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Mr René van Wyk
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Basel Committee on Banking Supervision
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Dear Mr van Wyk,

IBFed Comment Letter on the Basel Committee Guidance on Accounting for Expected Credit Losses

The International Banking Federation (IBFed) is pleased to provide you hereafter with its comments on the draft Guidance document on Accounting for Expected Credit Losses.

Key points

- Given its global application, the Guidance should be principle-based and open to various approaches that are consistent with the accounting standard. This concept underlies the majority of our comments.
- The accounting model should be built upon credit risk management practices and processes but it should not drive the risk processes itself.
- In accordance with its objective, the Guidance should focus on credit risk practices associated with accounting for expected credit losses and clearly distinguish whether it relates only to risk management and control or to accounting for credit losses or to both aspects.
- The Guidance should group relevant aspects together to reduce duplication, ensure that terms used are consistent with generally accepted accounting terminology, and ensure that the wording does not give rise to contradictory interpretations of different sections of the Guidance.

- The wording should also be reviewed to ensure it is indifferent to whether collective or individual assessments (or both) are being made as long as the assessment for increase in significant deterioration and the estimation of risk parameters are in compliance with applicable accounting framework.
- The Guidance should clarify that it does not override the concept of materiality, as applied by accounting standards.
- The Guidance should recognize that the proportionality principle is relevant to ensuring that a bank has appropriate credit risk practices commensurate with the size, nature and complexity of its lending activities and so applies to all banks regardless of their size or complexity.
- The application of risk factors should be clearly limited to those that are meaningful and relevant to the measurement of expected credit losses in a particular portfolio.
- The Guidance should acknowledge that 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 affect the outcomes in a predictable manner, balancing the positive and the negative impact.
- The Guidance should clarify that the level of aggregation of lending exposures should be responsive to the underlying credit conditions and relevant credit characteristics of the borrower, rather than emphasizing frequent re-segmentation of portfolios.
- Practical expedients and exemptions that achieve the overall objective of the accounting standards and are compliant with the applicable accounting standards should be permitted to efficiently reflect the appropriate amount of credit risk in the portfolios.
- The Guidance should be consistent with both IFRS and U.S. GAAP. Before finalization, the IASB and FASB representatives should be given the opportunity to comment to ensure the final wording could not be interpreted in a way that would be inconsistent with the accounting standards.

General comments

Scope

We understand that the intention of the Guidance is to set out supervisory requirements on sound credit risk practices for the implementation and ongoing application of expected credit loss (ECL) accounting models, and that such practices include all aspects of a bank's procedures for managing credit risk. However, in this context, the scope of credit risk practices is limited to those affecting the assessment and measurement of credit loss allowances under the applicable accounting framework. We agree that the Guidance should focus on how and to what extent the accounting model should be built upon credit risk management practices and processes, but believe that accounting should not drive the risk processes itself. Therefore, consideration should be given to reducing or eliminating the Guidance under paragraphs 27, 31 and 58, which are primarily about risk management, with the risks being seen as a checklist for risk management practices and contrary to a principles-based approach.

We would support developing a title for the Guidance that more clearly reflects its scope and purpose. We would suggest adopting the subtitle *“Supervisory principles for sound credit risk management practices that interact with expected credit loss accounting”* on page 1 as the main title for the Guidance.

Application

Given its global application, the Guidance should be principle-based and open to various approaches that are consistent with the applicable accounting standard.

In several instances the wording of the Guidance might be interpreted as strict rules, while in our understanding the objective of the Basel Committee was to establish principles for credit risk practices that interact with ECL measurement. To underline the principle-based character of the Guidance, the Basel Committee should acknowledge the different levels of application and implementation of credit risk management practices in banks around the world. The Guidance should recognize that banks with sophisticated risk management processes will base their implementation of the accounting requirements on these existing processes and may already be, to a large extent, compliant with the sound credit risk practice requirements of the Guidance.

Structure and clarity

Similar ideas are often reflected using different terminology in different places within the Guidance. As implementing the accounting requirements is likely to require an integrated effort involving not only those charged with the financial management of a bank, but also from those responsible for capital management, risk management, as well as the entity’s overall governing bodies, we believe a common understanding of the concepts could more easily be achieved if the document groups relevant aspects together. This will ensure the consistency of the language, reduce duplication and ensure that the text supports each principle. For example, the guidance on forward looking information and economic forecasts could be addressed in one place to avoid similar points being made slightly differently in different places (e.g. contrast between paragraphs 53 and 60-64). Also, it is unclear how paragraphs 25 -28 and 31 relate to the ECL measurement. We believe the Guidance would be more effective if it focused more on the interaction with ECL estimates.

The Guidance should also differentiate between concepts and terminology of differing disciplines. For example, we understand and support the concept of robustness in terms of risk management processes and controls (e.g. assessment methodology, estimate, modeling, etc.). However, robustness in the context of accounting for credit losses represents a potentially significant change. We believe this could imply an expectation that ECL implementation should lead to a more-than-appropriate amount of allowance for credit losses. This would conflict with accounting requirements for neutrality and could lead to “earnings management” accusations by the investment community. Similarly, the term “robust” could imply a standard for internal controls that is more stringent than that generally applied, for example by auditors in their attestation of internal controls or in the opinion as to whether the financial statements are free

of material error. We believe that the Basel Committee does not intend such departures from general accounting and auditing principles. However, given that the Guidance contains supervisory requirements linking credit risk management practices with ECL accounting, and the intended audience is much broader than accountants, it will be necessary to make this clear in the wording. We suggest clarifying when a point applies to risk management and control or relates specifically to accounting for credit losses or both. Consideration should, therefore, be given to whether it is helpful to use the term “robust” in each context. To promote the consistency in application and to avoid confusion when referring to accounting concepts, language throughout the Guidance should be aligned with the generally accepted accounting terminology.

The document sometimes appears to provide conflicting guidance. For example, the document articulates the use of reasonably available information, but also states that no costs and effort for obtaining relevant information should be considered undue. Similarly, the Guidance does not require “an exhaustive search” for information; but also, it requires banks to “actively incorporate information.” While we support high standards for implementation of ECL accounting, we are concerned that inconsistencies in wording could result in diversity in implementation and implementation of processes that are not cost beneficial. We recommend reducing such duplication and utilizing generally accepted accounting terms when describing accounting requirements, such as “reasonable and supportable”. The Guidance could then clarify that the use of “reasonable and supportable information” should not be interpreted in a narrow way in order to diminish the expectation that banks will seek all reasonably available information and assess the impact of that information on the ECL allowances.

Proportionality and Materiality

Principle 1 refers to ensuring that the bank has appropriate credit risk practices commensurate with the size, nature and complexity of its lending operations. As such, we believe that the proportionality principle should not be limited to less complex banks but should also be applicable to portfolios that are not significant (and are not expected to be significant) in terms of their size, nature (including potential losses under all reasonable scenarios, as well as the data available for statistical analysis) and complexity.

Materiality is a fundamental principle of financial reporting and regulatory requirements of Basel II/III and should, therefore, be clearly discussed in the draft. The Guidance should clarify that it does not override the concept of materiality as applied in accordance with accounting standards. We agree that materiality should not be used to justify a low-quality implementation, but since materiality is a fundamental principle underpinning all financial reporting, we do not believe that materiality decisions should be seen as contrary to high-quality implementation. Complexity that does not contribute to improved compliance with the accounting requirements should be discouraged to reduce unnecessary operational risk and to help ensure timely reporting.

Specific comments

Collective vs. individual assessment

The wording of the Guidance should be reviewed to ensure it is balanced about whether collective or individual assessments (or both) are being made. The key is that, regardless of the methodology applied, the assessment for determining whether there is an increase in credit risk and the estimation of risk parameters must be compliant with the applicable accounting framework. In some places, the Guidance could imply that individual assessments are a lower quality implementation and in other places the Guidance could imply that collective assessments are to be avoided. For example, paragraph 51 implies a collective assessment is always required in addition to individual assessments and paragraph 46 suggests that groupings may mask the credit risk of particular items.

In many circumstances the individual assessment would be the most relevant analysis under both the IFRS 9 and U.S. GAAP frameworks. Some banks with sophisticated risk processes are contemplating a model where assumptions and calibration of parameters will be considered at the collective level (based on Basel portfolios) and subsequently assigned to the individual exposure level. The PDs will in this case be derived at the collective level but the transfer criteria and measurement of the allowances will be at individual client level so exposures can be moved between buckets at the individual level using specific risk factors. This is not only the case for significant wholesale exposures that are generally risk approved individually and subject to fundamental credit risk analysis but also could be applied to retail portfolios in some circumstances.

The rating methodology for retail portfolios is generally based on a broad data base reflecting the large number of customers. This allows for the modeling of statistically significant relationships between risk factors and the estimated parameters while by nature the extent of borrower-specific information is limited. The application of a rating tool for a retail portfolio is usually an automated process allowing banks to handle the sheer number of borrowers while maintaining efficient processes. By applying the rating tool, an individual rating is generated for every retail borrower using the available information on that specific customer.

For wholesale borrowers more information will in general be available for the specific borrower. Banks do have processes and staff in place to collect further relevant information as one part of the risk assessment of wholesale customers. The rating tool for a wholesale customer incorporates this more detailed information through specific quantitative and qualitative analyses within the rating tool. For this type of borrower the statistical basis is less broad compared to retail customers. Generally, for wholesale customers the rating process is not executed automatically but rather needs an experienced credit officer to pass through the rating. The result of this integrated risk management and rating process will also be an individual rating for the individual wholesale customer.

As a result, a bank with sophisticated processes (e.g. an IRB bank) will in general have different rating tools for different portfolios and may allocate an individual rating based on the specific

risk characteristics to every wholesale and retail customer. This rating (and the associated PD) should be taken as the relevant basis for the determination of the transfer criterion (where applicable) and the measurement of the ECL.

It is acknowledged that individually assessed exposures may, in certain circumstances need some collectively assessed overlays to deal fully with expected credit conditions as further explained in the next section.

Other banks that do not have such a degree of detailed individual loan information may perform substantially all analyses at a portfolio or sub portfolio level.

The paper should clarify that the requirements have to be interpreted with respect to the specifics of each portfolio. The characteristics of the available information should be considered adequately and it should be mentioned that high quality credit risk measurement is always tailored to the portfolio's specifics.

Use of forward looking information

It is understood that forward looking information will be a critical element within both credit risk evaluation and measurement. The application of forward looking information, in particular when it comes to macroeconomic factors, is the most challenging area on which banks are currently focusing, considering a range of possible approaches. Many banks are considering how to employ mechanisms already in place, such as the forward-looking assumptions and risk factors considered in existing internal processes and in stress testing.

Various approaches are likely to be employed to best address the different credit risk characteristics within individual portfolios. Therefore, the Guidance should focus on the discussion of forward looking information (including macroeconomic factors) in Principle 6, which attempts to ensure that the forward looking information is developed through a properly governed process and that there are reasonable and supportable links between this information and its impact on ECL.

The Guidance should also recognize that there may be times when overlays addressing forward looking information are needed. In such circumstances, they should be properly controlled and governed, and double-counting should be avoided where factors are already included in the base model. This could happen, for example, when entities must estimate the effect of a sudden and sufficiently prolonged event that could have credit performance consequences for some obligors, such an oil price shock.

In addition, while we agree that relevant information should not be ignored, the current wording of the Guidance implies a standard that is not consistent with normal model development, which generally determines a sub-set of all possible information that directly drives the modeling.

The guidance does not acknowledge that a typical model building process will start with all potentially relevant data (including forward looking information) and narrow down to the data that is 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 modeled results. New information should 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. Further, 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, balancing the positive and negative impact. There may well be some future events or circumstances (such as the outcome of an election or country leaving Eurozone that may have unpredictable effects on the economy) where no amount of expert judgment will be sufficient to incorporate relevant information on its effect into the results. The exclusion of such events would therefore be considered consistent with a high quality implementation. We believe that the Guidance should acknowledge this.

Documentation and proof of relevance of individual forward looking factors is a potential operational hurdle if it is not closely tied to standard model validation processes. We suggest that the application of risk factors should therefore be clearly limited to those that are meaningful and relevant to ECL measurement. It also needs to be highlighted that different factors may be relevant for different portfolios. Should incorporation of further risk factors not lead to better information for risk managers, these should not be considered for accounting purposes. More complex models with large numbers of risk factors that are subject to constant change would not necessarily lead to a better understanding of risk, or to higher quality output.

Segmentation

Banks will need sufficiently granular databases in order to identify common risk factors. However, banks will need to balance the granularity with the size of portfolios on which statistical data is considered relevant and reliable and to ensure that risk management is properly reflected.

Paragraph 48 seems to imply that frequent re-segmentation is compulsory, even though we believe that was not the intention of the Basel Committee. The need for frequent re-segmentation, which assumes a particular method of application that may not be appropriate, conflicts with the idea that the measurement of ECL for regulatory capital purposes and for estimating ECL for accounting purposes should be consistent with risk assessment and measurement process as per Principle 7 (paragraph 41). For example, IRB banks may use the existing segmentation and rating grids as a sound basis for ECL analysis, since both of them have already been validated. As such, the segmentations are considered as consistent and homogenous on the basis of sound credit risk management practices. The appropriateness of

the grouping will be reviewed regularly as part of the model review process. However, they are not expected to be changed frequently, given the need for stable statistical data base. Models will be recalibrated and adjusted to incorporate new information rather than be rebuilt completely under different groupings. A requirement to explicitly incorporate the impact of forward-looking information and macroeconomic factors within the loan risk rating system (as implied by using the terms “credit risk rating system/process” in paragraphs 34 to 42), as opposed to ECL measurement as a whole, as well as the requirement to expand the risk rating classification to track all changes regardless of the significance of the change in credit risk, would lead to the creation and maintenance of two rating systems, which will be operationally complex and burdensome.

There are different ways to link ECL accounting to credit risk management as explained in the previous sections. Individual exposures may often be analyzed as part of multiple groups, based on various shared credit characteristics. Re-estimation of statistical parameters will be unmanageable if portfolios/subportfolios change frequently.

The Guidance should therefore highlight the overarching importance of ensuring that the grouping of exposures and the inputs to the accounting ECL models are risk sensitive so that the level of aggregation applied should be expected to be responsive to the underlying credit conditions (both current and forecasted) and the behaviour of the borrower. Further, the draft should also address the need to utilize data that is sufficiently reliable for relevant estimates. This would be more consistent with the ability to build on the Basel modeling process, including its governance and validation processes.

Use of practical expedients/exemptions

Practical expedients, whether directly defined in IFRS 9 or not, are intended to be used by banks only to efficiently reflect the appropriate amount of credit risk in their portfolios. In other words, it is not the intention of institutions to use practical expedients to materially modify the level of allowances or mask significant credit deterioration. Examples of the usage of practical expedients are included below.

30 days past due:

Many IFRS-based banks intend to use the 30 days past due practical expedient only as a backstop as required by the standard, and it is not expected to be used as the sole transfer criterion for significant and material portfolios. This practical expedient is intended to be used: (1) only for portfolios that are currently and expected to continue to be immaterial and/or where no additional information is available, or (2) when evidence that additional information, including forward looking information, has been considered and determined to have no substantive relationship with the level of credit deterioration.

Low credit risk exemption:

The low credit risk exemption was not introduced by the IASB solely as a practical expedient. Given that banks will have to track changes in credit risk, operational burden will not be

reduced. The reason for the low credit risk exemption is that it was believed that lifetime expected loss was not appropriate for the exposures with low credit risk from the credit risk management perspective.

Estimates based on fair value:

U.S. GAAP-based banks expect the current practical expedient of estimating credit losses on the fair value of the underlying collateral to continue.

Other practical expedients that efficiently estimate a lifetime loss may surface over time, both in the U.S. and elsewhere. Considering all this, we recommend that language in the draft to address practical expedients be modified to emphasize that all processes – including practical expedients – that appropriately address the overall objective of reflecting credit risk should be permitted. This will give banks around the world the flexibility of developing and using more efficient methods of estimation without sacrificing the overall quality of the estimates.

Integration of internal systems

Paragraphs 65, 69 and 70 and other parts of the document imply that there is a requirement for a new integrated data system aligning the budgeting processes, stress-testing processes, and allowance processes. If this is the intention, it will substantially increase the efforts necessary for development and implementation of the accounting requirements, and banks are unlikely to have such integrated systems in place by the effective date of the accounting standards. We assume that the intention is not to mandate such extensive and widespread systems changes and therefore, we recommend that the document be clarified accordingly.

Disclosures

In our view, the detailed disclosure requirements will create confusion and inconsistency, given the differences overall regulatory environments among jurisdictions. It is also unclear how efforts to provide enhanced financial disclosures under Pillar 3 or through the Enhanced Disclosure Task Force (EDTF) should be factored into the process to identify adequate disclosures. Rather than suggesting any detailed disclosures, such as sensitivities to changes in main assumptions or differences between regulatory and accounting data/assumptions, the Guidance should encourage a dialogue between banks and users of the financial statements to ensure that any enhancements to the accounting disclosure requirements will meet users' needs in a way that is as cost effective as possible.

Consistency with IFRS 9

The guidance set forth in the Appendix is quite restrictive in terms of how an ECL under IFRS 9 model should be developed. Whereas the draft Guidance stresses that its intention is to set forth supervisory requirements on accounting for ECL that do not contradict applicable accounting standards established by standard-setters, the extent to which the consistency with

the principles and requirements of IFRS 9 is achieved, including the practical implications arising from the way the guidance is likely to be interpreted by regulators and applied in practice, should be examined. Accordingly, we think it would be advisable to request a further review of the Guidance by the IASB once the amendments from the consultation have been incorporated, to obtain additional comfort that it will not result in outcomes that are inconsistent with IFRS 9.

For example:

- The requirement to consider the changes in expectations of macroeconomic factors in paragraph 24f, in our view, conflicts with the point in time nature of IFRS 9 where the ECL estimate should reflect the current macroeconomic forecast of future economic conditions. Also, IFRS 9 does not consider the existence of concentration, and the Guidance notes that changes in the level of concentration listed in paragraph 24f are factors that may require qualitative adjustments.
- Paragraph 47 seems to conflict with IFRS 9, particularly with the top-down approach shown in Example 5 of the Implementation Guidance to IFRS 9, where only 20% of floating rate loans are to be transferred to bucket 2. We believe paragraph 47 should be reworded to allow a portion of the group or the sub-group to be transferred.
- In case of constant migration matrices, the usage of 12 month-PD and lifetime-PD may often lead to the same result, and 12 months may be a reasonable approximation of the change in the lifetime risk of a default occurring. To ensure consistency with IFRS 9, A3 should be changed as follows: *“The committee would like to draw particular attention to the examples set out in IFRS 9, paragraph B5.5.14. In such cases, the change in the risk of a default occurring over the expected life of the financial instrument must be considered.”*
- Paragraph A5 seems to combine “default” with the assessment of significant increases in credit risk, and implies that banks should extend the notion of default to situations when an actual default will have not yet occurred. In effect this could mean that a default is defined as a significant increase in the credit risk of a default occurring. Unless this is addressed, this circularity in definition would render both regulatory capital measures and measures of significant credit deterioration under IFRS 9 inoperable.
- The requirement in paragraph A7 for a bank to demonstrate that exposures have not experienced a significant increase in credit risk since initial recognition is not only considered a high operational hurdle (it is almost impossible to prove such a negative, especially when considered in hindsight, as most supervisory and audit reviews will be) but is also considered inconsistent with IFRS 9 requirements to identify significant increases in credit risk since initial recognition.
- The requirement in paragraph 49 to identify “any” changes in credit risk “as early as possible” would not appear to be in keeping with the new ECL accounting standards nor with standard credit risk management. While ECL accounting will invariably result in earlier recognition than under current standards, it is premised upon appropriate measurement based upon relevant information and data better characterised as “timely” than “early”.

- Paragraph A11 requires proof that a grouping of financial instruments does not obscure information, whereby IFRS 9 requires only that groupings share the risk characteristics.
- It is stated in paragraph A15 that "any post-origination increase in credit risk is unlikely to be fully compensated by the interest charged". The Committee should note that various factors affect loan pricing and that loans are often originated at the high end of a wide credit grade range. Therefore, for the same price, a change in the credit risk may often still be compensated by the pricing at initial recognition.
- Footnote 33 to factor (a) of paragraph A27 seeks to add an additional rebuttable presumption around the ability to distinguish the reasons for changes in the credit spread within pricing. Given the operational challenge to rebut the presumption (difficulty to distinguish credit spread from changes in credit spread from changes in pricing due to other factors), the footnote would result in lifetime expected loss being recognized where there may not be a significant increase in credit risk. This is not considered compliant with IFRS 9.
- IFRS 9 is misquoted in paragraph A35, implying that collective assessments must be performed instead of that they may be necessary.
- Paragraphs A50 to A58 are unclear and could imply a lower threshold for determining the significance of a change in credit quality for exposures with a lower credit risk on initial recognition than those with a higher credit risk. The initial credit risk of the loan must be taken into account in determining whether there has been a significant increase in credit risk and it should be made clear that this aspect of IFRS 9 is not an operational simplification. The operational simplification is to avoid tracking for "low credit risk" exposures, but paragraph A52 requires tracking for all exposures. If tracking is always required, then the determination of low credit risk and the related disclosure would never be applicable, so the rest of the section is unnecessary.

We thank you for taking our comments into consideration and would be pleased to discuss our letter in further detail at your convenience.

Yours sincerely,



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