraph 13, which states that "This paper covers the credit risk practices for lending exposures that are subject to the recognition of allowances under ECL accounting frameworks. While credit risk practices for other bank exposures, such as debt securities, are outside the scope of this paper, banks should ensure that sound credit risk practices are in place in these areas and that credit risk is properly considered in developing ECL estimates for these other exposures." As such, we understand that the scope-out reference for "other bank exposures such as debt securities" applies equally to the second part of the Guidance in the Appendix, and that all types of transactions that are related to securities (for example, securities financing transactions) are outside the scope of the Guidance.

<u>Proportionality:</u>

We also welcome the recognition on proportionality for less complex banks given in paragraph 12. However, we believe that the proportionality principle should not be limited only to institutions of different size or complexity. Large internationally active banks should be able to apply the proportionality principle to smaller portfolios or smaller subsidiaries or branches.

<u>Materiality:</u>

The Guidance is currently silent on materiality. As materiality is a fundamental principle in financial reporting (and is also relevant to regulatory requirements), the Guidance should clarify that the concept of materiality as applied in accordance with accounting standards is not overridden.

<u>Comments on the Principles:</u>

Given the intention as stated in paragraph 4 that the "requirements described in the main section of this paper are equally applicable under all accounting frameworks", we believe that the Guidance should be grounded on principles rather than highly prescriptive credit risk practices.

We would note that the principles should be applied in a way that reflects the business. For example, in paragraph 21, there is a statement that "The Committee expects banks to maximise the extent to which underlying information and assumptions are used consistently within a bank to determine when credit should be granted and its corresponding terms; monitor credit quality; and measure allowances for both accounting and capital adequacy purposes". This sounds reasonable as long as it does not imply that firms should have the same level of review for all their decisions: some loan books may be more material than others and in that case different levels of review would be appropriate.

Disclosure:

We note that the Basel Committee has set out enhanced disclosure requirements relating to credit risk as part of the revised Pillar 3 framework. Accounting standard setters have also set out disclosure requirements.

We would encourage the Committee to coordinate with the Pillar 3 working group and with the accounting standard setters to ensure that the requirements set out in paragraphs 72 to 81 interact appropriately with the other disclosure requirements. We would suggest that the Committee consider whether Principle 8 and the related paragraphs would be better included in the Pillar 3 framework.

Other points:

We note that there are various uses of terms such as "backtesting" and "concentration". If these terms are to be used, we consider that it would be appropriate to give a definition or explanation, preferably by reference to existing definitions of these terms, in order to avoid multiple definitions.

Additionally, we are concerned with the use of "full spectrum" in paragraph 30, in particular as to how this is going to be interpreted and implemented. As such we would propose to the Committee to align it to the accounting requirement of reasonable and supportable information that is available and relevant.

Second part of the Guidance - Appendix on IFRS

We have some specific comments on particular paragraphs in the Appendix.

Paragraphs A4 and A5 – definition of default:

Paragraph A4 states that "IFRS 9 does not directly define default, but requires entities to define default in a manner consistent with that used for internal credit risk management. ... The Committee expects that the definition of default adopted for accounting purposes will be guided by the definition used for regulatory purposes. The default definition provided in the Basel capital framework includes both: (a) a qualitative criterion that requires a bank to identify credit deterioration before the exposure becomes delinquent ("unlikeliness to pay" events); and (b) an objective indicator based on a material delinquency status equivalent to the rebuttable presumption in IFRS 9, paragraph B5.5.37 (the obligor being past due more than 90 days)".

Paragraph A5 states however that "the list of elements provided in the Basel framework as indications of unlikeliness to pay should be supplemented with other elements that affect the borrower's ability or willingness to meet the contractual obligations, as identified on either an individual or collective basis, and adjusted to incorporate current conditions and forward-looking information. The inclusion of those other elements is aimed at capturing indicators of credit risk that precipitate eventual cash shortfalls".

We are concerned that a supervisory requirement to include supplemental information would create inconsistency with the current definition of default used for risk management purposes. We would suggest that the supervisory requirements should be aligned with IFRS 9.

<u>Paragraph A8 – origination of high credit risk loans:</u>

Paragraph A8 states that "The Committee understands that banks will only rarely originate exposures that are high credit risk. Indeed, where high credit risk exposures are originated and their allowances are initially measured at 12 month ECL, the Committee expects the bank to monitor these exposures closely for increases in credit risk that would result in the exposure moving quickly to LEL measurement."

Based on feedback from banks, we understand that it is in fact not uncommon for banks to originate exposures that are high credit risk. Of course, at the same time banks need to have a sound credit risk assessment process that provides them with a strong basis to assess and price credit risk.

Accordingly, we would suggest that the first sentence in paragraph A8 should be deleted, and that the second sentence should start "Where high credit risk..."

<u>Paragraph A22 – use of delinquency data:</u>

Paragraph A22 states that "Delinquency data are generally backward-looking, and the Committee believes they will seldom be appropriate in the implementation of an ECL approach by banks."

Our understanding is that banks would use delinquency data as *part of* their assessment of expected credit losses. It would seem to be inappropriate simply to ignore delinquency data.

<u>Paragraph A23 – wording going beyond IFRS 9:</u>

Paragraph A23 states that "the Committee believes that, in order to meet the objective of IFRS 9 in a robust manner, banks will need to have a clear view – supported by persuasive analysis – of the linkages from macroeconomic factors and borrower attributes to the level of credit risk in a portfolio."

We are concerned that the Guidance should not go beyond what is in IFRS 9. In particular, there is no reference to "persuasive analysis" in IFRS 9. Accordingly we think that Paragraph A23 should be aligned with IFRS 9.

Paragraph A27 – significant increase in credit risk:

Paragraph A27 states that "While it is neither possible nor desirable for universally applicable criteria to be developed, the Committee emphasises that the presence of any of the conditions (a) – (f) below would suggest that there has potentially been a significant increase in credit risk. Banks should take particular care to avoid the risk of a significant increase in credit risk not being acknowledged promptly when it is, in fact, present. In forming their assessments, banks should pay particular attention to the factors listed below: (a) a discretionary decision by management such that, were an existing loan newly originated at the reporting date, the element of the price of the loan that reflects the credit risk of the exposure would be higher than it was when the loan was actually originated as a result of a change in credit risk since inception." The related footnote 33 states that "Where management is unable to distinguish this element of pricing from others, such as the general price of credit risk or changes in gross margins charged due to other factors such as changing capital requirements, the Committee expects banks to adopt a rebuttable presumption that any increase in the credit spread that would be charged for a particular loan is due to an increase in the bank's assessment of the credit risk of that exposure".

Our understanding is that paragraph A27 and the related footnote 33 are intended to relate to the assessment of a *significant* increase in credit risk. We think this is clear from the drafting at the beginning of paragraph A27, and that the conditions (a)-(f) should be interpreted accordingly. We trust we have understood this correctly. Having said this, we note that the six conditions as indicated in paragraph A27 of the draft Guidance appears to be amongst (albeit with different wordings) the non-exhaustive list of factors contain in IFRS 9 B5.5.17 that may be relevant when assessing significant increase in credit risk. It is not clear to us why these six conditions are particularly selected to be given greater prominence. It is our view that all relevant and reasonably available information, including those factors in IFRS 9 should be considered. Hence, we recommend to the Committee to delete the six conditions as currently referenced in the draft Guidance. If necessary, a reference could instead be made to paragraph B5.5.17 in IFRS 9.

We would also note that there appears to be an inconsistency in approach between footnote 33 and the requirements of IFRS 9. IFRS 9 requires that a bank needs to demonstrate that there has been a significant increase in credit risk in order to move to the next stage of impairment. On the other hand, footnote 33, by assuming that any change in credit spread element of pricing is due to changes in credit risk, could result in lifetime expected loss being recognised when there is no significant increase in credit risk. Hence, we recommend to the Committee that footnote 33 be deleted.

Paragraphs A40 and A46 – A49 – use of practical expedients:

Paragraph A40 states that "the Committee is of the view that, in order to implement IFRS 9 in a robust manner, practical expedients...should rarely be used by banks, as these have the potential to introduce significant bias."

Paragraph A46 states that "The Committee regards many of these practical expedients as inappropriate for use by internationally active banks more sophisticated in the business of lending, particularly because – given their business – the cost of obtaining relevant information is not considered by the Committee to be likely to involve "undue cost or effort".

Our view is that banks should be considering the best "*reasonable and supportable* information that is available, without undue cost and effort" as set out in IFRS 9.

We believe that this is consistent with our view, set out earlier in this letter, that banks should be able to apply the proportionality principle to smaller portfolios or smaller subsidiaries or branches.

Practical expedients are relevant here because their use would be consistent with the way in which portfolios are managed.

We trust that these comments are helpful and we would be pleased to engage further with the Committee as the Guidance is finalised if that would be useful.

Yours faithfully,

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