COMMENTS FROM THE ASSOCIATION OF SUPERVISORS OF BANKS OF THE AMERICAS (ASBA) TO CONSULTATIVE DOCUMENTS

"Regulatory Treatment of Accounting Provisions – Interim Approach and Transitional Arrangements" (Consultative Document) and "Regulatory Treatment of Accounting Provisions" (Discussion Paper)

(ISSUED BY THE BASEL COMMITTEE ON BANKING SUPERVISION FOR COMMENTS BY 13 January 2017)

I. Purpose of the revision

Recent modifications from accounting standards' setters, incorporated changes in the provisioning standards by including forward-looking assessments for the estimation of credit losses. In particular, IASB published its IFRS 9 on July 9, 2014 (to take effect on January 1, 2018) and FASB published its final standard for the Current Expected Credit Losses (CECL) in June 2016 (to take effect on January 1, 2020). Both standards imply fundamental changes to current bank's provisioning practices and may imply higher provisions due to the 'lifetime loss concept' and the inclusion of forward-looking information when assessing and measuring ECL.

Since there is a limited time between publication and the entry into force of IFRS 9, the Committee is issuing for consultation the proposal to retain for the interim period the current regulatory treatment of provisions, as is currently applied under the standardized approach (SA) and the internal ratings-based (IRB) approach.

The Committee has identified some reasons why it may be appropriate to introduce a transitional arrangement to measure the impact of ECL on regulatory capital.

As for the above, and given that a distinction between general provisions (GP) and specific provisions (SP) does not exist under most of the currently used accounting frameworks; then, jurisdictions will need to extend the existing approaches for categorizing provisions as GP or SP to provisions obtained under ECL. Therefore, the Committee seeks feedback on whether the transitional arrangement considered in this consultative document warrants banks to timely adjust to the impact of the new ECL accounting framework on capital for regulatory purposes.

Also, and due to the intention of Basel of using the proposed approach on further analysis for other regulatory policy options, Basel is issuing, along with the consultative document, a discussion paper aimed at deliberating on such longer term policy considerations. Specifically, the Committee's long-term regulatory treatment of provisions under the new ECL standards are outlined in such discussion paper.

Following are the comments of the Association of Supervisors of Banks of the Americas (ASBA), based on the opinion of some of its members.

I. General Comments

1. Within the context of the introduction of IFRS 9 and CECL and their associated accounting standards, Basel agrees with the use of ECL models instead of the more traditional incurred losses models. However, the use of ECL would represent fundamental changes in provisioning practices for institutions, which may result in significant increases in provisioning expenses and, as a consequence, in the capital required to cover credit risk. The latter will

occur in banks using the standardized approach for capital requirements for credit risk as well as in those institutions using internal models.

2. For some jurisdictions in the Americas, these changes in the accounting framework may not have an impact on capital requirements, since they are not planning to adopt IFRS 9 in the short term. Even though these jurisdictions allow banks the use of internal models, the use of the standardized approach is more generalized.

3. Notwithstanding, ASBA welcomes the suggestion of the Basel Committee to establish a transition period to allow entities to mitigate unexpected impacts on capital requirements. This transition period is even necessary for those jurisdictions adopting the approach of expected losses (IFRS 9 or CECL).

4. On the other hand, regarding the introduction of IFRS 9, the Basel Committee points out the convenience of the approach of expected losses since it allows for an earlier recognition of losses as well as it supports banks to follow optimal risk management practices. However, it is advisable to assess possible impacts of this new framework on the procyclicality of financial results and capital requirements since these requirements might modify credit cycles and generate impacts on the stability of the financial system.

5. The relationship between modeling expected losses with the economic situation is not clear, i.e. the specific set of economic variables to be used is not specified in the proposal, nor the suggested methodology to measure future expected losses.

6. ASBA suggests considering the use of forecasts based on models of expected losses using transitional probabilities to predict possible portfolio losses and to compare them with models of incurred losses considering macroeconomic variables (the latter about the economic situation in general) as well as microeconomic variables (those applicable to the specific entity). With this comparison, the most suitable models may be selected.

7. Finally, we consider adequate the framework for introducing a component for expected losses under the SA, under which all accounting provisions would be recognized in the same way for regulatory purposes. This would be aligning the SA with the IRB in a more harmonized way and for any jurisdiction and accounting framework.

II. Specific Comments (Consultative Document)

1. Regarding the proposed transitional arrangements, Approach 1 seems to be the most adequate. However, it is suggested not to calculate the adjusted amount of CET1 based on an initial transitional adjustment amount but allowing, for each year of the transition period, updates according to the following example:

   Take, for instance, a bank with a transitory adjustment equal to €300 at day 1 of year 1, €275 at day 1 of year 2 and €325 at day 1 of year 3. Assuming that Basel would allow for a transitional period of 3 years, then the bank would include the following amounts in its CET1 capital:

   - The first day of Year 1 up to Year 1 end: the bank would include in CET1 capital an "adjustment amount" of €300 * 3/4 = €225.
   - The first day of Year 1 up to Year 2 end: the bank would include in CET1 capital an "adjustment amount" of €275 * 2/4 = €137.5
   - The first day of Year 1 up to Year 3 end: the bank would include in CET1 capital an "adjustment amount" of €325 * 1/4 = €81.25

   In the example above, no amount would be included in CET 1 capital since at the beginning of year 4 and after that date, no further "adjustment amount" will be needed.

   ***(Cf.* Section 3.3.2 Mechanics of the Transitional Arrangements *on Page 7*)**.

2. Regarding Approach 2, the fact of considering a fixed percentage for the transitory adjustment during the whole transition period could be inadequate since provisions vary according to the economic cycle, thus a fixed percentage would not be reflecting the impact of it.

   ***(Cf.* Section 3.4 Approach 2: CET1 capital adjustment linked to Day 1 proportionate increase in provisions *on Page 8*)**.

3. As for Approach 3, while being aligned with IASB, it is not aligned with FASB, given the differences between both provisions accounting methodologies, i.e., the former works by establishing differentiated stages whereas the latter does not work by establishing differentiated stages. Also, a transition period of 3 years could be more adequate than that of 5 years.

   ***(Cf.* Section 3.5 Approach 3: Phased prudential recognition of IFRS 9 Stage 1 and 2 provisions *on Page 8*)**.

III. Specific Comments (Discussion Paper)

1. Under Section 3.1 General and Specific Provisions, we envisage that there should be more consistency between SA and IRB, i.e. if a distinction is made between SP and GP, then the IRB would also need to do so, and vice versa, if IRB does not make such a distinction, then the SA would not do so, thus, introducing minimum EL regulatory rates.

   ***(Cf.* Section 3.1 General and Specific Provisions *on Page 12*)**.

2. On Section 3.2 Regulatory Expected Loss, we endorse the BIS proposal regarding the need for an explicit regulatory EL charge under the SA. This charge could be set by product type and risk category (using a rating), creating at least 5 or 8 risk categories (for instance from A to E).

   Under the same section, explicit regulatory EL charges shall be established on a permanent basis but considering a historical data set of an economic cycle of at least seven years.

   ***(Cf.* Section 3.2. Regulatory Expected Loss *on Page 13*)**.

3. Under Section 3.3. Treatment of General and Excess Provisions, we adhere to the idea that as long as SP and GP distinction is avoided, such as under IRB, only excess provisions shall be added back to Tier 2 capital, thus incentivizing banks to follow conservative provisioning policies.

   ***(Cf.* Section 3.3 Treatment of General and Excess Provisions *on Page 13*)**.

4. About Section 3.4 Level Playing Field, we consider that the establishment of regulatory EL minima, as well as common minimum provisioning requirements, are crucial to achieve comparability and uniformity in the estimation of provisioning and capital amongst different jurisdictions.

   ***(*Cf. Section 3.4 Level Playing Field *on Page 13*)**.

5. Section 3.5 Complexity and Simplification specifies the possibility of relying on accounting determinations of provisions subject to minimum requirements, including lifetime provisions for deteriorated, impaired or defaulted loans. However, lifetime considerations can be technically difficult in practice, which could result in an increase in provisions. Therefore, if such change is introduced, it shall be done gradually.

   (Cf. Section 3.5 Complexity and Simplification on Page 14).

IV. Other: Developing a Regulatory Specific Provision (RSP)

1. First and foremost, we believe that the definitions set on the BCBS´ former consultative document "Prudential treatment of problem assets – definitions of non-performing exposures and forbearance[1]" shall be considered as the starting point for the debate on the Regulatory Specific Provision (RSP) under the Standardized Approach, for the sake of harmonization of different prudential standards and definitions.
2. Due to the nature of the definitions of non-performing exposures and forebearance, the total amount of provisions associated with forborne exposure shall be classified as RSP whether they are classified as either performing or non-performing exposure.[2] The provision associated with forborne exposure shall be classified as RSP until the exposure exits from the category, satisfying the exit criteria described in the consultative document.[3]

IV.I *Relationship between RSP and Accounting Provision*

1. Once calculated the RSP, the next step is to compare the figure with the (total) accounting provision, independently of which GAAP is in place in any jurisdiction, and verify whether there is an excess of accounting provision when compared with RSP.[4]
2. In the case of excess – that is the accounting provision is higher than the RSP – the figure related to the difference between them might be added back to Tier 2, in accordance with the appropriate cap.[5]

[1]Prudential Treatment of Problem Assets – Definitions of Non-performing Exposures and Forbearance. Basel Committee on Banking Supervision. April 2016. http://www.bis.org/bcbs/publ/d367.pdf

[2] In the above referenced document, it is stressed that the definition of forbearance covers exposures of performing and non-performing status before the granting of forbearance measures. (Numeral 42, page 14).

[3] Also, it establishes that two conditions must be satisfied to cause the exit from forbearance classification (i) when repayments as per the revised terms have been made in a timely manner (principal and interest payments) over a continuous repayment period of not less than one year (minimum probation period for reporting). The starting date of the probation period should be the scheduled start of principal or interest payments under the revised terms; and (ii) The counterparty has solved its financial difficulties. (Numeral 41, page 14).

[4] The framework related to calculation of the accounting provision implies that it shall be at least equal to the RSP. It is mean that we can observe excess but not shortage of the accounting provision.

[5] The Basel II rules that general provision qualifies for Tier 2 capital up to 1.25% of risk-weighted assets. In the RSP framework the excess of accounting provision can be dealt as general provision.

IV.II Advantages of the RSP approach

1. The main benefit of the RSP comes from being defined using only the conceptual regulatory approach. In other words, there is no need of defining which proportion of the accounting provision shall be classified as both specific and general provisions.

2. An additional positive side effect is to enhance the level playing field since the adjustment on the regulatory capital can occur on those jurisdictions that are going to maintain the accounting framework based on the incurred losses. In this case, almost the totality of accounting provisions would be classified as RSP, with little room to add a parcel back to the Tier 2.