The voice of banking

BBA response to the Basel Committee's proposal for the

Regulatory treatment of accounting provisions

January 2017

Introduction

The British Banker's Association (BBA) is pleased to respond to the Basel Committee on Banking Supervision's Task Force on Expected Loss Provisioning (TFP) consultation paper *Regulatory treatment of accounting provisions - interim approach and transitional arrangements*[1] and its discussion paper on *Regulatory treatment of accounting provisions*[2].

The BBA is the leading association for UK banking and financial services representing members on the full range of UK and international banking issues. It has over 200 banking members active in the UK, which are headquartered in 50 countries and have operations in 180 countries worldwide. Eighty per cent of global systemically important banks are members of the BBA, so as the representative of the world's largest international banking cluster, the BBA is the voice of UK banking.

Our members manage more than £7 trillion in UK banking assets, employ nearly half a million individuals nationally, contribute over £60 billion to the UK economy each year and lend over £150 billion to UK businesses. BBA members include banks headquartered in the UK, as well as UK subsidiaries and branches of EU and third country banks.

In our response below we address the two papers separately but firstly make some key messages raised by our consideration of both.

Key messages

- The capital impact of IFRS 9 is not fully understood and will only become evident after the 2018 implementation. Behaviour under stressed conditions is particularly unclear. However, significant increases are expected in impairment allowances which will have a direct impact on banks' capital ratios.
- There are unresolved issues relating to the interactions of the IFRS 9 and the regulatory framework which require investigation in order to clarify or resolve in order to determine the appropriate strategic design. The IRB approach, and any revisions, must be part of any strategic review.
- The procyclical effects of IFRS 9 are of particular concern and we favour solutions that minimise any cyclical effects on CET1.

[1] https://www.bis.org/bcbs/publ/d386.htm
[2] https://www.bis.org/bcbs/publ/d385.pdf

BBA
Pinners Hall
105-108 Old Broad Street
London
EC2N 1EX

T +44 (0)20 7216 8800
F +44 (0)20 7216 8811
E info@bba.org.uk
www.bba.org.uk

- We support the TFP in its recognition that a transitional approach is needed in advance of IFRS 9 implementation. Irrespective of the design of such an approach any amortisation factor should be maintained at 100% until the strategic design is determined.

Our preferred transitional approach is a partial neutralisation of IFRS 9 that requires IFRS 9 Stage 2 impairments beyond 1 year to be added back for all regulatory purposes such that one year impairments would therefore be recognised for all stage 1 and 2 exposures and lifetime impairments for stage 3/defaulted exposures. Part of the IFRS9 impact will therefore be taken upon implementation but the pro-cyclicality risks will still be mitigated.

Transitioning to IFRS 9

We are pleased that the TFP recognises that an interim solution is required for banks to phase-in the impact of IFRS 9. We fully support this as it will avoid potentially significant deleveraging with consequent impacts on bank lending were Common Equity Tier 1 (CET1) capital to be significantly reduced at implementation. Our views on the TFP's proposals are detailed below along with our own preferred option. It is important to note that whichever approach the TFP resolves to use any amortisation factor should be maintained at 100% until the strategic direction is determined. Maintaining the amortisation factor at 100% will allow the TFP and industry sufficient time to fully consider the interactions between the accounting and regulatory frameworks to ensure all capital impacts are appropriate and fully understood.

Accounting capital is the starting point for regulatory capital calculations and the implementation of IFRS 9 will have significant impacts on banks, the extent of which will not be known until the current initiative to finalise the Basel III framework is better understood and banks come to understand better the behaviour of IFRS 9 allowances as their implementation programmes and methodologies for calculating Expected Credit Loss (ECL) develop. This will only become evident sometime after the January 2018 implementation date.

The extent of the impact will also be dependent on the path of the development of the global economy and the particular phase of the economic cycle in the country in which the bank has the preponderance of its RWAs, and its approach to calculating those RWAs. So it will be important that due consideration is also given to the bank regulatory capital impacts in the early years of IFRS 9 implementation. In a deteriorating economic scenario the future behaviour of ECL under stress, is unknown, but likely to be pro-cyclical, as exposures transition into stage 2. Were loan loss provisions to increase, these accounting changes, which do not fundamentally alter a bank's risk profile, could result in adverse behavioural responses resulting in a reduction in lending capacity. This should be avoided and we encourage the TFP to undertake a QIS to examine the possible impacts of IFRS 9 on lending in an economic downturn.

In light of these uncertainties further clarification on a number of areas related to the interactions of the regulatory and accounting frameworks would be helpful, including:

- the potential overlap in IRB through the maturity function;
- the interaction of standardised risk weights with Expected Loss and Unexpected Loss;
- the misalignment of time horizons and the correct treatment of lifetime ECL greater than 12 months losses;
- the calibration of recently developed (but yet to be finalised) standardised approaches (SA);

In our view the amortisation profile within any transitional period should not commence until these issues have been clarified or resolved.

We address each of the possible transition approaches proposed by the TFP below.

Approach 1: Day 1 impact on CET1 capital spread over a specified number of years

Approach 1 would spread the day one difference between the CET1 calculated using the IFRS 9 ECL amount and the immediately preceding closing balance sheet level CET1 level using the existing IAS 39. Any decrease would then be spread over the transition period, the length of which has still to be determined based on the resulting amortisation fractions.

The advantage of this approach is its simplicity, but the quantum of any negative impact on CET1 would be frozen at implementation which may not be representative of actual impacts on ECL should banks encounter an economic stress after the transition period had started.

As it is likely that interim solutions may be in place for a number of years, therefore this more simplistic approach, and its proposed modification, would be less relevant as balance sheet and ECL measurement changes are not reflected in these proposals.

Furthermore differing treatments of the allocation of provisions to either specific provisions (SP) (in the EU) or general provisions (GP) (in the US) will result in less comparability of bank capital ratios.

Approach 2: CET1 capital adjustment linked to Day 1 proportionate increase in provisions

Approach 2 calculates the percentage change in CET1 linked to the proportionate increase in impairment provisions due to the introduction of the IFRS 9 ECL requirements immediately post implementation. This 'fixed' proportionate increase would be applied to the stock of provisions at each reporting date and amortised based on the amortisation fractions.

In our view this approach is superior, although more complex, to the Approach 1 alternatives as it recognises the dynamic nature of provisions over an economic cycle, albeit that the percentage is fixed at the outset. It would also offer a greater prospect for accommodating change as the TFP iterates towards a more permanent solution to the amendments to the prudential capital framework needed to take account of IFRS 9.

Approach 3: Phased prudential recognition of IFRS 9 Stage 1 and 2 provisions

Approach 3 takes account of the total stage 1 and 2 provisions at the point of implementation and phases these in over the transition period. This is our preferred approach, subject to a modification as noted below.

As the TFP notes this approach assumes that all stage 1 and 2 provisions post implementation will be new, whereas in reality some exposures already provided for will, in the future, be allocated to stages 1 and 2.

We believe that for banks following the standardised approach, any currently recognised provisions that become reported in stages 1 and 2 would usually be treated as GP and added back as Tier 2 capital. Approach 3 would therefore seem the most appropriate transition method if buckets 1 and 2 were not to be added back as Tier 2 capital going forwards.

Whilst it appears to us that approach 3 is the most dynamic approach the question of how to make the adjustment for exposures already provided for is unanswered and doing so would probably over complicate the transitional adjustment process. So we would support a modified approach 3, corrected for the weakness discussed above, by adding back the portion of the excess of lifetime expected loss over 12 month losses for stage 2 exposures. This proposal is a partial neutralisation of IFRS 9, which requires IFRS 9 Stage 2 impairments beyond 1 year to be added back for all regulatory purposes such that one year impairments would therefore be recognized for all stage 1 and 2 exposures and lifetime impairments for stage 3/defaulted exposures. Part of the IFRS9 impact will therefore be taken Day 1 but the pro-cyclicality risks will still be mitigated.

For institutions operating current expected credit loss (CECL) the equivalent portion of all non-defaulted allowances would be added back.

The importance of communication by the TFP to support transition

Experience has shown that bank analysts and other users of bank's financial disclosures tend to focus on the fully loaded 'end state' capital ratios so it will be important that the TFP supports the industry in explaining to other audiences the need for and benefits of a transitional arrangement, whilst a permanent solution to the treatment of accounting provisions is developed.

Finding a more permanent solution to the IFRS 9 regulatory capital overlap

The prudential regulation of banks has evolved significantly since the global financial crisis which prompted a review of accounting impairment methodologies. Banks hold much higher levels of capital, including countercyclical buffers; hold highly liquid instruments set against regulator-prescribed quantitative requirements and are subject to stress testing that results in Pillar 2 capital levels being set to ensure survivability in a period of economic stress. In the near future it is expected that greater conservatism will be introduced into the Basel credit risk weighted asset calculation.

So in identifying the policy options for the longer term regulatory approach to the treatment of provisions that the discussion paper explores it will be important that the impacts of the recalibrated prudential capital regime are taken into account and any potential double counting avoided under both SA and Internal Ratings Based (IRB) credit risk approaches. This is particularly important when considering the extent to which ECLs may cover similar future credit loss estimates to those already captured via the unexpected and expected loss components of the SA and IRB approaches.

The discussion paper aims to address differences between jurisdictions in the capital treatment of revisions, and particular the difference between SP and GP and how they should be treated in prudential capital regime. This treatment of provisions differs between the standardised approach (SA) and Internal Ratings Based (IRB) approaches to calculating credit RWAs. The discussion paper also proposes changing the standardised treatment and leaving the IRB approach unchanged. Given the areas of interaction identified in the previous section that require clarification or resolution, we are of the view that IRB must be part of any strategic review.

The three options given in the discussion paper are:

1. Maintain the status quo by retaining the current regulatory treatment of provisions, including the distinction between GP and SP. Specific provisions would continue to be deducted from CET 1 with general provision added back to Tier 2, up to a cap of 1.25% of RWA. This would be the easiest option to implement but does not move accounting practice on is it continues to recognise general provisions. We do not support option 1 because of the significant differences between jurisdictions in the recognition of GPs and the level playing field issues this causes and the significant variation in CET1 caused by the varying treatments of GP/SP. Nevertheless, should the TFP decide to leave the existing treatments unchanged, unresolved discussions regarding potential overlap between the regulatory and accounting frameworks would nonetheless warrant further clarification.

2. Create a binding definition of *specific provision* and *general provision*. This would alleviate the definition issue present in option 1, and therefore would have some merit, although would not in itself solve the misalignment between the frameworks. It is also not clear how IFRS 9 allowances, which would be split into the 3 stages for IFRS 9, map into the 2 different categories for regulatory capital purposes. It is likely therefore that if differing treatments of allowances continue under the regulatory framework, the distinction should not be based upon GP and SP but on an alternative basis, for example distinguishing between 12 month accounting allowances and those on a longer time horizon.

3. The third option would change the current regulatory treatment of accounting provisions by removing the GP/SP distinction and introducing regulatory Expected Loss (EL) under the SA. Thus the capital treatment of accounting provisions under SA and IRB would be aligned and RWA comparability improved - an objective we support.

   The TFP would prescribe regulatory EL for Standardised asset classes, effectively introducing a floor for accounting provisions in calculating regulatory capital. Any double counting between the regulatory prescribed EL for each asset class and the RWA would be removed by adjusting the latter through application of a scaling factor. These prescribed ELs should be exactly aligned with the granularity of the relevant risk weights.

   Implemented proportionately, this also removes a potential double-counting issue for SA banks. A minimum EL as part of the SA calculation, which adds back to capital the impact of accounting provisions, would allow robust implementation of IFRS 9 in applicable jurisdictions and still allow a common regulatory capital approach across the international banking sector.

   The view expressed in paragraph 2.3.4 that “the overall level of regulatory EL amounts should be comparable between the SA and the IRB approaches” is particularly important in the context of proportionality. With the SA already effectively applying an additional capital buffer to smaller banks with predominantly standardised portfolios, unintended consequences that could adversely affect the competitiveness of such banks through reduced lending especially to SME’s must be avoided.

   If introduced correctly, this approach could also provide a more balanced outcome to stress testing, as the regulatory ELs would be based on 12 month Probability of Default (PD) and therefore mitigate the effect of assets moving into stage 2 under stress and thus requiring lifetime EL. So we therefore support further investigation into this fundamental change to the standardised approach. We also support the option that local regulators could apply deductions from Pillar 2 credit risk as part of the Supervisory Review and Evaluation Process (SREP).

But challenges remain as the TFP acknowledges. These include:

- the treatment of excess provisions in both the SA and IRB approaches;
- the 'centrality' of the EL rate in each risk category in a particular asset class;
- the need to take only unexpected losses (UL) into account without including EL too. Risk weights under the SA are calibrated to cover both EL and UL, whereas the IRB approach addresses UL only;
- the relationship between risk weighting and the Loss Given Default (LGD) from which the PD is re-engineered for SA purposes and in particular how any differences in loan performance between jurisdictions and different types of portfolio are recognised;
- the mechanism for reflecting credit risk mitigation through this approach and how that links to the TFP's desire to have equivalent approaches across IRB and SA;
- the treatment of defaulted assets in order to avoid double-counting;
- the need for this change and the ongoing revision to the standardised risk weighting methodology to be considered as a coherent whole.

Response to specific feedback requests

Should the distinction between general and specific provisions be retained?

The distinction between GP and SP is outdated and should be removed. If any distinction is required of future allowances it should be based on contemporary accounting practices.

If approach 3 is adopted, as we support, the distinction falls away. If it is not, then the definitions should be retained – to do otherwise would erode tier 2 capital. IFRS 9, with its definitions of stage 1 and 2, would seem to provide an opportunity to better define the distinction.

Regulatory expected loss

i) The need for an explicit regulatory EL charge in the SA

We support further development of a regulatory EL methodology for standardised approach as it would increase comparability between standardised and IRB approaches and clarify EL and UL concepts. However, as the proposals stand, further enhancements would be necessary.

Subdividing the SA between EL and UL could be beneficial for transparency purposes, particularly post-IFRS9 when smaller banks will have better modelling available for credit losses, allowing calibration over time between EL for SA capital and EL under IFRS9.

ii) How regulatory EL level should be set - globally by product type?

The EL should help bridge the gap between a SA and a typical IRB framework by allocating a matrix of ELs by borrower type (e.g. individual / SME / large corporate) and by product, based on the bucketing granularity to be introduced in the expected revisions to the Standardised approach to credit risk.

iii) The degree of granularity of regulatory EL

Regulatory EL must be at least as granular as the underlying standardised approach. However, it is unlikely that this will be risk sensitive enough to provide truly meaningful estimates of expected losses. Standardised EL is therefore likely to be a regulatory backstop. We suggest the EL levels are recalibrated as frequently as it is felt the underlying risk weights require recalibration. We note that whilst the EL rates provided in the DP are purely illustrative they are much higher than the rates actually experienced by many of our smaller bank members. So the regulatory EL levels should be calibrated in order to avoid being punitive for banks with conservative business models. The conservative nature of the propose EL rates confirm the previously communicated industry view that the RWs proposed under the standardised approach require recalibration.

Treatment of general and excess provisions

i) Should general or excess provisions continue to be included in tier 2?

Stage 1 provisions should continue to be included in Tier 2 capital up to 1.25% of RWAs. Particularly for smaller banks total capital is more significant than CET1 alone.

However our preference is for a harmonised approach to the treatment of excess provisions in Pillar 1, which will ensure the comparability of CET1 capital ratios.

ii) Alternatively should provisions be included in Pillar 2?

Inclusion of provisions in Pillar 2 would have no justified rationale. Pillar 2 requirements are to be met at all times and would need to be met with regulatory capital resources of the same quality as used to cover Pillar 1 risks.

iii) Are there any TLAC implications?

General provisions are by definition not “ascribed to identified deterioration of particular assets whether individual or grouped”. Therefore there is no TLAC implication; holding general provisions is akin to holding free capital. The real question is what qualifies as general and if no international agreement can be reached by the TFP, the decisions as to what qualifies as a general provision could be made a supervisory option, albeit that this would potentially unlevel the playing field, which we do not generally support.

Excess provisions should qualify for TLAC purposes since TLAC is an extension of the capital framework. Eligibility for regulatory capital purposes should be automatic.

Level playing field

i) How can capital differences arising from jurisdictional differences in accounting standards for provisioning be levelled out?

One solution could be splitting allowances into 12 month losses and those over 12 months. Even if an accounting regime does not require a 12 month expected loss, as under CECL, it is probable that banks would have these classifications anyway, as part of their assessment of lifetime losses. Aligning timescales for implementation would also promote a level playing field.
In the longer term, we believe a move to a regulatory view of credit risk capital which ignores the local accounting approach and levels the playing field between SA and IRB banks is beneficial.

Complexity and simplification

If the concept of standarised EL is pursued, the TFP could consider recognising ECL directly rather than estimate EL based on a measure back-solved from IRB LGD and standardised risk weights. However, this would remove all the advantages that the TFP is seeking through its introduction of standardised EL, as IRB would not directly recognise accounting whilst standarised would. Therefore, whichever concept is adopted, SA EL should be derived on the same basis as under IRB.

IFRS9 implementation requires banks to analyse loan loss data in a more granular, more complex way. Small banks will not necessarily have a rich enough data history to implement an IRB approach. So we see a standard matrix which allows a simpler pseudo-IRB approach to EL for SA banks as a good stepping stone which in the longer term it may allow more banks to convert to IRB.

Burden

Balance needs to be applied given the significant work being undertaken on IFRS 9 at this time. It is important to get it right and improve the still incomplete proposals. If a clear end state for capital treatment is defined and this is less burdensome, our members would accept more work upfront.

Responsible Executive

Simon Hills
✉ simon.hills@bba.org.uk
☎ 020 7216 8861