

Basel Committee on Banking Supervision
Centralbahnplatz 2
4051 Basel
Switzerland

Head Office
Gogarburn
PO Box 1000
Edinburgh EH12 1HQ

30 April 2015

Dear Sirs

Consultation: Guidance on accounting for expected credit losses

We welcome this opportunity to comment on the BCBS consultative document: Guidance on accounting for expected credit losses.

RBS is a major UK-focused bank. We serve and meet the banking needs of individuals and businesses in every sector and of every size, and the needs of financial institutions. Regulated by the UK Prudential Regulatory Authority, we have had IRB permissions since 2008 and also apply standardised approaches across our credit portfolios. Our response to this document draws on our experience of operating these approaches to the management of credit.

We are submitting our response in addition to those from the Institute of International Finance (IIF) and the British Bankers Association (BBA) to which we have contributed, due to the importance of this topic to the successful implementation of IFRS 9.

We appreciate the efforts of The Basel Committee, which has met an industry request to publish the consultation early. We are supportive of the benefits of additional guidance where this helps with the development of policy and process for the complex implementation issues of IFRS 9, and recognise the importance of this topic to the regulatory community.

However, we are concerned that the Committee may be seen as setting specific accounting interpretations that could conflict with the role of directors in setting the most appropriate accounting policies and practices for a bank. We support the right of the regulator to establish standards and principles for how banks establish governance, systems, controls and processes. However, since accounting requires the exercise of judgment to specific fact patterns, this responsibility should be the sole responsibility of a bank's directors. Separate regulatory processes exist that enable the regulator to address specific concerns within an individual bank.

UK Application

While the document is intended to provide guidance and establish good practice, we are aware of a particular interest from the PRA in requiring firms to formally attest their compliance. This places a higher hurdle on implementation, and we are concerned about the use of the document as a checklist. The Committee helpfully accelerated its thinking to support industry implementation, and while clearly setting out supervisory concerns on IFRS 9, does not provide the precision necessary for a checklist basis for compliance.

Key issues raised by the document

1. Scope

The guidance is titled "Guidance on accounting for expected credit losses", but in fact covers both matters of accounting and risk practice. This creates a lack of clarity as to whether it is limited in

scope to accounting processes and measurement or it represents required and good practice in matters of credit risk management.

2. Proportionality and materiality

The document states that the guidance applies specifically to encourage a “high quality implementation” of IFRS 9, and to internationally active banks. However, while the document permits proportionality at a bank level (ie more simplistic approaches permissible for “less complex banks”), it does not make the same concession within organisations.

For RBS, adherence to the requirements would be appropriate in our large scale products (such as mortgages), but for other areas, meeting the full requirements will pose a considerable challenge (notably areas that are currently outside the scope of our IRB modelling, such as wealth management).

There is no reference to materiality. This creates a risk that a bank's management cannot apply suitable judgments as to the need for measurement across all areas of its book. This also would prevent organisations from concluding that sufficient work has been performed to establish a reasonable measurement of loss and that no benefit would arise from further analysis. We believe the Committee should explicitly state that the document recognises the accounting principle of materiality and its application.

3. Principle based approach

We are supportive of guidance and principles that enable banks to achieve an effective implementation of IFRS 9, even where these establish greater restrictions on a bank's ability to choose options available under the standard. As such, guidance should add to and enhance the material published by the International Accounting Standards Board. Where additional guidance confuses the material from the IASB, or is overly prescriptive, this purpose will not be achieved; this is unlikely to support the objective of the Committee in achieving a high quality implementation that promotes consistency across the industry.

The consultative document is very prescriptive in some areas; this “one size fits all” approach risks creating ineffective processes and could lead to management directing effort to the wrong aspects of credit risk, as well as diverting attention away from implementing new processes to develop an expected loss accounting model. For instance:

(a) Model development and validation

The document specifies organisational constructs that will not be consistently in place across banks, resulting in the potential need to change organisational construct. A better approach would be to specify key outcomes and allow banks to select the best constructs to achieve these. Specifically, it requires annual review of models to be undertaken solely by the validation team, rather than the development team; the assessment of model performance under stress; and expected loss outcomes to be assessed as part of model validation, rather than simply the PD and LGD measures.

(b) Underwriting

The document sets out what represents “inadequate” underwriting standards, when the objective is to highlight that the ECL framework should reflect underwriting standards; weaker standards would result in earlier deterioration triggers and higher losses. The reference to inadequate, as well as being prescriptive, actually hints at lending being inappropriate.

(c) Backtesting

Backtesting of economic scenarios themselves is not realistic or relevant. Instead, backtesting of PD and LGD models should be undertaken, and the correlation of economic indicators to loss drivers should be regularly reviewed and re-assessed.

We believe the document should establish key principles and then request management to evidence how they meet these, but allowing organisations flexibility in how they do this.

We note that for an integrated approach that combines effective risk management and accounting, the consequential volume of stage 2 exposures has relevance. Establishing criteria that move loans too quickly to stage 2 (especially where this is not linked to likelihood of actual default) is unlikely to result in equivalent changes in credit management. A successful IFRS 9 implementation will be where a bank applies additional credit management processes to reflect reported changes in credit risk. We are concerned that the Committee is setting the bar too low, which will result in a separated accounting process, where stage 2 is seen as an accounting construct with no relevance to credit management; this will not lead to the "high quality" implementation envisaged by the Committee.

4. Segmentation

IFRS 9 anticipates a greater level of segmentation in determining ECL calculations. The Committee has extended this by suggesting that they anticipate frequent re-segmentation, and also that collective portfolios cannot straddle stage one and stage two – with the premise that if the assets are genuinely homogenous then a sign of deterioration would impact all assets in the pool. While RBS anticipates creating a number of pools to undertake the calculation – taking account of geography (including region), industry grouping etc, it is not expected that frequent re-segmentation should be necessary and it is expected that stage classification will be split within a pool. We do not believe this would mask individual cases, and is particularly relevant when considering the impact of forward-looking macro information.

5. Expert credit judgment

The document appears to provide mixed messages on the need to prove linkage of macro- and forward-looking factors to loss and the need to exercise expert credit judgment. Expert credit judgement is critical in the evaluation of credit, and while due weighting should be applied to factors that have statistical relevance; this should not be to the exclusion of the former. The guidance should recognise the relevance of expert credit judgment and require that bank's establish and document clear governance as to how this credit judgment is applied to support a fair assessment of loss and in a manner that is consistent period to period.

In addition, we have set out detailed comments within the appendix.

We would be happy to meet to discuss our comments in more detail if this was considered helpful.

Yours faithfully



Rajan Kapoor
Financial Controller

Appendix

Detailed comments

Purpose and scope

The guidance is titled “Guidance on accounting for expected credit losses”, but in fact covers both matters of accounting and risk practice. This creates a lack of clarity as to whether it is limited in scope to accounting processes and measurement or it represents required and good practice in matters of credit risk management.

Paragraph 14 refers to different documents developed by the Basel Committee without indicating whether this guidance should be read instead of or alongside these documents. For the avoidance of confusion, we believe that the guidance should concentrate on accounting matters and refer readers to the relevant other documents for sources of appropriate practice in credit risk management.

Paragraph 11 highlights the intention for internationally active banks to apply this guidance. We would note that even within such banks, there will be smaller loan portfolios where it may not be fully appropriate to apply the same standards. As a point of comparison, RBS has loan portfolios that have IRB permissions as well as portfolios that do not. Reasons for not having IRB permissions include small portfolios where there is insufficient internal loss data/experience to support model development. We believe that the guidance set out should also recognise proportionality within internationally active banks.

The guidance makes no reference to materiality, which is a fundamental accounting concept. Just as proportionality applies to banks, so should materiality – with no requirement to apply the full guidance where the resultant ECL would be immaterial to the organisation.

Principle One: A bank’s board of directors and senior management are responsible for ensuring that the bank has appropriate credit risk practices, including effective internal controls, commensurate with the size, nature and complexity of its lending exposures to consistently determine allowances in accordance with the bank’s stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

RBS has no comments on this principle.

Principle Two: A bank should adopt, document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring the appropriate level of credit risk on all lending exposures. The robust and timely measurement of allowances should build upon those methodologies.

RBS supports the overall principle, but notes that the associated guidance becomes prescriptive and may not be suitable in all circumstances.

Paragraph 23 refers to the Basel Core Principle 17, but extends these definitions to include “all relevant information”. Principle 17 only establishes the requirement to have “continued analysis” of a borrower’s capacity to pay, and “timely and appropriate information of the condition of the bank’s asset portfolios”. We believe the proposal should refer to Principles 17 and 18 and highlight the need for these principles to be extended to include “information that is forward-looking”. To require analysis of all relevant information is not helpful without a clear articulation of “relevant” since this would be a matter of judgment – and would likely result in inefficient processes. We believe it would be appropriate to indicate that:

- “As a minimum, forward-looking information relating to both the individual customer (or collective portfolio) and macro-economic factors should be considered”.
- Additionally, it is appropriate that a bank “document how it concluded that the information considered was relevant”

We believe this better articulates how a bank makes appropriate judgments.

Paragraph 24 indicates that “while not an all-inclusive list, a robust and sound methodology...will” include 18 specific factors. This suggests that only if at least all 18 are met can a bank conclude it has a sound and robust approach. Given that banks will have portfolios of different sizes and materiality it is unlikely that all 18 factors would equally apply. We believe it would be better to indicate that sound practice would “typically include” such factors. We would also note that there is a difference between credit risk assessment and ECL measurement and the 18 factors would not equally apply to both.

Sub-paragraph 24(k) refers to the need to capture and hold data for “at least a full credit cycle” without providing any indication of how long a full credit cycle is. Again, we believe the focus should be that management are asked to rationalise their approach – and therefore would recommend that the requirement should be for the bank to document the suitability of the loss history applied.

We believe that there are significant differences in the approaches taken to credit risk management between wholesale and retail portfolios, and this distinction is not properly identified within the document. For instance paragraph 27 appears to be more relevant to commercial rather than retail lending.

Paragraph 29 requires that “a bank should document...how ECL is estimated in the period following that which is reasonably estimable.” RBS does not agree with this requirement, since if a bank is capable of a reasonable estimate, it cannot be the case that the time period is not reasonably estimable. It is clear that economic forecasts are typically of short duration, and lending will exceed these durations. However, we believe best practice will be to apply a long run view on economic growth (using either a consensus long-run GDP or a gilt-rate linked level). As such, it would be more appropriate for the Committee to either indicate that a long-run average growth rate is appropriate, or to stipulate an alternative, if it does not support the use of long-run average growth rates.

Paragraph 29 also requires “back testing” of appropriate factors and scenarios. We do not believe this is appropriate or even possible, since due to the complexity of economic growth (in-house forecasts cover in excess of 100 factors) there are multiple impacts on ECL and it would be near-impossible to fully isolate each factor and its contribution to ECL and variance against forecast. Equally, even if the bank did not determine the correct forecast economic indices (realistically a certainty) then we are not sure what the consequences would be and how back-testing helps this analysis. Instead, we believe the Committee should focus on the need to back-test PD and LGD model performance and continually review whether the bank is considering the most relevant economic indicators in considering impact on ECL.

Paragraph 31 sets out underwriting criteria. Given the stated purpose, we are unsure why detailed underwriting processes are stipulated, and would recommend that the Committee limits comment to the need for the bank to apply sound underwriting practice. The paragraph also refers to indicators of “inadequate underwriting practices” and it is unclear why such reference is made – since the factors noted indicate higher credit risk, but do not necessarily result in inadequacy.

Paragraph 32a refers to the fact that “the level of ECL should not decrease” as a result of restructuring. We believe this is not appropriate as a standalone statement. We recognise the concern about whether a period of satisfactory performance would apply in assessing the application of lifetime or 12-month ECL calculations and we would recognise that it is appropriate for a bank to consider carefully whether a modification should lead to a change in ECL – but do believe that in some cases it may be appropriate. This is often the case with loan extensions, since this has similarity with broader workout strategies, where the expectation is that shorter term enforcement process will result in a worse recovery outcome than a longer term strategy. Therefore, it is possible for a lower ECL, and a reduced Probability of Default, but we would agree that it is unlikely that the probability of default would return to its origination level.

Principle Three: A bank should have a process in place to appropriately group lending exposures on the basis of shared credit risk characteristics

The guidance is unclear as to whether this principle relates to credit risk management or to ECL assessment and measurement. If the former, we would agree. If the latter we would not entirely agree. IFRS 9 requires assessment to be made either at individual or collective level, with consideration being given under either approach as to whether ECL is complete. Therefore, in an accounting context, it is not necessary to group lending where individual assessment is applied.

We further note that paragraphs 33-42 do not relate to this principle but instead talk about the design of credit rating systems and we are not sure whether they should be included. We disagree with the wording of paragraphs 34, and 37-42 and believe that this overall section should be removed from the guidance. Principle 2 already addresses credit risk assessment, and some of the ECL specifics are better addressed in the appendix.

Paragraph 44 suggests a need for frequent re-segmentation. We would note that supervisors already acknowledge bank approaches to portfolio segmentation as part of IRB permissioning, and we would prefer consistency of approach. We are supportive of a requirement that expects checks to be performed on whether asset pools remain homogenous and to actively consider whether pools lose shared characteristics.

Paragraphs 46 & 47 suggest that a single homogenous pool of assets cannot have elements calculated under 12-month ECL and lifetime ECL – and therefore that a single pool of assets cannot be split across stage 1 and stage 2. We believe this is inconsistent with IFRS 9, which on publication included a worked example that did indeed split across stages. The IFRS 9 worked example (Example 5, Region 3) shows a split of a portfolio between stage 1 and stage 2 due to the expected impact of a future change in interest rate. Moving a portion of this portfolio to stage 2 recognises an appropriate assessment that for some of the portfolio there is heightened risk but that for some of the portfolio there is no change. Re-segmentation does not achieve this.

Principle Four: A bank's aggregate amount of allowances, regardless of whether allowance components are determined on a collective or an individual basis, should be adequate as defined by the Basel Core Principles, which is an amount understood to be consistent with the objective of the relevant accounting requirements.

Paragraph 49 states: "This requires that banks identify as early as possible any changes in credit risk and report increases in credit risk through the allowance account." We believe this is inconsistent with IFRS 9. IFRS 9 highlights that the changes in accounting will result in earlier recognition *in comparison* to IAS 39, but does not itself require the earliest possible recognition. Rather, the standard is based upon appropriate measurement based on relevant information and data, and would be timely rather than early. We do agree that the measurement of ECL for any individual exposure is not static since PD will continually move.

Principle Five: A bank should have policies and procedures in place to appropriately validate its internal credit risk assessment models

Paragraph 57 states that the "use of models requires extensive judgment". We disagree with this statement. We agree that the development of models requires extensive judgment, but the application of models is mechanistic. The outputs are used by credit officers who must also bring extensive judgment to individual customer credit risk assessment.

Paragraph 58 identifies a requirement for Board sanction. We do not believe this should be included in this section, since the role of the Board is properly set out in Principle 1. As such, we believe that this section should refer to what good practice looks like for senior management.

Paragraph 58 is highly prescriptive, and as such, is inconsistent with a statement of principles. As such, we do not believe that all the matters covered in paragraph 58 are suitable, and we would prefer the paragraph to be simplified through reference to key points:

- A documented overarching governance framework that clearly establishes the role of model validation
- Formally defined roles and responsibilities for model validation, including articulation of the necessary skills required for these roles
- Written policies for the oversight and control of model validation process, including how the effectiveness of the function is assessed and how model validation actions and findings are implemented
- The need for periodic reporting to relevant Board committees

We note that as drafted, there is significant overlap with model development functions (eg the need for both to document the model) which we believe are unnecessary and are better addressed in the roles and responsibilities that a bank documents. In a normal business context, we believe that model validation is not the sole determinant of suitable changes to models. It is appropriate that validation identifies when a model is no longer operating effectively, but a suitable split of responsibility would allow for a development function to also perform this role, with suitable challenge from validation.

Paragraph 58 indicates that stress testing be used to assess model performance. We disagree since we do recognise that model performance can differ between gradual economic environments and stress environments. Separate activities should identify portfolio performance under stress and model documentation should establish the expected ranges where model performance would be reliable.

Principle Six: A bank's use of experienced credit judgment, especially in the robust consideration of forward looking information that is reasonably available and macroeconomic factors, is essential to the assessment of expected credit losses.

Paragraph 60 is unnecessary.

Paragraph 61, which states "Banks must demonstrate that the forward-looking information selected has a link to the credit risk of particular loans or portfolios", suggests that banks should only use information where a proven historical relationship exists. It then states a "bank's experienced credit judgment will be crucial" in assessing ECL where there is no strong link. It would be preferable to state that banks should, as a minimum, include forward-looking information where proven historical relationships exist. Additionally experienced credit judgment should consider additional indicators of credit risk for factors that are not already covered through underlying modelling and measurement processes.

Principle Seven: A bank should have a sound credit risk assessment and measurement process that provides it with a strong basis for common systems, tools and data to assess and price credit risk and account for expected credit losses

No comments.

Principle Eight: A bank's public reporting should promote transparency and comparability by providing timely, relevant and decision-useful information

It is unclear how this section has relevance to the wider purpose of the document, being guidance on accounting for expected credit losses. The specific comments contained in paragraphs 72-81 duplicate some of the requirements that already exist within IFRS 7 (as amended by IFRS 9), or under the framework of the EDTF.

Principle 8 as it stands is broader than just ECL, and as such we believe it may be adequately reflected by Basel Core Principle 28. A comment that it would be expected that it was considered that Principle 28 would apply to appropriate disclosure on how a bank has established ECL would be appropriate.

Principle Nine: Banking supervisors should periodically evaluate the effectiveness of a bank's credit risk practices

No comments

Principle Ten: Banking supervisors should be satisfied that the methods employed by a bank to determine allowances for accounting purposes produce a robust measurement of expected credit losses under the applicable accounting framework

We believe the principle needs to be amended to state: "Banking supervisors should be satisfied that the methods employed by a bank to determine allowances for accounting purposes are robust, and produce a reasonable measurement of expected credit losses under the applicable accounting framework." We note that robust is a term that, in the context of accounting, has relevance to the design and operation of systems and processes, but does not have relevance or meaning in terms of measurement. Measurement is typically expected to be reasonable, given the judgment applied, and for which materiality has relevance. It is unclear how the Committee would consider materiality and robust relate to each other.

We note that paragraph 84(e) should better read: "regardless of the method used to determine ECL, the bank's internal processes for measuring ECL take full account of the credit risks that the bank has taken on."

Principle Eleven: Banking supervisors should consider a bank's credit risk practices when assessing a bank's capital adequacy

This section is a comment on the interaction of credit risk management with capital adequacy rather than how an accounting ECL measurement interacts with the capital measurement. The document has already highlighted that there are "fundamental differences" between accounting and regulatory frameworks and that banks should document and explain differences that apply. Therefore, while the principle has broad relevance, it is unclear how it applies to a framework of accounting measurement.

Paragraph 89 states: "When assessing capital adequacy, supervisors should consider how a bank's accounting and credit risk assessment policies and practices affect the quality of the bank's reported earnings and, therefore, its capital position." Since, regulatory requirements already adjust to account for specific measurement of credit loss that would automatically create additional capital deductions where the regulatory measure exceeded an accounting measure; it is not clear what further process would be required. We would support the principle that a bank can articulate the differences between its accounting and regulatory measures, but this appears to have been adequately addressed elsewhere in the document.

Appendix

1. Loss Allowance at an amount equal to 12-month ECL

Paragraph A1 states that “a bank will measure ECL for all lending exposures, and that a nil allowance will be rare.” We would note that while a PD of zero should not arise, we would note that it is possible for LGD to be zero for highly collateralised positions. Additionally, since accounting takes account of materiality, the issue is whether the overall calculation of ECL is materially accurate.

Paragraph A2 states that “The methodology used to estimate 12-month ECL should be robust at all times and should allow for the timely build-up of allowances.” We do not support the idea that ECL measurement would allow for the timely build-up of allowances, which we do not believe is consistent with IFRS 9. We support the idea that the measurement of ECL will continually reflect changes in the probability of default but this is not the same as “timely build up”.

Paragraph A5 sets out the regulatory definition of default, and suggests that this list should be supplemented by additional criteria, such as willingness or ability to meet contractual obligations. We would note the characteristics that demonstrate heightened credit risk are not themselves matters of default (stage 3) but relate to transfer to stage 2. Overall, we believe that the definition of default should broadly align, though we note that the current regulatory definition is circular in the context of IFRS 9 (eg the booking of impairment is a default event), and the days past due criteria will differ with IFRS 9 having only a 90-day window against some regulatory windows of 180-days.

2. Assessment of significant increases in credit risk

We note that IFRS 9 is silent on the definition of significant increase in credit risk. We note that the Committee has not identified guidance on items that would and would not be significant which would be more helpful in enabling banks to narrow the definition of significance to a more industry-wide standard. We note that much of the comment here on credit risk assessment is already covered within the specific 11 principles.

Paragraph A15 notes that “any post-origination increase in credit risk is unlikely to be fully compensated by the interest rate charged.” We disagree with this statement, since pricing is often banded, meaning that small changes in credit within a cohort would not change pricing. Equally, for many products pricing is subject to internal thresholds – with rejection only triggered if lending margin is not above a determined level. We note that IFRS, in its basis of conclusions (paragraphs BC5.93 and 94) that it considered the move to lifetime measurement was to reflect a significantly greater expectation of economic loss, and not simply to reflect a move away from initial expectation of credit risk.

IFRS 9 is clear that a loan (or portfolio) should be considered in stage 2 where it meets the definition of “significant increase in credit risk.” Equally it is clear that if this definition is not met, then the item is in stage 1. This does not allow for a “cure” period (paragraph A44). We support the idea that to be in stage 1 that there must be a history of performance, but in keeping with the approach that (essentially) two missed payments on a credit card (ie c30 days past due) must indicate that such an increased risk exists, so 2 subsequent on-time payments would be sufficient to unwind this. Consequently, we believe that the definition of significant increase in credit risk must include a description of how a bank defines adequate “performance” on a loan. If properly defined then the boundary between stage 1 and stage 2 is clear.

Paragraphs A26 and A27 relate to the specific criteria against which to consider significant increases in credit risk. We would note that these seek to cover both retail and wholesale exposures. As a consequence, it is not possible to apply all 16 categories to every exposure (and indeed it may be unnecessary as a matter of policy – eg IFRS 9 B5.5.17 (c) on CDS spreads is unlikely to ever apply to a retail population). However, we believe it is appropriate for a bank to document how it uses each of the 16 categories within its methodologies and approaches. We note that the Committee then highlights a subset of 6 of these 16 categories in paragraph A27 and it is unclear why it does so given the wording of A26. The focus on these might suggest that the remaining 10 categories are not relevant or of much less relevance – we do not believe it is helpful to a high quality implementation to restrict a bank’s approach in this way.

Footnote 33 to paragraph A27 should be removed since this is not consistent with IFRS 9, and by introducing a specific rebuttable presumption, would require all credits to be moved to stage 2 if there was any change from the day one view. This is not consistent with a proper measure of "significance". We believe IFRS 9 is clear (in its basis of conclusion) that while a read across to pricing had relevance in credit assessment, it could not be solely tied to it.

In general, we do not support the Committee's approach to fixing a view of significant increase in credit risk to a one-notch (or less than one-notch) movement in assigned internal credit rating, especially given the variety of ranges in existence currently. Such a stipulation would encourage banks to reduce the granularity of their rating scales. We believe that banks should establish appropriate frameworks that relate changes in credit risk to a quantifiable scale that take account of the potential significance of movements between credit gradings; these would then be supplemented with additional qualitative factors.

We would also note (paragraph A29) that ageing impacts PD ("survivability") – with experience showing that low PDs migrate to higher PD over time, and higher PDs will migrate to lower PDs. Therefore the assessment would compare the current period point-in-time PD with the appropriate point from the origination term structure. If a PD has deteriorated in line with the originally expected term structure, then this is not a "significant increase in risk", but equally if a PD is static but should have improved then there may have been such an increase.

3. Use of practical expedients

We would note that the purpose of practical expedients is to avoid incurring undue cost and effort for changes in ECL that are either immaterial, or which have reduced relevance to users. However, we note the Committee's preference that internationally active banks should carefully consider whether they need to make use of these expedients.

