Basel Committee on Banking Supervision

BIS

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Via email: commentletters@ifrs.org

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Mr Andreas Barckow
Chairman
International Accounting Standards Board
Columbus Building
7 Westferry Circus
Canary Wharf
London E14 4HD
United Kingdom

Subject: IASB Request for Information – Third Agenda Consultation

Dear Mr Barckow

The Basel Committee on Banking Supervision (the Committee) welcomes the opportunity to comment on the International Accounting Standards Board's (IASB or the Board) request for information on the *Third Agenda Consultation*.

The Committee has a strong interest in high quality financial reporting by banking organisations and strongly believes that the IASB's periodic formal agenda consultation is an important step towards enhancing the transparency of the accounting standard-setting process and the accountability of the organisation. The Committee supports the development of high-quality accounting standards, as accounting information generally forms the starting point for the Committee's prudential framework. Financial information that is relevant and faithfully represents the economic substance of transactions or other events helps to promote the safety and soundness of the financial system.

Our comments are set out in the Annex to this letter. We hope that you find them constructive and helpful. This letter has been prepared by the Committee's Accounting and Audit Expert Group, chaired by Katherine Tilghman Hill, Vice President, Federal Reserve Bank of New York. If you have any questions regarding these comments, please contact Joanne Marsden at the Basel Committee Secretariat (+41 76 350 8541).

Yours sincerely

Pablo Hernández de Cos

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Annex: Comments on the IASB's request for information Third agenda consultation

Strategic direction and balance of the Board's activities

The Committee generally agrees that the current level of focus for each main activity is appropriate.

Considering that major accounting standards became effective in 2018 (IFRS 9 *Financial Instruments* and IFRS 15 *Revenue from Contracts with Customers*) and 2019 (IFRS 16 *Leases*), the Committee recommends that sufficient resources should be secured to carry out the post-implementation reviews (PIRs).

While the development of new IFRS Standards and major amendments to IFRS Standards remain a priority for the Board, with the current level of focus at 40–45%, the Committee believes that the criteria for assessing the addition of new projects and the prioritisation of work are key.

As part of its current workplan, the IASB has undertaken major standard-setting projects that are yet to be completed. The Committee supports prioritising the completion of projects in its current workplan such as: the PIR of the classification and measurement (C&M) requirements in IFRS 9; the PIR of the expected credit losses (ECL) of IFRS 9; Dynamic Risk Management (DRM); and Financial Instruments with Characteristics of Equity (FICE).

- **PIR of C&M requirements in IFRS 9**. The Committee supports the IASB's intention to start the PIR of IFRS 9 by evaluating the C&M sections of the standard. One example – raised by the banking industry – of a potentially important C&M issue is that banks are actively considering the treatment of "green loans" with variable payments linked to environmental, social and governance targets[1] specifically in the context of the "solely payments of principal and interest test". The Committee encourages the Board to progressively clarify over time the application of the standard to new and evolving features such as this, which will be important for banks, investors and supervisors. These variable payments have the potential to add "new risks" that go beyond traditional credit/interest rate risk for banks.

- **PIR of IFRS 9 ECL**. The Committee supports performing the PIR of IFRS 9 ECL on a timely basis. Assessment of the implementation of the ECL standard in due course will be very important to determine the adequacy of disclosures, the challenges of applying ECL and the benefits of aligning accounting with risk management, and the consideration of a range of data to ensure the consistency and quality of interpretations and approaches.

  At this stage we have three recommendations regarding the PIR of IFRS 9 ECL:

  1. **<u>The Board should examine the case for enhancing credit risk disclosures</u>**. Clear, comparable disclosures support supervisory and regulatory monitoring and enhance market discipline from investors. While there have been challenges applying IFRS 9 through the pandemic, the more granular, forward-looking ECL disclosures may have been helpful for investors in assessing banks' exposure to risk. We understand that investors and supervisors, however, generally struggled to make meaningful comparisons because of

[1] For example, if a borrower fails to meet an environmental target the interest paid goes up.

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inconsistent disclosures across banks. Good disclosure practices have emerged since IFRS 9 was introduced, in part prompted by initiatives such as the UK's Disclosures about Expected Credit Losses (DECL) framework, but there is an important question as to whether IFRS disclosure requirements for ECL need to be enhanced to improve comparability across the world.

2. **The IASB may wish to consider the topic of procyclicality**. This topic has been raised by a range of commentators and, in the Committee's view, the PIR would be more complete if the IASB had regard to procyclicality. While there is no universally agreed definition of the term, it is perhaps best understood as mutually reinforcing dynamic interactions (positive feedback mechanisms) between the financial and the real sectors of the economy that tend to amplify business cycle fluctuations and cause or exacerbate financial instability. The Committee has examined this matter and recently published a literature review of the procyclicality of loan loss provisions which provides a number of suggestions for future work.[2] In July 2021, the Committee also published a report on early lessons from the Covid-19 pandemic, which addresses the cyclicality of the Basel framework including the impact of credit loss provisioning.[3] The outcome of our recent work could be a useful input to the IASB's potential future work as part of the PIR, and we would be pleased to engage in further dialogue with the IASB if it pursues this project.

3. **Consider data reflecting the impact of Covid-19**. The extraordinary nature of the Covid-19 pandemic has increased the use of judgment, for example, in how support programmes should be incorporated into the ECL process. The Committee believes it will be possible to perform a more insightful analysis of the ECL requirements once data is available for periods during which exceptional government pandemic-related support is no longer available.

- **DRM**. It is important that interest rate risk arising from positions outside banks' trading books is properly measured and managed on a consistent basis, so the Committee supports the objectives of the DRM project. We support an accounting approach built on the basis of banks' risk management practices. We observe that banks typically manage interest rate risk on a portfolio basis and that those portfolios are frequently "open". This will allow the DRM model to be much closer to banks' approaches than current "work arounds" – such as proxy hedging and treating open portfolios as a series of closed portfolios. Hence, the Committee encourages the IASB to develop a sound framework for DRM with supporting disclosures. To maintain the credibility of financial reporting with DRM, there need to be appropriate guard rails in place to prevent abuses, including requirements that guard against inappropriate loss deferral. While it has not yet formed its views about the proposed core financial reporting model for dynamic management of interest rate risks, the Committee is supportive of the IASB finding a solution to the accounting challenges identified on a timely basis.

- **FICE**. As the Committee noted in its comment letter on the *FICE discussion paper*, there are application issues in the existing standard, IAS 32 *Financial Instruments: Presentation* that result in an inconsistent accounting classification of instruments. The distinction between liabilities

[2] *The procyclicality of loan loss provisions: a literature review* (bis.org)

[3] *Early lessons from the Covid-19 pandemic on the Basel reforms* (bis.org)

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and equity is essential, as it gives relevant information on solvency, leverage and liquidity. As such, the Committee considers it important that the IASB finalise the FICE project to clarify the principles of IAS 32 so that the standard can be applied consistently, and to enhance the presentation and disclosure requirements.

Criteria for assessing the priority of financial reporting issues that could be added to the Board's workplan

The Committee agrees that the proposed prioritisation criteria are reasonable and allow the IASB to focus on projects that are both relevant and realistic. However, the Committee encourages the Board to consider the following ways to enhance the criteria:

- include a forward-looking component to consider the implications of new and emerging risks on financial reporting that would ensure that the Board is perceived as more proactive and less reactive;
- frame its work programme to limit the number of active projects underway at any given time so that it is able to complete projects within a reasonable timeframe;
- consider diversity in practice as well as the urgency of the issue to help with prioritisation; and
- consider whether there are any lessons to be learnt from the current crisis, and the importance of potential projects in light of its mandate, which includes a component of fostering long-term financial stability in the global economy.

Financial reporting issues that could be added to the Board's workplan

The Committee supports the Board's focus on current and emerging issues of global interest in the current environment including climate-related financial risks and cryptoassets.

In the context of the IASB's proposed workplan, the Committee believes that the highest priority should be given to the following potential projects:

- **Climate-related financial risks**. Climate-related financial risks are global issues which may impact the safety and soundness of individual financial institutions and have broader financial stability implications for the banking system. In early 2020, the Basel Committee established the Task Force on Climate-related Financial Risks to undertake work on these risks. The assessment, measurement and mitigation of climate-related financial risks is an area of focus in the Committee's 2021–22 work programme.[4] Given the importance of this topic, the IASB should set aside sufficient time and resources to engage closely with existing and potential future sustainability boards to ensure that interdependencies between the work of the boards are systematically identified, consistently treated and adequately covered. The Committee also believes the IASB should consider how climate-related financial risks impact the recognition

4 Basel Committee work programme and strategic priorities for 2021/22 (bis.org)

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and measurement of assets and liabilities under current standards and develop proposed solutions to address any inconsistencies or lack of comparability.

- **Cryptoassets**. The Committee is of the view that the growth of cryptoassets and related services has the potential to raise financial stability concerns and increase risks faced by banks. While banks' exposures to cryptoassets are currently limited, the continued growth and innovation in cryptoassets and related services, coupled with the heightened interest of some banks, could increase global financial stability concerns and risks to the banking system. To that end, the Committee has taken steps to address these risks, and in June 2021 issued a consultation document on preliminary proposals of the prudential treatment of banks' cryptoasset exposures.[5] The Board may find the consultation document useful as it explores potential future work in this area. Given the complexity of the issues and the potential time commitment for the IASB to fully and timely address cryptoassets from an accounting perspective, adding the project to the agenda in the near term will be important. The Committee encourages the Board to maintain flexibility in setting its agenda to accommodate the potential size of the project.

  The Committee recommends that the scope of the potential "cryptocurrencies and related transactions" project be expanded to include all cryptoassets which have been defined as private digital assets that depend primarily on cryptography and distributed ledger or similar technology (including cryptoassets with stabilisation mechanisms, tokenised versions of traditional assets and other types of cryptoassets).[6] The Committee recommends that the IASB research the nature and various uses of cryptoassets and examine if current accounting standards, such as IAS 2 *Inventories*, IAS 38 *Intangible Assets*, and the definition of a financial asset, as well as the characteristics of cash, under IAS 32, are capable of faithfully representing the economic substance. If so, the Committee supports appropriately amending the scope of existing standards to include cryptoassets. The Committee further supports the IASB considering whether there is a need to develop a standard specifically to cover cryptoassets.

5 *Prudential treatment of cryptoasset exposures* (bis.org)

6 *Regulation, supervision and oversight of "global stablecoin" arrangements* (fsb.org)