

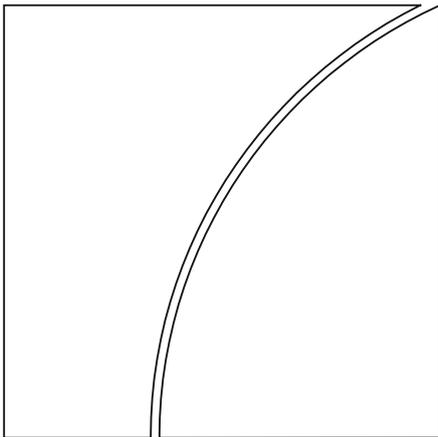
Basel Committee on Banking Supervision

Discussion paper

Regulatory treatment of accounting provisions

Issued for comment by 13 January 2017

October 2016



BANK FOR INTERNATIONAL SETTLEMENTS

This publication is available on the BIS website (www.bis.org).

© *Bank for International Settlements 2016. All rights reserved. Brief excerpts may be reproduced or translated provided the source is stated.*

ISBN 92-9197-997-4 (online)

Contents

- Regulatory treatment of accounting provisions 1
- Executive summary 1
 - Standardised approach for credit risk..... 2
 - IRB approaches 3
- 1. Current regulatory treatment of accounting provisions 4
 - 1.1. Standardised approach (SA) 4
 - 1.2. Internal ratings-based approaches (IRB approaches) 5
- 2. Policy options for the longer-term regulatory treatment of provisions 5
 - 2.1. To retain the current regulatory treatment of provisions, including the distinction between GP and SP, as a permanent approach 6
 - 2.2. To introduce a universally applicable and binding definition of GP and SP 6
 - 2.3. Fundamentally change the current regulatory treatment of provisions – remove the GP/SP distinction and introduce regulatory EL under SA..... 7
- 3. Request for feedback 12
 - 3.1. General and specific provisions..... 12
 - 3.2. Regulatory expected Loss..... 13
 - 3.3. Treatment of general and excess provisions 13
 - 3.4. Level playing field 13
 - 3.5. Complexity and Simplification 14
 - 3.6. Burden 14
- Annex 1: Accounting and regulatory expected loss models..... 15
- Annex 2: Stylised example of the longer term approach 17

Regulatory treatment of accounting provisions

Executive summary

This paper discusses policy considerations related to the regulatory treatment of accounting provisions under the Basel III regulatory capital framework.¹ The timely recognition of, and provision for, credit losses serve to promote safe and sound banking systems and play an important role in bank regulation and supervision. An important lesson learnt from the 2007–09 global financial crisis was that incurred loss models often resulted in provisions that were “too little, too late”. This led the G20 Leaders and the Basel Committee on Banking Supervision to recommend that accounting standard setters consider modifying provisioning standards to incorporate forward-looking assessments in the estimation of credit losses.

In response to this recommendation, both the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) have adopted provisioning standards that require the use of expected credit loss (ECL) models rather than incurred loss models. The IASB published International Financial Reporting Standard (IFRS) 9 in July 2014, which will take effect on 1 January 2018 (earlier application is permitted). The FASB published its final standard on current expected credit losses (CECL) in June 2016. The FASB’s new standard will take effect on 1 January 2020 for certain banks that are public companies and in 2021 for all other banks, with early application permitted for all banks in 2019. The Basel Committee supports the use of ECL approaches and encourages their application in a manner that will achieve earlier recognition of credit losses than with incurred loss models while also providing incentives for banks to follow sound credit risk management practices.

Against this background, by moving from incurred loss to ECL models, the new IFRS 9 and CECL provisioning standards share similar objectives for the earlier recognition of credit losses than under incurred loss models. Likewise, both the IASB’s and the FASB’s models require expected credit losses to be estimated not only on the basis of past events and current conditions, but also reasonable and supportable forecasts about the future, including future economic conditions. There are, however, differences between the IFRS 9 and CECL ECL models, and regulatory expected loss (EL) calculated under the internal ratings-based (IRB) approach in Basel III (regulatory EL). The high-level differences between IFRS 9, CECL and regulatory EL are described in Annex 1.

The Basel Committee is supportive of the ECL approaches, but the Committee nevertheless needs to consider the implications for regulatory capital of these approaches. The new accounting provisioning models introduce fundamental changes to banks’ provisioning practices in qualitative and quantitative ways, as higher provisions are possible with the lifetime loss concept and the inclusion of forward-looking information in the assessment and measurement of ECL. In addition, ECL provisioning might cause more volatility in regulatory capital. The Basel Committee therefore set up a task force to: (i) analyse the application of the new ECL accounting standards; (ii) undertake impact analyses on regulatory capital; (iii) review the rationale for the current regulatory treatment of provisions (including the inclusion of limited amounts in Tier 2 capital) which were designed under the incurred loss model; and (iv) consider possible regulatory capital policy options, as a response to the changes in accounting standards.²

¹ *Basel III: A global regulatory framework for more resilient banks and banking systems* available at <http://www.bis.org/publ/bcbs189.htm>

² As a separate project, the Basel Committee published *Guidance on credit risk and accounting for expected credit losses* in December 2015 in order to set out supervisory guidance on sound credit risk practices associated with the implementation and ongoing application of ECL accounting frameworks.

In reviewing the rationale for the current regulatory capital treatment of accounting provisions, the Basel Committee identified varied practices in accounting and regulatory provisions under the existing incurred loss models. Specifically, there is: (i) variability in the levels of provisions across accounting standards and jurisdictions; (ii) variability in the levels of provisions across banks applying the same accounting standard; and (iii) variability in the classification of accounting provisions as specific provisions (SP) or general provisions (GP) for regulatory purposes. The Committee also understands that some jurisdictions/banks may not apply the IFRS 9 or CECL framework and might retain an incurred loss approach. This variability in practice may contribute to level playing field concerns. Therefore, the Basel Committee is considering whether prudential capital regulation should be based on a more harmonised regulatory treatment of accounting provisions across banks and jurisdictions.

To provide clarity on the long-term regulatory treatment of provisions when the revisions to the standardised approach (SA) and IRB approaches become applicable, the Committee is reviewing whether to: (i) retain the current regulatory treatment of provisions;³ (ii) retain the distinction between GP and SP for regulatory purposes based on definitions that would produce universally aligned categorisations of ECL provisions as GP or SP across jurisdictions; (iii) introduce a standardised regulatory EL component to the standardised approach (SA) for credit risk; or (iv) pursue another alternative based on comments received on this discussion paper. As such, this paper is viewed as the starting point for a dialogue with stakeholders.

To proceed further and assess the implications of these regulatory treatments of ECL accounting provisions, the Basel Committee has decided to seek comments and conduct a quantitative impact study (QIS).⁴ At the Basel Committee's discretion, a transitional arrangement for the impact of ECL accounting on regulatory capital could be introduced. Possible transitional arrangements are outlined in the separate consultation document, which is being published concurrently with this document, *Consultative document: Regulatory treatment of accounting provisions – interim approach and transitional arrangements*⁵.

Standardised approach for credit risk

In addition to the approach of retaining the current regulatory treatment of provisions, one approach would be to introduce a universally applicable and binding definition of GP and SP, which would be designed to produce consistent categorisations of ECL provisions under IFRS 9 and CECL across jurisdictions. Another approach would introduce an EL component under the SA, ie standardised regulatory ELs for which all accounting provisions would be recognised in the same way for regulatory purposes. This approach would align the treatment of accounting provisions under the IRB approaches and the SA and could be applied in a reasonably harmonised manner across accounting frameworks. It would also allow the Basel Committee to align better the definitions of exposures and capital in the IRB and SA regulatory approaches for credit risk. Under this approach, similar to the IRB approaches, any "shortfall of provisions" would be deducted from Common Equity Tier 1 (CET1) capital.

³ The Committee has issued for consultation its proposal that, for the interim period, jurisdictions would extend their existing approaches to categorising provisions as GP or SP to provisions measured under the applicable ECL accounting model. See *Consultative document: Regulatory treatment of accounting provisions – interim approach and transitional arrangements*, available at <http://www.bis.org/bcbs/publ/d386.htm>.

⁴ The Committee has analysed possible regulatory capital impacts of banks implementing the new ECL accounting standards. However, there is no clear indication of by how much provisions will increase as a result of the ECL accounting standards. Moreover, the change in provisions that results from the change in accounting standards is likely to vary based on the business model and credit quality of each bank. Therefore, the Committee has concluded that it will need data from banks showing the estimated impacts of the accounting changes on regulatory capital requirements before concluding what regulatory changes are needed to respond to the introduction of the ECL accounting standards.

⁵ Available at <http://www.bis.org/bcbs/publ/d386.htm>.

IRB approaches

The Basel Committee is currently not considering changing the regulatory treatment of accounting provisions under the IRB framework (except for possible transitional arrangements) as, unlike the SA, the IRB framework does not rely on the distinction between GP and SP. Nevertheless, if necessary, the Basel Committee could extend any transitional arrangement more broadly to cover instances where the IRB approaches are also applied.

The Basel Committee agrees that, ideally, if any change is made to the current framework for the regulatory capital treatment of provisions, the change should be consistent with the robust provisioning standards achieved by the accounting standard setters, be relatively simple to implement, be capable of being implemented in a consistent manner across banks and jurisdictions, and ensure a level playing field. In addition, any change should not open up arbitrage opportunities.

The Basel Committee is seeking comments on the extent to which the approaches discussed in this discussion paper meet the principles articulated above and the feasibility of implementation. Further, the Committee is open to considering approaches other than those presented in this paper.

The Basel Committee welcomes comments from the public on all aspects described in this document by **13 January 2017** using the following link: www.bis.org/bcbs/commentupload.htm. All comments will be published on the Bank for International Settlements website unless a respondent specifically requests confidential treatment. In parallel, the Basel Committee is conducting QIS exercises to collect evidence on the implications and potential impact of each approach. All calibrations in this document are for illustrative purposes and thus subject to revisions.

1. Current regulatory treatment of accounting provisions

In 1988, the Basel Committee issued the *International convergence of capital measurement and capital standards* (Basel I).⁶ The Committee recognised the close relationship between capital and provisions and sought to distinguish between provisions that have some of the loss-absorbing characteristics of capital, known as general provisions, and those that should not be included in capital, described as specific provisions. Basel I permitted a limited amount of general provisions to be included in total (Tier 2) capital to reflect that they are freely available to meet future losses that currently are not identified, while preventing specific provisions from being added back (see the following sections).

In February 1991, the Basel Committee published *Proposals for the inclusion of general provisions/general loan-loss reserves in capital* (BCBS 1991 Proposal). That paper noted that general provisions created against the possibility of future losses that are not ascribed to particular assets (that is, they are not created against identified losses) and do not reflect a known deterioration in the valuation of particular assets qualify for Tier 2 capital up to 1.25% of risk-weighted assets (RWAs).⁷

The Committee decided to retain this treatment of GP when it adopted the standardised approach for credit risk under *Basel II: International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (Basel II).⁸ Basel I also recognised that the diversity of accounting and supervisory policies in respect of provisioning and capital across countries generated inconsistencies in provisioning, and that in practice it was not always possible to distinguish between specific and general provisions. To address inconsistencies and uncertainties, Basel II continued to limit the additions of general provisions to Tier 2 capital to 1.25% of RWAs.

When the Basel Committee designed the IRB approaches under Basel II, the differences in provisioning practices, including the use of general and specific provisions, were confirmed. Thus, the treatment of provisions under the IRB approaches was specified in a manner that allowed all provisions to be treated in the same way for the comparison of total eligible provisions with the total regulatory EL amount (Basel II, paragraph 384), which avoids the need to define which portions of provisions can be considered general or specific. As a consequence, the current regulatory capital treatment of provisions under the SA and IRB approaches differ.

1.1. Standardised approach

General provisions and specific provisions

General provisions are defined in Basel III paragraph 60 as “provisions or loan-loss reserves held against future, presently unidentified losses are freely available to meet losses which subsequently materialise and therefore qualify for inclusion within Tier 2”. The same paragraph implies that specific provisions include “provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped” that are excluded from general provisions.

As noted above, the Basel Committee has observed variability of the classification of accounting provisions as SP or GP for regulatory capital purposes. The variability can be explained, in part, by differences in implementation of the incurred loss model under the current accounting standards. For

⁶ *International convergence of capital measurement and capital standards*, July 1988, paragraph 8.

⁷ Subsequently, in the light of comments received, the Basel Committee replaced the text that said “against the possibility of future losses” with “losses not yet identified”. The definition for general provisions in Basel III, paragraph 60, refers to “future, presently unidentified losses”.

⁸ Available at <http://www.bis.org/publ/bcbs128.htm>

example, banks in some jurisdictions classify all or most accounting provisions as SP, while banks in other jurisdictions classify all or most accounting provisions as GP.

Tier 2 add-back

Under the SA, banks are permitted to include general provisions in Tier 2 capital up to a limit of 1.25% of credit RWA (Basel III paragraph 60) which is broadly the same as in Basel I and Basel II. Specific provisions do not qualify for inclusion in Tier 2 capital.

Exposure

Under the SA, exposures are risk-weighted net of specific provisions (Basel II paragraph 52) and gross of general provisions.

1.2. Internal ratings-based approaches

Total eligible provisions

The Basel II framework defines “total eligible provisions” under the IRB approaches as the sum of all provisions (eg specific provisions, partial write-offs, portfolio-specific general provisions such as country risk provisions or general provisions) that are attributed to exposures treated under the IRB approaches (Basel II paragraphs 380-383). In addition, total eligible provisions may include any discounts on defaulted assets. Specific provisions set aside against equity and securitisation exposures must not be included in total eligible provisions.

CET 1 deduction and Tier 2 add-back

Under the IRB approaches, banks compare the total eligible provisions to the regulatory measure of EL calculated by banks as probability of default (PD) times loss given default (LGD) times exposure at default (EAD). Any shortfall between total eligible provisions and regulatory EL is fully deducted, without considering tax effects, from CET1 capital (Basel III paragraph 73); whereas any excess is added to Tier 2 capital, up to a limit of 0.6% of credit RWAs calculated under the IRB approaches (Basel III paragraph 61).

Exposure at default

Under the IRB approach, all exposures are measured gross of specific provisions and partial write-offs (Basel II paragraph 308).⁹ Thus, neither specific provisions nor general provisions are deducted from EAD.

2. Policy options for the longer-term regulatory treatment of provisions

With respect to the longer-term approach, the Committee has discussed and is considering several possible ways forward. The following are the preliminary approaches under discussion, although these

⁹ Paragraph 308 also requires that: “the EAD on drawn amounts should not be less than the sum of (i) the amount by which a bank’s regulatory capital would be reduced if the exposure were written-off fully, and (ii) any specific provisions and partial write-offs. When the difference between the instrument’s EAD and the sum of (i) and (ii) is positive, this amount is termed a discount. The calculation of risk-weighted assets is independent of any discounts. Under the limited circumstances described in paragraph 380, discounts may be included in the measurement of total eligible provisions for purposes of the EL-provision calculation.”

should be viewed as the starting point for a dialogue on the issues, as the Committee is open to comments and proposals other than those raised in this document.

2.1 To retain the current regulatory treatment of provisions, including the distinction between GP and SP, as a permanent approach

As an interim measure, the Committee is proposing to retain the current regulatory treatment of provisions as applied under both the standardised and IRB approaches.¹⁰ However, one option for consideration is to retain the current regulatory treatment of provisions as a permanent approach.

The merit of this approach is that it would accommodate the differences in accounting practices between jurisdictions and would be able to appropriately reflect the idiosyncratic nature of provisioning standards and practices within the regulatory capital framework in each jurisdiction. For example, in jurisdictions where provisions for specifically identified losses on individual loans are promptly charged off, and any remaining provisions are collectively set aside for unidentified future losses, the proportion of GP should be higher than in those jurisdictions where provisions are mostly held against identified losses on individual loans (ie SP). This may still be valid in the longer term, particularly in the light of the prospect that there will be different provisioning approaches, including ECL models, and dissimilar charge-off rules between jurisdictions for the foreseeable future.

On the other hand, a loss expected by management and estimated in a robust credit risk assessment and measurement process may be seen to qualify as an identified loss/identified deterioration under the ECL models. In addition, this approach would not be able to resolve the level playing field issues, as it may allow the substantial discrepancies in the GP/SP classification currently observed between jurisdictions to continue. Another issue is that retention of a differentiated treatment of accounting provisions (ie SP and GP) implies different definitions of both exposure values and capital for regulatory purposes, depending on whether banks apply the SA or the IRB approaches.

2.2 To introduce a universally applicable and binding definition of GP and SP

In order to address the level playing field issues, an alternative approach would be to introduce a universally applicable and binding definition of GP and SP while retaining the current regulatory treatment based on the GP/SP distinction.

The advantage of this approach is that if the right balance could be struck, the idiosyncratic nature of provisions in individual jurisdictions could be appropriately reflected within the regulatory capital framework while reducing unjustified variation around the world in regulatory practices. This approach could be pursued either by clarifying or elaborating on the current definitions under Basel III, paragraph 60, or by replacing them with new definitions which could be made more binding and suitable for use under the ECL accounting frameworks as well as the incurred loss approach which will continue to be required under many national accounting standards for the foreseeable future.

However, striking the right balance in defining GP and SP would be a challenge under this approach. For example, the agreed regulatory definition of "default" (or "non-performing") could be universally applied to make a distinction between SP and GP, but it would treat as GP some provisions as deteriorated but not defaulted assets that would normally be treated as SP. While the Committee intends to further explore the specificities under this approach, the Committee is open to, and would welcome, other concrete proposals in this regard.

¹⁰ See *Consultative document: Regulatory treatment of accounting provisions – interim approach and transitional arrangements* available at <http://www.bis.org/bcbs/publ/d386.htm>.

2.3 Fundamentally change the current regulatory treatment of provisions – remove the GP/SP distinction and introduce regulatory EL under SA

2.3.1 A case for changing the current regulatory treatment of accounting provisions

The varied practices in accounting and regulatory provisions and the different treatment of SP and GP under the SA, which are mentioned in the previous section, create level playing field concerns across jurisdictions and banks. While both SP and GP reduce CET1 capital, the impacts on capital ratios are different. This is because GP improves the numerator of the total capital ratio via Tier 2 add-back (though capped at 1.25% of credit RWAs), whereas SP reduces RWAs¹¹ in the denominator of the capital ratios, thus slightly reducing the capital requirement even for the CET1 capital ratio but only up to a small percentage of regulatory capital.¹²

While specifying the mapping of accounting provisions to GP or SP (as proposed in the previous option) can reduce differences in the classification across banks, this does not fully address the fundamental issue that differences in accounting standards, together with those in practices and assessments across banks applying the same accounting standards, can result in varied implementation for identical exposures. Two banks with identical portfolios, and thus comparable credit risk, can have different capital ratios under the SA solely because one accounting approach requires more provisions than the other does, or classifies a larger portion of accounting provisions as GP instead of SP.

The level playing field issue needs further consideration both because there are different ECL provisioning standards and because there will be banks that remain on national generally accepted accounting principles (GAAP) which are under an incurred loss model.¹³ Thus, it is difficult to fully address the level playing field issues under the SA by implementing uniform definitions of GP and SP under different accounting provisioning standards.

In the future, different ECL accounting frameworks will coexist. This, coupled with the fact that some banks will remain subject to incurred loss models under national GAAP and will not have to apply an ECL accounting framework, is a clear argument in favour of a regulatory framework that more explicitly includes an expected loss concept.

Against this background, this approach treats all accounting provisions in the same way under the SA, as is done under Basel II IRB approaches. This solution removes the need to distinguish between GP and SP. It would also enhance consistency between the SA and the IRB approaches. This is desirable because IRB banks will have larger SA portfolios should modelling for certain exposures, for regulatory purposes, be removed or otherwise constrained. Further, a consistent regulatory treatment of accounting provisions improves comparability of RWAs between the SA and the IRB approaches, which will gain additional importance if the capital floor for IRB banks is based on the SA.

Another important aspect of this approach is to introduce regulatory “floors” for provisioning in the regulatory capital calculation (ie a minimum CET1 reduction requirement) in order to address the variability issues.¹⁴ When a bank makes lower accounting provisions than the standardised regulatory EL

¹¹ SP reduces exposure values and thereby reduces RWAs which are calculated as the product of the exposure values and respective risk weights.

¹² For the 8% minimum capital ratio, the reduction in capital requirements is only 8% of the SP multiplied by the risk weight (which is between 0% and 150%), ie $8\% * 150\% = 12\%$ at the maximum.

¹³ For example, there are different treatments for performing exposures, eg 12-month expected loss (IFRS 9), lifetime expected loss (CECL) and no forward-looking expected loss (incurred loss accounting standards).

¹⁴ One of the key objectives of the Committee’s post-crisis reform is to reduce the variability of capital charges (or, equivalently, RWAs for credit risk in the banking book) for similar portfolios. An important tool for achieving this aim is to set regulatory floors for risk parameters or capital charges that banks determine using their internal models. This option would translate this approach into the impact of provisioning on regulatory capital.

amounts, the shortfall would be deducted from the bank's CET1 capital, which would incentivise robust provisioning. Such a scheme has already been introduced and successfully operated under the IRB approaches. The imposition of regulatory floors for provisions would, by itself, not address level playing field issues posed by high levels of provisions. But at this stage, the Committee is most concerned about low levels of provisions rather than the converse.

2.3.2 Key concept and design

This section sets out the key concept and design of this approach.

- (i) All accounting provisions, including partial write-offs, are treated in the same way to calculate exposure values and regulatory capital, aligning with the IRB approaches (thus there is no need to distinguish between GP and SP). The critical criterion for a provision to be recognised for regulatory purposes is that it has reduced banks' CET1 capital when calculating capital ratios, irrespective of whether this results from direct adjustments to accounting values (eg partial write-offs, asset value adjustments or fair value writedowns) or indirect adjustments (eg provisions or impairment allowances). In addition, it does not matter whether it is based on a single exposure, a group of exposures or the credit portfolio as a whole. This treatment would provide consistency in a world of diverse provisioning standards.
- (ii) Standardised regulatory EL is introduced under the SA and serves as the minimum amount of credit losses that regulators require banks to cover in the form of CET1 reduction under the Pillar 1 capital requirements (ie it is accounting-independent). Whatever accounting provisioning has been made for credit losses, full recognition up to the regulatory EL would be given as long as those provisions reduce CET1 capital. Since accounting provisions can be lower than the minimum credit losses mentioned above, the requirement to cover these minimum credit losses as a reduction in CET1 capital effectively introduces regulatory floors for accounting provisions in the context of capital ratio calculations, which would also provide consistency in a world of diverse provisioning standards. The excess or shortfall should be assessed at the aggregate level of accounting provisions in comparison with total standardised regulatory EL.¹⁵ If accounting provisions do not reach the floor amount, the shortfall would be deducted from CET1 capital (minimum CET1 reduction requirement). The treatment of excess provisions tentatively would be the same as the current IRB approaches (ie inclusion in Tier 2 capital up to 0.6% of credit RWAs) but will be subject to review by the Basel Committee in the final calibration of the option.¹⁶

Under this approach, the overall level of CET1 reductions and regulatory capital required for credit RWAs together should be consistent between the SA and the IRB approaches. Thus, the methodologies to derive standardised regulatory EL amounts should be consistent with the IRB approaches.

- (iii) After making initial system changes, implementing this approach should not impose a significant ongoing additional burden for banks. The Basel Committee would provide standardised regulatory EL rates and banks would multiply these figures with relevant exposure values, in the same manner as risk weights are used to calculate RWAs today. The standardised regulatory EL rate for each exposure would be readily at hand as a percentage of the exposure value also used

¹⁵ This avoids dependencies on the allocation of accounting provisions to individual exposures, groups of exposures or the whole credit portfolio.

¹⁶ The Basel Committee will separately review the inclusion of such excess amounts in Tier 2 capital up to a cap because the implementation of IFRS 9 and CECL is still work in progress and the magnitude of the possible increase in accounting provisions arising from the implementation of IFRS 9 and CECL is still unknown.

for calculating RWAs under this approach. The standardised regulatory EL rate is assigned to each risk weight in each exposure class under the SA in the same way as for calculating RWAs.¹⁷

- (iv) There is an additional condition for defaulted exposures. As a general rule, regulatory EL amounts where credit losses have materialised or are highly likely to materialise should be measured as accounting provisions if a bank estimates higher credit losses under the applicable accounting standards. These cases are typically where a default event (90 days past due or unlikely to pay) has already occurred (ie defaulted exposures). In such cases, accounting provisions are likely to provide a better estimate of loss than standardised regulatory EL rates prescribed by the Basel Committee.¹⁸
- (v) Additionally increasing overall capital requirements across banks is not an objective of this approach. If the overall capital requirements increase significantly, compared with the revised SA framework,¹⁹ particularly due to the newly introduced minimum coverage of regulatory EL or removal of the current treatment of exposure values net of specific provisions and partial write-offs, the Basel Committee will assess to what extent adjustments may be necessary.

This approach could result in EL amounts covering some portion of credit risk that is currently already captured by the risk weights. If there is significant double-counting of a Pillar 1 credit risk element between standardised regulatory EL rates and relevant risk weights under the SA, the Basel Committee will assess the extent to which adjustments may be necessary. The Committee is of the view that this option should not fundamentally affect the level of calibration under the revised standardised approach for credit risk currently under deliberation and probably would seek adjustments, such as scaling factors,²⁰ to ensure that the risk weights assigned for exposures under the SA would not be affected.

2.3.3 Specification

This section sets out the current specification of this possible approach in comparison with the current SA for credit risk.²¹ This approach would introduce the following changes to the SA (see Annex 2 for a stylised example).

2.3.3.1 *Non-defaulted exposures*

- **Exposure values:** measured gross of provisions, partial write-offs and discounts (that is determined in the same way as under the IRB approaches, using the EAD definition in Basel II, paragraph 308).

¹⁷ This means that the standardised regulatory EL rates are designed to have the same granularity as risk weights for the SA.

¹⁸ The Basel Committee will further assess whether it would be appropriate for a standardised approach to allow that such higher accounting-based loss expectations need not be considered if the bank has demonstrated, to the satisfaction of the supervisor, that the regulatory EL does already fully reflect the conditions in the market in which it operates.

¹⁹ The Basel Committee is currently deliberating changes to the SA for credit risk.

²⁰ If downward-scaling is considered necessary, RWAs would afterwards be multiplied with a scaling factor to reduce RWAs where justified. Whether such a factor should be set at the aggregate RWA level and/or at a more granular level (eg apply to relevant risk weights / asset classes, where justified) will be subject to further deliberation based on QIS exercises.

²¹ The scope of credit risk and definitions of exposure classes are the same as those in the revised standardised approach for credit risk currently under deliberation.

- **Standardised regulatory EL rate:** determined by the Basel Committee for each risk weight in each exposure class (see Section 4.4).
- **Regulatory EL amount:** calculated by multiplying the standardised regulatory EL rate by the same gross exposure value used for calculating RWAs (ie as in Basel II, paragraph 308).

2.3.3.2 Defaulted exposures

- **Exposure values:** determined as net of regulatory EL amounts to avoid considerable double-counting of the exposure amounts from both RWAs and regulatory EL amounts.²²
- **Standardised regulatory EL rate:** introduced separately for each exposure class and set equal to the respective LGD used for deriving a standardised regulatory EL rate if the exposure were not defaulted (typically 45% for senior exposures and 75% for subordinated exposures),²³ because the PD is 100% for defaulted exposures.
- **Regulatory EL amount:** calculated as the higher of:
 - the standardised regulatory EL rate (ie LGD) multiplied by the gross exposure values defined in Basel II, paragraph 308 (that is, gross of provisions, partial write-offs and discounts); and
 - accounting provisions related to credit losses for the defaulted exposure under accounting standards, including partial write-offs associated with the defaulted exposures.²⁴

2.3.3.3 Other specifications common to both non-defaulted and defaulted exposures

- **Total eligible provisions for offsetting regulatory EL amounts:** any credit loss-related accounting provisions (including partial write-offs) that have already reduced CET1 capital (ie expensed) – the same eligible provisions as under the IRB approaches, as defined in Basel II, paragraph 380.
- **Treatment of excess and shortfall of provisions of exposures (except equity exposures and securitisation exposures):** after calculating the difference between the total regulatory EL amount for all exposures (except equity exposures²⁵ and securitisation exposures) and total eligible provisions for these exposures on an aggregate basis,²⁶ in case of higher regulatory EL

²² The Basel Committee may need to further consider implications of this treatment once the revisions to the IRB framework currently under deliberation are finalised. Since the Foundation IRB approach in the current framework does not give rise to any unexpected losses (ie RWAs) for defaulted exposures, introducing regulatory EL on top of assigning RWAs on such exposures could result in double-counting of capital requirement. A possible solution would be to determine the exposure value for a defaulted exposure net of the regulatory EL amount. This is consistent with the split of LGDs for defaulted exposures under the IRB approaches (where own estimates of LGD are used) into the best estimate of expected loss and an estimate of additional losses during the workout period. Applying the 150% risk weight to the remaining net exposure serves as a proxy for the additional losses during the workout period. As there are no RWAs for defaulted exposures under the Foundation IRB approach (since, as a simplification, all credit losses are treated as expected), one alternative may be to reduce the LGD by the amount that is double-counted from RWAs under the SA.

²³ This LGD would be possibly reduced by the amount that is double-counted from RWAs under the SA, since there are no RWAs for defaulted exposures under the Foundation IRB approach.

²⁴ The Basel Committee will further weigh the pros and cons of considering accounting provisions when calculating regulatory EL amounts for defaulted exposures by using QIS data.

²⁵ Equity exposures may need to be treated separately, as under the IRB approaches, to avoid a position in which, despite likely losses, equity value reductions above standardised EL for equity are used for offsetting EL gaps for other exposures.

²⁶ Regulatory EL amounts for all exposures (except equity exposures and securitisation exposures) are summed up and this total regulatory EL amount is then compared with total eligible provisions on an aggregate basis.

amounts, the difference (shortfall) is deducted from CET1 capital, while, in case of higher accounting provisions, the difference (excess) is tentatively treated as under the IRB approaches (ie currently included in Tier 2 capital up to a cap set at 0.6% of credit RWAs) subject to review. The treatment for equity exposures will need to be further considered.²⁷

2.3.4 Calibration of standardised regulatory EL rates

Developing standardised regulatory EL rates is a key element of this approach because the existing SA does not have such elements.

Standardised regulatory EL rates are designed to have the same granularity as risk weights for the SA, ie each standardised regulatory EL rate is set up separately for each risk weight in each of the exposure classes under the SA for credit risk. This means that the Basel Committee assigns one specific fixed EL ratio to each risk weight in each exposure class and then banks would multiply the EL ratio with relevant exposure values in order to calculate a regulatory EL amount. The Basel Committee considers that, in the context of this option, the overall level of regulatory EL amounts should be comparable between the SA and the IRB approaches. Thus, the methodology for deriving standardised regulatory EL rates follows the IRB logic.

The calibration of each standardised regulatory EL rate is determined using the regulatory fixed LGD (in the Foundation IRB (FIRB) approach) applied to the respective exposure type, where available. The PD is backed out of the relevant IRB risk-weight function, given the SA risk-weight and FIRB LGD. The standardised regulatory EL would then be determined by the Basel Committee using the formula $EL = PD * LGD$.²⁸

As an example, for an unrated senior unsecured corporate exposure with 100% risk weight under the SA, the LGD is 45% based on the FIRB. An implied PD is determined as 1.06% by using the IRB risk-weight formula for exposures to corporates and arriving at the same risk weight of 100%. By using this implied PD and the 45% LGD, the EL rate ($PD * LGD$) would be 0.48% (= 1.06% * 45%) for such exposures.

Likewise, the following standardised regulatory EL rates would be derived for such exposures (illustrative purposes).

| RW under SA | 0% | 20% | 50% | 75% | 85% | 100% | 150% | Defaulted |
|-----------------------------|-----------|--------------|--------------|--------------|--------------|--------------|--------------|------------------|
| Standardised EL rate | 0% | 0.02% | 0.10% | 0.23% | 0.32% | 0.48% | 1.89% | 45% |

2.3.5 Policy considerations for the introduction of regulatory EL under the SA

This approach has a number of benefits (described above), such as addressing variability issues via a minimum CET1 reduction requirement and more closely aligning the SA with the IRB approaches. On the other hand, the question might arise whether under this option there is possible double-counting of regulatory EL. It is not fully clear whether or not it should be assumed that the SA risk weights already count part of regulatory expected losses in addition to unexpected losses.²⁹ As mentioned above, this issue will be addressed if necessary, for example by applying downward-scaling factors or other

²⁷ If equity exposures are recognised in the financial statements via mark-to-market or fair value accounting methods, such exposure values may already count all or part of regulatory EL amounts. The Basel Committee will consider this technical aspect and the magnitude during the consultation process.

²⁸ Where the EL rate under the IRB approaches is directly assigned to an IRB risk weight (as for the slotting approach for specialised lending exposures), this EL rate is used for the same risk weight under the SA for comparable exposures, for non-defaulted and defaulted exposures. For SA risk-weight figures not existing under the IRB approaches, a linear interpolation approach would be used (ie the ratio between an EL rate and a risk weight for a certain exposure representing average risk would be used for deriving EL rates under the SA, considering the relative increase or decrease of risk weights under the SA).

²⁹ See "An Explanatory Note on the Basel II IRB Risk Weight Functions" published in July 2005 for the objectives of unexpected losses and expected losses.

adjustments. However, the current SA relies on accounting provisions to cover EL and thus, if accounting standards do not capture EL in full, this results in insufficient coverage of losses, which was also seen as the “too little, too late” shortcoming of incurred loss provisioning. That said, the proposed minimum CET1 reduction for standardised EL could address that issue for banks staying under incurred loss provisioning models. In this case, the standardised regulatory EL charge may exceed accounting provisions and may reduce the capital ratios of some SA banks using incurred loss models.

This approach aims to align the SA with the IRB approaches and thus does not aim to address limitations which are also found in the IRB approaches. For example, this approach does not provide a solution to excess provisions resulting from the fact that the expected losses under the IRB approaches are based on 12-month PDs for RWAs rather than on the losses for all defaults expected to occur over the whole lifetime under IFRS 9 (Stages 2 and 3) and CECL. As a result of this factor alone, the amount of accounting provisions under the new ECL framework may outweigh the amount of 12-month regulatory EL under the IRB approaches and this approach. Furthermore, this approach also does not provide a solution to the fact that, for loans in IFRS 9 Stage 1, IFRS 9 uses 12-month expected credit loss while CECL would use lifetime expected credit loss for the same exposures. Because the implementation of IFRS 9 and CECL is work in progress and the magnitude of a possible increase in accounting provisions due to IFRS 9 and CECL is still unknown, this point is out of scope under this option (and the interim approach as well). Thus, the Basel Committee will revisit the treatment of excess provisions, including the current approach of including excess provisions in Tier 2 capital up to a cap, after the public comment period. This applies in the same manner to excess provisions resulting from the expected loss treatment under the IRB approaches.

Finally, the IRB capital functions were developed assuming that a bank has an infinitely granular portfolio. The Basel Committee recognises that this assumption does not hold for many banks. Hence, the proposal is to develop regulatory EL rates that would correspond to an expected loss for each risk weight in each exposure class. This assumes that this EL rate is primarily reflective of a central or typical value for each risk weight in each exposure class. Also, the method used in this option to calculate PDs assumes that the risk weight is determined by PD and LGD, and thus there is a relationship between risk weight and LGD which determines the PD. However, these assumptions may not necessarily hold, particularly under changing economic conditions.

3. Request for feedback

The new accounting provisioning models introduce fundamental changes to banks’ provisioning practices in qualitative and quantitative ways, as higher provisions are possible with the lifetime loss concept and the inclusion of forward-looking information in the assessment and measurement of ECL. In order to thoroughly consider the implications for regulatory capital, the Committee is seeking feedback on the following, including how proposed alternatives achieve the objectives of the regulatory framework.

3.1 General and specific provisions

Historically, there has been a distinction between general and specific provisions with different regulatory treatments, particularly in the SA. Comments are welcome on whether the Basel Committee should retain the distinction as a means to address inconsistencies in provisioning practices across jurisdictions and banks and, if so, whether and how the Committee should clarify the distinction between general provisions and specific provisions.

3.2 Regulatory expected loss

One of the longer-term approaches proposed in this paper is the introduction into the SA of a regulatory expected loss requirement that would set a minimum requirement for provisioning similar to what exists in the IRB approaches. Comments are welcome on: (i) the need for an explicit regulatory EL charge in the SA; (ii) the approach to be taken for setting regulatory EL levels, including whether there should be a regulatory EL that is global by product type; (iii) whether regulatory EL should be highly granular (with subcategories for each type of loan and special treatment of defaulted assets) or less granular; and (iv) whether regulatory EL levels should be permanently established or subject to ongoing review and adjustment.

In addition, comments are welcome on the current regulatory treatment of accounting provisions under the IRB framework and also whether there are other alternatives that the Committee should consider for banks under the IRB approach.

3.3 Treatment of general and excess provisions

General provisions held against future, presently unidentified losses under the SA are eligible for inclusion in Tier 2 capital up to a specified limit. Likewise under the IRB, where total ECL accounting provisions exceed total regulatory expected loss, the excess provisions can be added back to Tier 2 capital up to a limit.

Comments are welcome on whether general and excess provisions should continue to be included in Tier 2 capital, for example as an incentive for banks to make adequate provisions, or whether inclusion in Tier 2 is becoming less important than before, given that the focus of stakeholders is increasingly on CET1. Comments are also sought on whether inclusion in Tier 2 for general and excess provisions that are for losses that are already expected could weaken regulatory capital because the provisioned amount may not be available to absorb other losses that subsequently materialise elsewhere in the bank on a going- or gone-concern basis.

The Committee is also seeking feedback on whether general or excess provisions could potentially be recognised in other parts of the regulatory capital framework, in particular under Pillar 2, thus reducing the amount of additional capital required as a result of the supervisory review process based on a bank's internal capital adequacy assessment process. Comments are welcome as to whether, how, and under what circumstances it may be appropriate for provisions to be recognised under Pillar 2.

The Committee, further, seeks feedback on the implications of the inclusion of general and excess provisions in Tier 2 for the purposes of calculating Total Loss-Absorbing Capacity (TLAC). Comments are welcome on the appropriate regulatory capital treatment of ECL provisions established prior to or during the resolution process.

3.4 Level playing field

Variations exist between accounting standards for provisioning that could result in meaningful differences in provisions and capital across jurisdictions. Comments are welcome on how best the Basel Committee should seek to level the impact of accounting differences, and as to which approaches could level the playing field (eg introduction of regulatory EL minima, setting of a common minimum provisioning requirement, enhanced add-backs to Tier 2 capital, or clarification of the distinction between specific and general provisions) in a manner appropriate for meeting the objectives of the regulatory capital framework.

3.5 Complexity and simplification

The Committee is interested in views on whether and how to simplify either the current regulatory treatment of provisions or an approach that would use regulatory EL minima.

Comments are also welcome on whether it would be preferable to have an alternative simplified approach that relies largely upon accounting determinations of provisions subject to some minimum requirement (such as one-year provisions for performing loans and lifetime provisions for deteriorated, impaired or defaulted loans) with a deduction from CET1 capital when the accounting provisions do not meet the minimum, but otherwise eliminates add-backs to Tier 2 capital and the distinction between specific and general provisions.

3.6 Burden

Efforts to simplify the treatment of provisions could lead to a lower regulatory burden over time but may require upfront changes. Comments are welcome on whether it is preferable to limit the number of changes to the regulatory treatment of provisions to reduce the immediate burden, or preferable to introduce modifications to the treatment to achieve a less burdensome longer-term outcome.

Annex 1

Accounting and regulatory expected loss models

1. IASB and FASB ECL models

The main differences between the two ECL accounting models relate to the following factors:

- (a) The **FASB** has adopted a single measurement objective that results in the recognition of lifetime expected credit losses for all exposures in scope.
- (b) The **IASB**'s measurement model recognises expected credit losses based on a 12-month probability of default (PD) until a significant increase in credit risk on a financial asset or group of financial assets is identified, at which point lifetime expected credit losses are recognised. In other words, provisions for credit losses are based on three stages, with 12 month expected credit losses recognised for Stage 1 and lifetime expected credit losses for Stages 2 and 3.

Stage 1 – Performing loans: when loans first come onto balance sheets, banks must recognise the 12 month expected credit loss for these loans. This is the probability in the next 12-months of a loan defaulting (PD), multiplied by the amount which a bank would lose on the default.

Stage 2 – Underperforming loans: where a loan begins to show a significant increase in credit risk, banks will have to provision for the lifetime expected credit loss (ie based on the lifetime, not the 12-month PD). The increase in the provisions resulting from a move from 12-month to lifetime expected credit loss is typically expected to be sizeable.

Stage 3 – Impaired loans: banks have to recognise the lifetime expected credit losses for these loans, although the provision may already have been taken if the loan has migrated from Stage 2. One of the differences between Stage 3 and Stage 2 is that banks must accrue interest income on loans net of provisions in Stage 3 rather than on the gross carrying amount of loans.

Expected Credit Losses Measurement

| | Performing assets | Underperforming assets (assets with a significant increase in credit risk) | Impaired assets |
|------|------------------------------------|----------------------------------------------------------------------------------|-----------------------------------|
| IASB | "Stage 1" 12 months ECL | "Stage 2" Lifetime ECL | "Stage 3" Lifetime ECL |
| FASB | Lifetime ECL | | |

Note: The use of a PD/LGD method to measure ECL is not required and other methods, such as a loss rate method, can be used.

2. Main differences between the IASB/FASB ECL models and the IRB EL model

The table below compares the ECL models of the IASB and the FASB with the EL model in the IRB approach in the Basel III standards. The IRB regulatory EL estimates use a 12-month PD. IFRS 9 uses a 12-month PD in Stage 1 and a lifetime PD in Stages 2 and 3. The CECL model uses a lifetime PD for all assets without regard to stages.³⁰

The Basel LGD and EAD estimates are based on loss severity experienced during economic downturn conditions while accounting LGD and EAD models represent a neutral estimate based on expected economic conditions. In addition, there are other differences, such as the fact that the Basel LGD estimate includes collection costs which are not included in accounting ECL models.

Given the various differences, it is possible that accounting ECL could be higher or lower than regulatory EL although **the shift to a lifetime PD is expected to result in accounting ECL exceeding regulatory EL in possibly many cases**. If EAD and LGD were the only factors, accounting ECL would normally be lower than regulatory EL when 12-month PDs are used for both because the use of regulatory downturn EAD and LGD is more conservative than those used under accounting standards. However, the accounting PD could be higher than regulatory PD in down-cycle periods, or where the lifetime PD is applied when estimating lifetime expected credit losses under CECL and in Stages 2 and 3 of IFRS 9.

Performing assets and under-performing assets (with a significant increase in credit risk)

| | | IASB | FASB | Basel Committee |
|-------------|---------------------|-----------------------------------------------------------------------------------------------------------------|-----------------|--------------------------|
| PD | Measurement period | 12 months (Stage 1) Lifetime (Stage 2) | Lifetime | 12 months |
| | Cycle sensitiveness | Point-in-time , considering forward-looking information, including macroeconomic factors | | Economic cycle |
| LGD/ EAD | Measurement | Neutral estimate, considering forward-looking information, including macroeconomic factors | | Downturn estimate |

³⁰ Under IFRS 9 and CECL, the use of a PD/LGD method to measure ECL is not required and other methods, such as a loss rate method, can be used.

Annex 2

Stylised example of the longer-term approach

1. Stylised case

Subject to further refinement of certain details and calibration, this option could work as in the following example. Let's assume the following bank's credit portfolio:

- (1) A senior unsecured bond of €100³¹ issued by unrated corporate A – RW=100%, standardised regulatory EL rate = 0.48%.³²
- (2) A senior loan of €100 to corporate B secured by commercial real estate (CRE) property with €200 market value, ie LTV = 50%, and no material dependency on the cash flow generated by the property – RW = min (60%, RW of counterparty) = min (60%, 100%) = 60%, standardised regulatory EL rate = 0.58%.³³
- (3) A defaulted subordinated loan of €100 to corporate C – RW=150%, standardised regulatory EL rate = 71.59%.³⁴

The bank has an accounting provision of €0.50 individually assessed for the CRE exposure (2) that does not meet the criteria of GP in Basel III, paragraph 60, and is therefore classified as SP,³⁵ and has made a partial write-off of €85 for the defaulted subordinated loan (3). In addition, the bank has one separate accounting provision of €0.50 that meets the condition for GP in Basel III, paragraph 60.³⁶

Table 1: Stylised case

| | Gross exposure value (EAD) | Risk weight | Provisions (incl partial write-offs) |
|------------------------------------------------------|----------------------------|-------------|--------------------------------------|
| General provisions | | | €0.50 |
| Specific provisions | | | |
| (1) Senior unsecured bond (corporate A) | €100 | 100% | |
| (2) Senior CRE exposure (corporate B) | €100 | 60% | €0.50 |
| (3) Defaulted subordinated loan (corporate C) | €100 | 150% | €85.00 |
| Total | €300 | | €86.00 |

³¹ The use of Euros as the currency unit in this stylised example is for illustrative purposes only.

³² Resulting from regulatory LGD=45% for senior unsecured corporate exposures under the FIRB approach, which requires a PD of 1.06% to arrive at the same risk weight of 100% when using the IRB risk-weight function for corporate exposures – hence $EL=1.06\% * 45\% = 0.48\%$.

³³ Resulting from regulatory LGD=20% after a 50% haircut for CRE collateral under the FIRB approach, thus applicable to $50\% * €200 = €100$ (hence to the full secured loan of €100), which requires a PD of 2.92% to arrive at the same risk weight of 60% when using the IRB risk-weight function for corporates exposures – hence $EL=2.92\% * 20\% = 0.58\%$.

³⁴ Resulting from regulatory LGD=75% for subordinated debt under the FIRB approach and PD=100% for defaulted exposures – thus $EL=100\% * 75\% = 75\%$. However, considering a capital requirement of $8\% * RW$ under the SA (whereas RWAs are zero under FIRB, simplified assuming all loss is already EL), EL needs to be reduced to arrive in total at LGD, ie $LGD = EL + 8\% * 150\% * (1 - EL)$, thus $EL = (LGD - 8\% * 150\%) / (1 - 8\% * 150\%)$, thus $EL = 71.59\%$ for $LGD = 75\%$.

³⁵ It is assumed that this accounting provision exclusively reflects a decline in the CRE collateral value to 200. No significant decline in the credit quality of the borrower (ie its payment ability) is perceived; however, no default event for the borrower is triggered.

³⁶ For the purpose of this example, the current caps for inclusion in Tier 2 capital of general provisions and of excess provisions are tentatively used.

2. Calculation under the current SA

Under the current SA, the exposure value for RWAs is calculated net of SP and partial write-offs. Thus, each exposure value would be €100 for the senior bond (1), €99.50 (= 100 – 0.50) for the CRE exposure (2) and €15 (= 100 – 85) for the defaulted subordinated loan (3). Hence, total credit RWAs would be $100\% * 100 + 60\% * 99.50 + 150\% * 15 = €182.20$, which requires $4.5\% * 182.20 = €8.199$ CET1 capital. Together with the CET1 reduction by total accounting provisions of €86, the total CET1 capital needed is $86 + 8.199 = €94.199$ (assuming no corporate tax). The GP is less than the current cap for the Tier 2 add-back of $1.25\% * 182.20 = €2.2775$, thus completely included in Tier 2 capital (for illustrative purposes, it is here assumed that the cap is 1.25%).

Table 2: Current SA

| | Exposure value net of SP/partial write-offs | RWAs | 4.5% CET1 minimum capital requirement | Total CET1 capital need (RWAs + provisions) | Cap for Tier 2 (1.25% SA -RWAs) | Included in Tier 2 capital |
|-----------------------------------|---------------------------------------------|----------------|---------------------------------------|---------------------------------------------|---------------------------------|----------------------------|
| General provisions | | | | €0.500 | €2.278 | €0.50 |
| (1) Senior unsecured | €100.00 | €100.00 | €4.500 | €4.500 | | |
| (2) CRE exposure | €99.50 | €59.70 | €2.687 | €3.187 | | |
| (3) Defaulted subordinated | €15.00 | €22.50 | €1.013 | €86.013 | | |
| Total | €214.50 | €182.20 | €8.199 | €94.199 | €2.278 | €0.50 |

3. Calculation under this approach

3.1 Shortfall of provisions

Under this approach, the exposure value is gross of accounting provisions and partial write-offs – hence €100 for each exposure. Thus, regulatory EL amounts are $0.48\% * 100 = €0.48$ for the senior bond (1) and $0.58\% * 100 = €0.58$ for the CRE exposure (2). Since the subordinated loan (3) is already in default and the accounting provisions made are higher than the standardised regulatory EL, these higher accounting provisions are used as a regulatory EL amount for the defaulted exposure.³⁷ Thus, the EL amount is $\max(71.59\%, 85\%) * 100 = €85$. Hence, the total EL amount is $0.48 + 0.58 + 85 = €86.06$. Since total accounting provisions (including partial write-offs) are €86 (= 0.50 + 85 + 0.50), the shortfall of €0.06 (= 86.06 – 86) is additionally deducted from CET1 capital.

³⁷ Provided the Basel Committee comes to the conclusion that supervisory assessment should be introduced as part of the standardised approach, the higher accounting provisions (including partial write-offs) could be disregarded if supervisors permit this based on demonstration by the bank that for the defaulted exposures the standardised regulatory EL already fully reflects the conditions in the market in which the bank operates, meaning that the higher accounting provisions (including partial write-offs) are not related to credit losses. If the accounting provision for the defaulted exposure is disregarded, this reduces the total EL amount to $(0.48\% * 100) + (0.58\% * 100) + (71.59 * 100) = €72.65$ – thus this results in an excess of total accounting provisions (including partial write-offs) over total EL of €13.35 (86 – 72.65).

Table 3: Shortfall of provisions

| | Provisions (incl partial write-offs) | SA-EL ratio | EL amount | EL coverage by provisions |
|-----------------------------------|--------------------------------------|-------------|-----------|---------------------------|
| General provisions | €0.50 | | | |
| (1) Senior unsecured | | 0.48% | €0.48 | |
| (2) CRE exposure | €0.50 | 0.58% | €0.58 | |
| (3) Defaulted subordinated | €85.00 | 71.59% | €85.00 | |
| Total | €86.00 | | €86.06 | -€0.06 |

3.2 Excess provisions

No excess provision occurs in this example because of the shortfall of accounting provisions (including partial write-offs) compared with total regulatory EL amounts. In contrast, if eg the accounting provision for the CRE exposure (2) was not €0.50 but €1.50, total accounting provisions were $0.5 + 1.5 + 85 = €87$, which results in an excess above the total regulatory EL amount of €0.94. Thus, no further CET1 reduction required. The excess is included in Tier 2 capital up to the cap. Since €0.94 is below the current 0.6% IRB cap for inclusion of eligible provisions in Tier 2 capital (€1.09), the entire €0.94 is included in Tier 2 capital.³⁸

Table 4: Excess provisions

| | Provisions (incl partial write-offs) | SA-EL ratio | EL amount | EL coverage by provisions | Cap for Tier 2 (0.6% SA-RWAs) | Included in Tier 2 capital |
|-----------------------------------|--------------------------------------|-------------|-----------|---------------------------|-------------------------------|----------------------------|
| General provisions | €0.50 | | | €0.50 | | |
| (1) Senior unsecured | | 0.48% | €0.48 | | | |
| (2) CRE exposure | €1.50 | 0.58% | €0.58 | €1.50 | | |
| (3) Defaulted subordinated | €85.00 | 71.59% | €85.00 | €85.00 | | |
| Total | €87.00 | | €86.06 | €87.00 | €1.09 | €0.94 |

3.3 Difference between the current SA and this approach

Consequently, for the figures in this example, moving to this approach increases the CET1 capital need by $94.273 - 94.199$ (current SA) = €0.074 and reduces Tier 2 capital by no longer including €0.50 GP, which results from the shortfall of accounting provisions (including partial write-offs) compared with the total regulatory EL amount.³⁹ In contrast, there would be no shortfall of accounting provisions if eg the SP for the CRE exposure (2) were not €0.50 but €1.50 (which would increase the CET1 capital need under the current SA to €95.172),⁴⁰ thus moving to this approach would reduce the additional CET1 capital need to

³⁸ Even if the cap is reduced to 0.6% RWAs as under the IRB approaches, the excess of €0.94 is still less than $0.6\% * 181.672 = 1.09$.

³⁹ Under such a scenario, downscaling of RWAs or other adjustments may need to be considered.

⁴⁰ Under the current SA, CET1 capital is reduced for the full increase in provisions by $1.50 - 0.50 = €1$ but the reduction of required CET1 capital for RWAs in turn does not fully reflect the CET1 reduction but solely 4.5% of the increase in provisions multiplied by the risk weight, ie $4.5\% * 60\% * (1.50 - 0.50) = €0.027$.

95.213 – 95.172 (current SA) = €0.041, and including the excess provisions of €0.94 would even increase Tier 2 capital by 0.94 – 0.50 = €0.44.

Table 6: Current SA vs this option

| | Provisions (incl partial write-offs) | Current SA | | | This approach | | | Difference | |
|-----------------------------------|--------------------------------------------|----------------|----------------------------------|---------------------------------------|----------------|---------------------------------------------------------|----------------------------------|---------------------------------------|-----------------------------------------|
| | | RWAs | Total CET1 capital need | In- cluded in Tier 2 capital | RWAs | Total CET1 capital need (incl shortfall) | Included in Tier 2 capital | CET1 impact of this approach | Tier 2 impact of this approach |
| General provisions | €0.50 | | €0.500 | €0.50 | | €0.500 | | | -€0.50 |
| (1) Senior unsecured | | €100.00 | €4.500 | | €100.00 | €4.500 | | | |
| (2) CRE exposure | €0.50 | €59.70 | €3.187 | | €60.00 | €3.200 | | -€0.013 | |
| (3) Defaulted subordinated | €85.00 | €22.50 | €86.013 | | €22.50 | €86.013 | | | |
| Shortfall | | | | | | €0.060 | | -€0.060 | |
| Total | €86.00 | €182.20 | €94.199 | €0.50 | €182.50 | €94.273 | €0.00 | -€0.074 | -€0.50 |
| General provisions | €0.50 | | €0.500 | €0.50 | | €0.500 | €0.94 | | €0.44 |
| (1) Senior unsecured | | €100.00 | €4.500 | | €100.00 | €4.500 | | | |
| (2) CRE exposure | €1.50 | €59.10 | €4.160 | | €60.00 | €4.200 | | -€0.041 | |
| (3) Defaulted subordinated | €85.00 | €22.50 | €86.013 | | €22.50 | €86.013 | | | |
| Total | €87.00 | €181.60 | €95.172 | €0.50 | €182.50 | €95.213 | €0.94 | -€0.041 | €0.44 |