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Mr. Bill Coen
Secretariat of the Basel Committee
on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Mr Coen

Consultative document: Regulatory treatment of accounting provisions – interim approach and transitional arrangements

Barclays welcomes the opportunity to comment on the Consultative Document (Regulatory treatment of accounting provisions – interim approach and transitional arrangements, "Consultative Document") and the Discussion Paper (Regulatory treatment of accounting provisions, "Discussion Paper").

We are supportive of accounting provisioning standards that require the use of expected credit loss (ECL) models rather than incurred loss models so that forward-looking assessments are incorporated in the estimation of credit losses.

We are also supportive of the implementation of transitional arrangements from the 1st of January 2018 for the impact of ECL accounting on regulatory capital for the following reasons:

1. Maintaining a level playing field between US GAAP banks and European IFRS 9 banks as both transition to new accounting standards for ECL.

   For example, IFRS 9 requires for the reporting of standalone entities that ECL are recognized for intra-group lending, financial guarantees and loan commitments between fully consolidated legal entities. Such intra-group exposures are significant for large banking groups, and include internal TLAC. Since US GAAP scopes them out, the Committee and national standard setters will need to neutralise this difference to achieve a level playing field in both the transitional and final treatment of ECL provisions under the regulatory capital framework.

2. Avoiding the contraction of lending to the real economy that could occur if European IFRS 9 banks were forced to reduce CET1 by the whole amount simultaneously on 1 December 2018.

3. Reducing the risk of exacerbating downturns in the real economy; the scale of the stress impact on bank lending capacity due to the inconsistency between IFRS 9 and the regulatory capital frameworks for both standardised (SA-CR) and internal ratings based approaches (IRB) for credit risks needs to be better understood and an appropriate response implemented.

In particular the impact on lending capacity due to migration of balances in to and out of IFRS 9 Stage 2 through a downturn needs to be addressed by regulators and policy makers if unintended impacts on the real economy are to be avoided.

Given the above we recommend that the impact of Stage 2 impairments on capital should be eliminated during a transition period in which Stage 2 balances should be treated as Stage 1 balances for regulatory capital purposes. In other words, for Stage 2 exposures, banks continue to calculate ECL Stage 1 provisions during the transition period and the difference would be reinserted into CET1 regulatory capital.

In parallel we would also note:

1. Our concern that the current Discussion Paper does not consider the issues and inconsistencies created between the new IFRS 9 ECL framework and the existing IRB regulatory capital regime. The interaction between

   i. the changes in bank capital requirements since Basel II, and
   ii. the changes to ECL provisions under IFRS 9, and
   iii. the IRB framework

   is complex, and given the possible feedback effects from the banking sector into the real economy in a downturn, should be given due consideration.

2. Our concern that no impact data has been collected, either at the European or Basel Committee level, on the IFRS 9 impact on bank CET1 in a stress scenario. The absence of a quantitative understanding by regulators and policy makers of the impact of IFRS 9 on lending capacity in a downturn could leave them without the tools and framework necessary to prevent a magnification of a slowdown in the real economy.

We would like to reiterate the importance for banks to work towards a final regulatory capital framework in which uncertainties such as changes to accounting standards should be eliminated as much as possible. This emphasises the need for sufficiently long transitional periods during which the Committee can evaluate the quantitative changes in the levels of provisions and its sensitivity to regulatory capital ratios through additional impact studies.

Given the scope and scale of both the accounting changes to provisions and the reform of the regulatory capital framework as part of the G20 package of post-crisis reforms it seems appropriate to us to ask the Committee to look into any duplications in the capitalisation of risks and into unintended consequences such as pro-cyclicality.

Further detail on the points above and responses to the other items the Committee is seeking feedback on are set out in more detail in the attachment to this cover letter and the separate response we provide on the Discussion Paper.

We hope that you find our comments and suggestions helpful. Please do not hesitate to contact Andrea Schnoz (andrea.schnoz@barclays.com, +6563087291) if you have any comments on any of the issues raised in this response.

Yours sincerely,

Dipal Patel
Managing Director
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Appendix 1: Detailed comments on the Consultative document – Regulatory treatment of accounting provisions – Interim approach and transitional arrangements

1. Interim approach

Comments are welcome on the proposal that jurisdictions extend their existing approaches to categorising provisions as GP or SP to provisions measured under the applicable ECL accounting model for an interim period.

The proposal that jurisdictions extend their existing approaches to categorising provisions as GP or SP to provisions measured under the applicable ECL accounting model would mean that the industry would continue to have discrepancies in whether provisions are used to reduce exposures or included in T2 capital under the SA-CR during the interim period.

We would like to note that comparability of regulatory capital ratios is one of the key objectives of the Committee in its proposals to revise both the IRB and SA-CR approaches and the differences in the treatment of provisions are fundamental in comparison of the rules between the EU and the US:

- In the EU, credit provisions under the relevant European Commission Delegated Regulation are generally allocated to SP and therefore deducted from exposures under the SA-CR.
- In the US, allowances for loan and lease losses (ALLL) are considered unallocated amounts under the definition of the US Federal Agencies and therefore considered GP which are included in T2 capital up to a maximum of 1.25% of RWA.

The magnitude of this difference in treatment on total capital ratios can be illustrated by a simple example of a risk-weighted loan portfolio of 100 with loan-loss provisions of 1 and eligible capital of 10:

- Under the US approach, the provisions are added to the eligible total capital (10+1=11) which is then divided by 100 so that the total capital ratio is 11%.
- Under the EU approach, the provisions are deducted from RWA (100-1=99) by which the existing capital is divided (10/99=10.1%).

Accordingly, under the example of the EU approach, looking at total regulatory capital, banks only obtain 10% of the benefit that is otherwise available if provisions are considered GP.

Therefore it would be our preference for the Committee to issue globally applicable standards to be adopted by national supervisors that address the distinction of GP and SP under both the current and future ECL accounting provisioning standards which would ensure a level playing field and comparability of capital ratios in the interim period.

2. Possible transitional arrangements

Comments are welcome on the various objectives for potential transitional arrangements identified above as well as on any other possible objectives of such arrangements. Comments are also welcome on the design of any transitional arrangement – in particular, how much importance should be attached to the simplicity of the chosen design, what the reference metric should be, what length of transitional period would be appropriate, and whether or not any such arrangement should be applied only to provisions recognised at the point of transition to ECL accounting. Comments on any implications of the transitional arrangements outlined for banks' IT systems would also be welcome.

2.1 Objectives for potential transitional arrangements

The objective for transitional arrangements should be to avoid the contraction of lending to the real economy that could occur if banks were forced to reduce CET1 by the whole amount of new ECL provisions simultaneously on 1 January 2018. Additionally, cliff effects in banks' regulatory capital ratios and depending on the magnitude of additional provisions banks missing their regulatory capital ratio targets should be avoided.

Sufficiently long transitional arrangements are important to support banks to build up their regulatory capital bases to meet the fully phased-in Basel 3 capital requirements in 2019. In the absence of transitional arrangements, IFRS9 will undermine this process by eliminating sizable parts of banks' CET 1 capital bases.

With respect to capital adequacy under Basel 3, the focus should not only be on Pillar 1 but also on Pillar 2 where we expect ECL to have a significant impact on the results of various stress tests undertaken by banks for the purpose of supervisory monitoring but also internal risk management:

i) Under certain stress scenarios, a number of credit exposures would be expected to move from stage 1 to stage 2 accounting provisions under IFRS9.

ii) Point-in-time PDs used under both IFRS9 and CECL could move substantially under stress which could cause volatility and add pro-cyclicality to regulatory capital ratios.

In addition there will inevitably be a period of refinement after IFRS 9 is effective as the results and judgements taken by preparers upon implementation are analysed and stakeholders gain greater experience over time which may lead to drives for changes or areas of more consistency.

Transitional periods will ensure that the comparability of regulatory capital ratios stays unaffected by different accounting requirements across the globe and judgemental differences in the approach taken by banks in their initial implementation of IFRS9 and CECL.

Sufficiently long phasing-in arrangements will ensure a level playing field between US GAAP banks and European IFRS 9 banks as both transition to new accounting standards for ECL. A transition period will also allow for any changes to the regulatory capital framework to account for any differences between IFRS 9 and CECL (for example in credit cards where IFRS 9 requires behavioural life and CECL may require 1 day).

The consequences of insufficient phasing-in arrangements could be a reduction in the extension of credit and/or an increase in the pricing of credit in an actual economic downturn. The forward looking nature of the provisioning of Stage 2 lifetime losses in the IFRS 9 calculation and the regulatory treatment of these provisions is likely to significantly magnify the withdrawal of credit to the real economy. This in turn could be expected to further exacerbate an economic downturn.

2.2 Scope of transitional arrangement

The most significant step in achieving the goals of a transition period is the elimination of the impact of IFRS 9 Stage 2 ECL provisions as outlined further above.

The entire impact of IFRS 9 impairment does not need to be neutralised, rather the incremental impacts of IFRS 9 Stage 2 on capital should be eliminated and the transitional arrangement shall be to entirely exclude IFRS 9 Stage 2 provisions from CET 1 calculations. In other words, for Stage 2 exposures, banks continue to calculate ECL Stage 1 provisions during the transition period and the difference would be reinserted into CET1 regulatory capital.

This would ensure that all assets would have an impairment impact on capital whilst reducing the pro-cyclicality risk until a final framework is agreed. This will be required before the implementation date of CECL so that a even level playing field can be created between banks under US-GAAP and IFRS.

IFRS 9 recognises losses earlier than IAS39 and is forward looking and prescriptive. It is generally expected that the IFRS 9 impairment for Stage 1 (12mth expected credit loss) + Stage 3 (credit impaired) will be greater than IAS39 provisions today because Stage 1 recognises losses on initial recognition considering defaults over a 12month period. IFRS 9 also requires impairment for Stage 2 (lifetime ECL when there is a significant increase in credit risk since initial recognition and before an exposure becomes credit impaired). Stage 2 therefore leads to volatile impairment charges that are procyclical in nature and a cliff effect under times of stress. The Stage 2 IFRS 9 provisions under stress drive the overlap with provisions already recognized in the capital framework leading to excessive provisioning for the same losses which needs to be addressed in the regulatory framework.

The other impacts from IFRS 9 from classification and measurement, own credit and hedging are expected to have a less significant accounting and regulatory capital effect, are less volatile, do not overlap in the same way such that the effects are already included within CET 1 and there is more of a level playing field between different reporting frameworks such as IFRS and US GAAP.

Notwithstanding this, if a phased approach were to be adopted, reaching 100% should not be viewed as the end state. We see a need to move to a different standard at the end of the transitional period to reflect changes made in the prudential framework throughout the transition.

2.3 Design of transitional arrangement

We recognise that the Committee may prefer to adopt a phased in approach, rather than a deferral of the impact of IFRS 9 Stage 2 ECL provisions over the transitional period. We believe though that a phasing in / glide-path would not be appropriate given the end state prudential framework is as yet unknown.

With respect to the second order impact of whether the transition of the impact should be static or dynamic, a static approach would not achieve the reduction in risk to the real economy of magnifying economic downturns while the inconsistencies between the capital framework and the new accounting framework are addressed.

A dynamic approach, as proposed in the Committee's Approach 3 and in the CRR, where a percentage of the capital impact of IFRS 9 at each reporting date is taken through the transition period better addresses the risk of a significant withdrawal of bank lending to the real economy in a downturn during the transition period. This is particularly relevant if a time of stress is forecast after 1 January 2018 which might create significant regulatory capital impacts after initial adoption. Dynamic adjustments recognise the volatile nature of provisions over an economic cycle and offer a greater prospect of accommodating change towards a more permanent solution to the necessary amendments of the prudential capital framework. Finally, cliff-effects at the end of the transitional period can be avoided which allows both supervisors and analysts to consider the reported capital ratios to be their baseline (which can under Approaches 1 and 2 not be ascertained).

We note the preference of the Committee for Approach 1 where the advantage is its simplicity. However, the reduction in CET1 capital would be frozen at the effective date of ECL accounting provisioning regimes which may not be representative of actual impacts on ECL under stress scenarios and could set transitional amounts and effective ECL provisions significantly apart.

Approach 2 is superior to Approach 1 as it recognises the dynamic nature of provisions over an economic cycle, albeit that the percentage is fixed at the outset. As such, should the Committee opt for only part tapering mitigation throughout the transitioning period, Approach 3 is preferable to us despite the additional work it will create.

2.4 Reference metric

We agree that the reference metric for transitional arrangements to apply to should be CET1 capital since

i) the availability of CET1 capital is the main prudential capital constraint for banks, and

ii) provisions are built through PL and as such CET1 capital.

We agree with the Committee to consider how transitional arrangements are recognised in other aspects of the regulatory framework so that the reference metric will ultimately not be CET1 capital only:

DTA
The creation of DTA on day 1 of the implementation of IFRS 9 reduces the decrease in CET1 capital but may at the same time create additional capital deductions. This does not only apply to DTA but needs to be considered in the broader context of threshold deductions in the calculation of CET1 capital. For consistency, we would therefore refrain from treating these DTA any differently from other DTA but instead require banks to recalculate their CET1 capital bottom-up under both fully phased-in and transitional IFRS 9 implementation. The resulting difference in CET1 capital should be the basis for phasing-in arrangements.

Inclusion in T2 capital / reduction in exposures
Any ECL accounting provisions that are subject to phasing-in arrangements cannot be included in T2 capital nor can they be used for reductions in the exposures under the SA-CR.

Leverage Ratio
Any ECL accounting provisions cannot be used for exposure reductions for the calculation of leverage ratio exposures. The same applies to the Large Exposure Framework and any other supervisory regimes where regulatory exposure values are used.

2.5 Simplicity

We agree that transitional arrangement should be as simple as possible. However, simplicity should not be prioritised over a methodology that appropriately considers the development of a final capital framework.

Therefore, it will be important that the Committee follows the proven and tested steps of finalising a framework based on quantitative impact studies and only once the final framework is available to start phasing in if necessary.

2.6 Length of the transitional period

The length of the transitional period should be informed by the magnitude and volatility of additional provisions under ECL accounting provisioning standards and its impact on industry CET1 capital ratios.

Given that the FASB standard on CECL only becomes effective in 2021 for all reporting entities it would be our recommendation to the Committee to part neutralise the effects of ECL on CET1 capital ratios of banks operating under IFRS through eliminating the provisions required under Stage 2 until at least then.

This will provide the Committee with the necessary time to re-evaluate the need for transitional arrangements in general and determine the final capital rules for ECL accounting that the globe should smoothly transition towards. We expect that with the earliest full US GAAP CECL public disclosures emerging in Q1 2021 a transition period of at least five years is reasonable.

2.7 National discretion

There should be no national discretions giving competent authorities the ability to front run / fully load measures on an accelerated timeframe i.e. the standard should be applied equally in all jurisdictions. Any acceleration would run counter to the intention of mitigating any sudden unwarranted impact of IFRS 9 ECL as well as having implications for comparability and cross-border competition.

2.8 Disclosure requirements

In addition, due consideration should be given to any disclosure requirements that will be necessary during a transitional period. We understand the necessity from a prudential perspective for banks to disclosure the impacts of applying transitional arrangements.

The experience with the implementation of Basel 3, however, shows that users of financial information focus on fully loaded capital ratios to assess a bank's capital adequacy and in a holistic way – in particular when the then final regulatory framework is known.

Therefore, for the transitional capital ratios to be respected by the financial industry, it will be important for the Committee to acknowledge that the end state of the regulatory framework continues to be under discussion.

2.9 Implications of the transitional arrangement on IT systems

Any transitional arrangements will have an impact on IT systems as from our perspective banks will be required to run additional calculations in parallel. However, the clarity and planning certainty of transitional arrangements will in your view outweigh the cost of maintaining parallel processes during the phasing-in period.