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

Dear Basel Committee members:

Re: Basel Committee on Banking Supervision Consultative Document: Guidance on accounting for expected credit losses

The Canadian Bankers Association[1] ("CBA") would like to thank the Basel Committee on Banking Supervision ("BCBS" or the "Committee") for the opportunity to comment on the February 2015 consultative document *Guidance on accounting for expected credit losses* (referred to in this comment letter as the "BCBS ECL guidance"). Our members have reviewed the draft guideline and we have summarized our recommendations below.

Canadian banks are fully supportive of, and are currently engaged in, a high quality implementation of all aspects of IFRS 9 Financial Instruments ("IFRS 9"), including the impairment provisions of the standard (referred to as "IFRS 9 Impairment" in this letter).

We appreciate the opportunity to engage with members of the BCBS involved in the drafting of the BCBS ECL guidance. We understand the document is intended to provide guidance to internationally active banks on developing a sound credit risk management process, regardless of the accounting framework applied, and to also provide guidance in the implementation and application of IFRS 9 Impairment. We support the development of the BCBS guidance, however we believe that in some instances the draft guidance is not clearly articulated and could be subject to misinterpretation.

We have structured our comments into two categories: 1) general themes that require clarity and are applicable to the main body of the guidance document and the IFRS Appendix and 2) drafting changes which can be found in the Appendix attached to this letter.

[1] The Canadian Bankers Association works on behalf of 60 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.

Materiality
The BCBS ECL guidance appears to apply the concept of materiality to both credit risk management practices and to the measurement of ECL. This gives the impression that the guidance is expected to be implemented without regard to financial statement materiality. The draft guidance calls for, in paragraphs 60 and A49, IFRS 9 Impairment implementation to occur without regard to the cost of the implementation. We believe that materiality is an overriding concept in IFRS and is equally applicable to IFRS 9 as it is any other standard. We do not believe it is appropriate to scope out the issue of materiality in the determination of ECL as materiality is applied to the financial statements as a whole. This is equally applicable to the use of undue cost or effort in the accounting standard. The intention of accounting is not to create burdensome processes that do not contribute to enhanced financial statement results and presentation. We believe that the concept of undue cost or effort should also be respected.

IFRS materiality is an independent concept from the development and application of sound credit risk management processes. Application of IFRS materiality to reporting will not reduce the quality of the credit risk management practices that are developed under the BCBS ECL guidance nor the quality of ECL measurements in accordance with IFRS 9 Impairment. We are fully supportive of Canadian banks continuing, and enhancing where appropriate, sound credit risk management practices and our implementation of IFRS 9 will embrace the BCBS guidance. However we believe the BCBS ECL guidance should not make reference to, or interpret, IFRS materiality or undue cost or effort.

Proportionality
The BCBS ECL guidance should permit the appropriate application of proportionality within sound credit practices for domestic systemically important banks and internationally active banks. The current drafting of the BCBS ECL guidance in paragraphs 11 and 12 suggests proportionality is not available to more complex banks. We do not agree with this premise as it prevents the BCBS ECL guidance from being scaled to the nature of the risks that are being managed. It is not uncommon for large, internationally active and other more sophisticated banks to have a range of types of portfolios, from those that contain complex risk exposures to those that are relatively straightforward and managed within a more simplified risk management framework. In practice, and in line with what we view to be strong credit risk management practices, it is necessary that the BSBC ECL guidance permit the credit risk loss estimation approach to be aligned with the nature, size and complexity of the loan portfolio, which may not be related to the complexity of the bank. We believe the guidance should be revised to permit the concept of proportionality to apply to large banks and that it would be more appropriate to apply proportionality on a portfolio basis rather than on the bank in its entirety.

As noted above, the BCBS ECL guidance states the IFRS 9 Impairment implementation is to occur without regard to the cost of the implementation which is inconsistent with the requirements of IFRS 9 Impairment that require the incorporation of reasonable and supportable information that is available without undue cost and effort. We believe this implementation goes beyond achieving sound credit risk management practices and would result in banks implementing credit risk management practices that are not aligned with the requirements of IFRS 9 Impairment. We believe the Committee should clarify that this requirement, along with the use of terms such as "actively incorporate" and "reasonably available" (paragraph A6), is not meant to redefine the IFRS 9 Impairment guidance.

Forward-looking Information
In relation to macroeconomic and forward-looking information, IFRS 9 explicitly states that this information be reasonable and supportable and available without undue cost and effort. The BCBS ECL guidance has drafting inconsistencies in this regard. The guidance explicitly excludes any reference to reasonable and supportable in certain paragraphs and in others it requires consideration of all possible macroeconomic and forward-looking information. We feel it is critical that the BCBS ECL guidance support the IFRS 9 Impairment requirements and the guidance should align with the accounting requirements of reasonable and supportable information that is available without undue cost and effort and the application of materiality considerations. We believe the Committee should

clarify that the use of terms such as "actively incorporate" and "reasonably available" (paragraph A6) is not meant to require an exhaustive use of all macro-economic factors.

In the application of forward-looking information, larger banks will leverage their internal economic information that is used in forecasting, planning and stress testing as this achieves consistency in source data for management, capital and financial reporting. This internal information is determined having considered a wide range of internal and external inputs. We believe the BCBS ECL guidance requires clarification that it does not preclude or severely restrict the use of portfolio or regional specific assumptions and approaches even though there is a general principle of consistent application of assumptions and data entity-wide to reduce bias. That is, if a loan portfolio is segmented on a regional geographic basis, a bank should be able to use regional forward-looking data even if it is not used elsewhere in the bank, as long as the information is relevant and reliable.

Practical Expedients

The proposed guidance views significant reliance on past due information as being a very low-quality implementation of an ECL model. However, in practice many credit risk models are based on past due information where the results of the base models are supplemented by overlays that are intended to adjust for lagging information in order to reflect current and forecast conditions. We strongly believe the approach of using past due information that is supplemented by an overlay is appropriate. The language in the guidance should be amended to reflect this.

Segmentation

We do not believe the IFRS 9 Impairment guidance or the BCBS ECL guidance are intended to force banks to re-segment their exposures more frequently than underlying economic factors or loan experience would dictate. Banks presently use models that require segmentation based on shared risk characteristics and drivers which are generally stable over time. It is this stability that supports the view that the segmentation is appropriate. As the drivers are stable, any specific change that may cause a consideration for re-segmentation should be based on the significance and the duration of the change. Too frequent re-segmentation will cause concern as to whether the segmentation is appropriate at any reporting date. We believe re-segmentation may be occasionally necessary only when the specific change persists over a period of time and it affects a significant portion of the segment, should exposures be re-segmented.

Risk Rating Systems

The guidance as drafted requires use of forward-looking information in determining the risk rating of exposures. While using this approach for estimating ECL may be appropriate in certain circumstances, this is not the only approach that is appropriate. There should be flexibility to incorporate forward-looking information through risk ratings or the ECL measurement methodology. The current drafting requiring forward-looking information to be incorporated into risk ratings should be amended to permit alternative approaches for incorporation of forward-looking information.

Furthermore, in those instances where the forward-looking information is incorporated through an overlay process, the risk rating system may not incorporate the forward-looking information directly. We believe this is an appropriate approach and therefore the language in the guidance should be amended to reflect the varied approaches that can be adopted.

Symmetry

The IFRS 9 ECL model is a symmetrical model in which changes in credit risk since origination are used to determine the level of ECL allowance. Where an exposure or group of exposures no longer meets the “significant deterioration in credit risk” criterion, it may be transferred back to stage 1. In addition, the use of forward-looking information and macroeconomic factors can result in an increase or a decrease of credit risk. The emphasis of the document is mainly on impact of increases in credit risk. We recommend that the BCBS ECL guidance be amended throughout the document to reflect that the IFRS 9 guidance is intended to be symmetrical.

Unit of Account
The guidance makes reference to making qualitative adjustments in the estimation process and notes that concentrations of credit risk is a factor that may require adjustment in paragraphs 24(f) and 28(d). As the unit of account is the individual loan we do not believe that it is appropriate to make adjustments for concentration risk. Concentrations do not increase the probability of default on individual exposures or the loss on individual exposures.

General Principles
The principles in the BCBS ECL guidance are the foundation of the scope and focus of the supervisory guidance. We recommend the BCBS consider including Principle 7 as the third principle as it speaks to having sound credit risk assessment and measurement processes and building a strong foundation on which credit risk management processes are built. This principle belongs with the guiding principles at the beginning of the document.

We also note that, for certain principles, the Committee has outlined specific policies, procedures or criteria that banks should consider in developing a sound risk management framework. We have concerns that local regulators, external auditors and internal auditors will use this as a checklist to test compliance with the guidance. We strongly encourage the Committee to remove lists such as paragraph 24, including the requirement to document why the selected ECL measurement models are the most appropriate by portfolio (paragraph 24(e)), and retain principles that banks should employ.

Throughout the BCBS guidance several instances of inconsistency with the requirements of IFRS 9 Impairment were noted, including many instances where it could be interpreted that the BCBS guidance goes beyond the requirements of IFRS 9 Impairment (e.g. modified lending exposures, use of practical expedients, etc.). The scope of the document should clearly indicate that the purpose of BCBS guidance is to assist with implementation and not to further expand the requirements of IFRS 9 Impairment.

Disclosures
The disclosure requirements in the document overlap with the IFRS 9 Impairment disclosures. As the focus of the BCBS ECL guidance is to provide a framework for sound credit risk management practices, and as IFRS 9 Impairment contains detailed disclosure requirements, we believe the BCBS ECL guidance should either remove the section on disclosures or provide only guiding principles for disclosures.

We thank the BCBS for taking our comments into consideration. We strongly believe that addressing the above noted areas will result in a document that will be a strong foundation for banks in development of their IFRS 9 Impairment processes and the ensuing supervisory oversight of these processes.

Sincerely,

Attachment

Materiality / Proportionality

Consistent with the key messages above, we recommend the BCBS include a clear statement in the document that the BCBS ECL guidance does not override IFRS financial statement materiality. As well, we propose the following edits to the guidance to ensure banks are able to build ECL models that are appropriate and proportionate with the risks in the portfolios they hold.

> 12. ~~For less complex banks,~~ Consistent with the Basel Core Principles, the Committee recognises that supervisors may adopt a proportionate approach with regard to the standards that supervisors impose on banks and the conduct of supervisors in the discharge of their own responsibilities. This allows ~~less complex~~ banks to adopt approaches commensurate with the size, nature and complexity of their lending exposures.

Both paragraph 60 and A49 state the costs to implement IFRS 9 Impairment should not be considered when implementing an ECL accounting model and speak to not avoiding costs a bank considers unnecessary. We believe that this is inconsistent with the requirements of IFRS 9 which states that "an entity shall measure expected credit losses of a financial instrument in a way that reflects: … reasonable and supportable information that is available without undue cost or effort at the reporting date about past events, current conditions and forecasts of future economic conditions". (IFRS 9 5.5.9, .11, .17 and BCE.95)

> 60. The Committee understands that it is challenging and costly to incorporate forward-looking information and macroeconomic factors into the estimate of ECL and that ECL estimates will inherently have a significant degree of unavoidable subjectivity. 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~~.

> A49. IFRS 9 states that "an entity shall consider the best reasonable and supportable information that is available, without undue cost and effort" and that "an entity need not undertake an exhaustive search for information".[34] The Committee expects that banks will not read these statements restrictively. Since the objective of the IFRS 9 model is to deliver fundamental improvements in the measurement of credit losses, the Committee expects banks to develop systems and processes to use the reasonable and supportable information needed to achieve a high-quality, ~~robust and~~ consistent implementation of the approach.~~ This will potentially require costly upfront investments in new systems and processes but the Committee considers that the long-term benefit of a high-quality implementation far outweighs the associated costs, which should therefore not be considered undue~~.

Individual versus Collectively Assessed

As ECL accounting guidance, including IFRS 9 Impairment, applies only to expected credit losses and not to unexpected credit losses we believe the following clarification to Principle 4 is required.

> **Principle 4**: A bank's aggregate amount of allowances <u>for expected credit losses</u>, regardless of whether allowance components are determined on a collective or an

individual basis, should be adequate as defined by the Basel Core Principles, which is an amount understood to be consistent with the objectives of the relevant accounting requirements.

Paragraphs 49 through 55 discuss the determination of the allowances and how they should incorporate forward-looking information. We believe that clarifying language is required to ensure that 1) readers understand that using historical information as a starting point in determining ECL is permissible as long as they are supplemented by overlays that are intended to adjust for lagging information in order to reflect current and forecast conditions and 2) that if forward-looking information and macroeconomic factors were considered when assessing the loan on an individual basis, they should not be considered for collective overlays as well.

Paragraph 50 should be amended to read:

> 50. … The information set considered may be based on historical data but then also must go beyond historical and current data, to include forward-looking information and macroeconomic factors.

Paragraph 51 could be clarified as follows:

> 51. Individual assessments of credit risk may be appropriate in many circumstances, such as when an exposure is closely monitored or for large-value loans. Regardless of the nature of the assessment, ECL estimates should always incorporate the expected impact of all reasonably available forward-looking information and macroeconomic factors, whether incorporated at the individual assessment level or collectively as an overlay~~, or both~~. In the case of individually assessed exposures where historical information is used as the basis to determine ECL and it is not reasonable to incorporate forward-looking information and macroeconomic factors into the individual assessment, loans may need ~~This might require exposures (even those that are initially assessed individually using primarily historical and current information)~~ to be placed in a group with shared credit risk characteristics and forward-looking information and macroeconomic factors may need to be assessed collectively using a top-down approach ~~to consider forward-looking information and macroeconomic factors that could not be assessed on an individual basis~~. ~~Such collective assessment could allow identification of relationships between risk factors, as affected by forward-looking information and the ensuing cash shortfalls, that may not be apparent at the individual exposure level.~~ When exposures are assessed both individually and collectively in this way, banks should be careful to ensure that there is no double-counting.

Paragraph A35 states that IFRS 9 “requires” a collective assessment to determine if there has been a significant increase in credit risk since initial recognition when evidence of such an increase is not yet available at the individual instrument level. We believe that this is an incorrect interpretation of IFRS 9, which states only that a collective assessment “may be necessary.” Furthermore, paragraph A35 appears to create an expectation that if one or more exposures within a collectively-assessed group experiences a significant increase in credit risk, the entire group will transfer to recognition lifetime expected credit losses. We do not believe that such an expectation reflects the Committee’s intent as it is not consistent with paragraph A36 which states that “the proportion of the group that has increased significantly in credit risk should be subject to LEL measurement.” To avoid misinterpretation or misapplication, we suggest that paragraph A35 be removed from the document.

~~A35. IFRS 9, paragraph B5.5.1, requires that, in order to meet the objective of recognising lifetime expected losses for significant increases in credit risk since initial recognition, assessment be performed on a collective basis by considering information that is indicative of significant increases in credit risk in a group or subgroup of financial instruments even if evidence of such significant increases in credit risk at the individual instrument level is not yet available. Accordingly, the Committee expects that, in instances where it is apparent that one or more exposures in a group have experienced a significant increase in credit risk, the relevant group or subgroup will transfer to LEL measurement of ECL even though it is not possible to identify this on an individual exposure basis.~~

Macroeconomic and Forward-looking Information

As noted in our key messages, we believe the guidance document should be consistent with IFRS 9 Impairment and refer to "reasonable and supportable" information being used in the development of models to measure expected losses. We suggest the BCBS consider a change to the language in paragraphs 30 and 53 which requires banks to consider "the full spectrum" of information.

> 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~~ <u>reasonable and supportable</u> information that is relevant to the product, borrower, business model or economic and regulatory environment when developing estimates of ECL. ~~In developing such estimates for financial reporting purposes, a bank should consider the experience and lessons from similar exercises it has conducted for regulatory purposes, although the Committee recognises that stressed scenarios developed for regulatory purposes are not intended to be used directly for accounting purposes.~~ Where relevant and practical, forward-looking information and related credit quality factors used in ~~regulatory~~ expected loss estimates should be consistent with inputs to other relevant estimates within the financial statements, budgets, strategic and capital plans, and other regulatory reporting.[19]
>
> 53. Robust methodologies and parameters should consider different potential scenarios and <u>incorporate information that is considered reasonable and supportable and not incorporate information</u> ~~not rely~~ purely on subjective, biased or overly optimistic considerations. Banks must use their expertise to consider ~~the full spectrum of reasonable~~ information that is <u>reasonable, supportable and expected to impact credit risk measurement</u> relevant to the ~~group or individual~~ exposure, to ensure that allowance estimates incorporate timely recognition of changes in credit risk.

We recommend deleting paragraphs A23 and A24 of the guidance as they indicate demonstrating a very high level of precision in modelling that isn't likely to be demonstrable in most situations.

> ~~A23. For example, within retail portfolios adverse developments in macroeconomic factors and borrower attributes (such as the sector from which they earn their primary income) will generally lead to an increase in the objective level of credit risk long before this manifests itself in lagging information such as delinquency. Thus, the Committee believes that, in order to meet the objective of IFRS 9 in a robust manner, banks will need to have a clear view – supported by persuasive analysis – of the linkages from macroeconomic factors and borrower attributes to the level of credit risk in a portfolio. This will be obtained through analysis of data for the past, adjusted using experienced~~

~~credit judgment for differences between historic, current and forward-looking information and macroeconomic factors.~~

~~A24. The Committee expects analyses of this kind to be also performed for large, individually managed exposures. For example, for a large commercial property loan, banks must take account of the considerable sensitivity of the commercial property market in many jurisdictions to the general macroeconomic environment, and use information such as levels of interest rates or vacancy rates to determine whether there has been a significant increase in credit risk.~~

We believe the wording of paragraph A28(a) should be revised as the meaning of "sufficiently rich" is unclear.

A28. …(a) deterioration of the macroeconomic outlook relevant to a particular borrower or group of borrowers to the extent they are significant. Macroeconomic assessments should consider ~~must be sufficiently rich to include~~ factors relevant to sovereign, corporate, household and other types of borrower. Furthermore, they must address any relevant regional differences in economic performance within a jurisdiction. See principle 6 in the main section of this guidance for additional considerations for forward-looking information and macroeconomic factors; and ...

Use of Practical Expedients

The BCBS has effectively prohibited the use of practical expedients on the basis that cost considerations should not factor into the implementation of IFRS 9 Impairment. We understand, based on discussions with certain BCBS members, that it was not the intent of the Committee to prohibit the use of information such as days past due but to emphasize that information such as delinquency needs to be used in conjunction with forward-looking information and macroeconomic factors. However, the guidance is being interpreted as a prohibition against the use of delinquency information in the credit risk management process. We recommend that the wording around practical expedients be amended to reflect the Committee’s intent.

15. This guidance includes an appendix relating to International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) and which describes supervisory requirements specific to jurisdictions applying the IFRS ECL requirements. Nevertheless, the paper is intended to set forth supervisory requirements for ECL accounting that do not contradict the applicable accounting standards established by the IASB or other standard setters. Rather, the paper presents the Committee’s view of the robust application of those standards, including guidance on ~~circumstances in which the Committee expects~~ internationally active banks ~~to limit their~~ use of particular simplifications and/or practical expedients included in the relevant accounting standards.

A40. Banks should be alert to any possibility of bias being introduced which would prevent the objectives of the Standard from being met. ~~For this reason, the Committee is of the view that, in order to implement IFRS 9 in a robust manner, practical expedients (see below) should rarely be used by banks, as these have the potential to introduce significant bias. For example, as noted below, use of a 30-days-past-due criterion introduces bias leading to a move to LEL later than the objective of the Standard requires.~~

A46. IFRS 9 includes a number of practical expedients, intended to ease the implementation burden for a wide range of companies in recognition of the fact that IFRS 9 will be used by a variety of entities, including firms outside the banking industry. The Committee expects that appropriate consideration of macroeconomic and forward-looking information will be incorporated where these expedients are viewed to be an appropriate application of credit risk management. ~~regards many of these practical expedients as inappropriate for use by internationally active banks and those banks more sophisticated in the business of lending, particularly because – given their business – the cost of obtaining relevant information is not considered by the Committee to be likely to involve "undue cost or effort".~~

A48. In instances where these exceptions from the core requirements of the Standard are applied, the Committee expects ~~that justifications for~~ the use of such practical expedients by banks should be clearly documented ~~and disclosed~~. They will be subject to increased scrutiny by supervisors to determine appropriateness.

In regard to the low credit risk expedient clarification could be achieved as noted below.

A50. IFRS 9 introduces an exception to the general model in that, for "low credit risk" exposures, entities have an option not to assess whether credit risk has increased significantly since initial recognition. It was included as a practical expedient to provide relief from tracking credit risk for high-quality lending exposures ~~financial instruments such as highly rated debt securities~~. ~~Although use of the low-credit-risk exemption is provided as an option in IFRS 9, in the Committee's judgment use of this exemption by banks would reflect a low-quality implementation of the ECL model in IFRS 9.~~ The Committee expects that this exemption ~~it~~ would be used by banks only in ~~rare and~~ appropriate circumstances, since the Committee views lending activities as the core of the bank's business.

A52. In that context, the Committee expects that a significant increase in credit risk will always result in an exposure moving to LEL measurement, and ~~for good-quality implementation of IFRS 9 any rare~~ use of the low-credit-risk exemption must be accompanied by clear evidence that credit risk as of the reporting date is so low, on an absolute basis, that a significant increase in credit risk since initial recognition could not have occurred. …

A54. IFRS 9 does not provide definitions of "near" and "longer" term; thus, in those ~~rare~~ situations where a bank uses this practical expedient, a bank should establish its own internal definitions of "near" and "longer" term….

Disclosures in bank financial statements will be based on the requirements of IFRS 9, which already address disclosure requirements when this practical expedient is used.

A56. The Committee expects banks' public disclosures to provide full information on the criteria applied in order to identify low-credit-risk exposures and classes of financial instruments to which it applies, and in particular the Committee recommends that information be provided on the internal definitions adopted for "near" and "longer" term.

Related to the 30 days past due practical expedient, we believe the guidance may be clarified with the below edits.

We agree that relying solely on delinquency data will seldom be appropriate. However, we believe paragraphs A22 and A59 should be clarified to indicate that delinquency data when considered in conjunction with other inputs (e.g. forward-looking information) would be acceptable.

> A22. It is important that banks' analyses take into account the fact that the determinants of credit losses very often begin to deteriorate a considerable time (months or, in some cases, years) before any objective evidence of delinquency appears in the lending exposures affected. Delinquency data are generally backward-looking, and the Committee believes that, for most exposures, they will seldom be appropriate in the implementation of an ECL approach by banks without the additional consideration of relevant forward-looking information.
>
> A59. The Committee agrees with the view expressed in IFRS 9 that delinquency is a lagging indicator of significant increases in credit risk. Banks should have credit risk assessment and management processes in place that are sufficiently robust to ensure that credit risk increases are detected well ahead of exposures becoming past due or delinquent. Where appropriate ~~The Committee would view significant~~ reliance on past-due information (such as using the more-than-30-days-past-due rebuttable presumption as a primary indicator of transfer to LEL) should be accompanied by incorporation of relevant forward-looking information ~~as a very low-quality implementation of an ECL model~~.
>
> A62. In the ~~limited~~ instances where past-due information is the best criterion available to a bank to determine when exposures should move to the LEL category, banks should pay particular attention to their measurement of 12-month ECL allowance to ensure that ECL are appropriately captured in accordance with the measurement objective of IFRS 9….

Segmentation

As noted in our key messages, a sound credit risk management framework should not be subject to frequent re-segmentation. To establish appropriate segment groupings of like risks care must be taken and re-segmentation should be based on sustained behaviour or performance. The guidance should reflect this approach in the guidance.

> 41. Both accounting and regulatory frameworks recognise credit risk rating systems as tools for accurately assessing the full range of credit risk. Where a credit risk rating ~~system~~ methodology is used for both regulatory capital calculations and financial reporting, the Committee expects banks to seek consistency between credit risk ratings assigned to a lending exposure, or portfolio of lending exposures. Where credit ratings assigned differ for regulatory capital and financial reporting purposes, the rationale should be documented.
>
> 46. Exposures must ~~not~~ be grouped in such a way that a change ~~an increase~~ in the credit risk of a significant portion of the ~~particular~~ exposure~~s~~ is not masked by the ~~performance~~ change of the segment as a whole. Conversely, exposures must be grouped in such a way that a change in an insignificant portion of the exposure does not trigger the migration of the entire group. Where changes in credit risk after initial recognition affect ~~only some~~ a significant portion of the exposures within a group and the changes are observed to persist over time, those exposures must be segmented out of the group into relevant subgroups, to ensure that the ECL allowance is appropriately updated.

We believe paragraphs 46 and 47 may be inconsistent as paragraph 46 indicates that a change in credit risk after initial recognition would result in a portion of a group migrating to a higher credit risk rating, whereas paragraph 47 seems to indicate the entire group should migrate to a higher credit risk rating. We believe that paragraph 47 should be clarified to indicate that a change in credit risk that only affects some exposures within a group would not result in the entire group migrating to a higher risk rating if that condition does not exist in the remaining portfolio. We believe this can be achieved through the requirement to dynamically group and regroup exposures.

> 47. Where it is assessed that the level of credit risk has significantly changed ~~increased~~ on a group basis (which assessment includes consideration of forward-looking information), the entire group should migrate to a different ~~higher~~ credit risk rating, indicative of a change in ~~lower~~ credit quality, assuming the entire group continues to share similar credit risk characteristics. In addition, a bank should consider the potential effect on other groups or individual exposures held by the bank. This may in some cases require a bank to also perform a credit risk assessment on an individual basis.

As previously noted, there will be circumstances that will cause banks to re-evaluate their segmentation. It is not expected this will be frequent, if the initial groupings were determined in the spirit of the guidance. We have made edits to incorporate this approach in the guidance.

> 48. The grouping of exposures should be re-evaluated and exposures should be re-segmented ~~whenever~~ as necessary, e.g. when a bank's expectations of credit risk for a group of loans within the portfolio has ~~and~~ changed significantly enough from the date the grouping was originally made ~~have changed~~ and the credit risk characteristics of that group is no longer homogenous with the remainder of the portfolio. The group of exposures assigned should receive a periodic formal review ~~(eg at least annually or more frequently if required in a jurisdiction)~~ to reasonably ensure that those groupings are accurate and up to date.

Risk Rating Systems

We have noted that forward-looking information may be incorporated through risk rating systems (such as lifetime probability of default) or through an overlay process where it is not feasible to incorporate forward-looking factors at an individual loan level. Accordingly we believe that certain paragraphs should be amended to allow for circumstances where forward-looking factors will not be incorporated into risk ratings of loans. As well, we suggest amendments to clarify that forward-looking information is not restricted to risk rating systems. We recommend paragraph 35 be removed as we do not believe the independent review function is necessary in a sound application of credit risk practices. The people assigning credit risk ratings to loans are those closest to the credit risk assessment and work within bank policy and governance processes. An independent reviewer will not improve identification of credit risk.

> 34. With regard to ECL measurement ~~rating systems~~, the procedures should clearly specify the key factors, including forward-looking information and macroeconomic factors that form the basis for determining ~~assigning~~ ECL measurement ~~credit risk ratings~~ and thus help support the monitoring, assessment and reporting of ECL for all lending exposures across the entire credit risk rating system.

> 35. The credit risk rating process should include an independent review function. While front-line lending staff may have initial responsibility for assigning credit risk ratings and

ongoing responsibility for updating the credit rating to which an exposure is assigned, this should be subject to the review of the independent review function.

37. The design of the credit risk measurement ~~rating~~ system should ensure that a bank incorporates all reasonable and supportable ~~relevant~~ information, including forward-looking information and macroeconomic factors, into its ECL measurement, ~~credit risk assessment and rating processes~~ both upon initial recognition and over time. ~~In this context, an effective credit risk measurement rating system will allow a bank to track changes in credit risk, regardless of the significance of the change, and consequent changes in credit risk ratings.~~

38. The credit risk rating system must capture all lending exposures to allow for an appropriate differentiation of credit risk and grouping of lending exposures within the credit risk measurement ~~rating~~ system, reflect the risk of individual exposures and, when aggregated across all exposures, the level of credit risk in the portfolio as a whole.

39. In describing elements of its credit risk measurement ~~rating~~ system, a bank should clearly define each credit risk rating and delineate the personnel responsible for the design, implementation, operation and performance of the system as well as those responsible for periodic testing and validation, such as interest rates and unemployment rates. In this context, the rating of guaranteed or collateralised exposures on the basis of credit risk should consider the bank's expectation of the debtor's paying capacity.

40. Credit risk rating systems should take into account a borrower's current and expected financial condition and payment capacity over the expected life of the lending exposure or portfolio of exposures. This includes expectations of impacts from forward-looking information and macroeconomic factors.

Symmetry

We have noted that the intention of BCBS ECL guidance is for the symmetrical treatment of all exposures or groups of exposures. In paragraph A2 the Committee notes that the methodology should allow for the timely build-up of allowances. We propose amending the wording to also indicate that the methodology also has to allow for the timely reduction of allowances as well.

A2…..The methodology used to estimate 12-month ECL should be robust at all times and should allow for the timely recognition or de-recognition ~~build-up~~ of allowances.

Further, in paragraph A6 we suggest symmetry of allowance movements be incorporated.

A6….. In particular, for the measurement of an amount equal to 12-month ECL to be sufficiently sensitive to all relevant sources of credit risk, it is necessary that forward-looking information that is reasonably available and macroeconomic factors are considered in the estimate. This will permit allowances to increase or decrease ~~build over time~~ in response to changes in credit risk and better reflect the inherent credit risk associated with lending.

It is not practical to list the many instances where "significant increase in credit risk" are noted in the proposed guidance. We recommend that the guidance be amended to refer to increases and decreases (or simply, "changes") in credit risk.

Significant Increase in Credit Risk

We believe the final sentence of paragraph A25 should be removed as in certain circumstances credit risk mitigants (e.g. collateral or guarantees) may be relevant when determining risk of default if the collateral or guarantee specifically impacts the probability of default of the borrower. We believe the point the Committee is communicating is already reflected in IFRS 9 guidance and providing additional clarification is not required and could potentially be misinterpreted.

> A25. Banks must have a clear policy, including well developed definitions, of what constitutes a "significant" increase in credit risk for different types of lending exposures. Such definitions and the reasons why they are considered appropriate should be disclosed in accordance with IFRS 7, paragraph 35F. IFRS 9, paragraph 5.5.9, requires that, when making the assessment of significant increases in credit risk, "an entity shall use the change in the risk of default occurring over the expected life of the financial instrument instead of the change in the amount of expected credit losses". ~~In other words, this assessment is made before consideration of the effects of credit risk mitigants such as collateral or guarantees.~~

We believe that paragraph A32 should clarify that an internal credit rating downgrade may be indicative of significant credit deterioration; however such a downgrade is not considered a rebuttable presumption that a significant deterioration has occurred.

> A32. The Committee stresses that thorough consideration and full weight must be given to factors which change only on the basis of a discretionary decision. For example, if a decision is made to lower the internal credit rating for an exposure, ~~it is unlikely that~~ the likelihood of such action being ~~would have been~~ taken by the decision-maker had the deterioration not been perceived as significant should be considered.

We believe paragraph A38 should be clarified to indicate that the Committee does not prohibit the use of a maximum credit risk approach as long as its application meets the principles of IFRS 9.

> A38. The IASB ECL model is a relative model. This means that the assessment of significant increases in credit risk is based on comparing credit risk on exposures at the reporting date relative to credit risk upon initial recognition. Where credit risk has increased significantly, exposures are required to move to LEL measurement. IFRS 9, paragraph BC 5.161, suggests that banks can set a maximum credit risk for particular portfolios upon initial recognition that would lead to that portfolio moving to LEL measurement when credit risk increases beyond that maximum level. This is an example of the application of the principle in the Standard, in which changes in the risk of default need to be assessed relative to that upon initial recognition rather than as an exception to that principle. The Committee notes that this approach ~~simplification~~ is ~~only~~ relevant when exposures are segmented on a sufficiently granular basis such that a bank can demonstrate that the analysis is consistent with the principles of IFRS 9.

Disclosures

As noted in our key messages, we believe the disclosure requirements should either be removed from the document or the document should provide guiding principles, deferring to the IFRS 9 Impairment disclosure requirements. If these changes are not made, at a minimum, the disclosure requirements in the BCBS ECL guidance should be reviewed to identify any overlap with IFRS 9 Impairment, or other existing disclosure requirements and redundancies eliminated. Additionally, the disclosure of similarities and differences in methodology, data and assumptions used in measuring ECL for accounting purposes and expected losses for regulatory capital adequacy purposes should only be required if they provide relevant information to the users of the financial statements.

> 78. The Committee expects banks to disclose similarities and differences in the methodology, data and assumptions used in measuring ECL for accounting purposes and expected losses for regulatory capital adequacy purposes <u>when this information is relevant and meaningful</u>.

Robust

Throughout the BCBS ECL guidance document the word robust is used to characterize both the expected credit loss measurement as well as the credit risk management processes (e.g. model design and model inputs). Robust is not a defined term in an accounting or audit context. The use of robust in a measurement context throughout the guidance may be viewed to conflict with the IFRS 9 Impairment guidance which does not characterize the estimate of credit losses as robust but reasonable and supportable. We strongly recommend the word robust be removed in reference to measurement. The paragraphs in the BCBS ECL guidance that refer to robust measurement are: Principle 2, Principle 3 and Principle 10 and paragraphs 16, 20, 32a, 59, 84a, 84b and A2, A23.

The Core Principles for Effective Banking Supervision (Basel Core Principles) which underpin the BCBS ECL guidance refer to the need for adequate credit risk management processes. The use of robust in the BCBS ECL guidance is a new concept which appears to change the requirements for credit risk management practices. Without appropriate clarity, the reference to robust processes may result in different applications across entities and jurisdictions.

Modified Lending Exposures

We believe Paragraph A44 should be removed as IFRS 9 Impairment already contains detailed guidance related to assessing significant changes in credit risk for modified lending exposures. This paragraph could be interpreted as the Committee's expectations extending beyond the requirements in IFRS 9 Impairment. Additionally, this paragraph does not consider if the modification was 'at market' (i.e. whether the borrower can obtain the same modified term(s) with a new loan at a different bank) which could be an important consideration when assessing credit risk.

Paragraph A27(f) indicates that Banks should pay particular attention to factors such as the expectation of forbearance or restructuring when assessing significant changes in credit risk. We suggest adding the term "significant" to this paragraph as it would not be practical or meaningful to track all instances of insignificant forbearance or restructuring clarification:

> A27(f) expectation of <u>significant</u> forbearance or restructuring.

Title of the Document

The reference to accounting guidance in the title of the document implies the guidance provides IFRS 9 Impairment accounting implementation guidance. We understand this was not the intention of the Committee and that the title will be amended to remove the reference to accounting. We support this change.