

Finaxium answers to the BCBS consultative document on its

Guidance on accounting for expected credit losses

We would like to thank the Committee for this opportunity to provide comments on its thorough and detailed guidance on accounting for expected credit losses.

In the context of banks preparing for the implementation of IFRS 9 and in need of clear directions, in order to evaluate the means and efforts needed to adhere to the new requirements in terms of credit risk evaluation, documentation and disclosure, the Committee's Guidance is welcome. By the extent and variety of its requirements, it may however raise concerns as to the banks' ability to meet each and every one of them. We hope that our answer may help clarifying some of these concerns.

As we consider that most of the Guidance coincides with our view and requires no further comment, our answer focuses solely on three topics: non-credit risks, forward-looking information and potential inconsistencies in definitions and requirements.

1 - Non-credit risks

As the Guidance requires a high number and wide variety of factors to be taken into account in the determination of ECL, we would like to ensure that factors not related to credit risk, and exposures that may default due to these factors, are clearly excluded from the calculation.

For example, paragraph 24.(b) mentions "borrower incentives, willingness or ability to perform on the contractual obligations". While factors influencing a borrower's ability to repay would clearly influence credit risk, factors related to the borrower's willingness may not.

A clear occurrence of this is when, under economic pressure or opportunity, a borrower will seek means of avoiding the contractual obligations rather than means of meeting them. This can be reached through finding legal flaws in the contract (legal risk), or in the underwriting/collections process (compliance/operational risk). A borrower stopping repayments because of these flaws would be classified as defaulted, although the cause of default would not be linked with credit risk. Some jurisprudence have had the consequence of mass trials for loans cancellations and, in terms of credit risk modeling, the whole sub-group had to be excluded from statistics, if not always for PD (which may remain relevant under certain conditions), always for LGD determination.

From a credit risk modeling perspective, including losses due to non-credit risks would lead to flaws in the determination of discriminant factors influencing credit risk, inclusion of incorrect factors or attribution of incorrect weight to these factors, and eventually unreliable results.

In addition to paragraph 24.(b), we believe that paragraphs 24.(i), 28. (in particular 28.(a)) and 36. of the Guidance may, among others, be clearer about this distinction.

2 – Forward-looking information

Throughout the Guidance, the need for inserting “forward-looking information and macroeconomic factors” in the models is clearly emphasized. As a basis of this forward-looking information, there is however little rational source offered aside from “experienced credit judgment”, “experts” and “reasonable availability”.

Given that another requirement of the Guidance is the need for appropriate, granular, documented and validated data, for which every deviation or change from the initial calculation must be explained and justified, the low level of validation required for forward-looking information is surprising.

Regarding macroeconomic factors, we see experts with as valid backgrounds and similar levels of seniority achieving exactly opposite conclusions with exactly the same original basis. Also in terms of timeframe and reliability, we see that economic forecasts may change within weeks, while the validity of an ECL model, used every quarter for accounting and reporting purposes, should last a bit more than a quarterly period.

We understand that the IASB emphasized the need to insert some form of forward-looking consideration into the ECL calculation, since the ECL is itself a forward-looking result. However, it would be appreciable if the Committee could, in its Guidance, propose a solution in order to canalize the insertion of forward-looking information into ECL models, in a way that would prevent banks from using it as a model-adjustment factor, and/or prevent regulators from dealing with a simultaneous range of completely different forecasts across banks.

The rationale for this request is based on IFRS requirement that accounts reflect fair values rather than conservative values. As a consequence, in calculating ECL allowances, banks have to take into account positive forecasts as well as negative ones¹. If ECL models allow forward-looking factors to have a large influence on their final results, the positive or negative view of the banks’ experts on the evolution of economic factors taken into account in the models may override the quantitative direction of data. Without clear rules on the extent to which this forward-looking information may be taken into account in the models, this allows banks to pilot their ECL allowances based on their expectations on portfolios evolution.

From a regulatory point of view, although it may be difficult to approve several banks’ ECL models which are based on opposite forecasts, it may be equally difficult to reject them if all requirements in terms of expertise and availability have been met. It would therefore be useful for regulators to have some principles on which to judge the reasonableness of forward-looking information included in ECL models.

¹ From what the Committee states in paragraph A32., we believe that it may consider forward-looking information from the negative side rather than as a two-side effect. Indeed, if the Committee considers that “full weight must be given to factors which change only on the basis of a discretionary decision”, based on the example that “if a decision is made to lower the internal credit rating for an exposure, it is unlikely that such action would have been taken by the decision-maker had the deterioration not been perceived as significant”, the reasoning is less evident in the case of a rating upgrade.

The below paragraph proposes some principles which could be used in order to lower the risk of qualitative arbitrage on forward-looking information:

- Maximum weight of non-verifiable input: a limit could be set between quantitative and qualitative input to ECL models, in order to ensure that non-verifiable forward-looking information does not overweight verifiable data.
- Restriction to combined changes: restrictions/conditions could be set when the direction of forward-looking information changes simultaneously with a change in the way the information is taken into account in the model.
- Backtesting of reliability of external sources: when external sources of forward-looking information are used (e.g. government announcements, professional associations' data), the reliability of the information could be backtested, in order to determine whether it may actually serve as input to ECL models. Regulators should have the ability to require backtesting and reject some of these sources when insufficiently reliable as model input.
- Backtesting of banks' forecasts: when internal forecasts are used in ECL models, the backtesting process should include a measurement of variation between forecasts and actual evolution. Regulators should be able to set limits on these variations, above which internal forecasts may not serve anymore as model input.

3 – Potential inconsistencies in definitions and requirements

Paragraph 47. states that “the entire group should migrate to a higher credit risk rating, indicative of lower credit quality”. We believe that this statement may be misleading, depending on the meaning given by banks to the expression “credit risk rating”.

We would like to emphasize, first, that credit risk ratings may be used either as indicators of PD (borrower rating) or as indicators of ECL (loan rating). Depending on this distinction, a change of credit rating does not automatically result in a change of credit quality for the final exposure. Conversely, a change of credit risk on a group basis does not necessarily lead to a change of credit rating for the group. Secondly, this principle may contradict the principle of internal rating assessment. In the IRB method defined in the Basel framework, internal ratings should be spread across a given population. Should the credit quality of the entire population decrease, while the relative quality of each borrower remains the same within the group, the ratings of these borrowers would remain the same. What would change is the scale of PD/ECL associated to each rating.

We therefore believe that the above statement could be clarified, potentially by leaving considerations on credit ratings out of the statement.

Paragraph 62. states that “Macroeconomic forecasts and other relevant information should be applied consistently across portfolios, where the credit risk drivers of the portfolios are affected by these forecasts/assumptions in the same way”. We believe that this could potentially contradict the IFRS principle of fair value.

Indeed, if one direction of economic forecast is identified as being the most likely, it could be applied consistently to all affected portfolios, regardless of the way in which these portfolios are affected. For example, a raise in construction price index could have a negative effect on mortgage loans,

while it would have a positive effect on corporate loans to building companies. The fact that the effects of the forecast would be opposite in the two ECL models should not prevent its consistent application, in line with IFRS principles. Conversely, in jurisdictions where accounting principles demand conservative allowances, economic forecasts could indeed be applied differently across portfolios, depending on the most impacting scenario.

We therefore believe that the end of the above statement could be removed, in order to leave banks free to apply their forecasts consistently with their potentially different accounting standards.

Lastly, we also raised a potential misunderstanding between paragraphs A9. and A25. of the Appendix, caused by the inconsistent application of the expression “increase of credit risk”.

Paragraph A25. refers to “increase of credit risk” as per IFRS9, where it is limited to borrowers’ PD rather than to loans EL. On the contrary, paragraph A9. mentions “increases in credit risk to be reflected in increased allowances”, which refers to “increase of credit risk” as increase of ECL.

In order to make a clear distinction between the two meanings, we would recommend a differentiation in the way they are mentioned in the Guideline. For instance, by referring to “increase of loan/portfolio credit risk” as opposed to “increase of borrower credit risk”.

As a conclusion, we would like to reiterate our very positive view of the overall content of the Guidance, along with our thanks to the Committee for the detailed ideas and clarifications brought forward in the document.

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