EACB Comments

EBA draft GL on credit institutions' credit risk management practices and accounting for expected credit losses

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EACB AISBL – Secretariat • Rue de l'Industrie 26-38 • B-1040 Brussels
Tel: (+32 2) 230 11 24 • Fax (+32 2) 230 06 49 • Enterprise 0896.081.149 • lobbying register 4172526951-19
www.eacb.coop • e-mail : secretariat@eacb.coop

Contact:

For further information or questions on this paper, please contact:
- Mr. Volker Heegemann, Head of Department (v.heegemann@eacb.coop)
- Mr. Marco Mancino, Senior Adviser, Banking Regulation (m.mancino@eacb.coop)

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Introduction

The members of the EACB welcome the opportunity to comment on the EBA draft Guidelines (GL) on credit institutions' credit risk management practices and accounting for expected credit losses (ECL).

EBA plays a key role in the international harmonisation of supervisory frameworks and rules, however we believe there should be a clear line between its role and the one of accounting standard setters in determining rules for financial statements within a given financial reporting framework.

Overall, we see that some of the requirements laid out in the draft guidelines are particularly challenging and complex making compliance extremely burdensome. This will only add upon the costs needed to comply with IFRS 9. As a consequence, we suggest to postpone the date of application of the guidelines until 1 January 2020.

We welcome that the adoption of a proportionate approach is contemplated in the draft GL, however the proportionality principle should be more appropriately reflected in the GL. 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 institutions are not 'familiar with' internal credit risk assessment systems based on an expected loss approach to the same extent as the larger ones. Therefore, before finalising the GL a clear understanding of the potential operational difficulties should be achieved. In this respect we believe transitional and grandfathering rules should be envisage according to which institutions, particularly less complex ones, may rely more on the use of practical expedients. We would like also to highlight that in a context in which not all EU banks apply the IFRS/IAS the right application of the proportionality principle is even more determinant.

We also believe that the draft GL would gain in clarity if it built on the existing risk management processes, so to focus purely on the use of sound credit risk management system for accounting purposes and ECL estimation. Moreover, we believe that the draft GL should be based on a clear set of principles rather than specific rules which might create inflexibility and redundancies. In addition, the draft GL should highlight more that the results of existing regulatory capital models for IRB-purposes for the measurement of expected losses would already be considered compliant to a certain extent with the draft GL, as in the case of the so-called 'modular validation'.

Answers to specific questions

Q.1 Is the scope of application of the guidelines appropriate and sufficiently clear?

We understand that the scope of application is only loans and advances and not debt securities, trade receivables or lease receivables.

We would support this scope of application and welcome that credit institutions would need to comply with the guidelines on different levels of consolidation under the CRR scope of consolidation (individual, sub-consolidated and consolidated levels).

Q.2 Is the date of application of the guidelines of 1 January 2018 appropriate?

We understand that the date of application is proposed keeping in mind the need to be IFRS 9 compliant by beginning of January 2018. However we would like to point out two aspects to call for a postponement of the date of application to 1 January 2020.

- By January 2018 institutions may have had different time periods to test their systems, however this is no substitute for live testing which, in the past, has been shown to provide significant insights. Furthermore, it will take time for new IFRS 9 related internal governance processes to establish themselves on an operating level, a process which can only really start after 1 January 2018.
- We expect an emergence of new trends in best practice in critical areas such as significant increase of credit risk (SICR). In this respect we expect an increase in positive inputs during 2018, i.e. peer disclosures, discussions with auditors and regulators. Also in case of major change requests, the application of the guidelines should be postponed to a later date.

Moreover, the draft GL also introduce additional requirements compared to IFRS 9, especially in relation to sound credit risk management practices. Overall, we think that the costs of implementing the guidelines will only add up to the already high costs of complying with IFRS 9. Postponing the date of application of the draft GL to 1 January 2020 will allow credit institutions in scope of application to effectively allocate costs and resources and give them enough time to reach compliance with the guidelines.

Alternatively, as already indicated, transitional and grandfathering arrangements should be laid down in order to ease the burden associated with the implementation of the ECL model, thereby ensuring a better balance between benefits and costs.

Q.3 Please provide any comments you may have on the appropriateness of the proposed proportionality approach.

We strongly support the reference on how to apply the EBA GL considering the principle of proportionality. The proportionality principle should not only apply to institutions of different size or complexity, but also to subsidiaries or branches as part of banking groups, i.e. for example to subsidiaries which standalone would be considered "smaller or less complex credit institutions". In case of single portfolios, the applicable materiality principle should rather follow the criteria of the proportionality principle.

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, and one of those 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 with the internal credit risk assessment systems based on expected credit losses. Moreover since these banks aren't likely to have developed in the past such credit risk assessment mechanisms, dealing with new requirements will be especially challenging during the first years of the application of the IFRS9 due to the ensuing important information gap.

The requirements of the draft GL would make this situation even more challenging. 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 EBA to bear in mind the reasons that motivated the IASB to adopt these practical expedients. 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 transitional and grandfathering arrangements 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.

We think that considerations relating to proportionality or materiality, when choosing to adopt a particular approach to ECL estimation, be it 'ideal' or an approximation to 'ideal' measures, are especially well reflected and correspond to established practices. These two principles (proportionality and materiality) are already applied in practice today and are a part of the regulatory framework, as demonstrated, for example, by the possibility of a permanent partial use in IRB, and an accounting principle for useful information in the IFRS Framework.

The inclusion of proportionality reflects the real heterogeneity of the European banking industry. In this respect we would propose to explicitly include "less developed markets" as one of the criteria for proportionate application. One example in this respect is the use of forward looking information. The degree of availability and robustness of macroeconomic indicators varies from country to country. Another example is that the banks using STD or FIRB approach might need to additionally focus on development of some of the credit risk parameters during the implementation time.

We note that the proportionality principle is narrowly interpreted for the use of practical expedients (para. 129). The wording requires both criteria of small and less complex to be fulfilled. We believe that the proportionality principle should be applied consistently throughout the GL and suggest changing the wording in para. 129 to "credit institutions which are smaller or less complex". We believe that the application of practical expedients to non material portfolios, for instance, should be possible in order to help implementing the GL without additional complexity.

Q.4 Do you agree with the draft guidelines which introduce the relevant BCBS Guidance in the EU regulatory framework? Are there additional issues for which the EBA Guidelines should be amended in the context of finalising the guidelines?

In general, the EBA guidelines seem in line with the BCBS guidance. However, we see that there are still some instances where amendments should be considered:

- The draft GL should adequately take into account that the EU transposition of the BCBS standards rolls over to all banks (as well as investment firms) requirements originally developed for internationally active institutions. However, the total cost of compliance due to an increasingly complex prudential regulation places less sophisticated institutions at competitive disadvantage.
- We believe that the draft GL should not address guidelines on sound risk management practice in general, but rather should focus more on the use of credit risk management systems for accounting purposes. For instance, a description of what an effective internal control system for credit risk assessment and measurement should include (para. 27) is more of a specific credit risk requirement that should rather have a reference in existing regulation.
- The draft GL should be based on a set of principles. A principle-based approach is best suited for the application within the broad range of different accounting frameworks, business models and sizes of banks and as such can be adequately applied by credit institutions. Strict requirements and examples (e.g. para. 36, 37, 40) would be difficult to align with the proportionality and materiality principles recalled in the draft GL.
- The paper mentions that credit institutions may use existing regulatory capital models for the measurement of expected losses as a starting point for estimating ECL for accounting purposes. We believe it should be made more explicit that, in case of IRB banks, certain IRB-compliant parts of those models can be left unchanged for the purpose of achieving compliance with the draft GL. In addition, we recommend to specify that a modular approach can be taken to validating those models, i.e. in case a particular module has already been validated for IRB purposes, it also fulfils the proposed draft GL. Finally, it should be highlighted that it is not necessary to investigate or establish additional criteria to identify alternative portfolio segmentation, when adequate modelling and model validation processes are already in place.
- We welcome the fact that some paragraphs reproducing IFRS 9 text have been replaced by a reference to the specific paragraph of IFRS 9. However, from our perspective, this approach could be extended further. For example, a statement that "credit institutions should ensure that modifications or renegotiations do not obscure increases in credit risk…" (para. 124) relates to IFRS 9 preventing preparers from hiding credit deteriorations by modifications or renegotiations of the contractual terms and conditions and should be appropriately referenced.

Q.5 Do you agree with the impact assessment and its conclusions, having regard to the baseline scenario used for this impact assessment? Please provide any additional information regarding the costs and benefits from the application of these guidelines.

We generally agree with the impact assessment and baseline scenario and welcome the strong intention of the regulator to create a level playing field. In relation to the impact assessment for the proportionality approach, we believe that Option 2.1 is preferable given its most principle-based nature. Such an approach is best suited for the application within the broad range of different accounting frameworks, business models and sizes of banks.

On the contrary, specific exclusions or inclusions ("smaller/less complex" or "systematically important credit institutions") would lead to a reduced flexibility and would be impossible to account for all of the possible cases, when specifying certain criteria. The costs associated with those exclusions and restrictions would outweigh the potential benefits.

Q.6 Please provide any additional comments on the draft guidelines.

Regarding materiality principle, we would like to emphasise that even in case of large exposures/portfolios, the materiality and sensitivity of the amount of risk provisions should be a more relevant measure than magnitude of exposure amount. We would suggest to amend the following part of para. 18 "*In addition, materiality should not be assessed only on the basis of the potential impact on the profit or loss statement at the reporting date under the applicable accounting framework. For instance, large portfolio(s) of highly collateralized lending exposures like real estate mortgages should be considered material*" to reflect this idea.

<u>*Use of practical expedients*</u>: As recalled under Q.4 the IFRS 9 provisions should be adequately considered, as they provide the needed framework to adjust the implementation burden. This is especially the case for the so called practical expedients. We strongly disagree with the interpretation given to the provisions of IFRS 9 where according to the reporting company's industry in the case of credit institutions they should make a limited use of the practical expedients "*because – given their business – the cost of obtaining relevant information is not likely to involve 'undue cost and effort*".

The draft GL address 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 EBA 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 while the potential long term benefits that would justify such an upfront investment are not certain.
- "Low credit risk" exemption: The IASB has explicitly introduced the low credit risk exemption as a rule to establish an equilibrium between costs and benefits (IFRS 9.BC5.180). In contrast, the EBA requires banks to make a limited use of this exemption and the draft GL set the hurdles for the application very high. In our opinion the exemption is justified both from a conceptual and a material perspective. Therefore we disagree with the view that the use of the low credit risk exemption would result in a low quality implementation of the IFRS 9 ECL model.
- 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 EBA's view that using that presumption as primary indicator to transfer to lifetime expected credit loss 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.
In particular, with reference to para. 102, for small exposures which are monitored and controlled on a portfolio basis (in particular in the retail segment) a past due indicator may be appropriate given cost-benefit considerations. Many banks have statistical models that capture the connection between days past due and increased probability of default. For large exposures other factors will be considered, as these are monitored on an individual basis. However, this will usually not be possible for small loans, for which past due status may be an objective and comparable indicator. Defining borrower specific attributes for these portfolios will likely imply generating undue costs and effort.

Para 27: The word "relevant" is used in the context of "relevant and reasonable and supportable information". Reasonable and supportable is used in the IFRS standard however "relevant" has now been added and may lead to confusion.

Para 36: A clarification is needed about the factor e) *"the incentives or willingness of borrowers to meet their obligations" added compared to the BCBS guidance.*

Para 94: In our view, additional segmentation only seems appropriate if the segmentation is forced by a new, so far unrecognised significant risk or if risk factors or their correlation have changed.

Para 106/107: This states that indicators as defined by IFRS 9.B5.5.17 (a)-(p) should each be considered when determining whether an exposure should move to bucket 2. IFRS 9 states that the factors mentioned "may be relevant", but does not require entities to track all the factors for all loans. Point 106 refers to IFRS 9.B5.5.17 and the 16 classes of possible factors to be monitored when assessing changes in credit risk. Then point 107 picks out some and makes them more relevant than others. Also, the wording in point 107 is inconsistent with IFRS 9.B5.5.17, which will lead to additional diversity in practice. It seems that factors listed in point 107 generally lead to LEL. We do not see the need to establish these automatic moves to LEL as they might act as false incentives to banks (i.e., not to take additional collateral for an exposure when it would make economic sense, because it would lead to an automatic shift from bucket 1 to bucket 2). This paragraph should therefore either be rephrased or deleted.

Para 109: We strongly disagree with the mention of the absolute measure for the assessment of the significance of a change in credit risk since initial recognition (cf. Paragraph 109) as this will result in non-compliance with IFRS 9 requirements.

We strongly disagree that the width of the change in PD itself (i.e. PD at measurement date minus PD at initial recognition – an absolute measure) should be considered at all (paragraph 109) as IFRS 9 requires the assessment that is relative in nature, when determining whether the credit risk on a financial instrument has increased significantly since initial recognition;

Para 116: Even with reference to IFRS 9 B5.5.1, it is not defined, what the word “group” means in this context. Thus, further clarification is needed. In our opinion a downgrading of a single counterparty within a group with shared credit risk characteristics should not automatically lead to transfer of the entire group to LEL.

Para 120: It should be clearly stated in paragraph 120 that a comparison of past lifetime PD estimates at initial recognition with the lifetime PDs estimated on the reporting date makes sense economically only if the comparison is made for congruent periods of time (as implied in IFRS 9 B5.5.11). Hence only the former lifetime PD expectations at initial recognition for the (at that time) future period starting at the reporting date are the basis for the comparison with the current lifetime PD at reporting date.

Para 121: It is not clear whether the "additional factors" mentioned here in relation to SICR are over and above the factors mentioned in IFRS 9.B5.5.17.

Para 129, 132 etc.: It is not clear what is meant by "limited use" of the practical expedients and should be clearer i.e. whether they can be used or not. Otherwise this could lead to a situation that not using the practical expedients will introduce bias. However, in general and as recalled above, we believe that practical expedient should be allowed, to avoid an undue implementation burden in establishing and running models with no additional benefits.

Para 130: This imposes an additional burden of proof on the bank: the bank has to document and disclose why it has acted in a way that is permitted by IFRS 9, but is discouraged or forbidden by the guidelines.

Para 131: Just as with any implementation of new systems or processes required by a new standard, the implementation of IFRS 9 should be subject to cost-benefit analysis, as generally stipulated in IFRS. It is not clear why "nevertheless" has been used at the beginning of this sentence. Furthermore it is not clear why the sentences quoted by IFRS 9 could be interpreted "restrictively". Also it’s doubtful why it is considered that information for a high-quality application of IFRS 9 can be derived without ‘undue cost and effort’.

Para 132-134: It is not clear under what circumstances use of the low credit risk exemption would be acceptable.