Ref 509014

Mr Stefan Ingves
Chairman,
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland
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Email: baselcommittee@bis.org

Dear Stefan

SAICA SUBMISSION ON THE BASEL COMMITTEE CONSULTATIVE DOCUMENT: GUIDANCE ON ACCOUNTING FOR EXPECTED CREDIT LOSSES

In response to the Basel Committee on Banking Supervision's request for comments on the *Guidance on accounting for expected credit losses*, the Banking Project Group of the South African Institute of Chartered Accountants (SAICA) hereby provides comments attached as Appendix A. This comment letter results from deliberations of the BPG sub-committee, which comprises members from the banking industry and auditors.

Please do not hesitate to contact us should you wish to discuss any of our comments.

Yours faithfully

Azim Omar
Executive Director: Members and Global Alliances

cc: Johannes Grosskopf (Chairman: SAICA Banking Project Group)

cc: Tshegofaco Rametsi (SAICA Project Director: Financial Services Regulatory)

Appendix A - SAICA SUBMISSION ON BCBS GUIDANCE ON ACCOUNTING FOR EXPECTED CREDIT LOSSES

We welcome the opportunity to comment on the Guidance and support the Basel Committee's overall objective to ensure a high quality and consistent implementation of an Expected Credit Loss ('ECL') accounting model in accordance with the applicable accounting framework. Our comments mainly focus on practical difficulties in an African and emerging markets context as well as potential clarifications that are required. The most significant points have been set out below. Other matters have been included in the attached Appendix.

Clarification of the scope of the Guidance

International Financial Reporting Standards 9 *Financial Instruments* (IFRS 9) introduces a new ECL accounting framework for measuring and disclosing ECL in the financial statements of entities reporting in terms of IFRS. Our view is that the scope of the Guidance should focus on the implementation of an ECL model under IFRS 9 and should not introduce additional requirements or contradict the requirements in IFRS 9.

In addition the Guidance should not extend to providing guidance on broader credit risk management practices which do not impact the determination of ECL. While the BPG agrees that such guidance on sound credit risk practices is useful, we do not believe this to be the purpose of the Guidance.

Furthermore, the instruments and portfolios subject to the Guidance is ambiguous. We recommended that the scope of the Guidance be consistent with that of IFRS 9. Specifically, paragraph 13 states that the Guidance covers credit risk practices for lending exposures that are subject to the recognition of loss allowances with such loss allowances being for loans, loan commitments and financial guarantee contracts. That paragraph further states that the credit risk practices of other exposures, such as debt securities, are excluded from the scope of the Guidance. The term 'debt securities' is not defined by the Guidance and according we recommend that such a term is defined to clearly understand how the scope of the Guidance interacts with that of IFRS 9 and how to differentiate between exposures that are 'lending exposures' and those that are 'debt securities'. It is further questioned whether the Guidance intends to exclude portfolios of assets carried at fair value through other comprehensive income (FVOCI).

Additional disclosure created by Guidance

The BPG is of the view that the disclosure requirements contained in IFRS 9 are comprehensive and will promote transparency and comparability (Principle 8). The Guidance should therefore not introduce additional disclosure requirements not contained in IFRS 9, or where such additional disclosure is introduced, it should be through a formal framework such as Basel Pillar 3 disclosure requirements. Any consideration for further disclosures should be carefully considered in light of the International Accounting Standards Board's (IASB) disclosure initiative.

Definitions conflicting with IFRS 9 or not sufficiently defined

As the Guidance aims to aid the implementation of an ECL model under IFRS 9, we believe the Guidance should use definitions which are consistent with IFRS 9 and other terms defined in IFRS. Examples of where the definitions are inconsistent with IFRS 9 have been included in Appendix B.

Where the BCBS wishes to introduce terms not defined in IFRS, we suggest a glossary of definitions be provided. However, we would recommend that this be limited to the minimum.

Proportionality and materiality of application of Guidance

A number of South African banks have operations across the African continent and face challenges of product sophistication, client diversification, quality and availability of historic and forecast loss data (including for a full credit cycle), scarcity of skills in certain locations, availability of observable forecast macroeconomic variables, system capabilities (both in terms of existing and future state), and the potential for diversity in views and application of requirements from different country regulators (including divergence between accounting and other regulatory requirements).

The Guidance indicates in paragraph 12 that "*For less complex banks, consistent with the Basel Core Principles, the Committee recognises that supervisors may adopt a proportionate approach with regard to the standards that supervisors impose on banks and the conduct of supervisors in the discharge of their own responsibilities.*"

The BPG recommends that the Guidance clarifies that such a proportionate approach could be applied by complex banks or banking groups, which operates in challenging environments as detailed above. In considering the application of the proportionate approach, the bank or banking group would take into account the size (including materiality), nature and complexity of a bank's lending exposures.

In addition, clarification is requested as to whether complexity as referred to in paragraph 12 of the Guidance is to be determined on a consolidated banking group basis, an individual bank legal entity basis or a portfolio and/or product basis. We recommend that such a determination should be made based on individual products and/or portfolios basis as opposed to the consolidated banking group basis, due to the diverse product sets large banking groups operate. By determining complexity at this level, subsidiary products and portfolios which are determined within a banking group to be less complex, would be able to apply the proportionate approach in determining ECL, and the banking group would be able to utilise this determination within the consolidated group on the same basis.

The BCBS should note that practically a number of the functions involved in determining ECL that the Guidance refers to (e.g. model validation), would be implemented as group wide functions located at a head office/group level, often due to scarcity of specialist resources in a specific entity or jurisdiction, as well as process optimisation. These central functions would apply a proportionality approach in determining the complexity of ECL functions such as model development and governance used in determining ECL, and could operate both sophisticated and simple ECL models for similar product types depending on the materiality and environmental factors for the portfolio as detailed above.

We also recommend that the Guidance should include a concept of materiality with regards to the application of the standards, consistent with the definition of materiality in International Financial Reporting Standards (IFRS).

Credit Risk Experience

Paragraph A7 states that "…a bank must be able to demonstrate that these exposures *have not* experienced a significant increase in credit risk since initial recognition." This statement appears to conflict with IFRS 9, which focuses on exposures that *have* experienced a significant increase in credit risk.

The BPG is of the view that the guidance in paragraph A7 of the Guidance presumes all exposures have experienced a significant increase in credit risk since initial recognition, unless the bank can prove otherwise. The BPG believes this would be inconsistent with the principles and approach in IFRS 9.

Significant credit deterioration and compliance with IFRS 9

The list of significant credit deterioration requirements in the Guidance (e.g. A27, see below) has the potential to result in the recognition of a lifetime expected loss impairment when there has not been a significant increase in credit risk. To ensure compliance with IFRS 9, increases in credit risk which are not significant should not result in the recognition of lifetime expected losses.

Paragraph A27 provides a list of factors indicating whether a there has been a significant increase in credit risk. The BPG believes that a list of factors may drive a more rules based approach rather than a principal based approach as envisioned by IFRS 9. We recommend that clarification be provided that the list of factors is illustrative rather than prescriptive, and an entity should apply judgment to the specific facts and circumstances.

Frequency of re-segmentation

The Guidance suggests that the grouping of exposures should be re-evaluated and exposures should be re-segmented on a frequent basis, i.e. when new information is received or a bank's expectations of credit risk have changed. Although we agree with this principle, we believe that where a bank has appropriately segmented its portfolio upon initial recognition as required by IFRS 9, the re-segmentation thereof would happen fairly infrequently and would be driven by changes in the portfolio over time or unexpected or unforeseen events not anticipated at inception.

It is the BPG's view that the frequency of re-segmentation will largely be driven by what factors have been incorporated into the bank's probability of default (PD) models. Where the bank's PD models incorporate macroeconomic factors there will be less of a need to re-segment portfolios as the change in PD will already incorporate new information and changes in the bank's expectations of credit risk.

We recommend that the Guidance does not introduce a required frequency for re-segmentation nor suggest that re-segmentation must occur on a regular frequency. In addition, the concept of materiality should be introduced in determining whether new information or changes in expectation should result in re-segmentation as not all new information or changes in expectation will have a material impact on ECL.

In addition, the BPG does not agree that in all instances the entire relevant group or subgroup will transfer to life time loss measurement of ECL as contemplated in paragraph 47. We see the event of a whole portfolio or sub-portfolio transferred to lifetime loss measurement being a very rare occurrence. IFRS 9 paragraph IE39 provides an example where only a percentage of a group is deemed to have had a significant increase in credit risk. We recommend that the Guidance be aligned with IFRS 9.

Appendix B- DETAILED RESPONSE TO BASEL GUIDANCE ON ACCOUTNING FOR EXPECTED CREDIT LOSSES ('GUIDANCE')

OTHER MATTERS	
Observation	**Proposed solution**
Clarifications of definitions: Concerns were raised over the meaning of certain terms, in particular:	
1) Definition of default	1) The definition of default should be aligned with that of IFRS 9.
2) Notches/ one-notch downgrade (Paragraph A29 and A32)	2) We recommend that this term be further explained as to what is meant or considered a "one-notch downgrade" in the context of accurately measuring the drivers of a significant increase in credit risk. In many instances a one-notch downgrade will not be regarded as a significant deterioration of credit risk as envisaged by IFRS 9.
3) Full credit cycle	3) Paragraph A24(k) refers to "sufficient historical loss data for at least a full credit cycle be maintained,". The BPG believes that this requirement should take availability of data into consideration. Further guidance as to what is reflective of a full credit cycle should also be specified, especially for new products or emerging markets.
4) Experienced credit judgment	4) References are made to "experience credit judgment" in a number of paragraphs, however is it not clear as to what constitutes experienced credit judgment, or if this should be defined by the bank. The BPG believes that clarification should be added to the document in this regard.

Deterioration of internal credit ratings Paragraph A32 suggests that deterioration in internal credit ratings will always be considered as a significant increase in credit risk.	The BPG does not believe the deterioration as a result of a change in internal credit risk grade will always be significant in terms of its meaning from an IFRS 9 perspective, as alluded to in the guidance. Internal credit ratings could change for reasons other than significant changes in credit risk, for example recalibration of internal rating scales.
Rebuttable presumption regarding increase in the credit spread Footnote 33 indicates banks should adopt a rebuttable presumption that any increase in the spread that would be charged for a particular loan is due to an increase in the bank's assessment of the credit risk of that exposure. We are of the view that a number of factors influence pricing, for example liquidity spreads, the changes of which are not always apparent. In particular, spreads in Africa and other emerging markets are in many instances unobservable or very volatile driven by many factors other than an increase in credit risk.	We recommend that the rebuttable presumption be removed.
Annual model validation Paragraph 57 requires regular (at least annual) model validation is required. It is our view that for less material or simple models annual model reviews may not be appropriate. In addition, any guidance given in this regard should be principle based to align with the accounting standard.	The scope and depth of a model review should be proportionate to the level of risk and materiality of the exposures that those models serve. Appropriate controls should be implemented by the entity to determine if more frequent model reviews is necessary.

Delinquency data Paragraph A22 notes that the committee believes delinquency data will seldom be appropriate in the implementation of an ECL approach by banks. This appears to be inconsistent with IFRS 9 par. B5.5.3 In practice, South African banks are of the view that delinquency data, together with a portfolio segmentation analysis will need to be applied for certain retail products, as there may not be other reliable or accurate data available. Further, some quantitative studies have indicated that there is little, if any, additional benefit that other forms of data would provide as compared to the use of delinquency data. In some regions or countries, the only source of accurate and reliable data is delinquency data as other sources of information do not exist or are unreliable/inaccurate.	 Remove reference to "seldom be appropriate."
Data considered should be accurate and relevant Paragraph A26 states that *"….and in addition to consider whether there is further information that should be taken into account*". This suggests that all information available should be taken into account. In certain African jurisdictions even though forecast data (such as GDP or Interest rate forecasts) may be available, the information may not be proven to be accurate or relevant. Judgment may need to be applied in this determination.	 We suggest that the statement be clarified that only further information that is available, accurate, and relevant should be taken into account.
Collective assessments are not always required Paragraph A35 to A36 suggests that a bank is always required to perform a portfolio evaluation where a group of exposures have experienced a significant increase in credit risk. This appears to conflict with IFRS 9.	 In terms of IFRS 9 B5.5.1.a collective assessment *may* be necessary. Collective assessment is not always necessary when it is possible to perform the assessment at an individual exposure level. We recommend that the Guidance is aligned to IFRS 9.

Accounting for upside of forward looking information The focus of the Guidance is on accounting for the negative impact of forward looking information. The Guidance does not address the impact of positive forward looking information.	We would recommend that the Guidance be more explicit that in calculating ECL both the upside and positive impact of forwarding looking information should be considered and recognised in the determination thereof.
Practical expedients The Guidance limits the acceptable methods or choices available to a bank when implementing IFRS 9 even though these methods or choices are acceptable under IFRS 9. An example is the limitation of the use of practical expedients. Paragraph A48 notes that the use of practical expedients by the banks would require additional documentation and attract increased scrutiny by supervisors. In some cases the use of practical expedients would be necessary. In particular Paragraph A60 notes that there is an expectation that banks will not fall back on the 30-day rebuttable presumption. For many regions and/or products this will be an important consideration and the only available information to assess whether there has been a significant deterioration in credit risk. This links in with our comment regarding the proportionality of application. The members of the BPG from the audit profession noted that they would not be able to object (e.g. by qualifying their audit report) to the appropriate use of a practical expedient or a method of assessing credit risk that is specifically allowed by IFRS 9.	The use of practical expedients is in terms of IFRS 9 and the use thereof should not be limited by the Guidance. To disallow the use of such expedients could comprise an entity's compliance with IFRS and the ability for an auditor to opine appropriately thereon. We recommend that banks be able to apply practical expedients and exercise judgment in the application thereof considering the characteristics of the portfolio and the availability and relevance of information to support management of the portfolio.

Documentation Paragraph 24 requires extensive documentation, maintenance, and review of written policies and procedures in implementing this principle due care, reasonableness and relevance should be exercised. The Guidance's reference to 'extensive' is suggestive of volume of documentation rather than relevance. We believe that the documentation should however be regarded as appropriate in terms of the complexity and materiality of the models.	We recommend that this guidance not be prescriptive but rather emphasise the principle that appropriate documentation be maintained.
Transition The Guidance is not clear on how it applies on transition.	The Guidance should clarify that the transitional exemptions provided for IFRS 9 would also be applicable to the Guidance.
General wording Some concepts in the document are repeated and consistent terms are not used.	The BPG suggest considering combining sections, for example, having a single section on forward looking information and segmentation, respectively. We recommend that consistent terms are used throughout the document and where necessary should be defined (where not already defined in IFRS 9).