

30.04.2015

## **FRENCH BANKING FEDERATION COMMENTS ON BCBS GUIDANCE ON ACCOUNTING FOR EXPECTED CREDIT LOSSES.**

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

### **I. General Comments**

The French Banking Federation welcomes the opportunity to respond to the BCBS Guidance on Accounting for Expected Credit Losses. Overall, we agree with the Basel Committee that guidance should promote sound credit risk practices in relation to expected credit loss accounting models and that banks should achieve high quality implementation of new accounting standards.

However, we would like to highlight the following elements before specifying detailed comments on the Draft Guidance:

- Banks' goals when implementing ECL models are to leverage on credit risk management practices and to build forecasts in order to use forward looking information and macro-economic factors as required by accounting standards –to the extent that the information is available without undue cost and efforts as stated by IFRS 9.
- The application of risk and macro-economic factors should be limited to those that are meaningful and relevant to expected credit losses measurement of a particular portfolio.
- Accounting should neither become distanced from risk management nor should drive change in risk management, although we acknowledge that risk management may evolve as a consequence of new accounting requirements.
- The proportionate approach applied to less complex banks based on the size and complexity of the entity should be extended to loan portfolios' level taking into account their size, their nature or their complexity, irrespective whether the bank is complex or not.
- The concept of materiality should also be acknowledged as currently applied in the accounting standards.

- With regards to determining significant deterioration, the Draft Guidance should remove any references that would automatically trigger significant changes. Indeed, being misinterpreted, notably by auditors or supervisors, the list of risk factors may be wrongly considered as a check list of independent factors automatically triggering the transfer to stage 2 rather than requiring transfer based on significant increase in credit risk deterioration.
- Practical expedients should be implemented in line with new accounting standards when they are relevant. Nevertheless, it is not the intention of institutions to use such practical expedients significantly, to modify materially the level of allowances or, to mask significant credit deterioration.

## **II. Supervisory requirements for sound credit risk practices that interact with expected credit loss measurement**

### **• Segmentation**

- Segmentation for accounting purposes needs to be stable and should be consistent with risk management practices.

Indeed, we understand that frequent re-segmentations of portfolios would be required to adequately interpret changes in facts and circumstances into allowances.

For instance, the second sentence of paragraph 46 (“Where changes in credit risk ... affect only some exposures, those exposures must be segmented out...”) suggests automatic transfer into subgroups of those exposures that experience any changes in credit risk. Same requirement is suggested by paragraph 48.

There are many ways to adjust expected credit losses measurement of a segment to risk and macro-economic factors. Re-segmentation may be one of them but may not be the only one. At origination loans will be grouped to meet same credit risk characteristics and same sensitivity to forward looking information or to macro-economic factors. Depending on facts and circumstances, the grouping may still be adequate when the measurement will need to be adjusted. This calibration of credit risk parameters will be assessed at collective level. Alternatively, banks will adjust the weight of risk factors at individual level when specific factors increase credit risk of a given loan. Thus banks will be able to move these particular exposures between buckets when significant deterioration occurs.

Besides, frequent grouping would be disconnected from current risk management practices for regulatory purposes and could lead to extra allowance volatility. Moreover, we believe that it would be inconsistent with IFRS 9 requirements. Basis of conclusions (BC) of IFRS 9 consider that financial instruments should be grouped into portfolios sharing same credit risk characteristics. Whereas the BC acknowledged that the appropriate level of grouping may change over time, it does not consider that changes of grouping of portfolios should be frequent (IFRS 9 BC 5.142). Changes in the assessment of deterioration of credit risk of certain exposures may imply infrequent transfer in sub portfolios.

It looks as if the Draft Guidance considers that loans could be grouped in such a way that grouping of portfolios would “mask” increases of credit risks and, as a consequence, increases of the ECL allowance, or, application of an adequate forward-looking assessment. These concerns are addressed through risk management, internal governance and independent review of methodologies and processes. Thus, we believe that consistency of measurement of ECL for regulatory purposes and accounting purposes with risk assessment and measurement process should be rather addressed in principle 7 (as stated in paragraph 41).

Because the Draft Guidance makes no differences between wholesale and retail portfolios, some paragraphs (§38, §40) may be understood as a requirement to assess significant credit deterioration only on an individual basis even when it is not feasible. For example, for wholesale, taking into account the borrower's financial capacity on an individual basis is meaningful and practicable where it becomes difficult and burdensome for retail portfolios. Instead, it should be clarified that exposures should be initially grouped based on similar credit risk characteristics that allow a collective assessment and measurement.

Furthermore, there is confusion between rating and measurement. Paragraph 40 implies that macroeconomic factors should be included into the rating which is an implementation solution. It is one way to include macroeconomic factors; another way is to include them directly into the probability of default or to adjust globally the allowances.

- Grouping and segmentation of portfolios should be considered carefully at origination taking into account the right balance between size of portfolios and granularity of the information.

Paragraph 44 expects that banks provide demonstration of a linkage between changes in lending exposures and reaction to environmental changes. Thus, this would imply huge operational burden to segment exposures into sub-portfolios or individual loans in order to meet the "granular enough" concept. It would also raise questions about consistency and volatility with regard to group changing.

- The possibility to migrate individual exposures within a defined and homogeneous segment (i.e. without migrating the entire portfolios) should be feasible in compliance with IFRS 9 standard, as long as individual data are available. This compliance should therefore be demonstrated through sound credit and accounting policies and governance that will reveal robust credit risk indicators, allowing banks to prove deterioration as well as procedures that will explain how new events would be taking into account when deciding to migrate individual or group exposures from one stage to another.

- **Use of Forward Looking information :**

- Including macro-economic factors and forward-looking information will be most challenging for banks. Whereas, macro-economic factors are forward-looking, forward-looking indicators are not only macro-economic factors and may include other elements.

Banks will consider the benefit of various approaches including current processes where forward-looking information and risk factors are taken into account.

The Draft Guidance (principle 6 - paragraphs 59-64) provides guidance on the consideration of forward-looking information that is essential to the assessment and measurement of ECL. It requires that banks must demonstrate the link between forward looking information and credit risk. Banks will consider a large spectrum of forward looking information relevant to expected credit losses to retain only those relevant and affecting credit risk. However, it should be made clearer that in some circumstances banks' judgment will be essential when taking into account forward-looking information and macro-economic factors in order to determine an appropriate level of ECL allowances. Uncertainties and insufficient relation to credit risk will prevent incorporating this information when determining ECL allowances.

- The application of risk factors, when setting up forward looking drivers, should be limited to the risk factors that will lead to better information for accounting purposes and are therefore relevant for ECL purposes.

IFRS 9 states that when assessing expected credit losses “all reasonable and supportable information, including that which is forward looking” should be considered. Then, it explains that “reasonable and supportable” means no exhaustive search is required.

Several paragraphs requiring that banks should consider a “full spectrum” of information are more restrictive than IFRS 9 requirements and imply an unachievable target.

Paragraph 24(b) explains that “the assessment and measurement of ECL goes beyond considering historical and current information and should include all relevant factors that affect repayment, whether related to the borrower or the environment within which the lending is made. Relevant macroeconomics factors may be at the international, national, regional local level”.

Paragraph A23 requires that banks demonstrate clear linkage between macroeconomic factors and borrower characteristics supported by “persuasive analysis”. Paragraph A24 expands the analysis to “large, individually managed exposures”. Interpreted strictly, the requirements would imply the capacity to predict events which would be hardly feasible. These requirements go well beyond the “reasonable and supportable information” standard of IFRS 9.

While we understand the concern of the Basel Committee that banks should assess factors and information that might affect ECL measurements, the Guidance should not provide an additional list of indicators for banks to include in their credit risk management and underwriting practices. Banks intend already to consider a range of factors in determining whether significant deterioration has occurred. As drafted, paragraphs 24 (methodology for a sound credit risk assessment), 27 (factors to consider in credit risk assessment), 29 (documentation of the processes) and 31 (sound underwriting practices and pricing) may be misinterpreted, notably by auditors or supervisors, and be wrongly considered as a mandatory check list of factors automatically triggering the transfer to stage 2. There are two risks in this approach: the first one is to miss a significant increase in credit risk deterioration because the criterion is not listed and the second is to require banks to demonstrate compliance with all the items even if not relevant which introduces complexity when implementing IFRS 9.

All references to automatic significant changes should therefore be removed (notches, loan pricing in particular that incorporate much more information than simple credit quality such as liquidity cost, cost of equity, competition intensiveness...). Among others, the following examples illustrate elements that are required to be added to existing credit risk management practices and that may be confusing or burdensome when strictly interpreted or implemented.

- The wording of paragraph 24 should be modified so that factors listed should stay as examples and should apply where relevant. Reference to “at a minimum” should be deleted and “will” should be replaced by “may”.
- We understand that banks have to consider various methods, demonstrate that the method selected is the most appropriate and document the possible methods and outcomes (§24d & §24e). This could be burdensome. However, any change in measurement approach has to be the object of appropriate documentation.

Paragraph 29 requires to back test extrapolation of banks regarding forward looking information. However, it should be noted in paragraph 29 (e) that there can be different market indicators such as credit default swaps. Assessing differences between market indicators and expected credit losses might be irrelevant since fair value includes other factors than only credit risk factors such as liquidity.

Paragraph 31 requires that banks “demonstrate adherence to sound underwriting practices and that the price ... appropriately reflects inherent risks” and provides a list of criteria regarding “inadequate underwriting criteria”. This could go beyond the mandate of the Draft Guidance as it may lay the ground for supervisors to focus assessment of credit risk on potential inadequate underwriting practices of the bank and may jeopardize a number of financing segments. Furthermore, other regulatory and supervisory bodies have set out a framework of sound principles for underwriting practices that the examples listed in paragraph 30 would overlap. Therefore, rather than determining a linkage between underwriting and pricing, the Draft Guidance should focus on the link between credit deterioration and accounting requirements so that the accounting faithfully reflects the levels of credit risk that have been accepted by the bank.

The Draft Guidance does not acknowledge that a typical model building process will start with all potentially relevant data and narrow them down to the data that are significant in driving ECL. For example, paragraph 51 states that “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” whereas paragraph 53 requires banks to consider the full spectrum of reasonable information that is relevant to exposures. This highlights an important distinction between judgmental overlays and modelled results, where new information may be expected to be used in making judgments about significant factors that are not included in the models, for example due to the timing of changes in credit conditions and external events. However, even where expert judgment is being applied, that judgment will also need to be focused on information that is reasonable and supportable and can be expected to impact the outcomes in a predictable manner.

- **Interaction between accounting and risk management practices.**
- Accounting should reflect business practices and risk management rather than the other way round.

We believe it should be clearly articulated as a principle that accounting should be informed by risk management as noted in paragraph 7. Accounting should neither become distanced from risk management nor should drive change in risk management, although we acknowledge that improvements in risk management may be a consequence of the new accounting requirements.

- Consistency between accounting and prudential requirements upon capital adequacy is an appropriate goal. Intrusiveness into the credit management should be avoided.

Where different information is used across functional areas, underlying rationale for these differences should be documented and approved by senior management (Paragraphs 21, 22 and 30). Similar information is requested in all areas otherwise a process of approbation is needed. However, while ex ante differences between accounting and prudential could be documented, this would become difficult during the course of credit lifetime because of the differences of the parameters (time horizon, floors, downturn scenarios etc.).

- **Proportionality.**

We appreciate that the Draft Guidance recognizes the benefit of a proportionate approach for less complex banks (§12) based on the size and complexity of the entity.

However, we believe that the principle should also be applied at the loan portfolios' level taking into account their size, their nature or their complexity irrespective whether the bank is complex or not. Indeed, small portfolios should be considered for largest banks for which the proportionality principle and materiality approach could apply.

The principle of materiality should also be considered. In financial reporting, materiality is recognised as a fundamental principle. We agree that the principle should not be used to justify low-quality implementation. But, as a fundamental principle underpinning all financial reporting, materiality does not contradict high-quality implementation if appropriately justified. It would be inconsistent with high-quality implementation if complexity and increased operational risk were introduced, as would be the case if normal materiality considerations had to be disregarded. Such concerns would be addressed by risk management and effective internal control review.

- **Disclosure requirements.**

It is unclear why the Draft Guidance should require its own disclosure. These disclosures are close to accounting standard requirements but in slightly different terms. IFRS 7 already requires extensive disclosures at the level of both quantitative and qualitative information in order to explain risk management practices and assumptions related to ECL estimates. It is unclear whether there would be an overlap between the two set of disclosures and whether it would be really useful to market participants.

Specific disclosures required in the Draft Guidance are too granular to be useful to users of financial statements and raise operational issues –for example: sensitive test disclosure expected (§75), comparison between accounting and regulatory EL methodology (§78) which is complex to build due to the differences between accounting and regulatory requirements and changes in assumption (§79 and §80).

Overlap with other initiatives such as EDTF recommendations and prescribed disclosures under Pillar 3 should also be considered. We believe that initiative should be left to the EDTF group to take on board users and preparers views and to work out the scope and the level of detailed information that is useful to be disclosed. Therefore, we suggest that detailed requirements related to disclosures should be removed from the Draft Guidance.

- **Symmetrical approach.**

The Draft Guidance should explicitly mention that a symmetrical approach should apply when loans are supposed to move back to 12 month ECL from lifetime ECL when conditions of borrowers or forward-looking information and macroeconomic factors improve, in other words, when the “significant deterioration” criterion is no longer met.

- **Others.**

The interpretation and the implementation of the Draft Guidance according to jurisdictions may be different and may question the consistent application and understanding of IFRS 9.

### **III. Supervisory requirements specific to jurisdictions applying IFRS**

The appendix of the Draft Guidance outlines supervisory requirements applying to the IFRS 9 ECL model and deems them consistent with applicable accounting standards. However, the Draft Guidance contains statements that we believe are not substantiated by the final IFRS 9 text rationale and that are rather restrictive on the interpretation of ECL model that should be developed under IFRS 9.

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

Whilst IFRS 9 is not prescriptive regarding the assessment of expected losses on an individual basis or a portfolio basis, the Draft Guidance seems to consider that the assessment of an ECL should be conducted on an individual basis even for high quality loans because of “the possibility that a loss will occur” (§A1).

IFRS 9 does not provide a definition of the “default”. Therefore, the Draft Guidance considers that the prudential definition should be used, which we have always been in favour of. It limits the backstop to the rebuttable presumption of 90-days-past-due which seems to be the limit currently accepted within the regulatory framework. However, paragraph A5 and footnote 29 could be interpreted as providing another definition of the “unlikeliness to pay” indicator extending situations of transfer of loans when the default has not yet been occurred. To avoid such confusion we would suggest deleting paragraph A5.

Besides, the Draft Guidance favours a restrictive interpretation of the IFRS 9 by giving an important focus to the macroeconomic factors (§A6) when measuring credit risk.

It states in paragraph A7 that “a bank must be able to demonstrate that these exposures have not experienced a significant increase in credit risk since initial recognition”. It is different to prove that a loan has experienced significant credit deterioration than to prove that it has not experienced a significant increase. Such a negative statement, especially when considered in hindsight, as most supervisory and audit reviews will be, will be almost impossible to demonstrate.

Finally, the Draft Guidance favours an earlier determination of increase in credit risk; this is closer to LEL measurement model (FASB model) than the stage 1 /stage 2 IASB model, which is not the IASB’s intent.

- **Assessment of significant increases in credit risk**

#### General Principles.

The Draft Guidance adds further transfer criteria to those covered in IFRS 9 B5.5.17, but the six points of paragraph A27 are very similar to those in the standard, albeit worded differently, which is also not helpful for implementation. These points could be interpreted as a list of triggers to automatically apply within the banks’ processes in order to determine significant deterioration. We stress that regarding thresholds, triggers or criteria, no automatic decision should lead to significant credit changes.

#### Pricing issues

In paragraph A15, the Draft Guidance considers that there is a link between premium collected and credit risk with risk estimated at the origination of the loan. When the risk has increased and has not been covered by the premium collected or to be collected in the future then an allowance must be accounted for. The rationale developed by the Draft Guidance implies a loan by loan ECL model which was discussed when the first ED was issued but abandoned due to its complexity.

Paragraphs A15 and A27(a) state, in part: "any post-origination increase in credit risk is unlikely to be fully compensated by the interest rate charged." It seems to disregard instances where there are discounts and premiums to the corpus, which could be part of the pricing for credit risk, competition issues, and cost of liquidity or regulatory capital.

Factor (a) of paragraph A27 and its footnote 33 establish a linkage between pricing and significant deterioration of credit risk. It presumes that financial institutions have the ability to distinguish the reasons of changes in credit spreads due to credit risk from those due to other factors. Aside from the operational challenges of such distinctions, the presumption ignores that credit risk is only one of the components of pricing. Where new loans are originated, changes of credit spread are a result of changes of credit risk policies and do not mean that credit quality of loans has been deteriorated. Moreover more forward looking information would be considered when assessing deterioration of the credit performance to be reflected in expected loss and prior to a change in pricing.

Finally, such presumption implies that lifetime expected loss should be recognised whereas not motivated by a significant increase in credit risk. That would not be compliant with IFRS 9. For these reasons, we advocate that factor (a) of paragraph A27 and its footnote should be deleted.

#### Rating changes.

We do not believe that there is a systematic link between degradation of a rating and significant increase in credit risk. Degradation of a rating is an indicator but it should be considered among others. Should the example mentioned in paragraph A32 be seen as a rebuttable presumption, we would have an issue as we believe that no automaticity should prevail when determining if there is a significant increase of credit risk.

- **Usage of practical expedients**

Recommendations of the Draft Guidance related to practical expedient (§A46; §A59) go beyond IFRS 9 text and limit the scope of exceptions.

Indeed, IFRS 9 authorizes the use of practical expedient as some operational simplification in specific circumstances in order to provide relief to banks when assessing significant increases in credit risk for financial assets with low credit risk or for banks retail portfolios and other immaterial portfolios.

Contrary to the assumptions that the Basel Committee may make, it is not the intention of institutions to use practical expedients to materially modify the level of allowances or mask significant credit deterioration that could be material. Practical expedients are intended to be used only for portfolios that are currently and expected to continue to be immaterial and where no additional information is available or if banks are able to establish that their use will not make any difference to the ECL calculations compared to when not used.

The Basel Committee should acknowledge that there may be limited circumstances in which the more-than-30-days-past-due rebuttable presumption may be a relevant factor and be considered as an acceptable indicator. It would notably be the case for some retail portfolios where the 30-days-past-due indicator would better reflect consumer behaviour, whereas, for significant and material portfolios, the 30-days-past-due practical expedient will not be used as the sole driver but will be completed by other information available. In these cases, the 30-days-past-due practical expedient will be used as a backstop.