Position Paper
On Basel Committee's Proposal on

"Guidance on accounting for expected credit losses"

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VDA | Verband der Automobilindustrie

AKA Arbeitskreis Autobanken

The German Association of the Automotive Industry (Verband der Automobilindustrie – VDA) and the Association of Banks and Leasing Companies of the Automotive Industry (Arbeitskreis Autobanken – AKA) represent the automotive industry including its credit institutions, the so-called Finance Captive Companies, belonging to the car manufacturers. The Finance Captive Companies are an indispensable partner to the car manufacturers in the marketing of passenger and commercial vehicles. Each year, more than 13 million new passenger cars are registered in the European Union. Approximately 60 % of the cars sold are either financed or leased to support the sale of the vehicles.

We would like to seize the opportunity to comment on the Basel Committee's proposal on "Guidance on accounting for expected credit losses" and would be grateful if our comments were considered.

A. General remarks – Impact of the guidance on accounting for expected credit losses by the Basel Committee on the consolidated statement of the car manufacturer

As well known, not only banks but all groups including the car manufacturers with their Finance Captive Companies applying IAS/IFRS will have to adopt the IFRS 9. Due to the overarching accounting principle of a uniform application of accountings provisions in a group, restrictions of the Basel Committee with regard to the use of accounting options and practical expedients of IFRS 9 on supervised groups may have immediate repercussions on the whole group of the car manufacturer.

In particular, we are concerned that the intended restrictions as to the use of practical expedients might have a negative impact on the consolidated Sub-Finance-Captive-Groups that are under banking supervision as well as on the whole group of the car manufacturers: Car manufacturers and their finance companies that are not part of the supervised group could be virtually forced to abstain from using the practical expedients to warrant a group wide uniform application of accounting principles of IFRS 9. Although the Basel Committee's guidelines aim to give specific guidance for internationally active and large credit institutions, the guidelines are usually adopted for all credit institutions and groups under banking supervision in Europe and will therefore be of relevance.

B. Practical expedients should remain available for groups of finance captive companies under banking supervision

The practical expedients of IFRS 9 should, notably, remain available for credit institutions and groups under banking supervisions that belong to a manufacturer, because they have not been introduced for groups beyond the banking industry only, but are as an integral implementing guidance reflecting the implementing principle of “undue cost or effort” in general while observing the constraints prescribed in IFRS 9 to achieve the objective set by the standard. This applies in particular for mixed groups comprising, for instance, the car manufacturer and its finance captive companies. Such an approach is consistent with that of the Basel Committee seeking to balance the principles of “simplicity” and “risk sensitivity” appropriately. A general assessment as low-quality implementation is to refuse. The main points with regard to practical expedients are:

1. **The practical expedient with regard to “low-risk” portfolios should not be restricted** due to the limited risks linked with low-risk-portfolios.
2. **The practical expedient with regard to the time horizon to assess the significance of a potential increase in credit risk based on a 12 month time horizon as approximation for the life of the contracts should remain eligible** to avoid too much complexity without significantly increasing the certainty and accurateness of the credit risk measurement of expected losses.
3. **The more-than-30-days-past-due expedient should be eligible subject to the application of the principles of proportionality and materiality** which is of relevance in the retail business.

C. Particular relevance of practical expedients with respect to the retrospective application

The practical expedients are particularly important with regard to the required retrospective application of IFRS 9 in conjunction with IAS 8. The qualification as “low risk” allows abstaining from comparing PD’s, which is important if no historical PD’s are available at the time of the origination of the loans.

The application of the 12-M-PD in turn allows to base the comparison of the PD's on available Basel II-PD's instead of using historically retrospective lifetime PD's that are not available. If for instance no historical PD's at the time of origination are available in the retail business because the respective application scorecard is based on scores to discriminate between those loans to be accepted and those loans to be rejected but not on PD's then it might be important to use the more-than-30-days-past due criterion in the retail business as back stop at least until respective PD's are available for application scorecards as well.

If the practical expedients were not be available for credit institutions applying IFRS and belonging to a car manufacturer and if credit institutions are as a result not able to determine a significant increase in credit risk without such practical expedients then they will be virtually forced by IFRS 9 to build allowances on lifetime PD's. This would have an immediate temporarily significant adverse impact on the capital and the regulatory solvency ratios of such credit institutions. Thus it would adversely affect their lending business and finally the sales of the vehicles in the automobile industry due to equity restrictions until the assets of the "legacy portfolios" will have been derecognised from the balance sheet.

Thus, it is essential that the practical expedients of IFRS 9 are available in any case for the retrospective application to avoid probably unintended temporary impacts on the capital situation of credit institutions and the real economy. This is more important than ever considering that credit institution are still in the phase-in of Basel III and that the revised standardised approaches for the credit risk and operational risk will probably induce higher capital requirements.

D. The following principles should be acknowledged:

The guidance on **Expected Loss Accounting should follow and be based on sound risk management standards acknowledging**

a) **the principle of "proportionality"** not only on the level of the group, but also on the level of portfolios, branches and subsidiaries of such groups and

b) **respecting the general accounting principle of "materiality"** and the **accounting implementing guidance of the avoidance of "undue cost or effort"** of IFRS 9 with the qualification that the overall objective of the respective accounting standards as to the timely measurement of expected losses to be achieved in substance.

The presentation and accentuation of these principles would in our view support the sought balance of the overarching Basel Committee's principles of "simplicity" and "risk sensitivity" in Basel frameworks[1] appropriately. The current draft still seems to be imbalanced in this respect. This applies in particular for groups that are not very large in comparison to large internationally active banking groups.

E. <u>The following remarks should be taken into account:</u>

1. Differentiated requirements would be useful for corporate and retail portfolios due to the different business and risk management practices and procedures.
2. Grouping and segmentation respectively should be based on the segments being the basis for sound risk management practices and the application of robust rating and scoring procedures.
3. Forward looking macroeconomic information should be used carefully based on "all reasonable and supportable" information as required by IFRS 9. Its use should not be further reinforced to balance the assessment of expected credit losses with regard to objectivity, comparability, forward looking perspective (implying a certain level of uncertainty) as well as costs and merits.
4. The requirement under paragraph 58 (b) second bullet state that the validation unit should be independent from the model development process. If this point cannot be deleted, the requirement should follow the principle of proportionality and, therefore, should only be applicable for large internationally active banks but not for other groups still applying, for instance, the credit standardised approach. In addition, it has to be considered that it can be very challenging to be forced to double the required expertise on the specifics of portfolios and data warehouses. Due to the increased probability of making mistakes the required functional separation of model devel-

[1] See the paper of the Basel Committee: The regulatory framework: balancing risk sensitivity, simplicity and comparability

opment and model validation would entail additional operational risk that outweigh the potential conflict of interests and the linked operational risk that is in our view very low.

F. Specific remarks with regard to the appendix governing supervisory requirements for groups applying IFRS

A3:

Instead of a general requirement to consider the change in the risk of default occurring over the expected life of the financial instrument - which can be very burdensome - it should remain possible to determine changes in the risk of a default occurring over the next 12 months according to paragraph B5.5.13 of IFRS 9.

Acknowledging the requirements as set out under paragraph B5.5.14 it should only say: “The committee also emphasises 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 must be considered.”

A59:

The following sentence should be added: “However, if retail portfolios are not material in terms of exposure size and if a material impact on the financial situation of the group is not to be expected, than the use of the more-than-30–days rebuttable assumption can be an appropriate implementation that is proportionate to the risk of such retail exposures.”

A60:

It should be clarified that it is not required to demonstrate that all forward-looking information that is potentially relevant had no substantive relationship with the level of credit losses if it is retail portfolio, that is not material in terms of the exposure size, and if a material impact on the financial situation of the group is not to be expected.

A63 – to be introduced

In addition, a paragraph should be added after A62 relating to the retrospective application of IFRS 9 in conjunction with IAS 8. It should be stated that practical expedients are generally allowed if the required information are not available without undue cost or effort for a retrospective application. The sentence could be formulated as follows:

“Banks may use practical expedients for a retrospective application if the required data are not available and cannot be generated without undue cost or effort. This applies as well for the practical expedient as to the time horizon and the possible use of the 12-M-PD as approximation for the lifetime of the contract to determine a significant increase in credit risk.”

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