THE RISK MANAGEMENT ASSOCIATION

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Via Upload to http://www.bis.org/bcbs/commentupload.htm

Bank for International Settlements
Centralbahnplatz 2
4051 Basel
Switzerland

Re: Consultative Document, Guidance on accounting for expected credit losses (the "BCBS Guidance Document")

Dear Sir/Madam:

This letter is submitted by The Risk Management Association in respect of the BCBS Guidance Document issued for comment in February 2015. The purpose of the BCBS Guidance Document is to "set out supervisory requirements on sound credit risk practices associated with the implementation and ongoing applications of expected credit loss (ECL) accounting models."

The Risk Management Association ("RMA") is a 501(c) (6) not-for-profit, member-driven professional association whose sole purpose is to advance the use of sound risk management principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, and operational risk. Headquartered in Philadelphia, Pennsylvania, RMA has 2,600 institutional members that include banks of all sizes as well as nonbank financial institutions. They are represented in the Association by more than 16,000 risk management professionals who are chapter members in financial centers throughout North America, Europe, and Asia/Pacific.

One of the most important components of RMA's mission is to provide independent analysis on matters pertaining to risk and capital regulation. In this regard, the comments contained herein are informed by subject matter experts from member institutions of the Association, including members of RMA's ALLL Round Table. Please be advised that this letter does not necessarily represent the views of RMA's institutional membership at large, or the views of the individual institutions whose staff have participated in the ALLL Round Table.

Background

The majority of domestic US banks are not subject to Basel regulatory capital reporting standards. Those that are subject to Basel standards are also of a material size such that they are subject to Comprehensive Capital Analysis and Review ("CCAR") and Dodd Frank Act Stress Testing ("DFAST") requirements. While RMA generally is in agreement with the 11 principles identified in the BCBS Guidance Document, RMA is concerned that the implementation of such principles, as generally applied to domestic banks in the United States, may not be practical or efficient in all respects, because implementation decisions may create disparity in financial statement presentation, due to, among other things, (i) the assumption that US banks will leverage their Basel models and the effective backtesting framework for life of loan models; (ii) the lack of meaning for the Basel ECL to Accounting ECL required disclosure given the variance in definitions; and (iii) the provision regarding credit risk grading systems vis-à-vis forward looking information should better reflect the actual use of the risk grades in the overall ECL estimates.

Accordingly, RMA appreciates the opportunity to comment on the BCBS Guidance Document.

Larger financial institutions traditionally employ models to estimate credit loss in connection with the following:

- Allowance for Credit Losses ("ACL"): ACL processes estimate incurred or inherent loss in the portfolio employing a commercial and a retail portfolio methodology. For individually risk rated commercial loans, expected credit loss (PD x LGD x EAD[1]) models (adjusted for accounting loss recognition and realization purposes) are traditionally employed. For homogenous pooled retail portfolios, more simplistic forecasted loss coverage models (roll rate, loss regression, expected loss) are utilized with and without forward looking economic variables. As the Financial Accounting Standards Board ("FASB") rolls out their its Current Expected Credit Loss ("CECL") impairment guidance, models or methodologies that can estimate lifetime loss will be required; however, the FASB has not prescribed modeling approaches recognizing the breadth of banks subject to this guidance.

- Stress Testing: Stress Testing processes estimate charge-offs over a forecasted nine-quarter horizon. Bank Holding Companies ("BHCs") have been encouraged to develop for-purpose sophisticated loan level models which are statistically sensitive to forecasted economic variables. They specifically indicate that "By design, estimates based on long-run average behavior over a mix of conditions, including periods of economic expansion and downturn, are not appropriate for projecting losses under stress and should not be used for these purposes.[2]"

- Basel: Basel Advanced Measurement Approaches models have traditionally employed expected loss models using a one year PD window and downturn LGD and EAD with the downturn period defined by the number of defaults. Commercial models do not typically utilize forward-looking economic variables, while more sophisticated retail models employ forward-looking economic variables to achieve a point-in-time ("PIT") PD which is then neutralized to a through-the-cycle (TTC) PD.

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[1] Probability of Default or "PD"; loss given default or "LGD"; and exposure at default or "EAD."

[2] Source: Capital Planning at Large Bank Holding Companies: Supervisory Expectations and Range of Current Practice

Comments

While the FASB has not yet finalized its impairment document, there are certain implementation considerations that will be impacted by this BCBS guidance as well as certain assumptions in the BCBS guidance with which we do not agree.

- *Domestic US Banks will start with their BASEL A-IRB models when estimating current expected credit losses under Generally Accepted Accounting Principles (GAAP).* RMA respectfully dissents, noting that it is far more likely that larger US domestic banks will commence CECL implementation by leveraging their more sophisticated economically sensitive stress test models. Unlike European banks, relatively few domestic US banks are subject to the Basel Advanced Internal Ratings Based ("A-IRB") regulatory capital requirements. In fact, only eight banks today have been approved to exit the parallel year with their A-IRB approaches. Paragraph 8 indicates that "The measure of expected losses for regulatory capital purposes may be a starting point for estimating ECL for accounting purposes." While the BCBS Guidance Document recognizes that adjustments to the model and methodologies will be required for the 12-month PD and downturn LGD, the remaining paragraphs tend to assume that this is the implementation starting point. This assumption is further supported in the disclosure requirements in paragraph 78 which provides that, "The Committee expects banks to disclose similarities and differences in the methodology, data and assumptions used in measuring ECL for accounting purposes and expected losses for regulatory capital purposes." Given the fact that most US banks don't have A-IRB models and those that do are reporting regulatory capital using the standardized approach which appears to be the more restrictive capital requirement at this point in the credit cycle, this disclosure requirement becomes challenging, at best, and more likely is meaningless when compared against life of loan impairment estimates required under the draft CECL impairment approach advocated by the FASB. Thus, it is far more likely that the larger domestic US banks will begin CECL implementation leveraging their more sophisticated economically sensitive stress test models.

- *Banks subject to the same accounting framework will have consistent interpretations and practices resulting in comparable estimated results*. In paragraph 3 of the BCBS Guidance Document, express recognition is given to the lack of convergence in impairment accounting principles between the FASB and the International Accounting Standards Board ("IASB"), however, the BCBS Guidance Document also provides that one of its objectives is "…to drive consistent interpretations and practices, where there are commonalities and when the same accounting framework is applied." The BCBS has seen a very wide breadth of implementation practices in the advanced measurement approaches regulatory capital frameworks despite best efforts to bring the judgment applied to the various advanced measurement approaches into a narrow range. This wide range of acceptable practice is seen for regulatory capital with highly structured specifications and only applies for a one-year PD period. RMA respectfully disagrees with the assumption that domestic banks will have consistent interpretations and practices given the meaningful interpretative implementation requirements regarding the CECL impairment methodology. The lack of comparability between domestic US banks is supersized using lifetime estimates. The FASB has specifically maintained flexibility for banks in estimating lifetime loss estimates. Examples where the lack of comparability will occur include:

- No specific modeling approach is prescribed;
- No definition of "lifetime" for select portfolios or products is provided;
- Prepayments may be considered in the estimates but renewals may not; and
- Forward-looking indicators should be assessed for a reasonable time period but then either the forward-looking indicators or the loss rates should "revert to mean." Neither "reasonable time period" nor "revert to mean" application is defined.

- *Purchased Credit Impaired ("PCI") and Troubled Debt Restructuring ("TDR") accounting policies will remain intact.* As noted in paragraph 32 of the BCBS Guidance Document, "a bank's allowance methodology should include accounting policies related to the assessment and measurement of ECL to include criteria for (a) restructurings/modifications of lending exposures and (b) the treatment of purchased or originated credit-impaired lending exposures." One of the benefits of the CECL model was to move away from multiple impairment approaches. By migrating to lifetime loss estimates for the entire portfolio, the difference in impairment estimation and accounting for PCI and TDR portfolios is muted.

- *Banks will be able to disclose the quantitative impact on changes in forward looking indicators on their ECL estimates.* As noted in paragraph 76 of the BCBS Guidance Document, "(t)he Committee expects banks to provide qualitative disclosures on how these have been incorporated into the estimation process and quantitative information on how changes in forward-looking information and macroeconomic factors have affected ECL estimates." Disaggregating changes in lifetime ECL will be challenging particularly for smaller banks with less sophisticated modeling or loss estimation techniques. In some cases, this will be nonexistent.

- *Changes for forward looking indicators will be apparent each quarter.* Per discussion with the FASB, forward looking indicators should be considered when the current environment is not reflected in the reference data. One implementation consideration is ECL estimates in benign credit times may be held to historic averages so as to avoid meaningful volatility in financial statement reporting. Only where forward-looking indicators are not reflected in the historic reference data should they meaningfully impact the ECL estimates. This is another area where implementation decisions will create disparity in financial statement presentation and challenge comparability.

- *Lifetime loss models have an effective framework for backtesting.* Paragraph 29 of the BCBS Guidance Document indicates "backtesting should be performed to ensure that appropriate factors are considered and incorporated, in light of historical experience."

The backtesting of lifetime models is a relatively new science and proves to be quite challenging. In sample backtesting can be used for model development, but lifetime loss models traditionally do not perform well at the timing realization of loss for effective out of sample testing and backtesting. They tend to perform well over longer periods of time.

- *A credit risk rating system should ensure that a bank incorporate forward-looking information into its…risk rating process.* While paragraph 37 of the BCBS Guidance Document states this, we think that the Committee intended to state in this paragraph that a credit risk rating system, as a key building block for wholesale ECL estimates, should allow a bank to incorporate forward-looking information and macroeconomic factors into its perimeter estimates used for ECL. As currently stated, the paragraph could be interpreted to mean that each individual risk rating should be assigned using the exact same forward-looking information and macroeconomic scenarios that inform the ECL estimate. This would prevent the consideration of the full spectrum of risks unique to that individual credit when assigning a risk rating. This would also lead to rating migration when scenarios change but there is no change in the payment capacity of the borrower.

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Should there be any questions concerning the comments reflected above, kindly contact William G. Loftus, Director, Credit Risk at (215) 446-4193 or bloftus@rmahq.org.