



Grant Thornton

An instinct for growth™

Bank for International Settlements
Centralbahnplatz 2
4051 Basel
Switzerland

Grant Thornton International Ltd
Grant Thornton House
22 Melton Street
London NW1 2EP

30 April 2015

Submitted electronically through the Bank for International Settlements website
(www.bis.org)

Guidance on accounting for expected credit losses

Grant Thornton International Ltd is pleased to comment on the Basel Committee on Banking Supervision's (BCBS) consultative document *Guidance on Accounting for Expected Credit Losses* (the Guidance). We have considered the Guidance, including the Appendix: *Supervisory requirements specific to jurisdictions applying IFRS*.

About us

Grant Thornton is one of the world's leading organisations of independent assurance, tax and advisory firms. These firms help dynamic organisations unlock their potential for growth by providing meaningful, forward looking advice. Proactive teams, led by approachable partners in these firms, use insights, experience and instinct to understand complex issues for privately owned, publicly listed and public sector clients and help them to find solutions. More than 35,000 Grant Thornton people, across over 100 countries, are focused on making a difference to clients, colleagues and the communities in which we live and work.

Grant Thornton provides professional services to a great number of financial institutions across our international network of firms, including many of the largest financial institutions in the world. Often, these services relate to risk management practices, and as such we have a strong interest in this topic.

We appreciate the opportunity to provide our views.

General comments

We welcome the Guidance and support the BCBS's efforts to provide clarity concerning the relationship between sound credit risk practices and estimates of expected credit losses (ECLs).

First and foremost, we agree that sound credit risk practices, and the information that flows from them form the bedrock of estimates of ECLs under any accounting framework. To that end, we believe the Guidance has the potential to help create a common understanding of what constitutes sound credit risk practices in the context of ECL models. Such an understanding regarding sound credit risk practices is essential in achieving consistent interpretation and implementation of an ECL accounting framework across jurisdictions.

Additionally, we believe the Guidance has the potential to help improve the development of ECL accounting policies, procedures and practices that are consistent with the applicable accounting framework that, in turn, is the focal point for our work as auditors. Finally, we believe that a single set of authoritative guidance that is applicable to banks across different jurisdictions is more likely to be effective in encouraging high quality implementation of ECL accounting frameworks than if similar efforts were made at national levels.

We also fully support the eleven principles as set out in the bold text in the Guidance.

Against that background, we have various specific comments and suggestions on particular aspects of the Guidance. Our more detailed comments with regard to the Guidance's interaction with IFRS 9's ECL requirements are set out in an appendix. Our objective in making these comments is to help the BCBS ensure the final Guidance is clear, operational and consistent with IFRS 9 while maintaining its focus on sound practices and robust implementation.

Proportionality and materiality

Paragraph 11 of the Guidance indicates that the intent of the Guidance is to raise supervisory expectations for “internationally active banks and those banks that are more sophisticated.” The Guidance does not address to what extent the expectations in the Guidance are applicable to non-internationally active and less sophisticated financial institutions. We are concerned this lack of explicit consideration of proportionality could lead to a 'one-size-fits-all' approach by prudential regulators. We believe without explicit consideration of proportionality for less complex and sophisticated banks that the Guidance may serve as the general rule, from which departure would be an exception that would have to be justified. We recommend the Guidance include explicit consideration of proportionality, including examples of appropriate proportionate implementation of the principles in the Guidance to non-internationally active and less sophisticated institutions.

Furthermore, the Guidance sets an expectation that internationally active banks – and, we believe, by extension, all banks with portfolios of complex credit exposures – “limit their use of particular simplifications and/or practical expedients included in the relevant accounting standards.” While we agree that it may be inappropriate to make use of practical expedients for large and complex portfolios of credit exposures, many institutions – including internationally active banks – will have immaterial portfolios of credit exposures or portfolios of credit exposures for which the use of the provided practical expedients would not make a material difference. We recommend the language be made more accommodating, recognising that materiality should play a role in assessing the appropriateness of employing a practical expedient provided for in the accounting framework.

Additionally, materiality is a complex concept in the accounting literature, requiring the use of judgement. It would be helpful if the Guidance explicitly stated that nothing in the Guidance is intended to change how bank management and their auditors apply materiality concepts in the preparation or auditing of the bank's financial statements.

Consistency

The Guidance “emphasises the importance of a high-quality, robust and *consistent* implementation of ECL accounting frameworks across all jurisdictions” [our emphasis]. We agree that a materially consistent interpretation of key concepts in an ECL accounting framework across jurisdictions is desirable, and that the Guidance may be helpful to that end. We also believe ECL accounting models utilised by banks should be consistent with the applicable accounting framework and consistent within an institution from period to period.

However, we do not believe that consistent implementation means identical views of future economic conditions across institutions, identical ECL estimation methods across institutions, or identical application of judgment in all circumstances. Estimates of ECLs require bank management to exercise their best judgement, and it is expected that reasonable, well-informed bankers and professionals will differ in their views regarding complex, forward-looking estimates. We recommend the Guidance specify what is meant by “consistent implementation.”

Estimation uncertainty

Determining the accounting information to be incorporated into financial statements requires some degree of trade-off between 'relevance' and 'reliability' (by which we mean the extent of estimation uncertainty). This is particularly the case for accounting measurements that rely on forward-looking estimates. ECL accounting frameworks emphasise relevance over reliability, and far-horizon estimates about ECLs therefore necessarily introduce heightened levels of estimation uncertainty. Generally the estimation uncertainty associated with an estimate of ECLs, even one that makes use of all available information, reasonable professional judgment, and is implemented in a well-controlled environment, will exceed quantitative materiality for purposes of the audit of the financial statements.

The Guidance suggests that backtesting or similar methods should be used as part of implementing a sound methodology (Principle 2) and in the assessment of model output/performance. We agree that sound methodologies and model assessment are essential and that backtesting can be useful in both contexts. However, we also think it is important that the Guidance explicitly acknowledges that variances between the ECL point estimate determined by the financial statement preparer and actual outcomes, even those that exceed materiality, can arise for many different reasons and require careful interpretation based on each institution's specific facts and circumstances. The existence of material variances does not necessarily indicate a failure on the part of an institution to implement a sound methodology or a flaw in its model(s).

We believe the essential elements of financial reporting – and, therefore, the most important matters for auditors to evaluate – of ECL estimates under the applicable accounting framework are:

- a reasonable estimate of ECL that is the outcome of sound judgment, a consistent methodology, a strong internal control environment, and that is free from bias
- disclosure of the reasonable range of possible outcomes within an appropriate confidence interval
- clear and robust disclosure of all material methods and assumptions in management's ECL estimation methodology

We believe consideration of estimation uncertainty, including the need for disclosures in financial statements, and its impact on backtesting and other elements of model validation should be explicitly considered in the Guidance.

Suitability for attestation

We note that the Guidance does not call for a bank's external auditor to provide an attest opinion on the bank's compliance with the Guidance. The Guidance does acknowledge a possible role for the auditor in conducting an independent review of the model validation process, which may include providing observations and best practice recommendations in the context of the principles in the Guidance. The Guidance also refers to a supervisor's cooperation with internal and external auditors.

We support this position. We do not believe the Guidance is a suitable framework for an attest opinion based on the applicable International Standard on Assurance Engagements or that it was intended to be such a framework. We suggest it might be useful for the final Guidance to make an explicit statement to this effect, or for the BCBS to clarify expectations in this regard. This would reduce the risk that expectation gaps arise at jurisdictional level regarding the external auditor's role.

Consistency with IFRS 9

We understand the goal of the Guidance is to assist with high quality application of ECL accounting frameworks, not to introduce concepts that contradict or go beyond the relevant accounting frameworks. We support this goal. Accordingly, we have highlighted in the attached appendix certain matters which we believe are inconsistent with IFRS 9.

If you have any questions on our response, or wish us to amplify our comments, please contact our Global Head of IFRS, Andrew Watchman (andrew.watchman@gti.gt.com or telephone + 44 207 391 9510).

Yours sincerely,



Jack Katz
Global Leader – Financial Services
Grant Thornton International Ltd

Appendix – comments on the Guidance's interaction with IFRS 9

What follows is a list of non-exhaustive examples of areas where the Guidance and its Appendix may require additional clarity or conflict in its interaction with IFRS 9.

Need for clarity on interaction with IFRS 9

It is clear that the Guidance intends to narrow the choices among what are otherwise acceptable alternatives in IFRS 9 in certain areas. In particular, the Guidance explicitly limits the use of practical expedients. However, in certain places the Guidance uses different language than IFRS 9 without explaining what is intended by these differences. We think it is important that the final Guidance distinguishes clearly between statements intended to:

- limit the use of acceptable alternatives in IFRS 9 (eg, practical expedients); or
- clarify or explain the requirements of IFRS 9 through use of alternative or supplementary language without altering or restricting those requirements.

Some examples of the use of different language (in addition to the points made below under 'Other technical comments') include:

- use of “homogeneous” in paragraph 44 with regard to grouping loans, as opposed to “shared risk characteristics” used in IFRS 9
- use of “full spectrum” in paragraph 30, as opposed to “all reasonable and supportable information” in IFRS 9. The Guidance sometimes uses other variations, such as “forward-looking information that is reasonably available” in paragraph 60.

We recommend that the language used in the Guidance be made consistent with IFRS 9. Alternatively, the Guidance should explain the BCBS's intention whenever different language to IFRS 9's is used.

Robust implementation

The Guidance occasionally uses certain words and phrases whose meanings are subjective, unclear and may potentially be at odds with authoritative accounting guidance. One such phrase is “a high-quality, robust and consistent implementation”, which could be taken to mean that regulatory expectations for ECL models go beyond the accounting frameworks. We suggest that the Guidance explicitly state that it is not intended to go beyond the requirements of the accounting framework.

Financial instruments with low credit risk at the reporting date

Paragraph A50 of the Guidance asserts that use of IFRS 9's low credit risk exemption would, in the Committee's judgement, reflect a low-quality implementation of the ECL model in IFRS 9. We disagree with this position.

We acknowledge that the Basis for Conclusions to IFRS 9 characterises this as an operational simplification (BC5.186). However, the IASB also observes that “that for financial instruments with low credit risk, the effect of this simplification on the timing of recognition, and the amount of expected credit losses would be minimal. This would be the case even if the recognition of lifetime expected credit losses occurred later than it otherwise would have if there had been no simplification... The IASB also noted that financial instruments of such a quality were not the primary focus for the recognition of lifetime expected credit losses” (BC5.180 of IFRS 9)

Disclosures

The Guidance, most notably in paragraphs 75, 80 and 81, goes beyond the disclosure requirements in IFRS 9 and related accounting standards. Additionally, there are other international bodies, such as the Enhanced Disclosure Task Force (EDTF), focused specifically on this topic. It would be imprudent in our view, to set forth disclosure requirements in this Guidance that may ultimately be redundant with or even contrary to the work of the EDTF, thereby undercutting their important work. For these reasons we believe the Guidance should provide interpretations of the disclosure requirements in the accounting frameworks, not go beyond them.

Other technical comments

We have significant concerns about the following aspects of the Guidance:

- *guidance on 'default' (paragraphs A4 – A5):* we are concerned that the discussion in these paragraphs appears to expand the concept of 'default' to include a concept of 'defaulted but not reported'. In particular the language in paragraph A4(a) ("... a qualitative criterion that requires a bank to identify credit deterioration...") appears to conflate the concepts of default and credit deterioration. We suggest that this is amended along the lines: "... a qualitative criterion that requires a bank to determine that the obligor is unlikely to pay...". We note that, as stated in A4, IFRS 9 does not define 'default' and requires preparers to apply a definition(s) consistent with that used internally for credit risk management. We also agree that it is reasonable that banks will be *guided* by the definition used for regulatory purposes, while noting that IFRS 9 does not necessarily require the use of regulatory definitions.
- *significant increase in credit risk (paragraph A7):* we have a concern with the language "... a bank must be able to demonstrate that these exposures have not experienced a significant increase in credit risk since initial recognition." IFRS 9 requires an assessment of whether the credit risk on a financial instrument has increased significantly since initial recognition. Paragraph A7 changes the focus from assessing the evidence that a deterioration has occurred to demonstrating that one has not occurred. We are concerned that 'proving a negative' in the manner suggested would have very significant operational implications and may be impractical. We suggest changing the language along the lines: "a bank must assess whether these exposures have experienced a significant increase in credit risk since initial recognition."

Additionally, we have noted the following aspects of the guidance that we suggest merit clarification or possible correction:

- *paragraph 47* – we believe it is wholly possible that groups of loans may share similar risk characteristics in accordance with IFRS 9 and yet not be homogeneous. As such, not all loans within a group may experience a significant increase in credit risk at the same time. This is specifically stated in IFRS 9's Illustrative Examples (IE39). We think the Guidance should be accommodating of re-grouping loans or identifying subpopulations within a grouping of loans when assessing significant increases in credit risk
- *paragraph A33* – this paragraph seems to come close to introducing a rebuttable presumption that identifying a significant increase in credit risk for one exposure to a counterparty would result in all exposures to that counterparty being so categorised. This seems to go beyond IFRS 9.