EACB Comments

BCBS Regulatory treatment of accounting provisions – Discussion Paper and Interim approach and transitional arrangements (BCBS 385 and 386)

Brussels, 13th January 2017

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)

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 4.050 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 210 million customers, mainly consumers, retailers and communities. The co-operative banks in Europe represent 79 million members and 860.000 employees and have a total average market share of about 20%.

For further details, please visit www.eacb.coop

Introduction

The members of the EACB welcome the opportunity to comment on the BCBS proposals on the regulatory treatment of accounting provisions and their transitional arrangements.

The revised treatment of credit losses in accounting standards will introduce fundamental changes in banks' accounting practices, this will have regulatory effects that need to be assessed on both a quantitative and a qualitative basis. We would advise the Committee to undertake a comprehensive assessment to ensure the regulatory long-term approach appropriately takes into consideration accounting provisions.

From a conceptual perspective, the new standards has affects, albeit differently, the regulatory status of accounting provisions under standardized (SA) and IRB methods. The treatment of accounting provisions under both approaches needs to be addressed at the same time to ensure a level-playing-field.

General comments

The move to IFRS 9, and to ECL provisioning more in general, required a redesign of the regulatory treatment of accounting provisions. We appreciate that it is recognised that SA users are at an unfair disadvantage compared with IRB users in terms of the impact of accounting provisions on regulatory capital. This bias should be properly addressed, as IFRS 9 ECL provisioning is expected to drive a substantial increase in provisions.

The materiality of the impact of the solution proposed is a clear driver to identify the most appropriate option. As the increase caused by ECL provisioning might well reveal to be pretty substantial, solutions are needed that avoid any double counting, eliminate the unfairness to standardised users, and reduce any extra procyclicality.

Moreover, the introduction of a regulatory ECL is connected with a significant additional effort for institutions using the standardized approach for credit risk. This is mainly due to the fact that these institutions do not necessarily have sufficiently precise statistical data for their receivables to calculate an expected credit loss.

Finally, the higher provisioning numbers that will be driven by IFRS 9, and unbalanced impact for SA users, would justify a solution that foresees a one off implementation burden, and possibly slightly higher recurring administrative costs. But the overriding imperative is that there should be only one set of changes (including transitionals). Once any new treatment is agreed, it should not be changed for the foreseeable future.

➢ *Double counting*

To avoid "double counting", i.e. addressing the same risk through both accounting and prudential frameworks with an additive effect, a holistic approach is needed. The current prudential capital rules were calibrated on incurred loss models, thus a move towards an expected loss model, generating higher provisions, may not be the soundest way by simply assuming that the existing calibration of capital rules remains valid.

We believe that potential double counting lies in the overlap between the concepts of lifetime ECL and "unexpected losses".

Ideally both double counting and the SA/IRB bias should be addressed. The proposal (para. 2.3 DP) to introduce regulatory EL under the SA, while adding some complexity for SA users, does not address the issue of double counting.

An alternative, simplified approach based on using regulatory EL minima, could mitigate to some extent the procyclical volatility that the impact of ECL on capital would otherwise create.

Specific comments

- *General vs. specific provisions*

The Committee is aware that 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. In the EU the EBA (EBA/RTS/2013/04 adopted as Commission delegated regulation 183/2014, Art. 1) provides further guidance on the identification of general credit risk adjustments:

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 […]*

'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 IFRS9, while provisions for impaired assets (stage 3) can be easily identified as specific, the situation is less transparent for unimpaired assets. If they have experienced a significant increase in credit risk (stage 2) or not (stage 1) they can be meet with requirements under points 4(b) or 5(c) above, making categorization ambiguous.

If the Committee retains the concept of general and specific provisions, all provisions under the ECL models should be considered specific. The 12m ECL provisions would continue being deducted from the exposure for RWA calculation while the LTEL ECL should be added back to CET1 or alternatively subtracted times 12.5 from the RWA.

The distinction between specific and general credit risk adjustments has been used for tax purposes in some jurisdictions, and national authorities should retain the flexibility to consistently ensure a fair tax treatment for the entities within their jurisdiction regardless of the underlying accounting treatment.

- *Proposal for introduction of regulatory EL*

The proposal to introduce regulatory EL would align the IRB and SA conceptually and could provide a basis for introduction of a symmetric treatment of excess provisions both under STA and IRB. It is however impossible to fully evaluate the BCBS proposal without understanding the BCBS approach to the treatment of excess provisions. The BCBS proposal currently does not tackle the real issue of double counting (a portion of the exposure addresses simultaneously an EL and an UL). This could be addressed through a reduction of the SA RW calibration or through the non-recognition of the LTEL portion of provisions in the prudential capital as a permanent solution.

In any case the differentiation between general and specific credit risk adjustment in the standardized approach for credit risk has to guarantee that the reduction of CET 1 is not calculated on the basis of excessive parameters. The proposal of the BCBS that the ECL is calculated on the basis of a one-year-probability of default seems acceptable. Generally we support the proposal of the Basel Committee that for institutions using the standardized approach for credit risk the amount that exceeds the one-year-probability of default can be classified as Two Tier Capital in the 2nd stage of IFRS.

- *Timeline and implementation*

We would suggest that 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 the calculation of the transitional adjustment amount we could support either alternative 3 or 1. Alternative 3 is the preferred approach of the European regulator and has the advantage of having dynamic nature. We see however the merit of approach 1 in its simplicity and applicability at global level.

With regard to the modified approach 1 the suggestion that a "modest decrease in CET1" should be accepted might make things more complicated. We also see that the wording "modest" decrease in CET1 is too vague and could be clarified.