Federation of European Accountants
Fédération des Experts comptables Européens

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

E-mail: baselcommittee@bis.org

24 April 2015

Ref.: BAN/PKR/PPA

Dear Madam,
Dear Sir

Re: FEE comments on Basel Committee's consultation re guidance on accounting for expected credit losses

(1) FEE[1] (the Federation of European Accountants, www.fee.be) is pleased to provide you below with its views on the Basel Committee's consultation re the guidance on accounting for expected credit losses (ECL).

(2) FEE welcomes the initiative undertaken by the Basel Committee ("Committee") to provide guidance to banks re the regulator's perspective of the new accounting model for impairment of financial instruments- the ECL model.

(3) In FEE's view, one of the biggest challenges for Europe and other jurisdictions that apply IFRS is the proper implementation of financial reporting standards, especially those standards which introduce significant changes in the existing financial reporting requirements. IFRS 9's ECL introduces a new model for impairment for financial instruments. Banks and other financial institutions will face specific implantation challenges as they are exposed to a wide range of different financial assets.

(4) Broadly FEE agrees with the 11 principles included in the consultation paper. We see the principles as an effort from the regulator to flag specific areas of an ECL model that a bank should be aware of as these areas of the model might cause implementation challenges. We also support the principles for strengthening the control environment and the internal control systems of a bank to cope with the implementation challenges of the new model. However we do have some comments on the wording used in the explanatory text as well as some more detailed comments. All our detailed comments are included in the appendix of this letter.

(5) On the other hand we would like to stress that any intervention from regulators, market oversight bodies or any other bodies should not take the role of the standard setter or of the IFRS Interpretation Committee.

[1] FEE's represents 47 professional institutes of accountants and auditors from 36 European countries, including all 28 European Union (EU) Member States. It has a combined membership of over 800.000 professional accountants, working in different capacities in public practice, small and big accountancy firms, businesses of all sizes, government and education. Adhering to the fundamental values of their profession – integrity, objectivity, independence, professionalism, competence and confidentiality – they contribute to a more efficient, transparent and sustainable European economy.

(6) FEE firmly believes that, with the European Union's endorsement process for IFRS 9 still on-going and the establishment of IFRS Transition Resource Group for Impairment of Financial Instruments (ITG)[2], the Basel Committee should use these guidelines to help implementing a robust, effective and high-quality ECL model by banks across different jurisdictions that will meet the principles of the financial reporting standards, and that they should not be viewed as tentative interpretations of IFRS 9.

(7) FEE points out that the draft guidelines in some instances add complexity in the application of the ECL model. Some examples are: the different terminology used in the paper which sometimes mixes the regulatory and financial reporting terminology and the additional requirements that the guidelines ask for preparers in order to reconcile (or justify the differences) between the regulatory and financial reporting frameworks. This could lead to confusion among constituents in respect of the subject matter under discussion (for instance it is not clear whether paragraphs A35 and A36 refer to the need to align the accounting framework to the regulatory one or is just describing the regulatory requirements).

(8) While we understand the regulators' view that the use of the simplified solutions envisaged by the standard should be limited for international banks, we believe this use might be appropriate in some instances, for some portfolios/exposures without undermining the implementation of a high quality implementation of an ECL model (for instance for activities that are not significant at Group level where the use of such simplification might avoid undue implementation cost).

(9) Finally we disagree with footnote 22 on page 16 as we consider an independent review of the model for ECL to fall within the scope of audit services.

For further information on this letter, please contact Pantelis Pavlou, Manager from the FEE Team on +32 2 285 40 74 or via e-mail at pantelis.pavlou@fee.be.

Yours sincerely,

Petr Kriz
President

Olivier Boutellis-Taft
Chief Executive

Encl. Appendix – Detailed comments

[2] http://www.ifrs.org/About-us/IASB/Advisory-bodies/ITG-Impairment-Financial-Instrument/Pages/Home.aspx

General remarks:

(1) We acknowledge that the consultation paper refers to the regulatory capital reporting requirements. While we agree that there is a link between the regulatory and financial reporting frameworks, the consultation paper seems to ignore the main differences in the calculations, application and purpose between regulatory and financial reporting. Having said that, we agree that the processes, assumptions and other judgments used as input to the ECL model should be as closely aligned as possible with the regulatory framework.

(2) In addition, we agree with the prominence given to the need to use all the reasonably available information however sometimes the guidelines omit the reference to cost constraints. IFRS 9 refers to "[…] *information that is available without undue cost and effort* […]" (paragraph 5.5.17 (c)). As a result, the forward looking approach is given more prominence in the consultation. We, therefore, suggest that the Committee should revisit the guidelines that refer to forward looking information and include a reference to paragraph 5.5.17 (c) of IFRS 9 where necessary.

Principle 1: A bank's board of directors (or equivalent) and senior management are responsible for ensuring that the bank has appropriate credit risk practices, including effective internal controls, commensurate with the size, nature and complexity of its lending exposures to consistently determine allowances[1] in accordance with the bank's stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

(3) We strongly support the Committee's effort to stress the importance of the bank board of directors' and senior management's responsibility to ensure that appropriate credit practices, including effective internal controls are in place. In our opinion, the Committee is in the best position to provide guidance to banks re the responsibilities of their board of directors and senior management.

Principle 2: A bank should adopt, document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring the level of credit risk on all lending exposures.[2] The robust and timely measurement of allowances should build upon those methodologies.

(4) FEE firmly agrees with Principle 2. We agree that the underlying information and methodologies used to monitor the credit risk and measure allowances for accounting should be as closely aligned as possible with regulatory capital requirements. Despite some key differences in the information used to calculate the ECL and the capital adequacy, however the underlying data should be consistent.

(5) Furthermore, we understand that there is a need to define the key terms in the ECL model. The accounting frameworks (especially IFRS 9) for ECL do not explicitly define terms like default, increase in credit risk, strong financial position etc. therefore applying Principle 2 would assist banks in addressing the need for consistent definitions for both accounting and regulatory capital requirement purposes. Having said that, we also support the principles of IFRS 9 stating that a company should use those definitions that already exist for risk management purposes and if those definitions differ from the ones the bank uses for regulatory purposes, then the bank should be able to use them for financial reporting.

(6) We also draw the attention to paragraphs 24 – 32 of the consultation paper. While we agree with the efforts of the Committee to flag some of the areas of the ECL model that might require special considerations, some might believe that this is an attempt by the regulator to interpret accounting standards. The majority of the requirements of these paragraphs are part of the accounting framework for ECL, however some of the detailed requirements in these paragraphs might go beyond the financial reporting requirements.

Principle 3: A bank should have a process in place to appropriately group lending exposures on the basis of shared credit risk characteristics.

(7) We agree with the guidelines regarding grouping of exposures. We understand that banks do not usually monitor their exposure in credit risk on an individual basis for exposures that share the same risk characteristics and in addition in certain instances banks cannot assess the increase in credit risk on an individual basis. Therefore there is a need for banks to develop appropriate policies to group their lending exposures together on the basis of shared credit risk characteristics.

(8) We also agree that those policies used for accounting policies should be as closely aligned as possible with the policies used for regulatory capital requirements.

Principle 4: A bank's aggregate amount of allowances, 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.

(9) We agree with the reference to the objectives of the relevant accounting framework. We also support the introduction of the concept of neutrality of accounting information in paragraph 54.

Principle 5: A bank should have policies and procedures in place to appropriately validate its internal credit risk assessment models.

(10) We welcome the Committee's initiative to introduce requirements for the validation of the banks' internal credit assessment models. We also believe that this is directly linked to the principles 9-11 where the Committee discusses the recommendations for the banks' regulators and their task to ensure that the proper policies and internal controls are in place for validation of the internal credit risk assessments models.

(11) We believe that the reference to the external auditor in footnote 22 (page 16) should be excluded from the final guidelines. According to the International Standards on Auditing (ISAs), the external auditor should perform the necessary procedures to obtain sufficient and reliable evidence to base the audit opinion upon. Part of the audit procedures could be the use of the work of an expert (including the work of the internal auditor), which means that the audit procedures might include a review of the model validation process. This should therefore fall within the scope of an external audit. In addition, a reference to the review of the ECL by the external auditor may be seen as interpreting the auditing standards or as prescribing audit procedures for the external auditor by the banking regulator, which should not be the case.

(12) In principle, it should be up to the statutory auditor – according to the audit plan – whether to use the work performed either by the internal audit or an auditor's expert as part of the audit procedures. If the external auditor uses the work of the internal auditor or the work of an auditor's expert, then the external auditor should comply with the requirements of ISA 610[3] or ISA 620[4] (or other equivalent national auditing standards), which require the external auditor, among other things, to assess the independence and competences of the expert/internal auditor, review the work performed, and assess the findings and the conclusion(s).

Principle 6: A bank's use of experienced credit judgment, especially in the robust consideration of forward-looking information that is reasonably available and macroeconomic factors, is essential to the assessment and measurement of expected credit losses.

(13) While we agree with the main principles, we refer to our general comment (paragraph 2 of the appendix) where we mention the need to include the reference to "undue cost and effort".

(14) Furthermore, in paragraph 63 the Committee refers to prudence in the event of estimating the ECL using a range of possible amounts. While the guidelines state that neutrality should be achieved, introducing the concept of prudence might be seen as an effort to encourage recognising higher amounts as ECL for accounting purposes.

(15) The current IFRS framework does not explicitly define prudence however prudence is implied in the "faithful representation" qualitative characteristic of financial statements. In the current process of revising the IFRS conceptual framework the IASB will define prudence in a way that is better understood by constituents and does not impose any bias on the financial statements.

(16) Prudence is described as the exercise of caution when making judgments under conditions of uncertainty. The exercise of prudence is consistent with neutrality and should not allow the overstatement or understatement of assets, liabilities, income or expenses[5]. We therefore suggest that the Committee revisits this paragraph and defines prudence in a way that is consistent with the definition that will be embedded in the financial reporting framework.

Principle 7: A bank should have a sound credit risk assessment and measurement process that provides it with a strong basis for common systems, tools and data to assess and price credit risk, and account for expected credit losses.

(17) Paragraph 69 refers to proper documentation of differences in the model used for accounting purposes and the model used for regulatory capital requirements. While we agree with the principle, we draw attention to the fact that differences exist due to different calculations of the ECL under the two frameworks. For instance, IFRS 9 requires that the bank should use the PD for the following 12 months at the point in time (reporting date) while the regulatory framework is based on "through the cycle" PD. We would like to stress that the different definitions might prove burdensome and create operational issues and complexity which cannot be resolved through reconciliations between the capital regulatory and financial reporting requirements.

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[3] ISA 610 (Revised 2013), Using the Work of Internal Auditors
[4] ISA 620 Using the work of an auditor's expert
[5] January 2015 IASB update for the conceptual framework.

(18) We believe that the principle for proper documentation and justification of differences should only refer to differences other than those which are in fact due to the differences between the two reporting frameworks.

Principle 8: A bank's public reporting should promote transparency and comparability by providing timely, relevant and decision-useful information.

(19) FEE supports the need to promote transparency and comparability by providing adequate information in disclosure requirements. However there should be a link between disclosure requirements and usefulness to users (when it comes to financial reporting), and therefore, we do not agree with paragraph 78. IFRS 7 requires qualitative and quantitative disclosures to provide users with adequate information regarding the ECL model used for financial reporting purposes. We do not believe that introducing additional requirements to disclose information regarding the differences between the accounting and regulatory capital requirements meets the objectives of the financial reporting framework.

(20) This is also true for some additional requirements in the consultation that go beyond IFRS 7 requirements. Some examples are disclosures regarding how the processes incorporated management credit judgment, quantitative disclosures on how changes in forward looking information and macro-economic factors affect the estimates for ECL, quantitative disclosures on appropriate grouping and changes in grouping with corresponding impact on ECL estimates etc. We therefore urge the Committee to review the disclosure requirements introduced in the draft guidelines to ensure that they are in line with IFRS 7 and that any additional requirements are deleted from the guidelines.

Principle 9: Banking supervisors should periodically evaluate the effectiveness of a bank's credit risk practices.
Principle 10: Banking supervisors should be satisfied that the methods employed by a bank to determine allowances produce a robust measurement of expected credit losses under the applicable accounting framework.
Principle 11: Banking supervisors should consider a bank's credit risk practices when assessing a bank's capital adequacy.

(21) In general we support the Committee's initiative to provide guidance on the expected responsibilities of the banking supervisors in respect of accounting for ECLs. We agree with the principle that the supervisors should assess and evaluate the effectiveness of credit risk practices as well as the adequacy of internal controls surrounding the ECL calculations.

(22) We believe that adequate and timely communication between the bank, the regulator and the external auditor would assist in implementing a high quality ECL model for banks. We suggest that the Committee introduces this in Principle 11.

Appendix – Supervisory requirements specific to jurisdictions applying IFRS 9

(23) In general we support the initiative to draw the attention of preparers, auditors and supervisors to certain areas of IFRS 9 where the Committee believes that they might cause implementation and supervision challenges. However we are concerned that for some paragraphs the Committee might be seen as trying to interpret IFRS 9. We highlight those paragraphs in our detailed comments below.

1. *Loss allowance at an amount equal to 12-month ECL*

(24) We agree with paragraph A1 and the reference to nil provisions. We agree that such cases should be rare, especially in the current environment. However we believe that they might exist in cases when the Loss Given Default ratio is nil.

(25) In accordance with IFRS 9 the identification of changes in credit risk for accounting purposes should be made at each reporting date (paragraph 5.5.9 of IFRS 9). However paragraph A2 suggests that the identification of changes in credit risk should be made on a timely basis. We suggest that the Committee review this requirement and ensure that it is line with IFRS 9 in order to avoid confusion among constituents and to avoid undue complexity of the implementation of the IFRS 9 ECL model.

(26) FEE fully supports paragraph A3, where the Committee emphasises the definition of the 12 months expected credit loses as included in IFRS 9. The notion of the 12 months expected credit losses might not be well understood by financial reporting constituents; therefore proper reference to the definition in IFRS 9 enhances clarity around key definitions.

(27) We believe that the guidelines set out in paragraph A4 are in line with the requirements in IFRS 9 and with the principles of this paper which refer to the alignment of the accounting and the regulatory capital requirements models. Having said that, we stress that IFRS 9 does not define default, however it requires that an entity uses for financial reporting, the same definitions it uses for internal risk management purposes. These definitions might not be the same as the definitions required for regulatory purposes. Therefore we suggest that the Committee clarifies this in paragraph A4.

(28) Furthermore, the purpose of paragraph A5 is not clear as it lists the regulatory requirements under Basel capital framework. To avoid confusion and undue complexity we propose to clarify paragraph A4 (as explained above) and delete paragraph A5.

(29) Regarding paragraph A6, we refer to our general comment in paragraph 2 of this appendix. We believe that a reference to “undue cost and delay” serves to clarify the cost benefit assessment of IFRS 9.

(30) FEE believes that paragraph A8 is an example of a potential interpretation of IFRS 9. This paragraph refers to the “high credit risk exposures” while IFRS 9 does not refer to this category of exposures. While we agree with the principle as stated in paragraph A8, we strongly believe that such additional requirements should be avoided. We doubt that the earlier recognition of LEL is appropriate for “high risk exposures”.

(31) We stress the importance of paragraph A13 regarding the grouping of exposures for collective assessment which is in line with paragraph B5.5.5 of IFRS 9.

2. *Assessment of significant increases in credit risk*

(32) In principle we agree with the paragraphs that refer to the need for internal systems to monitor the credit risk to be supported by strong internal controls.

(33) However, in paragraph A27 the Committee might be seen as giving prominence to some (but not all) of the requirements of paragraph B5.5.17 of IFRS 9. We believe that banks should apply judgment in identifying the criteria they will use to assess the increase in credit risk of their credit exposures.

(34) An additional example of complexity in the guidelines is the different terminology used in paragraph A35 and A36 where the guidelines refer to “groups”, “subgroups” and “proportion of groups” without specifying which the preferred definition is. Therefore we propose that the guidelines should only use the definitions and terminology used in IFRS 9.

3. Use of practical expedients

(35) We believe that the use of practical expedients envisaged by IFRS 9 should not be forbidden for banks as long as their use does not affect the timing or the amount of ECL recognised in these situations. We understand that for some portfolios (e.g. trade receivables that a conglomerate bank might have on its statement of financial position) the use of practical expedients could be appropriate. We include below our detailed comments for this section:

Information set

(36) We agree with paragraph A49 where the Committee expects banks to develop systems and processes to use all the reasonable and supportable information needed to achieve a high-quality, robust and consistent implementation of the ECL. We also agree that this results in additional costs and therefore a proper cost benefit analysis should take place.

“Low credit risk exemption”

(37) FEE believes that this exemption should not be widely used by banks for lending exposures, as banks have the systems and processes in place to monitor the credit risk. However in order to implement a high quality ECL model the banks should use the information that is available without undue cost and effort.

(38) We believe that this simplification should be available for banks that wish to apply it to certain exposures or portfolio of exposures where necessary, Having said that, we believe that a bank should only use this exemption when it does not impair the implementation of a high quality ECL model.

(39) We agree with paragraph A54, where the Committee requires that a bank should clearly define the terms “near” and “longer” term. This is in line with Principle 5 of the consultation paper.

More-than-30-days-past-due rebuttable presumption

(40) We agree with the consultation paper (paragraphs A59 to A62) that this simplification should be limited. However, in some instances, we believe it might be appropriate for some portfolios/exposures without undermining the implementation of a high quality implementation of an ECL model. We agree in particular with the reference in A62 where the Committee stresses the need for a bank to ensure that IFRS 9 ECL model’s requirements are met.

(41) In our view the Committee’s objective for this section is to flag the area of the use of the forward looking information and its interaction with use of practical expedients. Information about the past performance of an exposure should be taken into account; however a bank should also use forward looking information in its assessments of the increase of credit risk.