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January 13, 2017

Secretariat of the Basel Committee
on Banking Supervision (BCBS)
Bank for International Settlements
CH-4002 Basel, Switzerland

Re: CBA[1] Comments on the BCBS discussion paper: *Regulatory treatment of accounting provisions*

We thank you for the opportunity to provide comments on the BCBS's discussion paper, *Regulatory treatment of accounting provisions* ("discussion paper"). In this letter, we provide overall comments on the proposals with more detailed comments included in the attached appendix.

We welcome the Committee's initial deliberations on the long-term regulatory treatment of provisions with the aim of providing clarity with respect to when the revisions to the standardized and IRB approaches to credit risk become applicable. We appreciate the BCBS's recognition that a lengthy implementation and phase-in period for these and other Basel reforms is likely to allow banks to migrate to the new framework in an orderly and manageable fashion[2]. With this in mind, we recommend that the Committee spend additional time assessing long-term options including any interrelationships with the revisions to the Basel framework once they are finalized to ensure there is no significant increase in capital in total for all the Basel III reforms. Similarly, the industry will need additional time to evaluate the impacts of the other changes to the Basel framework (particularly the revisions to the standardized approach to credit risk and a capital floor based on standardized approaches) in conjunction with options for the long-term regulatory treatment of provisions.

We urge the Committee to spend the necessary time to arrive at an appropriate long-term solution, with sufficient consideration of further input from industry as there would likely be material impacts caused by any significant changes to the current regulatory treatment of provisions. We have provided below our initial views on the advantages and disadvantages of the options as currently presented. We have also provided a suggested refinement for Option 3

[1] The Canadian Bankers Association works on behalf of 59 domestic banks, foreign bank subsidiaries and foreign bank branches operating in Canada and their 280,000 employees. The CBA advocates for effective public policies that contribute to a sound, successful banking system that benefits Canadians and Canada's economy. The Association also promotes financial literacy to help Canadians make informed financial decisions and works with banks and law enforcement to help protect customers against financial crime and promote fraud awareness. www.cba.ca.

[2] Keynote address by Mr Stefan Ingves, Chairman of the Basel Committee and Governor of Sveriges Riksbank, at the 19th International Conference of Banking Supervisors, Santiago, 30 November 2016. https://www.bis.org/speeches/sp161130.htm

along with a new Option 4 for consideration. To this end, we are pleased that the discussion paper is viewed as the starting point for dialogue with stakeholders.

Option 1: To retain the current regulatory treatment of provisions, including the distinction between general and specific provisions, as a permanent approach

This option ensures that provisions are fully recognized for capital consistent with their recognition in the profit and loss income statement. Banks should not be penalized for setting aside provisions for unidentified future losses relative to banks which only provide for incurred losses. However, we believe the current asymmetry in the capital treatment of shortfalls vs. excesses should be removed (i.e. shortfalls included in CET1 capital and excesses only included in Tier 2 capital) and that both shortfalls and excesses should be applied to CET1 capital.

A disadvantage of this option rests on its reliance on the concepts of general and specific provisions which are no longer relevant given the transition to the expected credit loss (ECL) models under the accounting frameworks (IASB & FASB). We believe that more deliberation should take place on determining whether differences in standardized and IRB provisioning approaches are still required given the adoption of ECL models.

Option 2: To introduce a universally applicable and binding definition of general provisions and specific provisions

While this option would be acceptable in principle, we are concerned that reaching agreement on universal definitions will be challenging. The requirements for accounting provisions are different under IFRS 9, CECL, and other accounting standards. To calculate general and specific provisions under a universally applicable definition would likely require a bank to run a separate process and model in parallel with the accounting derived model. This would be costly and may still not level the playing field. Since the accounting frameworks no longer include specific/general provisioning classifications, to ensure consistency we request clear guidance on the application of the new regulatory definitions within the context of, and linkage to, the new accounting frameworks.

More specifically, we question whether the suggested approach in the discussion paper based on an agreed regulatory definition of "default" (or "non-performing") would be implemented in a consistent manner across banks and jurisdictions given the differences that exist in practice today. We are also concerned about the additional costs of implementation associated with the proposed approach and whether a regulatory definition of non-performing would require separate tracking from the accounting ECL models. Similar to Option 1, we are concerned with asymmetry in the treatment of shortfalls vs. excesses, and we acknowledge that both Options 1 and 2 would maintain the inconsistency between the IRB and standardized approaches. As noted above, we also recognize that the concepts of general and specific provisions may not be as relevant with the transition to the ECL models.

Option 3: Remove the general and specific provision distinction and introduce regulatory expected losses under the standardized approach

We have significant concerns as to whether an accurate expected loss (EL) can be calibrated in a standardized fashion across various asset classes and risk profiles without regard for inherent differences that exist in various products within asset classes, jurisdictional differences, underwriting and risk management standards. We are concerned that the lack of granularity, accurate risk measurement, and lack of sensitivity of the standardized approach will be further exacerbated by the addition of standardized EL proxy rates, which would also be crude estimates.

For example, banks' Other Retail portfolio includes secured auto loans and unsecured credit cards which attract very different A-IRB risk weights and EL rates when modeled under the IRB approach. However, under the suggested standardized EL approach, these two types of loans would have the same EL rate assigned. We believe the resulting standardized EL calculation could result in significant under-provisioning from a regulatory capital view when in fact the accounting expected loss model indicates sufficient provisions. We believe that a standardized EL rate based solely on the exposure type (i.e. retail loan) would yield more imprecise results and would therefore significantly negatively impact the determination of EL shortfall/excess.

We do recognize that Option 3 offers the benefit of aligning the treatment of accounting provisions under the IRB and standardized approaches and improving RWA comparability across jurisdictions and banks regardless of the accounting provisioning treatment adopted. Changing the current regulatory framework and aiming to level the playing field to ensure consistency across banks and jurisdictions could be desirable but it would require major changes and further granularity. Moreover, the price of a marginally improved level playing field could come at the expense of less relevant results in terms of risk management and risk capital. Appropriate calibration of regulatory EL rates for standardized portfolios would be key, and we question whether this would be achievable.

The proposed EL rates for the standardized approach would need to be calibrated such that it does not result in higher capital requirements considering there is sufficient conservatism built into the standardized approach and to meet the BCBS's stated intention of not increasing the capital requirement. Ultimately, we believe that in order to keep the capital requirement the same as today's level, regulatory standardized EL rates and standardized risk-weights would need to be adjusted. If the Committee were to decide on Option 3, additional granularity for the standardized EL rates should be considered based possibly on retail and wholesale IRB average EL rates as a means of improving this option.

Similar to Options 1 & 2 above, we also believe that excess ECL provisions should be added back as CET1 capital (as opposed to Tier 2 capital treatment). By definition an excess provision is above and beyond what is expected and required by the regulatory model and therefore should be considered to be part of CET1 capital. Such treatment would have the additional benefit of having more comparable regulatory capital results amongst banks.

<u>Additional recommended discussion point for the Committee's consideration for Option 3</u>

The Committee has indicated that it is open to considering other relevant issues which may require further discussion. While Option 3 has the benefit of aligning the standardized and IRB approaches, we suggest that from Canadian IRB member banks' viewpoint this option's greatest weakness is its reliance on standardized EL proxy rates. We recommend to the Committee that IRB banks be allowed to utilize their internally calculated EL rates under the IRB framework for exposures that an IRB bank has reflected under standardized approaches (due to partial use related to waivers, exemptions, and exceptions). This ensures greater risk sensitivity of the standardized approach for IRB banks and ensures capital requirements for IRB banks are not drastically impacted by use of prescribed regulatory EL rates.

This would also avoid the introduction of new standardized regulatory EL rates for IRB banks at the same time that such banks may now be required to determine an aggregate RWA floor based on standardized approaches for credit risk, operational risk, and market risk under the

BCBS's earlier proposal on *Capital floors: the design of a framework based on standardized approaches (BCBS 306)*.

In essence, we see this alternative as an Option 3 refinement for IRB banks. We recommend that the Committee make this option available to IRB banks or alternatively, propose for further discussion purposes alternatives it considers more appropriate for IRB banks impacted by the capital floor proposal.

<u>Option 4: Elimination of the comparison of regulatory EL to accounting provisions for banks that adopt ECL accounting frameworks</u>

The BCBS has stated in the discussion paper that both Basel I and II reflected regulatory EL because of the use of incurred loss provisioning under accounting frameworks. With the pending adoption of ECL models in accounting frameworks, the comparison between regulatory EL and ECL accounting provisioning appears unnecessary especially in light of the fact that ECL accounting provisioning is fully reflected in a bank's retained earnings.

We note that EL under the regulatory capital framework has traditionally contemplated a 12-month observation period whereas ECL models such as IFRS 9 and CECL focus on a broader lifetime perspective.

A possible approach would be for the BCBS to eliminate the required comparison of Basel regulatory EL to accounting provisioning for institutions reporting under ECL models (IFRS 9 or CECL). In this option, regulatory capital requirements would rely solely on the financial statement ECL/CECL accounting provisions and we would add back to CET1 capital the accounting provisions beyond the 12-month observation period, to ensure alignment with the existing Basel regulatory framework.

<u>Conclusion</u>

In conclusion, we stress the importance of the Committee taking the necessary time to consider long-term options, recognizing that other parts of the framework are still in the process of being finalized and, based on our understanding, that significant lead time is anticipated prior to implementation. We request that the Committee consider our alternative Option 4 and we would welcome the opportunity to provide further feedback including written comments on any future consultative documents on long-term approaches to the regulatory treatment of provisions. As we did not reach consensus on supporting one of the options presented by the Committee, we hope that you will find our proposed alternative helpful. We request further opportunities to review any other alternatives in the future before a final decision on a long-term solution is made.

We thank you in advance for your consideration of our comments, and we would be pleased to discuss our submission at your convenience.

Sincerely,

cc: Karen Stothers, Senior Director, Accounting, Accounting Policy Division, OSFI
Jihan Bhuiyan, Senior Accounting Advisor, Accounting Policy Division, OSFI
Catherine Girouard, Director, Bank Capital, Capital Division, OSFI

CBA Members' Comments and Requests for Clarification
Overall Comments and Key Issues
Please refer to our cover letter for initial views on the different long term policy options that are presented in the discussion paper along with a suggested refinement for Option 3 and a new Option 4.
1.1 Standardised approach (p. 4-5)
We find it difficult to accept that certain jurisdictions classify provisions set aside to cover unidentified losses as specific provisions. It is more likely that jurisdictions with little to no general provisions are not taking charges for unidentified future losses and it appears unfair to treat jurisdictions which do set provisions for unidentified future losses at a disadvantage.
1.2 Internal ratings-based approaches (p. 5)
No comments
1. Policy options for the longer-term regulatory treatment of provisions (p. 5-6)
2.1 To retain the current regulatory treatment of provisions, including the distinction between GP and SP, as a permanent approach (p. 6)
The treatment of provisions between IRB and standardized approaches should be improved for more consistency. For banks with both SA and IRB RWAs, the methodology for allocating a shortfall in provision based on RWA split does not make sense particularly when the data necessary to calculate this on a portfolio basis should already be available.
2.2 To introduce a universally applicable and binding definition of GP and SP (p. 6)
We wish to refer the BCBS to our earlier communicated concerns about the resultant possibility of a third set of definitions – please refer to our CBA comments on the BCBS consultative document *Prudential treatment of problem assets - definitions of non-performing exposures and forbearance*. How would this level the playing field if jurisdictions under IFRS 9 still have larger allowances for credit losses regardless of whether they

CBA Members' Comments and Requests for Clarification
are classified as general or specific provisions? We believe adding the excess provisions compared to regulatory EL to CET1 may assist IFRS 9 institutions to be on a more level playing field with institutions not under IFRS 9. This may in fact promote the use of ECL models which is preferable for capital adequacy.
2.3 Fundamentally change the current regulatory treatment of provisions – remove the GP/SP distinction and introduce regulatory EL under SA (p. 7)
2.3.1 A case for changing the current regulatory treatment of accounting provisions (p. 7-8)
The concern in the second paragraph regarding a level playing field is further heightened by the differing accounting treatment for performing loans between IFRS 9 and US GAAP. As a result of the 12-month vs lifetime distinction, the IFRS 9 provisions will likely be lower than their US GAAP results and will be more volatile as loans migrate between the two stages. We note that BCBS consultative documents have been issued which require banks to apply the Foundation Internal Ratings Based (F-IRB) and Standardized approach for certain credit risk portfolios. Will the BCBS be putting forward for discussion any proposals for the special treatment of these portfolios for regulatory EL?
2.3.2 Key concept and design (p. 8-9)
Overall, this approach appears to add another level of complexity to the new standardized methodology. It could still result in differences since accounting allowances will still be model based and these new standardized EL will not be using the same models. We stress that the standardized regulatory EL rates that would be provided by Basel should ensure that overall capital requirements will not increase from adoption of the new methodology.
2.3.3 Specification (p. 9)
2.3.3.1 Non-defaulted exposures (p. 9-10)
No comments

CBA Members' Comments and Requests for Clarification
2.3.3.2 Defaulted exposures (p. 10)
We are concerned this proposal assumes too much simplicity due to a lack of detailed information – that all exposures in the asset class have the same LGD. We suggest that defaulted exposures should reflect a regulatory EL amount based on the higher of the standardized regulatory EL and the associated accounting provision and that sufficient differentiation within and between asset classes would be required. Monitoring of the impact would be helpful for the industry to get an understanding of the impact of this paragraph's proposal.
2.3.3.3 Other specifications common to both non-defaulted and defaulted exposures (p. 10-11)
Application of the ACL excess or shortfall to EL should be consistently applied to CET1 capital
2.3.4 Calibration of standardized regulatory EL rates (p. 11)
A-IRB approaches ensure no double counting based on their design. RWA is for unexpected losses. The standardized approach prescribes risk weights that are only directionally accurate and highly conservative. Attempting to replicate the bifurcation of EL from UL for standardized portfolios is not possible given the lack of information for each unique portfolio. Due to the conservatism embedded within standardized approaches there will be double counting. The description of the calibration suggests that it would result in fairly static measurements of the allowance. This is contrary to the philosophy underpinning both IFRS 9 and CECL that aim to create more responsive measures of credit losses.
2.3.5 Policy considerations for the introduction of regulatory EL under the SA (p. 11-12)
Although A-IRB portfolios are not infinitely granular, the significant depth of detailed loss information enables A-IRB to be much more risk sensitive and accurate relative to inexact standardized approaches.

CBA Members' Comments and Requests for Clarification
3.1 General and specific provisions (p. 12)
We note that the distinction between general and specific provisions could be eliminated given the expected loss accounting frameworks (IFRS 9 & CECL) have different terminology. Further discussions should take place between the BCBS and IASB and FASB to determine what portion of the expected loss categorization could be considered available for capital. Removing the distinction between general provisions and specific provisions for regulatory purposes would also reduce subjectivity and variation in provisioning practices across banks/jurisdictions.
3.2 Regulatory expected loss (p. 13)
An explicit regulatory EL charge would be beneficial by major product categories where there is sufficient data to determine the appropriate regulatory EL based on industry status. EL levels should be subject to on-going review (likely 3 year cycle) to ensure any changes in market conditions are appropriately reflected in capital calculations. We have concerns with the current proposed regulatory EL framework as it may be too punitive for our standardized portfolios. For a commercial standardized exposure that is non-rated with 100% risk weight under standardized rules, targeting a 100% risk weight with an A-IRB capital charge formula and taking an implied PD with a regulatory prescribed LGD will likely produce ELs, which would be higher than if the identical exposure was rated under A-IRB rules. We note that there are inherent inaccuracies when prescribing EL rates to portfolios which are already highly risk-weighted and often have limited granularity of information. Attempting to increase the granularity of the regulatory EL for standardized approaches beyond the risk weighting granularity does not resolve double counting (UL v EL) concerns or the challenges in informational granularity often associated with standardized portfolios.
3.3 Treatment of general and excess provisions (p. 13)
All tiers of capital have regulatory minimums and are therefore important. The BCBS should correct the asymmetry issue from the application of excesses vs. shortfalls by applying both to CET1 capital. This is supported by the following rationale: • An excess provision by definition is above and beyond what is expected and required by the regulatory model and therefore could be considered to be part of CET1 capital. Such treatment would have the additional benefit of requiring more comparable

CBA Members' Comments and Requests for Clarification
regulatory capital amongst banks and less reliance on accounting provisions that are subject to judgment and subjectivity. • The introduction of IFRS 9 will materially increase the provisions and could result in a significant decrease in CET1 capital. Conversely, it is unfair that the excess provisions only receive a Tier 2 treatment. • The provisions will increase even more significantly under stress when loans are moving from stage 1 to stage 2 or 3. Banks' regulatory capital would already be under pressure and higher provisions would result in an even lower CET1 ratio. • It would be highly pro-cyclical if banks cannot add excess provisions back to CET1 capital under stress situations.
3.4 Level playing field (p. 13)
Introducing regulatory EL minima, if appropriately calibrated, or clarifying the distinction between specific and general provisions would help in closing the gap between standardized and IRB banks.
3.5 Complexity and simplification (p. 14)
We are concerned that introducing regulatory EL for the standardized approach would add complexity and introduce a new process/calculation for banks to implement. Banks using the IRB approach will continue to run models to calculate regulatory EL for IRB portfolios, in addition to models to calculate accounting ECL provisions under IFRS 9. Since both the regulatory and accounting treatment of provisions under IFRS 9 (and CECL) are based on expected losses, it would be simpler for the regulatory treatment to align with accounting provisions for banks provisioning using an ECL approach.
3.6 Burden (p. 14)
Our preference would be to achieve a less burdensome longer-term approach which allows a level playing field and consistency across jurisdictions and amongst banks.