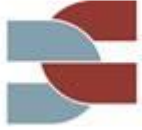

European Association of Co-operative Banks
Groupement Européen des Banques Coopératives
Europäische Vereinigung der Genossenschaftsbanken

EACB Comments on the Consultative Document of the Basel Committee on Banking Supervision

Guidance on accounting for expected credit losses

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The **European Association of Co-operative Banks** (EACB) is the voice of the co-operative banks in Europe. It represents, promotes and defends the common interests of its 31 member institutions and of co-operative banks in general. Co-operative banks form decentralised networks which are subject to banking as well as co-operative legislation. Democracy, transparency and proximity are the three key characteristics of the co-operative banks' business model. With 4.200 locally operating banks and 68.000 outlets co-operative banks are widely represented throughout the enlarged European Union, playing a major role in the financial and economic system. They have a long tradition in serving 205 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 78 million members and 860.000 employees and have a total average market share of about 20%.

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Key messages

The European Association of Co-operative Banks (EACB) gladly takes the opportunity to comment on the Basel Committee's consultative document on guidance on accounting for expected credit losses (ECL).

As a general comment, we consider that some of the requirements laid out in the proposed guidance are extremely challenging, complex and burdensome to comply with, which will add up to the costs of complying with IFRS 9.

While we understand the need to update the 2006 guidance, we believe that the provisions in IFRS 9 should be carefully considered and respected, as banks have invested important amounts in the adaptation to the new standard. As we will develop in our comments, we are especially concerned with the recommendations in the appendix devoted to IFRS jurisdictions, where the use of delinquency data and practical expedients (an integral feature of IFRS 9) is not recommended.

While we welcome that the adoption of a proportionate approach is contemplated in the guidance, in general terms we believe that the proportionality principle may and should be better addressed. For banks that apply the Standardised Approach and for the smaller ones, the implementation of the expected credit losses approach brings about many significant challenges. This is especially true if we bear in mind that these banks aren't likely to have developed internal credit risk assessment systems based on an expected loss approach. Therefore, a clear understanding of the potential operational difficulties should be achieved. It should be envisaged to include a transitional period and simplifications where appropriate. In this light, the possibility of resorting to practical expedients is of the utmost importance for smaller banks. Furthermore, we believe that a truly proportionate guidance should not just be applied at the entity level, but also at portfolio level.

We also consider that the cost of gathering the amount of information requested in many cases exceeds the potential benefits of using such information in the ECL model. Again, IFRS 9 should be abided by, i.e. "all reasonable and supportable information that is obtained without undue cost or effort" should be requested.

Finally, many of the prudential recommendations included in the guidance are addressed in other legislation. Therefore the need to achieving as much convergence and consistency as possible with other recently adopted Basel rules. In this regard, we appreciate the Committee's endeavour not to set out regulatory capital requirements on expected loss provisioning under the Basel capital framework (paragraph 7). Indeed, the final guidance should be carefully assessed so that it does not indirectly result in a negative impact on regulatory capital.

The guidance should stick as much as possible to the provisions in IFRS 9

By its great level of detail and restrictive stance, the proposed Basel guidance creates inflexibility and hinders the implementation of IFRS 9, bringing inconsistency. One example of inconsistency between the provisions in IFRS 9 and the guidance is the use of one-year PD in measuring a significant increase in credit risk: IFRS 9 allows its use as long as there are no hints that this is not appropriate, specifying those cases when this might be the case. On the other hand, the Basel guidance provides a list of very few examples of situations when the one-year PD can be used, meaning that lifetime PD has to be used in all other cases.

A lot of effort has already been invested in the adaptation to IFRS 9, which is largely accepted and set to be adopted in the European Union. Additional guidance in this regard should therefore aim to keep the same spirit in the IFRS 9 provisions, i.e. it should not become too prescriptive. Indeed, a too restrictive approach would render more difficult the application of this guidance at global level.

Moreover, the role of audit should not be neglected: a thorough audit of IFRS-compliant financial statements would in essence also attain the intended goal of this guidance.

Finally, it should be taken into account that the adoption stricter requirements can also lead to higher expected loss provisioning, which can end up having a negative impact on regulatory capital.

Proportionality should be better addressed and combined with the principle of materiality

Implementing the principle of proportionality is a demanding task. There are several complex regulatory areas in which the translation of this principle is not straightforward. One of those areas is surely the accounting for expected credit losses under IFRS 9. The implementation of the ECL model is especially challenging for smaller and less sophisticated banks, due to their lack of experience in the creation of internal credit risk assessment mechanisms. The requirements of the Guidance would render this situation even more challenging.

As stated previously, the possibility of resorting to practical expedients is of the utmost importance. They are indeed useful in order to both overcome the operational challenges posed by the ECL model and to ensure its application to all sizes of entities and to all types of instruments/portfolios without introducing significant bias. Therefore, we encourage the Basel Committee to bear in mind the reasons that motivated the IASB to adopt these practical expedients: to ease the burden associated with the implementation of the ECL model, thereby ensuring a better balance between benefits and costs.

Since the safe and sound implementation of the changes stemming from the IFRS 9-ECL model and the guidance will require significant lead time, we think that a transitional period should be envisaged, during which the use of practical expedients should be allowed. This would help in particular small and less sophisticated banks develop appropriate information systems, as well as appropriate policies, procedures and

corporate governance practices on forward-looking provisioning, in compliance with the guidance.

Moreover, we believe that the proportionality principle should be combined with the concept of materiality. In this regard, the adoption of a proportionate approach should not be limited to less complex banks: it should also be applicable to portfolios which are neither significant nor expected to be significant in terms of their size, nature (including potential losses under all reasonable scenarios as well as the data available for statistical analysis) and complexity.

Materiality is a fundamental principle of financial reporting (cf. IAS 1) and of the regulatory requirements of Basel II/III. It should thus be clearly addressed in the draft. The guidance should clarify that it does not override the concept of materiality as applied in accordance with accounting standards. We agree that materiality should not be used to justify low-quality implementation, but since materiality is a fundamental principle underpinning all financial reporting, we do not believe that materiality decisions should be seen as contrary to high-quality implementation provided they are appropriately justified. In order to reduce unnecessary operational risk and help ensure timely reporting, additional complexity not contributing to improved compliance with the accounting requirements should be discouraged.

The amount of forward looking and macroeconomic information requested is disproportionate

Furthermore, and despite the stated intention to address proportionality, we notice that there is a disproportionate emphasis throughout the guidance on the amount of forward looking and macroeconomic information required ("all relevant information"), which seems to disregard the provisions included in IFRS 9: "all reasonable and supportable information that is obtained without undue cost or effort". This leads to the Basel guidance requiring a lot of new data that have not been required before (and have therefore never been collected, such as the new information required at initial recognition of a loan). This implies a difficult challenge, especially for less complex institutions with limited resources. In this vein, and for the sake of consistency, we would favour an eventual alignment with the indicators required in the Standardized Approach, which is currently being reviewed.

Dealing with the new requirements will be especially challenging during the transition period, where there will be an information gap. In order to smoothen the process, banks should be allowed to work on the basis of "best available data".

Finally, it would be disproportionate to require a demonstration that forward-looking information is relevant in those cases where the potential impact is very low, as the costs would clearly outweigh the potential benefits.

Risk factors should be carefully chosen so that they are relevant to ECL measurement

The application of risk factors should also be clearly limited to those that are meaningful and relevant to ECL measurement, as different factors may be relevant for different portfolios. Those factors not leading to better information should not be considered for accounting purposes. Moreover, we suggest differentiating between retail and wholesale portfolios, as the approaches to retail and wholesale credit risk management and assessment are very different. As an example, the 30-DPD is not a good measure for wholesale loans because these are usually reviewed on an individual basis (as opposed to retail).

Interference with risk management and existing prudential requirements

Whereas the title of the document is "accounting" for expected credit losses, we consider that its scope goes beyond accounting, up to interfering with risk management. The goal of IFRS 9 is that internal risk management practices are represented in (external) reporting. The guidance should therefore clarify that risk management practices should be the basis for accounting purposes and not be changed by these. It should be strived to achieve consistency between accounting and prudential requirements upon capital adequacy, without evolving into an intrusion into the credit management practices.

As regards prudential provisions, the existing requirements should be born in mind and referred to in the document, instead of aiming to develop new requirements which will be difficult to frame.

Grouping of lending exposures on the basis of shared credit risk characteristics

The guidance also states that, regardless of the nature of the assessment and in order to include in the ECL estimates of the expected impact of all reasonably available forward-looking information and macroeconomic factors, exposures may be required to be placed in a group with shared credit risk characteristics and assessed collectively using a top-down approach for those factors that could not be assessed on an individual basis (paragraph 51).

The revision of the grouping and segmentation of portfolios should be carefully considered, so that the risk management practices applied are properly reflected. Instead of suggesting a re-segmentation, the guidance should strive to make sure that the groupings and the accounting inputs for the ECL models, as well as the inherent model governance and validation processes, are risk sensitive to the extent that these can react to the underlying credit conditions and behavioural aspects.

Furthermore, in accordance to IFRS 9, it should be possible to migrate individual exposures within a defined portfolio without needing to migrate the entire portfolio in those cases when individual data is available.

Finally, we question the meaningfulness of more frequent reviews for large exposures that already have good credit ratings.

Validation of the internal credit risk assessment models

The Committee proposes a sound model validation framework for internal credit risk models which is consistent with regulatory requirements. Such models should also be independently validated and reviewed, i.e. via the appointment of independent parties (such as internal or external auditors) who shall conduct regular reviews of the model validation process (paragraph 58). All this process requires a large organisation and resources, which is generally not a distinguishing feature of small cooperative banks. In this regard, a simplification of these requirements would be necessary. Furthermore, the know-how of employees developing the models should not be completely disregarded when it comes to the validation process. Finally, we also believe that validation by the supervisor would be sufficient in the context of the supervisory review and evaluation process.

Robust consideration of forward-looking information and macroeconomic factors

We appreciate that the Committee is aware of the challenges and the costs linked to the incorporation of forward-looking information and macroeconomic factors into the ECL model and the recognition that a significant degree of unavoidable subjectivity is linked to it. In this vein, and in order to avoid the disbursement of unnecessary costly investments in the development of a model that could turn out to be the outcome of a misinterpretation, we suggest deleting the disclosure requirements in paragraphs 75 and 76, as these clearly exceed the requirements in IFRS.

Supervisory requirements specific to jurisdictions applying IFRS

- *Assessment of significant increases in credit risk*

The Committee strongly endorses the IASB's view that "lifetime expected credit losses are generally expected to be recognised before a financial instrument becomes past due", which serves as a justification for its support for forward-looking approaches to calculate credit risk. In this line, we regret to see the Committee's disregard of delinquency data, which is considered to be backward-looking and not appropriate in the implementation of an ECL approach by banks. We believe that the use of delinquency data must be accepted in the ECL model as it may be in some cases the only information available for certain customer exposures. Furthermore, by analysing past payment behaviour, banks are able to better model future behaviour (which should be regarded as a source of forward-looking information).

As regards the use of macroeconomic data, such as the sector from which the customers earn their primary income, the national consumer protection laws applicable across different jurisdictions should be borne in mind, as these may restrict the banks' ability to track and collect information on individual customer accounts.

- *Use of practical expedients*

As previously commented, we believe that the IFRS 9 text should be respected, as it provides for the needed framework to adjust the implementation burden. This is especially the case for the so called practical expedients. We are therefore worried about the Committee's view that the use of these practical expedients is "inappropriate for use by internationally active banks and those banks more sophisticated in the business of lending, particularly because the cost of obtaining relevant information is not considered to be likely to involve undue cost or effort". We strongly disagree with this interpretation of the provisions of IFRS 9 according to the reporting company's industry or business lines.

The document addresses three practical expedients:

- *The information set*: According to IFRS 9 (paragraph B5.5.15), "an entity shall consider the best reasonable and supportable information that is available without undue cost and effort". However, the Committee expects banks to develop systems and processes to use all reasonable and supportable information needed to achieve a robust implementation of the approach. This would imply a disproportionate cost for some smaller banks that cannot afford to invest in new systems and processes. Moreover, it is not certain that the potential long term benefits of these would justify such an upfront investment. The requirements in the guidelines are a burden for the implementation process of the ECL calculations and thus reduce the time available to implement IFRS 9 before its application is mandatory.

- *"Low credit risk" exemption*: IFRS 9 provides for an exemption to the general model so that entities do not need to assess whether credit risk has increased significantly since initial recognition for "low credit risk" exposures. As regards the estimation of this change in credit risk, the Committee expects banks to rely primarily on their own credit risk assessments and not solely on ratings provided by CRAs. However, smaller institutions do not have the available internal resources needed to provide their own rating information, relying therefore in CRAs for such assessment. We therefore believe that the use of CRAs assessment should be allowed with no limitations for the use in the calculation of credit risk.

- *More-than-30-days-past-due rebuttable presumption*: While we understand the will to move towards a forward-looking approach to perform a credit risk assessment, the reliability of the 30-days-past-due rebuttable presumption should not be underestimated. We do not agree with the Committee's view that using that presumption as primary indicator to transfer to lifetime expected credit loss (LEL) is a very low-quality implementation of an ECL model. Modelling more robust methodologies and parameters is challenging and may not significantly improve the quality as compared to the 30-days-past-due rebuttable presumption.