Comments

on BCBS consultative document “Regulatory treatment of accounting provisions – interim approach and transitional arrangements” and discussion paper “Regulatory treatment of accounting provisions”

Register of Interest Representatives
Identification number in the register: 52646912360-95

Contact:

Jörg Ortgies	Ingmar Wulfert
Director	Advisor
Telephone: +49 30 1663 2170	Telephone: +49 30 1663 2120
Fax: +49 30 1663 2199	Fax: +49 30 1663 2199
Email: joerg.ortgies@bdb.de	Email: ingmar.wulfert@bdb.de

Berlin, 6 January 2017

The **German Banking Industry Committee** is the joint committee operated by the central associations of the German banking industry. These associations are the Bundesverband der Deutschen Volksbanken und Raiffeisenbanken (BVR), for the cooperative banks, the Bundesverband deutscher Banken (BdB), for the private commercial banks, the Bundesverband Öffentlicher Banken Deutschlands (VÖB), for the public banks, the Deutscher Sparkassen- und Giroverband (DSGV), for the savings banks finance group, and the Verband deutscher Pfandbriefbanken (vdp), for the Pfandbrief banks. Collectively, they represent approximately 1,700 banks.

Coordinator:
Association of German Banks
Burgstraße 28 | 10178 Berlin | Germany
Telephone: +49 30 1663-0
Telefax: +49 30 1663-1399
www.die-deutsche-kreditwirtschaft.de

General comments

We share the Committee's view that the forthcoming new IASB and FASB accounting standards on credit losses will introduce fundamental changes in banks' accounting practices. Therefore, there is a need to analyse the regulatory implications on both a quantitative and qualitative basis. With this in mind, we urge the Committee to undertake a comprehensive assessment to ensure that the long-term regulatory approach takes accounting provisions into consideration appropriately. We believe that the Committee's review should at least address the conceptual issue and the level playing field issue. From a conceptual perspective, the new standards question the current regulatory status of accounting provisions under the standardised and IRB approaches. Furthermore, we believe that the treatment of accounting provisions under both approaches has to be addressed to ensure a level playing field. We thus advocate that the treatment of new accounting provisions under both the standardised and IRB approaches should be reviewed at the same time. The relationship between risk weights and the concept of expected and unexpected losses should be clarified. The BCBS should maintain the fundamental principle that capital requirements only cover unexpected losses. In this context, it should be considered that the risk weights under the standardised approach are calibrated differently, compared to the risk weights under the IRB approach, to cover expected and unexpected losses. This might lead to double counting if at the same time the specific provisions that reflect the best estimate of expected losses could no longer be deducted from the exposure amounts in order to cover the unexpected losses in a standardised way. In addition, as for SA institutions, there are concerns that capital requirements for secured loans with low losses, such as auto loans for instance, will be confronted with significantly increasing capital requirements for defaulted loans due to the inappropriately standardised regulatory Expected Losses (EL) for such loans.

1. Interim approach and transitional arrangements

The current regulatory treatment of expected losses is built on the existing accounting frameworks based on incurred loss models. It therefore requires a holistic review in light of the changes introduced to the underlying accounting framework (mainly IFRS 9 and the corresponding US accounting standard, CECL) as well as changes made to the regulatory framework since 2009 (conservation and counter-cyclical buffer, buffers for systemically important institutions, systemic risk buffers in the EU, review of the standards of capital calculation, restrictions to IRB calculations, TLAC, etc.) in order to ensure proper interaction between accounting and prudential frameworks.

Given that such a holistic review will require time and extensive dialogue between regulators and industry to ensure its proper functioning, the GBIC supports the introduction of a transition period. We would prefer the transition period not to introduce any phase-in before there is clarity on how the prudential framework will be amended in the long term. Unless retaining the existing framework unchanged was decided upon as the long-term solution, the industry would be transitioning to an incorrect end-point. This could lead to inevitably misleading disclosures and end-users basing their analysis on inaccurate information

In addition, if the Basel Committee changes the prudential framework, they would be faced with unwinding any existing transitional amendments and potentially implementing another transitional regime to recognise the impact of the longer-term solution, resulting in unwarranted volatility in banks' capital ratios. We therefore believe that offsetting the impact of the changes to the accounting standards until finalisation of the revision is a more appropriate solution.

In addition to the issue of transitioning to an incorrect end-point, phase-in does not deliver a level playing field. There are different timelines for entry into force of IFRS 9 and CECL. Should the Basel Committee decide to keep the phase-in instead of neutralisation to ensure a level playing field, the GBIC requests the introduction of a 2-year period to neutralise the impact of IFRS 9 before CECL enters into force. This will ensure a level playing field and also analyse the impact and provide time to revise the prudential framework and calibrate the potential volatility. Should the final framework be in place by 2020, the phase-in as envisaged by the Basel Committee could then be adopted, which would make more sense given that phase-in would take place on the basis of a real impact.
We therefore propose that in the period from 1 January 2018 to 31 December 2019 a bank should be allowed to include in CET 1 capital an adjustment amount of 100 % (coefficient 1).
As for the approach to calculation of the transitional adjustment amount, we believe that, given its dynamic nature, alternative 3 is basically preferable.

However, in detail, we would appreciate an approach like the current proposal by the European regulator. We would recommend permanent calculation of the 12-month expected loss and the amount of loss allowances for financial instruments equal to the lifetime expected loss and the phase-in of possible higher provisions and the resulting decline in CET1 over a period of five years with the factors (1; 1; 0.8; 0.6; 0.4).

2. Permanent solution

2.1 Need for a holistic approach

As already mentioned, the current prudential rules were calibrated on accounting-based incurred loss models. An increase in balance sheet allowances under expected credit losses will result in a decrease in shareholders' equity and in the CET 1 under the current prudential framework. Without adjustments to the current capital regime, the CET1 ratios are expected to decrease without a corresponding change in the level of risk, risk appetite, banks' strategy, management or level of losses. The increased cost of capital is expected to impact banks' lending practices and pricing. The impact on capital ratios resulting from the accounting changes should therefore be taken into account in the overall calibration of the capital framework to avoid "double counting" and ensure a level playing field, regardless of the underlying accounting regime.

Given that "double counting" is perceived as the main issue by the banking industry, we were disappointed to find little reference to it in the consultation paper. In fact, "double counting" under the IRB approach is not addressed at all, although we noted that the treatment of excess provisioning will be addressed at a later stage. We believe that the discussions should be accelerated, as treatment of excess provisioning is a major component and revision of the treatment of accounting provisions cannot take place in blocks without considering all relevant aspects together.

The modification of the prudential framework must be conceptually sound, applicable under both IRB and STA approaches, understandable, operational and fairly applicable to different accounting regimes to ensure a level playing field among jurisdictions. Furthermore, it should be consistent with the whole prudential framework, which relies on a 12m unexpected loss being covered by own funds.

2.2 Double counting

a) Addressing the same risk under both the prudential and the accounting framework

The interaction between accounting and regulatory measures should be analysed in detail to understand the extent to which different measures address the same risk, such as, for example, the interaction with stress testing. Deterioration of macroeconomic expectations will be reflected in the stress test results, provoking a higher Pillar 2 requirement by regulators. It will, in addition, either increase the probability of an adverse scenario or introduce a new adverse scenario in the range of scenarios to cover the 'unbiased probability weighted' requirement, resulting in higher levels of provisions. Finally, if the deterioration of macroeconomic expectations is due to an expansive situation in the economy, the counter-cyclical buffer might have been activated in the past to tackle the same risk factor.

b) Overlapping of provisions >12m with capital

Expected losses, seen as a cost component of doing business, are managed through pricing and provisioning. Unexpected losses are covered by capital, given that these represent peak losses exceeding the expected levels. The own funds requirements under the Basel framework are determined to absorb unexpected losses in a time horizon of one year.

There is potentially an overlap between the accounting lifetime expected credit losses (LTECL) and unexpected losses as defined by the regulatory framework. It has to be determined to which extent the delta between 12 m EL and LTCEL is already reflected in the unexpected losses under the prudential framework, covered by capital.

As described in further detail in 'An Explanatory Note on the Basel II IRB Risk Weight Functions' (BCBS, July 2005), '*…capital is set according to the gap between EL and VaR, and if EL is covered by provisions or revenues, then the likelihood that the bank will remain solvent over a one-year horizon is equal to the confidence level*.'

When calculating the expected loss, '*the Expected Loss of a portfolio is assumed to equal the proportion of obligors that might default within a given time frame (1 year in the Basel context), multiplied by the outstanding exposure at default, and once more multiplied by the loss given default rate*.'

Under IFRS 9, as outlined in paragraph 5.5.3 of the IASB IFRS 9 Reporting Standard, '…*an entity shall measure the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses if the credit risk on that financial instrument has increased significantly since initial recognition*'. Lifetime ECL are defined as '*the expected credit losses that result from all possible default events over the expected life of a financial instrument'* as opposed to 12-month ECL being '*the portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a financial instrument that are possible within the 12 months after the reporting date*.'

Furthermore, IFRS 9 EL is to be measured as an unbiased and probability-weighted amount determined by evaluating a range of possible outcomes and by integrating forward-looking information.

While the provisions in excess of one-year expected credit losses are not set aside against unexpected losses, the defaults they are expected to cover are expected to be outside the time horizon of the capital

framework. In case these funds are needed to face losses within the next 12 months, such losses will be unexpected, and the loss-absorption capabilities of these provisions would be similar to CET 1 capital.

Assuming that the prudential expected loss (EL) is correct from a prudential point of view (12-month EL), the prudential rules need to be recalibrated to reflect the changes to the new accounting model (LTECL) consistently for STA and IRB approaches.

2.3 Our proposal for a permanent solution

Considering the nature and loss-absorption capabilities of provisions for expected losses beyond a 12-month time horizon, we suggest that these provisions be considered for capital purposes regardless of the method used to calculate capital (IRB or STA approach) to mitigate the inconsistency between the time horizons for calculation of expected losses and the overlap between the accounting requirements and the prudential framework.

Recognition of LTEL for capital purposes will at the same time:

1) address the volatility in capital that results from volatility in provisions due to the cliff effect when moving assets to Stage 2 under IFRS 9
2) conceptually align the IRB and SA models and level the playing field between both approaches, as provisions set aside for defaults over 12m are treated equally
3) level the playing field among different accounting standards, not only between IFRS 9 and CECL, but also any underlying accounting standard.

2.3.1 Our proposal for treating excess provisions under the IRB approach

We suggest that under the IRB approach the excesses and shortfalls of 12m ECL (accounting provisions) compared to the 12m EL under the prudential framework for IRB portfolios should be treated symmetrically. The current cap should be removed or recalibrated.

In our view, the characteristics of IFRS 9, i.e. the incorporation of expected loss on the whole portfolio, the incorporation of forward-looking information, the unbiased probability-weighted scenarios, etc., along with the more robust capital environment resulting from the new prudential framework, justify a consistent treatment of shortfalls and excesses of accounting provisions over regulatory provisions.

Moreover, in addition to the symmetric treatment, it is necessary to review/eliminate the cap included in paragraph 61 of the Basel III framework. This cap was calibrated with an accounting framework based on incurred losses, and the Basel Committee acknowledged the need to recalibrate it when at a time of change in the accounting framework. In 2009, when the last review was carried out, IFRS 9 development was still at early stage, and its final characteristics were not set until 2014.

The GBIC is of the view that the cap should be eliminated, or at least recalibrated, to be consistent with the new accounting model. Any possible cap should only apply to the excess of accounting 12-month expected credit losses over the prudential 12-month expected loss assets. This will require calculation of 12m ECL also for all Stage 2 assets, above the requirements of IFRS 9. The 12-month ECL for Stage 2 will therefore not be disclosed in financial statements and audited, given they will be computed for prudential purposes only.

2.3.2 Our proposal for treating excess provisions under the SA approach

To ensure consistency with the IRB approach in offsetting the ECL impact, the difference between LTECL and 12-month ECL should be incorporated into CET1. The GBIC suggests calculating accounting ECL for Stage 1 and Stage 2 with a time horizon of 12 months for prudential purposes. The accounting provisions above the level equal to accounting credit expected loss provisions in Stage 1 and Stage 2 with a time horizon of 12 months should be considered CET 1 capital.

This will require calculation of 12m ECL (IFRS 9 expected credit loss) for all Stage 2 assets, above the requirements of IFRS 9. The 12-month ECL for Stage 2 will therefore not be disclosed in financial statements and audited, given that they will be computed for prudential purposes only.

We believe that the 12-month accounting EL in Stage 1 and Stage 2 could be used as an approximation of the prudential 12 months for portfolios for which the standardised approach is applied and for which no prudential EL is computed. This should also be possible for institutions that are not IRB institutions.

As prudential EL 12 months is through the cycle (TTC) and accounting ECL is point in time (PIT), there will be a difference between the two measures at the different points in time in the cycle, though the sum of the differences on an average over a cycle should amount to zero.

Alternatively, the BCBS proposal for regulatory EL in the standardised approach could be used instead of the 12 m accounting EL provided it is recalibrated to take into account the comments made later in this document. In this case, defaulted exposures should be exempted for the comparison of the standardised EL with the specific provisions, because the specific provisions are better estimations of the expected loss than the standardised regulatory ELs. Otherwise, credit institutions whose main business is secured financing or leasing where the losses are low and which thus the need to build specific provisions could be confronted with significantly increasing capital requirements due to the change in the methodology. According to the consultation paper, the standardised regulatory EL of a defaulted loan would be 45%. If the best estimate of the loss after default is, however, 20%, then the credit institution would have to hold additionally 25% of the exposure amount as capital. At the same time, the credit institution could no longer deduct the specific provision from the exposure amount. In the case of a specific provision of 20%, this would mean a further increase in the capital requirement of 25% (100/100-20). As a result, the capital requirements for such loans would more than double due to the inappropriately standardised regulatory EL.

2.3.3 Our proposal for an alternative approach to the treatment of excess provisions under IRB and SA

While we believe that the absorption capabilities of accounting provisions beyond 12 months would be similar to CET 1 capital, we are aware of the concern expressed by regulators that they may not be unrestrictedly and immediately available to cover credit risks or losses, as this part of CET 1 could be used to cover other risk or new business.

We would therefore propose, as an alternative, that the LTEL portion (including that of Stage 3 according to IFRS 9) x 12.5 be subtracted from the RWA for IRB and STA banks. This approach is not new, as there is similar treatment for provisions in respect of IRBA securitisation positions in the EU ('*The risk-weighted exposure amount of a securitisation position may be reduced by 12.5 times the amount of any specific*

credit risk adjustments treated in accordance with Article 110 of the CRR made by the institution in respect of the position').

3. Basel Committee's proposals for SA

3.1 Distinguishing between general and specific provisions

Basel acknowledged from the initial phase of the prudential framework, back in 1988, the difficulties in clearly identifying general provisions: *'…the Committee accepts, however, that, in practice, it is not always possible to distinguish clearly between general provisions (or general loan-loss reserves) which are genuinely freely available and those provisions which in reality are earmarked against assets already identified as impaired. This partly reflects the present diversity of accounting, supervisory, and, importantly, fiscal policies in respect of provisioning and in respect of national definitions of capital*.'

Basel defines general provisions as *"(60) 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. Provisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped, should be excluded*."

In the European context, the EBA provides further guidance on the identification of general credit risk adjustments, defined as follows:

'*(a) are freely and fully available, as regards to timing and amount, to meet credit risk losses that have not yet materialised;*
(b) reflect credit risk losses for a group of exposures for which the institution has currently no evidence that a loss event has occurred.'

Furthermore, in the same document:

'4. Subject to meeting the criteria of paragraph 2, the following losses shall be included in the calculation of General Credit Risk Adjustments:

- *a) losses recognised to cover higher average portfolio loss experience over the last years although there is currently no evidence of loss events supporting these loss level observed in the past;*
- *b) losses for which the institution is not aware of a credit deterioration for a group of exposures but where some degree of non-payment is statistically probable based on past experience.*

5. The following losses shall always be included in the calculation of Specific Credit Risk Adjustments under paragraph 3:

- *a) losses recognised in the profit or loss account for instruments measured at fair value that represent credit risk impairment under the applicable accounting framework;*
- *b) losses as a result of current or past events affecting a significant individual exposure or exposures that are not individually significant which are individually or collectively assessed;*
- *c) losses for which historical experience, adjusted on the basis of current observable data, indicates that the loss has occurred but the institution is not yet aware which individual exposure has suffered these losses.'*

Under IFRS 9, provisions for impaired assets (Stage 3) can easily be identified as specific. However, unimpaired assets, both if they have experienced a significant increase in credit risk (Stage 2) or not (Stage 1), can be considered to have fulfilled bullet points 4b or 5c in the previous regulatory reference, making categorisation ambiguous.

We believe that, should the Basel Committee retain the concept of general and specific provisions, all provisions under expected loss models should be considered specific. This will require an amendment of the above-mentioned EU legislation. The 12 m ECL provisions should continue to be deducted from the exposure for RWA calculation, while the LTEL ECL should be added back to CET 1 or, alternatively, subtracted x 12.5 from the RWA, as outlined earlier in this document.

While a distinction between specific and general credit risk adjustments has been used for tax purposes in some jurisdictions, given that tax treatment is a matter for national authorities, we believe that national authorities can come up with a set of clear and consistent criteria to ensure a fair tax treatment for the entities within their jurisdiction regardless of the underlying accounting treatment.

3.2 BCBS proposal for introduction of regulatory EL

If a symmetrical treatment of excess provisions both under STA and IRB is accepted we see the advantage of the BCBS proposal to introduce regulatory EL as it provides a basis for the implementation of the symmetrical treatment. It is, however, impossible to fully evaluate the BCBS proposal without understanding the BCBS approach to the treatment of excess provisions. As drafted, the BCBS proposal does not tackle the real issue of double counting (a portion of the exposure simultaneously addresses an EL and an UL); this can be tackled through a reduction of the STA RW percentages calibration or through the non-recognition of the LTEL portion of provisions in the prudential capital as a permanent solution as highlighted above.

As mentioned above, the problem of double counting also applies to the SA because the risk weights are calibrated to cover the EL and UL. The standardised regulatory EL of 45% for defaulted exposures is significantly too high for secured loans such as auto loans, for instance. Thus, defaulted exposures should be exempted from the comparison of the standardised regulatory EL with the specific provisions. Otherwise the capital requirements might increase significantly due to the inappropriate standardised regulatory EL for such loans. The situation would be aggravated further if at the same time the specific provisions could no longer be deducted from the exposure amount.