LLOYDS BANKING GROUP

David Joyce
Finance Director,
External Reporting & Accounting Policy
25 Gresham Street
London
EC2V 7HN
Telephone: 02073561516
david.joyce@finance.lloydsbanking.com

Basel Committee on Banking Supervision (BCBS)

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Dear Sir / Madam

Lloyds Banking Group plc response to 'Guidance on accounting for expected credit losses'

We welcome the opportunity to comment on the BCBS consultative document on accounting for credit losses (the 'Guidance'). We have also contributed to the BBA response to the consultation. For specific paragraphs, where we wish to comment, we have provided responses in Appendix 1.

We support the aim of achieving a high quality implementation of IFRS 9 for major banks and appreciate the recognition that IFRS 9 can only be properly implemented with a combination of quantitative and qualitative information. The Guidance provides a principle-based approach for best practice implementation, however, we believe the current drafting does not always provide clear guidance that can be practically implemented, nor assessed against by regulators and auditors. It is vital that additional guidance issued by the BCBS does not lead to a disconnect between the accounting requirements and risk management practices of banks.

Summary of Proposed Changes

We highlight the following areas that we believe could improve the clarity and effectiveness of the Guidance:

- The objective of the Guidance should be clarified, in particular, with respect to expectations for credit risk practices in general and separately for impairment accounting.
- The application of materiality and neutrality underpinning the application of accounting standards should be explicitly acknowledged within the Guidance.
- The drafting around the forward looking information needs revising so that the language supports an achievable and consistent interpretation of the forward looking requirements of IFRS 9.
- The Guidance would be improved if the distinction between retail and wholesale credit risk practices were made throughout the text.
- We believe the appendix could lead to some confusion over the application of IFRS 9 by banks, and in places gives additional rules over and above those required by IFRS 9. We would particularly highlight the presumed linkage of pricing changes to credit risk changes and changes to the definition of default. We believe these paragraphs should not be included in the final draft of the Guidance. The language and terms used throughout should be made consistent with generally accepted accounting terminology.

We have provided further details on these critical areas that we believe the Guidance needs to address in order to achieve the intended results.

Clarity of Objective and Scope

The objective of the Guidance needs defining more clearly, in particular, the **differences between the accounting guidance in the appendix and risk management principles in the main body** of the paper. Risk practices will need to accommodate the accounting model for expected losses, but should not be driven by the accounting rules per se. It would be helpful if this point was made in the 'Objective and scope' section.

The **instruments within scope** of the accounting guidance should be explicitly defined. The objectives section refers to 'lending exposures' whilst the appendix uses the term 'financial instruments' (a much broader term) a number of times. Footnote 2 clarifies that 'lending exposures' includes loans, commitments and guarantees, and paragraph 13 states that debt securities are outside the scope of the paper. It is unclear whether items such as lease receivables and reverse repos are within scope.

The **proportionality principle** is recognised in paragraph 12 for less complex banks. We believe proportionality should also be applied to portfolios within a large bank. This should be based on the size and relevance of each portfolio to a bank, taking account of portfolio risks and future developments, and not just on the size of the loss allowance. While a high quality implementation is vital, this does not remove completely the need for a cost benefit assessment to be undertaken. The use of practical expedients may well be wholly appropriate for less material portfolios.

Fundamental Accounting Principles – Materiality and Neutrality

The Guidance sets out 'supervisory requirements', is **silent on materiality**, and requires a 'robust and timely measurement of allowances'. Under IFRS, the Conceptual Framework requires the principles of neutrality and materiality to be used at all times when applying accounting standards.

There should be an explicit statement that the accounting guidance provided is underpinned by the fundamental accounting concepts of neutrality and materiality.

Forward Looking Information – Completeness of Data

The forward looking component including macro economic factors is a key feature of the expected credit losses (ECL) model; a bank's approach to forward looking information needs to be bound by what is materially relevant and practically achievable.

The Guidance requires a 'full spectrum of information' (paragraph 30) and a 'range of possible future scenarios' (paragraph A2). It should be acknowledged that it is impossible and unnecessary to identify and capture all factors and then translate those factors into a quantified loss allowance. All available data and possible variables would be considered with a robust statistical build, and only those factors which are significant utilised.

More complex models with a large number of risk factors, subject to constant changes, would not necessarily lead to a better understanding of risk, and would therefore not be a high quality implementation of IFRS 9. We suggest that **risk factors applied to a forward looking view should be limited to the most relevant and measureable ones** to a particular portfolio or exposure, as identified by the risk experts within a bank.

We would consider economic, financial and credit cycles as something materially different from each other. The definition of an 'economic cycle' has been defined and agreed with our national authority. The Guidance requires consideration of data over a 'credit cycle' to be used in adjusting the collective and individual loss allowance (paragraph 24k). By using the term 'credit cycle', as opposed to 'economic cycle', allowances would not reflect the risks associated with the wider economy which, in our opinion, are more correlated with the drivers of loss. We suggest the Guidance should use terms consistent with IFRS 9, or explicitly define any new ones introduced. Furthermore it should be noted that not all banks will have such data for all portfolios, and a level of judgment will be applied.

A Distinction Between Retail and Wholesale Approaches

In places (e.g. paragraphs A24, A34) the Guidance makes reference to **retail or wholesale portfolios**, while in others it is not apparent whether the wording is aimed at one or both types of lending. As available data, models and existing risk practices will be very different for retail and wholesale exposures, the Guidance should be clear which paragraphs are more relevant to a particular type of lending.

For example, 30 days past due is not a particularly meaningful metric for wholesale loans and therefore this presumption could be rebutted without compromising on the quality of the implementation. Paragraphs A59-A62 seem to be drafted with retail exposures in mind with its focus on delinquency measures and an absence of forward-looking information; it would be helpful if this was clarified in the text.

Compliance with IFRS 9

There are a number of areas where the **Guidance seems to go beyond, alter, or conflict with the requirements of IFRS 9**.

Firstly, the interpretation of a '**significant increase in credit risk**' in section 2 of the appendix raises a number of concerns.

- Paragraph A15 requires any increase in credit risk 'to be <u>fully</u> compensated by the interest rate charged'. There is no such principle in IFRS 9 and so this introduces a different interpretation of 'significant' to that given in IFRS 9 (which is based on the change in risk of a default occurring over the expected life).
- Paragraph A27 places emphasis on six indicators that potentially suggest credit risk could have increased, while paragraph A26 states that all indicators given in IFRS 9 B5.5.17 should be considered. We suggest that the emphasis on the six stated indicators should be removed from the Guidance as they do not add to the factors already given in IFRS 9.
- Additionally, footnote 33 referenced in A27 introduces a **new rebuttable presumption that changes in price are due to credit risk changes**. In practice, prices can be driven by market share or targets, competition and many other factors not related to credit risk, but proving there is no element of credit risk at all would be extremely difficult to do. IFRS 9 is clear that pricing is only one consideration of many in assessing the deterioration of credit risk. An increase in pricing may occur due to market volatility, while the idiosyncratic credit risk could actually be reducing, and vice versa. This additional rule could lead to many assets having a lifetime expected credit losses (ECL) where no significant increase in credit risk has occurred. We do not believe this would be compliant with IFRS 9, nor lead to meaningful information being disclosed.

- In relation to the use of 12 month ECL, paragraph A7 requires a further, and almost impossible condition to apply in practice, of proving there has not been a significant increase in credit risk since origination. It is important that the interpretation of a significant increase in credit risk is aligned exactly to that given in IFRS 9, rather than adding to and under/over emphasising specific parts, to avoid potential conflicts around interpretation.

It would also be helpful if the symmetrical nature of the assessment of credit risk (assets moving from stage 2 to stage 1) was mentioned, rather than being silent on the issue (IFRS 9 5.5.7).

There is an expectation that a **nil allowance will be rare** for a 12 month ECL (paragraph A1). For highly collateralised loans, a nil allowance could be possible. Such a requirement would make the standard more pro-cyclical as it ignores the embedded mitigation offered by collateral. IFRS 9 does not stipulate such an expectation and clearly requires collateral to be taken into account. The magnitude of any loss allowance should be the result of detailed analysis and management judgement within a strong governance framework; and not specified by accounting or regulatory guidance.

There appears to be an expectation that **re-segmentation of portfolios for collective assessments** will occur frequently. While the appropriateness of portfolios is an important consideration, regular changes will dilute the usefulness of the statistical analysis and lead to spurious accuracy. IFRS 9 B5.5.6 states that the aggregation of assets may change over time as new information becomes available. The need for re-segmentation should be driven by risk practice and not accounting requirements. Furthermore, paragraph A35 requires that an entire portfolio of assets is transferred to lifetime ECL when an individual exposure within a portfolio is identified as having an increase in credit risk. Again, this in inconsistent with IFRS 9 B5.5.6 which states that a portion of the assets for which credit risk is deemed to have increased should recognise lifetime ECL.

The Guidance emphasises consistency of **definition of default** used for accounting purposes and regulatory purposes (paragraph A4). The definition default for regulatory purpose is agreed with national authority and IFRS 9 requires a 90 days past due rebuttable presumption (IFRS 9 B5.5.37), therefore the Guidance should not imply any change to the regulatory definition. Moreover, where banks have a regulatory definition greater than 90 days past due then this should be the basis for a strong case for rebutting the 90 days past due presumption. Paragraph A5 states that the 'unlikeliness to pay' criterion is the primary indicator of default, whereas neither IFRS 9 nor the regulatory definition stipulates this. In reality the primary indicator of default will be different across different products and the Guidance should be consistent with this by leaving the respective definitions unchanged and without additional emphasis.

We are happy to discuss any of the points raised and would welcome the opportunity to provide further clarification regarding any questions you may have.

Yours sincerely,

David Joyce

Lloyds Banking Group

Appendix 1 – Specific Comments

Reference	Comment
24. Policies and procedures of credit risk systems and controls… …a bank should maintain sufficient historical loss data over at least a full credit cycle…	On transition to IFRS 9 there will be gaps in available historic data and approximations and management judgement will be necessary where this is the case. Credit Cycle - Previous guidance ("84th BIS Annual report - Debt and the Financial Cycle - domestic and global") referenced a Financial Cycle. We would consider Economic, Financial and Credit Cycles as something materially different from each other. The definition of an Economic Cycle has been defined and agreed with our national authority. By use of the term 'credit cycle', as opposed to 'economic cycle', allowances would not reflect the risks associated with the wider economy which, in our opinion, are more correlated with the drivers of loss.
30. While a bank need not necessarily identify or model every possible scenario through complex scenario simulations, the Committee expects it to consider the full spectrum of information that is relevant to the product, borrower, business model or economic and regulatory environment when developing estimates of ECL.	Multiple scenarios with many inter-dependent variables do not necessarily lead to a better estimate of a loss allowance. It would increase the room for judgement and subjectivity making any meaningful, non-spurious, conclusions difficult if not impossible. Banks should assess a wide range of drivers of credit risk but only those that are materially relevant should be captured in their modelling approaches. To do otherwise could lead to the development of forward looking methodologies that are not stable and robust over time.
31. Bank management should be able to demonstrate its adherence to sound underwriting practice…	This seems to go beyond the scope of the Guidance as it does need relate specifically to an ECL impairment model.
34. With regard to rating systems, the procedures should clearly specify the key factors, including forward-looking information and macroeconomic factors, that form the basis for assigning credit risk ratings and thus help support the monitoring, assessment and	This appears to presume that forward looking information will be part of the internal credit rating system. This is not necessarily the case, particularly for retail exposures, where a collective assessment is likely to be used to incorporate forward looking information to supplement account level behaviour

reporting of ECL for all lending exposures across the entire credit risk rating system. 37. The design of the credit risk rating system should ensure that a bank incorporates all relevant information, including forward-looking information and macroeconomic factors, into its credit risk assessment and rating processes both upon initial recognition and over time.	scores that many banks use. Internal credit ratings can be used as the basis for ECL analysis, which may include additional information, and should be defined by management. The guidance seems to deviate away from the ECL measurement into how to define a ratings system.
80. Quantitative disclosures should include a reconciliation…provided separately for collective and individual allowances. ..the following information: recoveries previously written off…	There will be many portfolios where there is both an individual assessment and a collective assessment (e.g. management overlay or forward looking information) and therefore this split is not possible. This is not considered particularly useful information to give and is not required by IFRS 9. We would suggest that this should be principle-based and no specific disclosure requirements are given in the guidance. Also, emphasis should be placed on simplicity and interpretability to ensure comparability of results.
A15. The Committee believes that the rationale for this approach is that ECL anticipated upon initial recognition will be taken into account in the pricing of credit at that time. It follows, then, that any post-origination increase in credit risk is unlikely to be <u>fully compensated</u> by the interest rate charged, and, as a consequence, a bank must carefully consider whether there has been a significant increase in credit risk.	Pricing is only one factor that should be considered in assessing a significant increase in credit risk. Price can be influenced by many factors and often banks can be price takers. Requiring a ‘fully compensated’ credit risk increase is tantamount to saying any increase in credit risk should be regarded as significant. We do not believe this is compliant with IFRS 9.
A27. While it is neither possible nor desirable for universally applicable criteria to be developed, the Committee emphasises that the presence of any of conditions (a)–(f) below would suggest that there has potentially been a significant increase in credit risk. (b) a decision by management to strengthen collateral and/or covenant requirements for	It is not clear why six factors already included with IFRS 9’s longer list of factors should be highlighted in the guidance. Paragraph A26 states all factors need to be considered, therefore we suggest the guidance should be updated to remove these 6 indicators unless it is intended that these are the primary indicators. A risk appetite change should not put historic

new exposures that are similar to exposures already advanced because of changes in the credit risk of those exposures since initial recognition. Foot note 33 for "Where management is unable to distinguish this element of pricing from others, such as the general price of credit risk or change in gross margins……the Committee expects banks to adopt a rebuttable presumption that any increase in the credit spread that would be a charge for a particular loan is due to an increase in the bank's assessment of the credit risk of that exposure."	business into stage 2. The pricing by banks of assets is driven by several major factors including competitor pricing, profitability targets, return of equity, market share and targets, risk appetite and other regulatory constraints. Pricing should not be given undue prominence in assessing a significant increase in credit risk, but is just one of many factors that banks need to consider. Practically it will be very difficult, if not impossible, to rebut the presumption due to the multiple factors involved.
A29. It is possible that a significant increase in credit risk could occur before lending exposures experience even a one-notch downgrade.	This suggests that a 'one notch' downgrade or less is deemed to be a significant increase in credit risk. In practice the relevant movement in internal ratings that are deemed to be 'significant' will depend on the granularity of the rating system, the factors that drive the rating, the origination rating, and the loan type.
A35. Accordingly, the Committee expects that, in instances where it is apparent that one or more exposures in a group have experienced a significant increase in credit risk, the relevant group or subgroup will transfer to LEL measurement of ECL even though it is not possible to identify this on an individual exposure basis.	The rationale for moving an entire group to LEL is not consistent with credit risk practice and contradicts IFRS 9 B5.5.6 which states that a <u>portion</u> of the assets for which credit risk is deemed to have increased should recognise lifetime ECL.
A49. …the Committee expects banks to develop systems and processes to use <u>all</u> reasonable and supportable information…	This could be read as requiring all possible information no matter how trivial (and possibly statistically spurious) to be used. Information that banks need to consider and assess needs to be bound by what is practical and focused on the key drivers of credit risk.