

April 30, 2015

Basel Committee on Banking Supervision
Bank for International Settlements

Via website submission: <http://www.bis.org/bcbs/commentupload.htm>

Re: Consultative Document: *Guidance on Accounting for Expected Credit Losses*

To Whom It May Concern:

The American Bankers Association (ABA¹) appreciates the opportunity to comment on the Consultative Document *Guidance on Accounting for Expected Credit Losses* (CD). The CD, once finalized, will likely be a key reference for banks in many countries in implementing the new loan impairment accounting standards that are being approved by the accounting standard setters. As with other documents published by the Basel Committee, guidance included in the final CD attempts to set a benchmark for domestic regulators to use in supervising their banking institutions for expected credit losses.

The CD Should be Open to Change Upon a Final FASB Standard

Given that a new expected credit loss standard will not be finalized in the U.S. until after the comment period, we believe the CD should remain open to change until those final standards can be analyzed and incorporated into the discussion of lifetime expected credit losses. This is especially important to ensure consistent application and implementation across U.S. GAAP and IFRS-based banks for any portions of impairment standards that are comparable.

Currently, there is not a common understanding in the U.S. among bankers this CD is primarily meant to address (large, internationally-active banks), regional and community bankers, banking regulators, and auditors as to the complexity of the proposed Current Expected Credit Loss impairment model (CECL). incorporate them into the final CD. Resolution of these disagreements, for example, could affect implementation and recommendations regarding the use of historical data and long term forecasts, among other issues.

Once the Financial Accounting Standards Board (FASB) finalizes its impairment standard, we believe that certain concepts within the CD could require change in order to be applicable to U.S. banks. In fact, if the Committee desires consistent implementation of expected credit loss accounting, the CD will either need to undergo a second review after the CECL standard is issued or the U.S. regulators may need to develop their own guidance. For the purposes of the current CD, our comments are presented based on a general understanding and expectation of a final CECL standard. Although our comments below normally refer to CECL, we believe they would be equally relevant to the lifetime expected loss requirements within IFRS 9.

¹ The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's \$14 trillion banking industry and its two million employees.

High Level Principles Should Better Address Implementation of Lifetime Loss Estimates

The recognition and measurement of expected lifetime credit losses upon inception is a huge paradigm shift. Key issues must be addressed as to how processes related to lifetime expected losses are expected to be implemented. For example, as CECL requires expected lifetime credit losses upon initial recognition of all loans, CECL requires less emphasis to be put on identifying changes in individual credit risk after origination than under IFRS 9² and more emphasis on measurement of expected losses over the life of the total portfolio. However, we believe that there are issues that are common to all loans under both models that require a lifetime loss expectation:

- The changing relationship of current metrics (such as those based on current delinquencies, troubled debt restructurings, nonaccrual loans) to specific lifetime loss expectations will change how credit deterioration will be monitored. As expected credit loss (ECL) is recorded upon origination under CECL, we recommend discussion in the CD related to how ongoing metrics will need to be adjusted, especially in light of forward-looking factors, to identify those trends that indicate a change from the previously recorded ECL. For example, certain period-over-period increases in delinquencies can be considered favorable trends if the increases are less than forecasted and included within the lifetime loss estimate. This can be counterintuitive to many financial statement users.
- Within the CD, most of the discussion in credit risk management appears to address individual credit risks. Therefore, we recommend more discussion in the CD on how banks should address these individual credit risks in light of a pool of loans. While this issue can be applicable to both retail and wholesale product lines, focus on individual borrower credit risks within retail portfolios (with the exception of delinquent borrowers) may have smaller relevance under CECL, since identifying significant credit deterioration is unnecessary.
- The CD appears to make the inherent assumption that recent historical loss data have high relevance to current expected loss estimates³. Starting with recent historical data is logical in estimating incurred losses. It is also logical in estimates of 12 month probabilities of default and of lifetime losses for short tenored products. However, for long tenored loan products, the assumption that recent history is a good starting point for lifetime expected losses is not necessarily valid⁴. For example, when analyzing a

² This is not to say that identifying changes in credit risk under CECL will be irrelevant. Due to the lack of “cliff effect” in CECL, whereby allowances for loan losses are measured as “lifetime losses” rather than “12 month losses”, the specific timing of identification of loss will not have the same financial impact under CECL.

³ Paragraph 24(k): “An entity should maintain sufficient historical loss data over at least a full credit cycle to provide a meaningful analysis of its credit loss experience for use as a starting point when estimating the level of allowances on a collective or individual basis. An entity should adjust estimates of ECL based on historical data, for current conditions and forecasts of future conditions that did not affect the period on which the historical data is based.”

⁴ By “historical data”, we are referring to “charge-off” or “loss” data.

portfolio with a seven year expected life, full life of loan data will not be available for the most recent six vintages. We believe the point in the credit cycle, and data pertaining to similar points in previous cycles, could be the starting point for determining the appropriate historical data to use.⁵ This not only changes the kind of historical data that banks should start with, but also the amount of historical data that may be available.

Mandating a strict rule to use recent historical data as a starting point unnecessarily limits credit risk managers from modeling ECL in the most efficient and potentially effective fashion. As a result, we recommend that discussion should further address the different factors to consider regarding the use of historical data when making lifetime loss estimates.

High Level Principles Acknowledge Materiality

Underlying all accounting and risk management principles is the concept of materiality. When the risks within a loan portfolio are not believed to be material nor are forecast to be material in the future, many detailed aspects of a high quality and robust implementation over credit risk, capital management, and impairment accounting are not considered necessary. Dedicated time and resources to immaterial items would, in fact, likely result in a lower quality implementation, as it would unnecessarily shift focus from the areas that could have more material variances.

The materiality concept, however, appears to be overridden in Paragraphs 37 and 60 of the CD:

- Paragraph 37: “The design of the credit risk rating system should ensure that a bank incorporates all relevant information, including forward-looking information and macroeconomic factors, into its credit risk assessment and rating processes both upon initial recognition and over time. In this context, an effective credit risk rating system will allow a bank to tack changes in credit risk, *regardless of the significance of the change*, and consequent changes in credit risk ratings.” (emphasis added)
- Paragraph 60: “...Nevertheless, in the Committee’s view, consideration of forward-looking information and macroeconomic factors is essential to the proper implementation of an ECL accounting model, *and therefore these costs should not be avoided on the basis that a bank considers them to be excessive or unnecessary.*” (emphasis added)

We believe the Committee does not intend for banks to disregard elementary risk management principles in implementing high-quality systems to address expected credit losses. Where credit risk is regarded as significant, bankers fully expect to implement forward-looking procedures that appropriately address the risks as the Committee intends. Where credit risk is not significant, however, we believe the Committee expects proportionately fewer procedures.

With that in mind, considering the level of detail included throughout the CD and the admonitions spelled out in Paragraphs 37 and 60, an overall statement on materiality is sorely

⁵ The CD indicates that the “point in the credit cycle” (Paragraph 62) is one factor that would adjust initial estimates based on historical data. However, in many parts of the economic cycle, such an approach will likely lead to overly large qualitative adjustments from recent historical data in measuring ECL. We are concerned about ongoing implications if qualitative adjustments make up a majority of change in an estimate of expected loss.

needed. This may best be discussed in context of the overall adequacy of the total allowance (Principle 4). In addition to a statement on materiality, we recommend that Paragraphs 37 and 60 be either deleted or amended so that the emphasis of the paragraphs is on the higher level objectives of effective credit risk identification and use of forward-looking information.

High Level Principles Enable Proportional Implementation by All Banks

The CD is very detailed in many areas, setting high expectations of tightly integrated management of credit risk, capital, and expected credit loss (ECL) accounting. Paragraph 12, however, notes that supervisors of less complex banks may use a proportionate approach with regard to the standards to be imposed on more complex banks. In the U.S., this proportionality is extremely important at both the bank level and the portfolio level for all banks⁶. At the bank level, proportionality is crucial for all but a handful of banks (the largest, internationally active banks). Yet detailed statements within the CD often indicate that proportionality may not apply in many cases. In addition to the multiple instances in which banks and management “should” perform specific processes, examples in the CD include:

- Paragraph 30: “While a bank need not necessarily identify or model every possible scenario through complex scenario simulations, the Committee *expects it to consider the full spectrum of information* that is relevant to the product, borrower, business model or economic and regulatory environment when developing estimates of ECL...” (emphasis added)
- Paragraph 70: “Common processes, systems, tools and data that are used in assessing credit risk and measuring ECL for accounting purposes and expected losses for capital adequacy purposes include credit risk rating systems, estimated PDs (with adjustment), past-due status, loan-to-value ratios, historical loss rates, product type, amortization schedule, down payment requirements, market segment, geographical location, vintage, and collateral type, along with information of a forward-looking nature.”

Bankers in the U.S. (not only those that are large and internationally active) desire the highest-quality implementation of ECL accounting. However, a high quality implementation normally means that only relevant and necessary data are maintained and necessary procedures are performed, all in the context that such data and procedures are cost beneficial. As worded in the CD, it appears that anything short of systems that are described above will be considered less than high quality. In other words, while Paragraph 12 may emphasize “proportionality”, it is difficult, with all the detail otherwise presented in the CD, to see how a typical U.S. bank could meet the threshold of required complexity implied in the CD. We are also concerned that such detail will then become the template for all future analyses, thus, limiting the likelihood that other, more effective analyses will be implemented in the future. In other words, the CD could become a checklist for what is performed without regard to the underlying quality of credit risk management executed.

⁶ Proportionally fewer procedures would also be applied to portfolios that are insignificant, and expected to remain insignificant, no matter the size of the institution.

Our concern relates not only to banking operations in the U.S., but also to operations around the world. Consistent application of credit risk management and accounting principles is important. However, regulators in each country will need flexibility, based on experience and local business practices, to supervise their individual institutions in ways that achieve the overall principles, no matter the size of the entity.

ABA recommends that the level of detail included in the CD be significantly reduced so that institutions of all sizes and complexity can implement ECL accounting in a high-quality and robust fashion. We understand that the intent of the CD is to ensure consistent implementation of ECL accounting worldwide, but the overly prescriptive nature of the CD significantly reduces its usefulness to most U.S. banks. Such consistency will more likely be achieved through ongoing conversations between supervisors who can better assess the right level of complexity required for a high quality implementation on a bank-by-bank basis.

If the Committee elects to maintain the same level of detail throughout the CD, we recommend that the final CD clarify throughout the document that these are concepts to consider based on the size and complexity of the institution and provide guidance within each principle as to how less complex institutions can implement the ECL model in a high quality fashion.

High Level Objectives Allow Practical Expedients That Satisfy the Accounting Objective

The CD discourages most forms of practical expedients that are defined within IFRS 9. For example, paragraph A40 states “...practical expedients should rarely be used by banks, as they have the potential to introduce significant bias.” Such expedients are designed to address the migration from 12 month loss estimates to lifetime loss estimates (and thus, would not be relevant to concerns under a CECL credit loss model). While we agree that larger banks should not rely solely on a delinquency trigger, there are many other areas, including immaterial portfolios, with little or no risk of loss even in a stress scenario. In these cases, practical expedients may be appropriate.

While the practical expedient discussion is limited to the Appendix (which is solely dedicated to IFRS 9), we fear that, unless clarified, legitimate and effective usage of practical expedients will be discouraged for U.S. banks. In the U.S., practical expedients are used to satisfy an overall accounting objective. With an overall objective of measuring an expected loss for impaired collateral dependent loans, the method of recording impairment based on the fair value of the collateral is used often in the U.S. Such a practical expedient does not appear to be controversial, and we believe usage of this method satisfies the ultimate accounting objective.

With this in mind, we recommend that the Committee encourage the use of practical expedients (whether in IFRS or in U.S. GAAP) that address the ultimate accounting objective of early recognition of expected credit losses.

High Level Disclosure Principles Allow Banks to Better Respond to User Concerns

The CD sets high standards on its requirements addressing transparency and comparability. The following appear to be required:

- A process to proactively identify, in addition to required financial statement disclosures, additional disclosures that “fairly depict a bank’s exposure to credit risk.” (Paragraph 73)
- Disclosure of the main assumptions in developing ECL estimates and “the sensitivity of ECL estimates to changes in those assumptions” (Paragraph 75). Included within this should be “quantitative information on how forward-looking information and macroeconomic factors have affected ECL estimates.” (Paragraph 76)

ABA supports Principle 8 that “public reporting should promote transparency and comparability by providing timely, relevant and decision-useful information.” However, in the context of paragraphs 29 and 30 (which address various scenarios using a “full spectrum of information”), the above guidance appears to mandate additional disclosures in the financial statements far beyond those required by either the FASB or IASB, as well as the U.S. Securities and Exchange Commission. Further, it is unclear how efforts to provide enhanced financial disclosures under Pillar 3 or through the Enhanced Disclosures Task Force (EDTF) should be factored into the process.

Requiring disclosures based on assumptions and other levels of detail that may not be consistent from bank to bank would not only potentially make the disclosures overly voluminous, but also confusing. Confusion also can arise when such information is displayed differently, based on the other sources regulation. This is compounded by the inherent high complexity of addressing correlation and interdependency risk within a quantitative sensitivity analysis.⁷ With this in mind, it is important for the Committee to review whether specific rules-based disclosures are workable, given the varying level of overall regulatory environments among jurisdictions. ABA recommends that high level, over-arching principles be stressed within the CD, as opposed to the rules-based disclosures the CD appears to emphasize. This way, banks can more efficiently respond to disclosure needs of users of their financial statements.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss our views.

Sincerely,



Michael L. Gullette

⁷ Both FASB and IASB have both proposed and largely omitted sensitivity analysis from fair value disclosures, partially due to complexities that are similar to those facing estimates of expected credit losses.