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By email: baselcommittee@bis.org

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Dear Sirs

Basel Committee on Banking Supervision: Consultative Document - Guidance on Accounting for Expected Credit Losses (the Guidance)

We welcome the opportunity to comment on the Basel Committee's Guidance that sets out supervisory expectations regarding sound credit risk practices associated with the implementation of expected credit loss (ECL) accounting framework.

We agree with the Guidance's objective of a high quality implementation of an ECL accounting framework. We also agree that it is sensible to leverage and integrate the ECL accounting measurement, risk management and capital adequacy processes, but only to the extent that is consistent with meeting their different requirements and objectives.

The Guidance, however, provides additional supervisory requirements for some key areas specific to banks reporting under International Financial Reporting Standards (IFRS), namely limiting the use of certain simplifications and practical expedients allowed under IFRS 9 *Financial Instruments* in measuring ECLs and assessing significant increases in credit risk.

We believe the proposal to impose regulator-driven requirements to particular areas in IFRS 9 is inappropriate and problematic. Accounting and prudential regulations have fundamentally different objectives and purposes. The application of IFRS, with additional disclosures where necessary, is intended to result in financial statements that achieve a fair presentation. The Guidance may also have potential knock-on effects in the industry where regulators in different jurisdictions may require banks to comply with their jurisdiction-specific interpretations and requirements, thus creating divergence in ECL accounting. This would be contrary to the spirit of the Guidance that aims to drive convergence and consistency in ECL accounting frameworks.

We have set out our detailed comments below on the Guidance for your consideration.

1. Accounting measurement vs. credit risk management

- The Guidance replaces the existing Sound Credit Risk Assessment and Valuation of Loans guidance but it seems to concentrate more on accounting than credit risk assessment. We note that improvements to credit risk management systems may be necessary to ensure a high quality implementation of ECL accounting. We agree the scope should be limited to enhancing credit practices that should lead to improving the quality of ECL accounting. The Guidance should be clear when the guidance relates to risk management, accounting measurement or both.

2. Use of practical expedients and other supervisory requirements for banks

- As a matter of principle, we strongly disagree with the Guidance's assertion that the use of practical expedients is representative of the quality of the implementation of IFRS 9. On the contrary, the IASB introduced these simplifications into the ECL accounting standard where it was considered that their use would not have a material impact on the accounting results. Their inclusion in the standard avoids each entity wishing to apply the simplification having to prove that the impact is immaterial, which is often impractical.

- While consistency in accounting application is important, we believe it would be inappropriate for regulators to either prescribe or prohibit specific requirements in the accounting of ECL where preparers of IFRS financial statements already have a set of rules (IFRS 9) to abide by that ensures standardisation across jurisdictions. Different guidelines being introduced in different jurisdictions would be incompatible with consistent implementation, particularly for IFRS which should be applied internationally.

- Determining what is a high quality or robust ECL accounting implementation is highly subjective and judgemental. The degree of implementation work and effort are dependent on the entity's size and complexity of lending exposures, would vary from jurisdiction to jurisdiction, and the proposed supervisory requirements to limit banks' ability to use simplifications could run counter to the Guidance's aim to ensure consistency in the application of ECL accounting framework.

- Consequently, in our view, the Guidance's proposal to limit the use of simplifications and practical expedients is wholly contradictory to the ECL accounting framework established by the International Accounting Standards Board (by virtue of restricting banks from using practical application guidance made available by the accounting standard setter). We strongly believe the Guidance should be amended to reinforce the objective that banks are required to properly comply with ECL accounting, in its entirety, in accordance with IFRS 9.

- We agree that cost, considered in isolation, should not be used as a reason not to incorporate forward-looking information or be the main driver for the use of the practical expedients set out in IFRS 9. Nevertheless, the Guidance should make it clear that the general disciplines of balancing cost, time and quality apply. Complexity and increased costs should only be introduced where this will result in a better result; the operational risks of maintaining and operating complex systems and meeting reporting deadlines are also relevant in a high quality implementation.

- We believe the Guidance should explain that it is not intended to result in changes in the application of IFRS 9 accounting standard, or biased reporting leading to overstatement of ECL allowances.

3. Proportionate approach for less complex banks

- We understand that the Guidance does not aim to override the concept of materiality as applied to financial reporting. We think this should be clarified and the notion of a "proportionate approach" expanded to recognise that it also applies to all banks and not just less complex ones.

- This is consistent with Principle 1 of the Guidance where credit risk practices, including effective internal control should be commensurate with the size, nature and complexity of the exposure. It is also consistent with the fact that, even for large international banks, regulators do not permit or require A-IRB approaches to be applied to all portfolios. Where data volumes are not available to support sophisticated modelling approaches, simpler approaches, consistent with the entity's policies must be appropriate. Management judgements based on the materiality of portfolios will also be important to ensure resources are deployed as effectively as possible to support a high quality implementation.

4. Grouping of lending exposures including re-segmentation

- A properly governed model development and review process will determine an appropriate segmentation that maximises the use of relevant information. Other than as a result of the model review process, we would not expect the segmentation to change. With this approach, the rank order of individual exposures and the measurement of ECL can be determined without re-segmentation. In fact, if the Guidance results in frequent re-segmentation this could drive differences from regulatory capital models, losing the benefit of the model development and review process, including the benefit of historical data series, resulting in a lower quality implementation.

- Frequent re-segmentation will also hinder comparability of numbers from period to period impairing management's ability to understand and explain the resulting financial reporting. While re-segmentation may be important when simplified, backward looking approaches are adopted such as roll rate methods, the Guidance should clarify that this is not an expectation for all approaches, particularly the more complex approaches based on Basel models where ECL is measured at a more granular level.

5. Wholesale vs. retail lending

- The Guidance would benefit from clarity about whether a point relates particularly to retail or wholesale portfolios or is a general point. Some aspects seem more targeted at one rather than the other but this is not made explicit, for example, much of the discussion on credit risk ratings in Principle 3 seems more applicable to wholesale lending, and the IFRS 9 appendix discussion on more than 30 days past due is applicable to retail lending. For wholesale lending, which is often managed on an individual basis and where delinquency is not a key driver, credit deterioration should be identified before the loan is 30 days past due, and the presumption could be rebutted based on the individual facts and circumstances.

6. Common systems, tools and data to assess credit risk and account for ECL

- We agree that it is sensible to leverage and integrate risk management, capital adequacy and the ECL accounting measurement processes to the extent that is consistent with meeting their different requirements and objectives. Such alignment is likely to be efficient; it could also help ensure that the financial reporting provides useful information reflecting risk management practices. However, there are fundamental differences in requirements and objectives between financial and regulatory reporting which should be clearly distinguished and acknowledged in the Guidance.

7. Model development and review process

- We note that where credit rating systems are designed in conjunction with Basel A-IRB approaches or similar internal risk measures, these systems and models will be created through a properly governed model development and review process. This means that all reasonably available information or factors that may be relevant will have been considered initially and the continued relevance of the information used will be assessed regularly. Where impairment models build on existing risk systems and models, the Guidance should acknowledge that this process will be helpful in ensuring all relevant information is incorporated.

- In addition, further information will need to be assessed for factors that are not included in the Basel models such as macroeconomic factors and for differences in concept between accounting and Basel models (e.g. point in time vs. through the cycle). However, while we agree that relevant information should not be ignored, the current wording of the Guidance may imply a standard that is not consistent with normal model development; which generally determines a sub-set of all possible information that directly drives the modelling.

8. Supervisors may make use of work performed by external auditors

- The involvement of bank supervisors directly or through reliance on the work of auditors is unclear in relation to Principle 10. External auditors will perform procedures sufficient to be able to express an opinion on the financial statements as a whole and it is unclear whether it is intended that additional work in terms of providing assurance on the underlying risk management process is also required.

- We do not think the intention of this principle is for regulators to pre-approve models or processes for financial reporting purposes. We believe it is important to clarify this point in the Guidance.

9. Financial statements disclosures

- Accounting standards include disclosures that aim to provide quantitative and qualitative information to allow users to evaluate the amounts in the financial statements arising from expected credit losses, including changes in the amount of expected credit losses and the reasons for these changes. In addition, accounting standards require preparers to consider the appropriate level of aggregation or disaggregation and how much detail to disclose. We consider it is unnecessary for the Guidance to reformulate these requirements.

- Where the Guidance introduces disclosure requirements, such as sensitivity analysis and the disclosure of similarities and differences in the methodology, data and assumptions used in measuring ECL for accounting purposes and expected losses for regulatory capital adequacy purposes, we believe this would best be done through a forum such as the EDTF (Enhanced Disclosure Task Force), which facilitates dialogues between the preparers and users of financial statements to ensure that the information needs of the users are met effectively.

10. Others

- The title of the Guidance does not adequately reflect its content or target the risk audience. We believe the title should focus on credit risk practices rather than on ECL accounting given the accounting requirements are already set out in the IFRS 9 accounting standard.

For any questions, please do not hesitate to contact Ms. Emily Ngan of the Secretariat at 2526 6080.

Yours faithfully

P.P.

Henry Chan
Secretary

c.c. Ms Karen Kemp, Executive Director (Banking Policy),
Hong Kong Monetary Authority