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6 January 2017

By email: baselcommittee@bis.org

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

Dear Sirs

BCBS Consultation on Regulatory Treatment of Accounting Provisions

We refer to the Consultative Document on "Regulatory treatment of accounting provisions – interim approach and transitional arrangements" and the Discussion Paper on "Regulatory treatment of accounting provisions" issued by the Basel Committee on Banking Supervision ("BCBS") on 11 October 2016.

On behalf of our members, we set out in the enclosed annexes our comments on the proposals as set out in the two BCBS documents.

We hope you find our comments useful. Should you have any questions, please contact our Manager Ms Emily Ngan at (852) 2526 6080 or our Officer Ms Melissa Law at (852) 2567 1780.

Yours faithfully,

Celia Shing
Secretary

Enc.

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

Annex A: HKAB's Comments on BCBS Consultative Document on "Regulatory treatment of accounting provisions - interim approach and transitional arrangements"

Seq no.	Section	Part	HKAB Comments
1.	Section 1 Introduction	"The Basel Committee has identified a number of reasons why it may be appropriate to introduce a transitional arrangement for the impact of ECL accounting on regulatory capital." (Page 1)	The Committee mentions that the primary objective of a transitional arrangement is to avoid a "capital shock" by giving banks time to rebuild their capital resources following a negative impact arising from the introduction of ECL accounting. We are of the opinion that the transitional arrangement should not be phased-in over a number of years. In practice, internationally active banks monitor their capital ratios on a fully loaded basis. Banks' major stakeholders including market participants take a long-term view and disregard transitional arrangements in their assessments of banks' capital adequacy. In addition, some banks are contractually committed to monitor their capital ratios on a fully loaded basis. Until the Committee has reached a conclusion on the permanent interaction between ECL accounting provisions and the prudential regime (the interim period), it is premature to start reducing banks CET1 ratios by ECL provisions. Such approach may be inconsistent with the permanent treatment still under discussion and there is no certainty that it would bring banks CET1 ratios any closer to where they will stand under the permanent framework.
2.	Section 2.3 Proposal to retain the current regulatory	"The Committee is proposing that, for an interim period, jurisdictions would extend their existing approaches to categorising provisions as GP or SP to provisions	For interim period, we agree with the Committee's proposal to retain the existing approaches to categorise GP and SP:

Seq no.	Section	Part	HKAB Comments
	treatment of accounting provisions	measured under the applicable ECL accounting model." (Page 3)	- In our view, the distinction between GP and SP is no longer relevant under ECL accounting frameworks and it is not worth introducing an international definition for the purpose of the interim period only. - As previously mentioned, unless a transitional arrangement is introduced to fully neutralise the effect of ECL accounting during the interim period, there will be sizeable differences across jurisdictions and aligning the definitions of provisions would only marginally reduce these differences. - A change in the definition of provisions would require changes in the RWA and leverage ratios computations, while the necessary investments in systems and associated cost would only be of temporary value.
3.	Section 3.1 The Committee's primary considerations	"Any transitional arrangement would also need to address how accounting provisions that are not recognised (i.e., neutralised) in CET1 capital would be treated in other aspects of the regulatory framework. In particular, it would be necessary to include a clear principle that where an ECL accounting provision in effect has not been deducted from CET1 capital because of the application of the transitional arrangement, then: - any deferred tax asset (DTA) arising from a temporary difference associated with such a non-deducted provision amount should not be	We prefer a simple transitional mechanism. Should the Committee decide that a transitional arrangement needs to be amortised over a number of years, we favour straight line amortization. We note that all approaches require a number of regulatory adjustments in addition to an add-back of provisions to CET1. The following adjustments in particular will increase the calculation burden on banks: - Deferred Tax Asset (DTA): any DTA arising from a temporary difference associated with accounting provisions not recognised for regulatory purposes (accounting-only provisions) should not be risk-weighted nor deducted from capital as per the current framework. In addition, the CET1 add-back needs to be computed net of tax effects. - Exposure measure: Standardised exposures in the risk-based framework and leverage ratio exposures need to be adjusted as these should not be reduced by

Seq no.	Section	Part	HKAB Comments
		subject to deduction from CET1 capital and should not be subject to risk weighting. - such a provision amount cannot be included in Tier 2 capital, even if the provision meets the definition of "general" or "excess" provisions. - such a provision will not reduce exposure amounts in the SA even if it meets the definition of a "specific" provision. - such a provision amount cannot reduce the total exposure measure in the leverage ratio." (Page 5)	specific accounting-only provisions. Such adjustments will require system developments as well. We agree that these adjustments are justified from a conceptual standpoint, though the complexity introduced is such that a transitional arrangement may not be appropriate for all banks. Particularly, the costs of such adjustments may outweigh the benefits for banks that record a limited increase in their capital requirements from the introduction of ECL accounting. In our view, transitional arrangements should not be mandatory and banks should be given the option not to implement them.
4.	Section 3.3 Approach 1: Day 1 impact on CET1 capital spread over a specified number of years	"In this approach, a bank would compare CET1 capital based on the opening balance sheet using an ECL accounting standard with CET1 capital based on the closing balance sheet (i.e., the day prior to the opening day) under the existing incurred loss accounting approach." (Page 6)	We would compare CET1 capital before and immediately after the introduction of ECL accounting. Where this shows a reduction in CET1 capital due to an increase in provisions, the decline in CET1 capital is spread for regulatory purposes over a number of years. This approach is simple and would limit banks reporting burden. However, it is based on the day 1 impact and would not be adjusted for any subsequent increase in ECL accounting provisions.
5.	Section 3.4	"Under this approach, a bank would calculate the amount by which the increase	We would calculate the day 1 percentage increase in accounting provisions and the transitional adjustment amount would be calculated based on both that percentage and

Seq no.	Section	Part	HKAB Comments
	Approach 2: CET1 capital adjustment linked to Day 1 proportionate increase in provisions	in provisions due to ECL accounting at the point of transition, measured in currency units and net of tax effect, reduces CET1 capital." (Page 8)	the actual level of provisions. This approach is complex as it is dynamic. It would be adjusted to some extent for subsequent increase in provisions, though the adjustment is unlikely to reflect the actual increase in provisions. We do not favour this approach as it is complex and may not be very accurate.
6.	Section 3.5 Approach 3: Phased prudential recognition of IFRS 9 Stage 1 and 2 provisions	"This approach would address the likelihood that the proportion of total provisions that is due to the new ECL accounting will fluctuate over time. In the case of IFRS 9 – but not CECL – provisions are allocated to "Stages", which could allow "new" provisions to be identified." (Page 8)	We would phase in the recognition of stage 1 and 2 provisions for regulatory purposes over a number of years. Although this dynamic approach is more complex than approach 1, it still cannot accurately adjust for subsequent increases in provisions. Transitional arrangement should aim at fully neutralising the effect of ECL accounting without phase in or amortisation, and therefore approaches 1 and 2 are both not appropriate. They are derived from the day 1 impact and this metric looses relevance over time so that these approaches are not conceptually sounded unless subject to some form of amortization. Under approach 3, the assumption that stage 2 is equivalent to incurred losses under IAS 39, meaning stages 1 and 2 are therefore 'new' under IFRS 9 is not entirely correct. There will be provisions that would have been already existed under IAS 39 in stages 1 and 2 (e.g., incurred but not reported losses or collective provisions). This would mean that a reversal of all associated provisions could lead to an improvement in capital terms as compared to today. These conceptual limitations are such that we are unable to fully support approach 3 in its current form, though we recognise that the approach would provide IFRS banks with a simple definition of the provisions in scope for the transitional arrangement.

Seq no.	Section	Part	HKAB Comments
			We note that approach 3 is based on IFRS 9 definitions while banks applying US-GAAP may decide to adopt CECL as early as in 2019 and therefore also require a transitional arrangement. This could be addressed through the introduction of an equivalent transitional arrangement for banks applying CECL or through the definition of a more generic transitional arrangement that could also address the limitations of approach 3 mentioned above.

Annex B: HKAB’s Comments on BCBS Discussion Paper on "Regulatory treatment of accounting provisions"

Seq no.	Section	Part	HKAB Comments
1.	Executive summary	“The IASB published International Financial Reporting Standard (IFRS) 9 in July 2014, which will take effect on 1 January 2018 (earlier application is permitted). The FASB published its final standard on current expected credit losses (CECL) in June 2016. The FASB’s new standard will take effect on 1 January 2020 for certain banks that are public companies and in 2021 for all other banks, with early application permitted for all banks in 2019.” (Page 1)	Given IFRS 9 will be applicable to banks applying IFRS by 1 January 2018 while CECL is expected to be applicable to banks applying US-GAAP by 2020, how can we ensure a level playing field across all jurisdictions?

Seq no.	Section	Part	HKAB Comments
2.	Section 2 Policy options for the longer-term regulatory treatment of provisions	With respect to the longer-term approach, the Committee has discussed and is considering several possible ways forward. The following are the preliminary approaches under discussion, although these should be viewed as the starting point for a dialogue on the issues, as the Committee is open to comments and proposals other than those raised in this document. To retain the current regulatory treatment of provisions, including the distinction between GP and SP, as a permanent approach To introduce a universally applicable and binding definition of GP and SP Fundamentally change the current regulatory treatment of provisions – remove the GP/SP distinction and introduce regulatory EL under SA (Page 5 - 7)	In our view, the final framework should seek to: - Promote a level-playing field, i.e., allow consistent regulatory treatment across various accounting standards, jurisdictions, regulatory approaches (standardised or IRB) and to some extent banks' levels of conservatism. - Be conceptually consistent with both ECL as well as incurred loss accounting standards. - Address the concerns raised by ECL accounting models pro-cyclicality: contrary to regulatory EL, accounting ECL are expected to increase in an economic downturn which is not a desirable outcome from a prudential standpoint. - Not increase overall capital requirements across banks. - Do not act as a disincentive to implement ECL accounting standards.

Seq no.	Section	Part	HKAB Comments
3.	Section 2.3.4 Calibration of standardised regulatory EL rates	The calibration of each standardised regulatory EL rate is determined using the regulatory fixed LGD (in the Foundation IRB (FIRB) approach) applied to the respective exposure type, where available. The PD is backed out of the relevant IRB risk-weight function, given the SA risk-weight and FIRB LGD. The standardised regulatory EL would then be determined by the Basel Committee using the formula EL = PD * LGD. (Page 11)	The calibration of standardized regulatory EL rate is determined on FIRB LGD and while PD is backed by relevant IRB risk-weight function. The proposed EL calibration is heavily based on IRB related parameters, therefore there is only a small distinction between the standardized and IRB frameworks. We are worried that the calibration may lead to an increase in capital requirements. Standardized risk-weights were historically designed as conservative and in our view this level of conservatism reflected the absence of requirement for a minimum level of accounting provisions. Accordingly the risk-weights cover to some extent expected losses and the calibration should not assume that these only cover unexpected losses. We expect that the introduction of EL for standardized exposure should not increase capital requirements for most banks and the calibration should made on that basis.

Seq no.	Section	Part	HKAB Comments
4.	Section 2.3.3.2 Double counting between IRB UL (recorded in the form of RWA) and accounting life time expected losses.	"**Exposure values:** determined as net of regulatory EL amounts to avoid considerable double-counting of the exposure amounts from both RWAs and regulatory EL amounts." (Page 10)	In our view, ECL accounting frameworks introduce double counting between IRB UL (recorded in the form of RWA) and accounting life time expected losses. Unexpected losses (UL) are computed for regulatory purposes only and are not offset against accounting provisions. UL are computed as the difference between the output of the IRB model and regulatory EL. As explained in the July 2005 "An Explanatory Note on the Basel II IRB Risk Weight Functions", the IRB formula is based on a credit value at risk model calibrated to capture total credit losses at a 99.9% confidence level. The model uses the 1 year PD as an input, though the risks covered are beyond the 1 year horizon. In particular, the maturity adjustment in the formula has the effect of scaling the one-year VAR up to a cap of 5 years. In simple terms, two otherwise identical loans that have respectively a 1 year and 2 years maturity have the same EL, as the computation of EL is not affected by maturity and the 2 years maturity loan has a higher UL from the IRB formula maturity adjustment. Both loans have the same credit risk, computed at a 99.9% confidence level over a 1 year horizon. The higher UL on the 2 years loan therefore covers to some extent losses beyond the 1 year horizon. Such losses are also covered by accounting lifetime expected losses and this constitutes double-counting.

Seq no.	Section	Part	HKAB Comments
5.	Section 2.3.5 Policy considerations for the introduction of regulatory EL under the SA Section 3.5 Complexity and simplification	The consultation does not cover the treatment of excess provisions. It is mentioned that "The Basel Committee will revisit the treatment of excess provisions, including the current approach of including excess provisions in Tier 2 capital up to a cap, after the public comment period. This applies in the same manner to excess provisions resulting from the expected loss treatment under the IRB approaches." (Page 12) "The Committee is interested in views on whether and how to simplify either the current regulatory treatment of provisions or an approach that would use regulatory EL minima." (Page 14)	In order to reach the objectives for a final framework mentioned in sequence number two of this annex, in particular to ensure that the capital measure is as cyclically neutral as possible, to promote level playing field and to address the conceptual inconsistencies between the accounting and regulatory framework, it would be preferable to ensure that as much symmetry as possible is incorporated into the prudential treatment of excesses and shortfalls of accounting provisions against regulatory expected losses. We understand that the Basel Committee may be reluctant to agree with a CET1 add-back on the basis that CET1 should be able to absorb all losses and not only credit losses. We note however that most banks have predominantly credit risks RWAs. Also, we believe alternatives should be considered including: - An add-back to CET1 only to the extent that it covers credit risk. - A reduction in RWA (e.g., through a multiplier or other method).