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BCBS Discussion Paper: Regulatory treatment of accounting provisions

Key points:

- ◆ The regulatory framework must ensure that the same potential losses are not covered both by capital and provisions.
- ◆ Discussions on the treatment of excess provisioning should be accelerated. The revision of the treatment of accounting provisions cannot take place in blocks without considering all relevant major aspects altogether.
- ◆ Provisions in excess of 12 months should be considered for capital purposes regardless of the capital method used to calculate capital.
- ◆ Excesses and shortfalls in provisions should be treated symmetrically both under the standardized approach (STA) and internal ratings-based (IRB) approaches. If this symmetrical treatment is accepted, then the regulatory EL could be useful in providing a basis for such a symmetrical treatment for STA. However it needs further considerations and recalibrations to eliminate overlaps.

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EBF position

BCBS Discussion Paper: Regulatory treatment of accounting provisions

1. Need for a holistic approach

After the 2008 crisis, the G20 called in its April 2009 meeting for measures to mitigate procyclicality in the industry's loss absorption capacities. Since then, both the accounting and prudential standard setters have put forward measures to address the G20 call. The IASB and the FASB, to respond to the criticism of incurred loss models as providing too little and too late provision, put in place provisioning standards based on an expected loss (EL) model, that strengthen the accounting recognition of loan-loss provisions for credit risk by requiring a recognition of expected credit losses on the whole portfolio and by incorporating a broader range of credit data, including forward-looking information.

At the same time, prudential regulators put in place measures and mechanisms to reinforce the loss absorption capabilities of entities, such as capital buffers (conservation and counter-cyclical buffer, buffers for systemically important institutions), review of the standards of capital calculation, restrictions to IRB calculations; etc.

Due to the different expert teams involved in developing regulation, different nature of the measures and time constraints, there is an overlap between some measures, resulting in "double counting" of the loss absorption capacities. In particular, there is a duplication of loss absorbing resources between the new accounting standards (forward-looking loss provisions) and prudential regulations (regulatory capital).

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 level of capital will no longer be driven by regulatory but accounting measures. The volatility of the accounting provisions will be translated in the capital volatility. 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 be taken into account in the overall calibration of the capital framework to ensure the capital requirements are not increased substantially. It is important to understand the extent to which various measures introduced in response to financial crisis address the same risk of default of the counterparty and how the introduction of lifetime expected loss concept into accounting standards overlaps with capital requirements.

The regulatory framework must ensure that the same potential losses are not covered both by capital and provisions. Any 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.

2. Overlapping measures

The overlapping measures and the regulatory treatment of excess accounting provisions is perceived as the main issue by the banking industry. We were therefore disappointed to find little reference to it in the consultation paper. To consider the problem of excess

provisions, there is a need to revisit the fundamental purpose of accounting provisions, expected loss deductions and regulatory capital. We believe the discussions should be accelerated as treatment of excess provisioning is a major component and the revision of the treatment of accounting provisions cannot take place in blocks without considering all relevant aspects altogether.

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

The interaction between accounting and regulatory measures should be analysed in detail to understand the extent to which different measures are addressing the same risk such as for example the interaction with stress test. Worsening of a macroeconomic expectations will be reflected in the stress test results, provoking a higher Pillar 2G requirement by the 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 worsening of a macro expectations is based on 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 with capital

Expected losses, essentially 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. Conceptually the own funds requirements under the Basel framework are determined to absorb unexpected losses in a time horizon of one year (See Annex I). To calculate unexpected losses, the calculation of expected losses over the same time horizon is necessary.

The accounting expected loss provisions calculate the present value of expected credit losses. The accounting expected losses differ from the regulatory EL in that they require an unbiased point in time estimate of EL for 12 months in stage 1 and lifetime expected losses in stage 2 and for all CECL exposures.

The present values of gross expected losses are deducted from equity, even though the loan portfolios are still performing and are expected to generate an interest margin to compensate for the whole or part of the expected loss. For stage 1 assets, this could be seen as an approximation of a decrease in the contractual interest for expected losses. For all contracts with a contractual maturity beyond 12 months, this means excessive provisioning that goes beyond banks capital planning buffers that calculate the effect on equity from the net of earnings and expected losses.

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 CET1 capital.

c) Relationship between RW, Expected Losses and Unexpected losses

The Basel II framework was set to assure a level playing field between standardized and IRB portfolios:

- IRB approach – The RW formula was set to cover the unexpected losses (the difference between a VaR at 99,9 % and the EL). As the EL were already deducted from the RW formula, the resulting RW was designed to be applied to the gross exposure.
- SA approach– To guarantee that these banks would also calculate RWA just for the unexpected losses, the RW levels were calibrated to cover UL + EL but were applied to the net exposure (of provisions) in order to not duplicate the EL effect.

The relation of RWs to the concept of expected and unexpected losses should be clarified. The BCBS should maintain the fundamental principle that capital requirements cover only the unexpected losses. We assume that the RWs under the standardize approach cover both unexpected and expected losses given that specific provision were allowed to be deducted from EADs. If option 3 of the BSBC proposal for a permanent approach is to be considered, the standard RW should be revised downwards as the new EL measure for standard portfolios (the accounting provisions) will increase and go beyond what was currently understood as expected losses.

3. EBF proposal for a permanent solution

Considering the nature of provisions for expected losses beyond a 12 months' time horizon, the EBF suggests these provisions be considered for capital purposes regardless of the capital 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 excessive volatility in capital that results from volatility in provisions due to the cliff effect of when moving assets to stage 2 under IFRS 9 and use of point in time PDs in calculations of accounting EL as opposed to TTC PDs. Volatility could also result from changes in estimates stemming from the changes in forecasts of economic conditions both short term (e.g. results of elections, referendums) or long term.
- 2) Conceptually align the IRB and STA models and level the playing field between both approaches as provisions set aside for defaults over 12 months are treated equally.
- 3) Level the playing field among different accounting standards, not only between IFRS9 and CECL, but also any underlying accounting standard.

Please find hereafter an example (simplified) to illustrate the effect of the lack of LPF:

Two banks with identical mortgage portfolios that have experienced a significant increase in credit risk since origination. Bank A moves to IFRS9 and Bank B stays under IAS39. With the same risk profile, the image of capital comparison between these two banks would be distorted because of the different underlying accounting frameworks.

Case 1: 2 different timelines for entry IFRS9

	<i>Bank A</i>	<i>Bank B</i>
Accounting Framework	IFRS9	IAS 39
Portfolio	Mortgages	Mortgages
Capital before provisions	120	120

Accounting Framework

		<12m	>12m	Total	<12m	>12m	Total
t=0	Stage 1	5	0	5	5	0	5
t=1	Stage 2	5	2	7	5	0	5

Capital Framework

Starting point_ Capital Framework:

Capital=Capital before provisions-Provisions

		Capital	Capital
t=0	Stage 1	115	115
t=1	Stage 2	113	115

Proposal_ Prov > 12 m=CET 1:

Capital =Capital before provisions-Provisions+Provisions >12m

		Capital	Capital
t=0	Stage 1	115	115
t=1	Stage 2	115	115

3.1 EBF proposal to treat excess provisions under the IRB approach

The EBF suggests that under the IRB approach, the excesses and shortfalls of 12 months ECL (accounting provisions) in comparison to the 12 months EL under prudential framework for IRB portfolios should be treated symmetrically. The current cap should be removed or recalibrated.

In the view of EBF, the characteristic 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. alongside 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 IFRS9 development was at early stage and its final characteristics have not been set until 2014.

The EBF is of the view that the cap should be eliminated, or at least recalibrated to be consistent with the new accounting model. This will require calculation of 12-month ECL also for all stage 2 assets, above the requirements of IFRS 9. The 12-month ECL for stage 2 will therefore not be published in financial statements and audited given they will be computed for prudential purposes only.

Recognition of excess provisions in Tier 2 in this context would only be useful for TLAC. However the dynamics of the concept and Tier 2 is such that the EL would not be an appropriate instrument to cover for TLAC requirements. In case of a downturn in the economic cycle, part of the loans would move to stage 3 which would reduce the amount available in Tier 2, at the wrong moment as the bank could be obliged to issue in the market at potentially adverse conditions.

3.2 EBF proposal to treat excess provisions under the STA approach

To ensure consistency with the IRB approach in offsetting the ECL impact, the difference between lifetime expected loss and 12 months ECL should be incorporated within CET1. The EBF suggests to calculate 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 12-month 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 published in financial statements and audited given they will be computed for prudential purposes only.

We believe the 12 months 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. 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, however the sum of the differences on an average over a cycle should amount to zero.

Alternatively, the BCBS proposal for regulatory EL in the standardized approach could be used instead of the 12-month accounting EL provided it is recalibrated to eliminate overlaps given the assumption the risk weights under the STA cover both for expected and unexpected losses. Please see our comments further in the document.

Example to illustrate the EBF proposal for STA and IRB

	STA	IRB
-		
Regulatory EL		22
Stage 1: EL 12 m	5	5
Stage 2: EL 12 m	15	15
Stage 2: EL > 12 m	40	40
Stage 2: LTEL	55	55
Stage 3	10	10
Total accounting provisions	70	70
Book equity	1.200	1.200
Add back LTEL	55	40
Deduction 12m EL	-15	
Deduction: Regulatory EL > 12 EL		-2
CET 1 own funds	1.240	1.238

3.3 EBF proposal for an alternative approach to the treatment of excess provisions under IRB and STA

The EBF would propose as an alternative to CET 1 recognition of the excess provisions, that the LTEL portion x 12,5 is 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. One advantage of this approach is that it ensures that excesses in provisions for credit losses are only affecting the credit risk.

4. Basel Committee's proposals for standardized approach

4.1 Distinguishing between general and specific provisions

Basel acknowledged from the initial phase of the prudential framework, back in 1988, the difficulties to clearly identify 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.'*

Under IFRS9, provisions for impaired assets (stage 3) can easily be identified as specific. However, categorization of unimpaired assets, both if they have experienced a significant increase in credit risk (stage 2) or not (stage 1) will be ambiguous. While it can be argued that stage 1 provisions are set aside for a future deterioration (as opposite to the IAS39 IBNR, in which the deterioration is already there, although undetected) and free to be assigned to other losses (on average a portfolio will lose this amount, but probably not on this particular asset for which banks is provisioning on day 1) we believe clarification of the treatment of provisions as specific and general will be required.

4.2 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 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 overlapping measures (the extent to which a portion of the exposure addresses simultaneously an EL and an UL) that can be tackled through a reduction of the STA RW percentages calibration and through the non-recognition of the LTEL portion of provisions in the prudential capital (e.g. symmetrical recognition of excess and shortfall of the provisions in CET 1) as a permanent solution.

Notwithstanding the above, we have the following immediate comments on the calibration of the standardized EL as proposed in the document.

- Assuming that the RW cover both EL and UEL, the STA RW percentages should be revised downwards to account just for the unexpected loss (UL). This is considered a major issue that needs to be addressed. The EL standard rates framework proposed by the BCBS need to be changed.
- Standardized EL is unlikely to reflect the risk inherent in different portfolios and geographies.
- Better quality portfolios will be likely impacted by average parameters. Banks with high quality portfolios not having experience a credit risk deterioration might have shortage of accounting provisions. BCBS reasons that it will encourage banks to have robust provisions. But robust provisions do not mean more provisions but provisions that best reflects the risk of the exposures.
- Standardized EL as a single percentage would not be able to reflect the underlying approach of stages 1 and 2 nor the LTEL as it depends on the maturity of the loans.
- An increase in capital requirement is envisaged compared to current STA even for banks with stock of provisions equal to expected losses.

Example:

Current STA: Exposure: 100; RW: 100%; Accounting Provisions: 10

$RWA = (100 - 10) * 100\% = 90 * 100\% = 90$

Revised STA: Exposure: 100; RW: 100%; Accounting Provisions: 10, Expected Loss: 10 $RWA = 100 * 100\% = 100$

- For entities with general provisions (GP) the transition to standardized EL (with unchanged treatment of excess) would mean change from having GP considered as T2 capital until 1.25 % of RWA cap to having the excess compared to a regulatory EL capped at 0.6% RWA. This would impact total capital figure without any change in the risk profile.
- When calibrating the EL rates, the BCBS should clarify how credit risk mitigation (CRM) will be reflected. Currently use of the foundation LGD values would not adequately or consistently reflect collateral and other forms of credit protection. For example an LGD for a residential mortgage loan would be lower than that of an auto loan and both would be significantly lower than for an unsecured loan. Even within the same asset class the LGD would vary depending on the coverage of collateral and this needs to be properly reflected in the calibration. The Committee may intend to do this by utilising the revised standardised risk weights that are tiered by LTV for residential mortgages and recognising other forms of CRM through exposure value. However, this is not currently clear from the paper and would limit alignment between IRB and Standardised given residential property collateral would be reflected through the risk weight and other CRM would be reflected through exposure value under STA and through LGD under IRB.
- 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 thus the need to build specific provision could be confronted with significantly increasing capital requirements due to the change of 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 institution would have to hold additional 25% of the exposure amount as capital. At the same time, in case the credit institution could no longer deduct the specific provision from the exposure amount, assuming 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 calibrated standardised regulatory EL.

We believe several aspects of the prudential regime and BCBS intentions have to be clarified before providing definitive views on the appropriateness of the future approach for the regulatory treatment of expected losses. The EBF stands ready to exchange views with the BCBS in more detail and will be pleased to provide comments on the future consultations on the issue.

Annex I

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'.

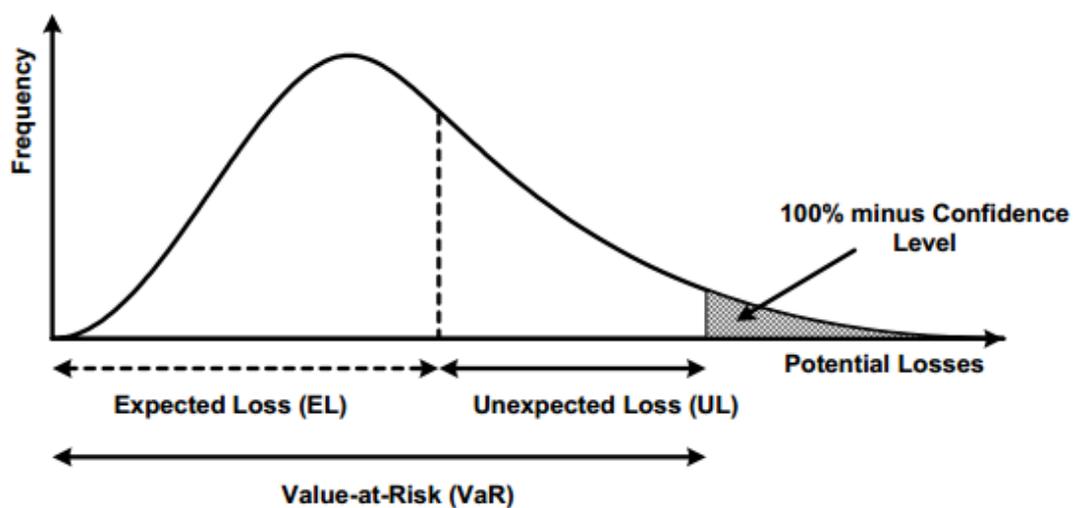


Figure 1

Figure 1 shows the approach for describing losses in the Basel II framework.

Under IFRS9, as expressed in paragraph 5.5.3 of the IASB IFRS9 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 shall be measured as an unbiased and probability weighted amount determined by evaluating a range of possible outcome and by integrating forward looking information (cf. IFRS 9§5.5.17).

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 CET1 capital.

The Basel framework (or balance sheet) takes its outset in the accounting balance sheets. For IRB approved banks, the IRB formula has been calibrated to account for the 1 year loss distribution at the 99.9% confidence. In this structure, capital for unexpected losses is accounted for in the risk exposure amount while the expected losses are accounted for through the deductions. Furthermore, the Basel framework states that the expected losses (EL) computed under the IRB formula are to be compared towards to the amount of eligible provisions. Should EL exceed the eligible provisions, a “shortfall” arises further increasing the gap between equity and CET1. Should eligible provisions exceed EL, the “excess” may under certain circumstances be added back to Tier 2 capital. For STA banks, this shortfall or excess is not recognised at all through deductions, while exposures amounts are reduced by credit risk adjustment (here eligible provisions) through the unexpected loss.

IAS 39 is based on historic cost and impairment losses are only recognised when a loss event has been identified, which has an impact on the estimated future cash flows of the financial asset. This is fundamentally different from Basel’s expected loss framework. Additionally, while Basel aims for a through the cycle stable expected loss, the IAS39 targets a fair and true allowance. With the introduction of IFRS9, perspectives continue to differ between accounting and Basel as IFRS9 imposes forward looking elements, increases time horizon (under stage 2 to lifetime) and requires “fair and true” (point in time) perspectives for allowances, again imposing fundamental perspective differences between Basel and accounting.

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