January 13, 2017

Mr. William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Comments on the Discussion Paper, Regulatory treatment of accounting provisions, and the Consultative Document, Regulatory treatment of accounting provisions – interim approach and transitional arrangements

Dear Mr. Coen:

The Institute of International Finance ("IIF") and the Global Financial Markets Association ("GFMA"), (together, the "Associations") appreciate the opportunity to comment on the Basel Committee on Banking Supervision's ("BCBS" or the "Committee") discussion paper on regulatory treatment of accounting provisions (the "Discussion Paper") and the consultative document on regulatory treatment of accounting provisions – interim approach and transitional arrangements (the "Consultative Document"). The Associations would also like to thank the BCBS Task Force on the Expected Loss Provisioning (the "TFELP") for the opportunity to raise with them in person some of the industry's comments on the proposals at the meeting in London on November 15 (the "outreach meeting").

The Associations are fully supportive of the initiative to review the regulatory treatment of the new standards for accounting provisions. The current adjustments of capital relating to accounting provisions were defined over ten years ago, when the Basel II framework was put in place. Since then, standard setters have undertaken transformative overhaul of both regulatory and accounting frameworks to address the lessons of the 2008 crisis. On the accounting side, banks under either IFRS or US GAAP will shift from long-standing incurred loss models to new expected loss models (the "new ECL" or "new accounting ECL"). This represents a complete change of paradigm of accounting for credit risk activities, which are at the very core of banks' business. On the regulatory side, capital requirements for credit risk are coming to the end of a long period of deep review, chiefly the consultations on the Basel III Standardized Approach (the "SA") and Internal Ratings-Based ("IRB") approaches for credit risk but also the introduction of standardized floors and capital buffers, not to mention the broad implementation of requirements for Total Loss Absorbing Capacity ("TLAC").

The combination of all the new changes leaves little doubt that the financial system will be adequately capitalized under the new regime; however, the full implications of new accounting and regulatory standards and the way they will interact are still not fully understood. Consideration and finalization of analysis of capital requirements is not complete and their ultimate impact remains to be assessed. Regarding accounting standards, banks under IFRS are advancing through the implementation phase, and will be able to narrow the range of their impact estimates over the coming year; banks under US GAAP are just beginning the process of implementing the new Current Expected Credit Loss (the "CECL") approach. Nevertheless, it is highly likely that new standards will lead to an increase of overall provisions under both IFRS and US GAAP.[1] Therefore, we believe that excess provisions, and its variability depending on the accounting framework, will be one of the fundamental issues the Committee will need to consider as a part of a broader review of how provisions are expected to relate to regulatory expected loss ("regulatory EL" or "EL") over the course of the credit cycle. As set out in the discussion below, we believe there are some potentially very serious financial stability implications from the additional procyclicality of capital requirements that would result from unmitigated translation of ECL provisioning effects into capital requirements, especially in severe downturns, resulting not only from potential contraction of lending to the real economy but from effects on confidence if banks' capital were materially affected.

Based on recent discussions with the TFELP at the outreach meeting, there seems to be no consensus as to the appropriate understanding of the interaction of the current regulatory framework with the new accounting ECL. We strongly urge the Committee to provide further clarifications and undertake the study necessary to reassure investors and the industry that the regulatory framework would appropriately work with the new ECL. After reviewing publicly available papers issued by Basel as to the intent behind the regulatory framework[2], further clarity would be welcome in respect of the analysis of expected credit losses under the SA and IRB approaches. The transition to ECL provisioning raises significant issues regarding both approaches that warrant a comprehensive consideration of their conceptual foundations.

In **Section I**, we set out some of the major aspects the Associations believe the Committee should look at to ensure the regulatory framework appropriately takes into consideration accounting

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[1] See EBA, press release relating to *Report on Impact Assessment of IFRS 9* (November 2016), "the estimated increase of provisions would be on average 18% (and up to 30% for 86% of the respondents)" at https://www.eba.europa.eu/-/eba-provides-its-views-on-the-implementation-of-ifrs-9-and-its-impact-on-banks-across-the-eu.
The Committee also acknowledges such likely increase at page 4 of the Consultative Document discussed herein. Given the notable differing features of the new IFRS and US GAAP accounting ECL (which we note in Section I.4), the magnitude of the increase of overall provisions will depend to an extent still to be determined on the relevant accounting framework.

[2] See BCBS, *The New Basel Capital Accord: An Explanatory Note* (January 2001).
Michael B. Gordy, *A Risk-Factor Model Foundation for Ratings-Based Bank Capital Rules* (October 2002).
BCBS, *Modifications to the capital treatment for expected and unexpected credit losses in the New Basel Accord* (January 2004).
BCBS, *An Explanatory Note on the Basel II IRB Risk Weight Functions* (July 2005).

provisions. We urge the Committee to broaden the review laid out in the Discussion Paper in order to clear up those outstanding questions and define conceptually the relationship the Committee expects to see between ECL provisions and prudential capital requirements (and the reasons therefor). Such review would be further warranted in light of the finalization of the Committee's post-crisis reforms (e.g. the changes to the Basel III SA and IRB approaches for credit risk). These changes need to be assessed in conjunction with the effectiveness of the new accounting ECL in 2018 for banks under IFRS and in 2020 for banks under US GAAP.

In Section II, we elaborate on possible approaches to the longer-term treatment of ECL provisions and comment upon the Committee's proposals laid out in the Discussion Paper. We highlight herein that it is not possible to have a firm view on what should be the longer-term regulatory treatment of ECL provisioning until fundamental questions set out in Section I are well understood. Nevertheless, the ultimate approach should aim at fully addressing inappropriate effects that could arise under the current framework, especially untoward impacts on CET1 capital owing to any overlap or double-counting under either of the SA or IRB approaches. To that end, the Committee should weigh the merits of a range of different options that we outline hereafter. The Associations wish to stress that they favor at this stage an approach that would in some manner include in CET1 capital the excess of new ECL provisions over capital requirements (the "preferred option").

In Section III, we discuss in detail issues relating to the interim period and proposals of the Consultative Document. As highlighted in the Consultative Document[3], the Associations believe that there are strong reasons for the introduction of transitional arrangements, chief among them the fact that the magnitude of the impact of new ECL is not yet known (as the Committee acknowledges in the Consultative Document[4]), and the fact that the different timelines and other differences between US GAAP and IFRS may imply significant level playing field issues.

We consider that only an interim period of at least five years would allow adequate time for addressing those issues. To implement transitional adjustments, the Associations urge the Committee to consider approaches that would fully neutralize the impact of new ECL on CET1 capital, until the longer-term treatment is determined and implemented. We note that such regulatory treatment would in no way undermine the accounting presentation of ECL provisions as envisioned by the new standards and therefore would not impede achievement of the G20 goals for provisioning. Should the Committee ultimately adopt an approach that phases in rather than neutralizes the impact, the Associations recommend, for simplicity purposes, linear amortization over the interim period.

[3] See Consultative Document, Section 3.1 at 4.

[4] See id., "At this point, the magnitude of the impact of the application of ECL accounting on aggregate capital requirements on capital requirements or on capital requirements at individual banks is uncertain", Section 3.1 at 4.

As always, we very much appreciate our ongoing interaction with the Committee and the TFELP. The Associations stand ready to discuss the points laid out hereby. Should you have questions on our comments, please contact the undersigned, Hassan Haddou (hhaddou@iif.com), Jaime Vazquez (jvazquez@iif.com) at the IIF or Sahir Akbar (sahir.akbar@afme.eu) at the AFME.

Very truly yours,

David Schraa
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I. Main conceptual issues for prudential regulation stemming from new accounting standards

In this section, the Associations wish to draw the Committee's attention to some major areas of concern the Committee should address before finalizing any policy options relating to new accounting ECL.

First, it is necessary to examine closely the conceptual basis of the current regulatory framework. This first step is essential to reassess the appropriateness of current rules, and the relationship between ECL provisioning and prudential capital requirements. As part of this review, the Committee should give consideration to the effects of the new ECL on regulatory requirements over the course of the credit cycle.

The Associations welcome the fact that the Committee is planning a Quantitative Impact Study (the "QIS"), given the "known unknowns" about the extent of the expected impact of ECL accounting standards as set out in footnote 4 of the Discussion Paper. It is likely, however, that the required data on the estimated impact of the new provisions will not be available to a reliable extent until further into the implementation phase for IFRS 9, and all the more so for CECL.[5] Furthermore, one of the purposes of the transition period discussed in the Consultative Document should be to allow the QIS to take into account the actual results of final implementation of IFRS 9 and CECL in due course.

Finally, the Associations stress that any new final policy relating to accounting provisions should promote consistency of outcomes across frameworks, in particular between banks under IFRS and US GAAP. That said, these comments do not address the occasional references to the incurred-loss standards that will persist after full implementation of IFRS 9 and CECL. Further study should be committed as to the ongoing significance of such standards and to the extent to which they should influence the outcome of the study of the effects of the new ECL standards. This is a question for another day, but the Associations flag it for ongoing considerations.

1. Conceptual issues, and identification of any overlap between frameworks

In addition to the fact that it will be important for the Committee to examine relevant features of the current regulatory framework in light of new characteristics of upcoming new ECL, a clearly articulated conceptual framework is essential to defining the ultimate treatment of accounting provisions. Below, we set out the major conceptual questions and ambiguities we have identified in attempting to respond to the Discussion Paper.

Standardized approach. As acknowledged by the Discussion Paper[6], the current SA does not

[5] As highlighted further herein, the impact of new ECL on capital would be additive to other impacts that the finalized Basel III rules will imply. When estimating the impact of new ECL, the Committee should include the impact of other regulations as now being finalized.

[6] See Discussion Paper, "It is not fully clear whether or not it should be assumed that the SA risk weights already count part of regulatory expected losses in addition to unexpected losses", Section 2.3.5 at 11.

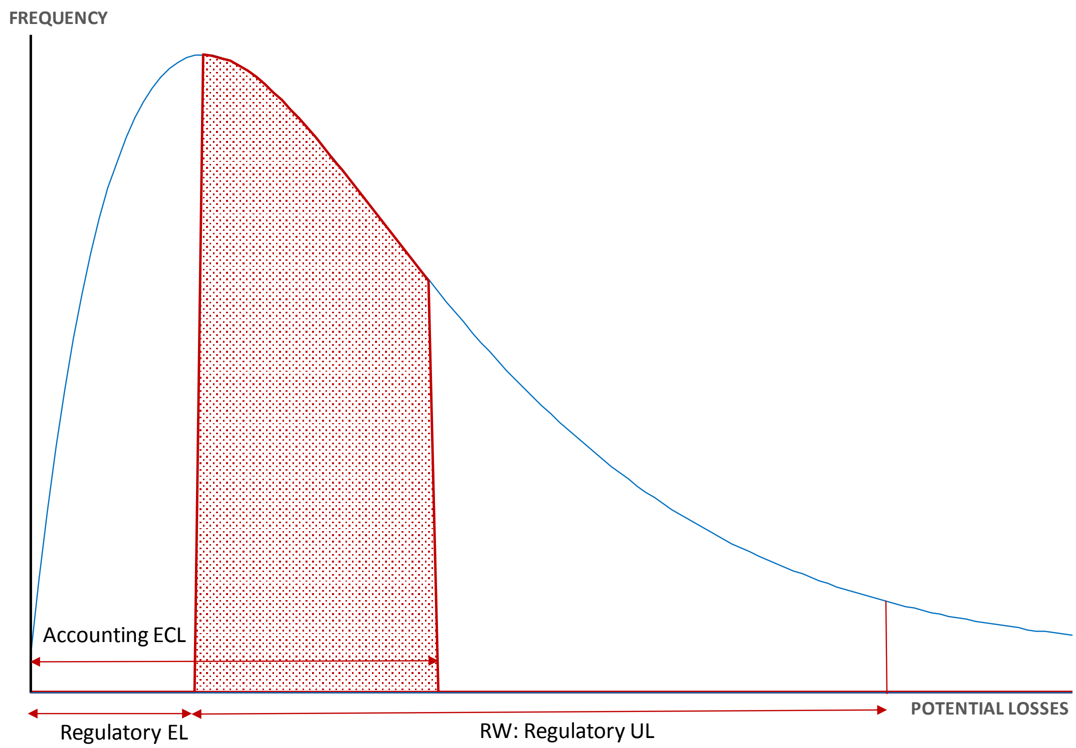
formally set out how standardized RWs articulate expected and unexpected losses. We note, however, that currently banks can remove Specific Provisions ("SP") from their Exposures At Default (the "EAD") and include General Provisions ("GP") in Tier 2 capital up to 1.25% of RWAs.[7] From those adjustments, we can reasonably infer that standardized RWs cover both risks – Expected Loss and Unexpected Loss – and that such adjustments aim at mitigating double-counting. But the current treatment does not fully adjust for the effect of provisioning on CET1 capital ratios.[8] So if, as expected, new provisioning significantly increases allowances for losses, double-counting might be magnified and the current adjustment would fail to reflect the fact that with the new ECL, banks will put aside loan reserves based on future credit losses. The result could well be overstated CET1 capital requirements. Consequently, we urge the Committee to make a clear statement of the conceptual design of current standardized RWs in order to enable regulators, investors, and the industry to do a formal assessment as to how they would be expected to interact with the upcoming ECL. This also seems essential to the development of any longer-term approach.

IRB approaches. It is equally important to examine the effects on the IRB approaches. As the IRB approaches clearly intend that IRB RWs are to cover only unexpected losses[9], questions arise relating to the articulation of new accounting ECL with regulatory EL and regulatory Unexpected Loss ("UL" or "regulatory UL") under the IRB approaches. Both US GAAP and IFRS ECL will require banks to recognize loss allowances for full lifetime expected credit losses (except for IFRS Stage 1 "12-month ECL"), while for non-defaulted assets regulatory EL considers a 12-month time horizon. That means that banks would face situations where new accounting ECL will be greater than regulatory EL, as illustrated by the following chart.

[7] See BCBS, Basel III, paragraph 60.

[8] The rationale for including GP only in T2 capital was more understandable under the Basel II framework than under the current framework. Under Basel, II the Tier 2 requirement stood for a far greater part of the Total Capital requirements (capital requirements were fixed at 8% of the RWAs and Tier 2 items could be used to meet 50% of them, see BCBS, Bale II, paragraph 40) than under Basel III (minimum capital requirement are fixed at 8% of the RWAs but Tier 2 items can only be used to meet 25% of them – see BCBS, Bale III, paragraph 50 – and there are also additional CET1 capital requirements related to capital buffers of at least at 2.5% of the RWAs, see BCBS, Bale III, paragraph 129), with the effect that the previous framework granted greater value to the loss absorption capacity of GP.

[9] See BCBS, Basel II, "The risk-weight functions produce capital requirements for the UL portion. Expected losses are treated separately" at paragraph 212.



It is important to highlight that the new ECL models will not alter the actual solvency of banks, as the underlying risk remains unchanged. So if the objective of prudential regulation is to ensure that banks have sufficient economic resources to cover a fixed level of risk, defined by regulatory EL and regulatory UL, we might expect to have steady capital ratios, despite the accounting change, as long as total capital, TLAC and requirements and economic resources do not change. Unfortunately, the structural misalignment, illustrated above, between regulatory EL and new accounting ECL would systematically affect CET1 capital insofar as excess provisions are only eligible to substitute for Tier 2 capital, up to 0.6% of RWAs.[10]

In addition, while it is clear that the regulatory EL is designed to cover the average level of credit losses that may occur owing to defaults experienced over a one-year horizon[11], we believe that there is a pivotal ambiguity about the time horizon embodied in the regulatory UL. Indeed, the RW calculation defines the capital requirement to ensure that the "bank will remain solvent over a one-year horizon"[12] for a supervisory confidence level fixed at 99.9%.[13] However, the Basel RW formula includes a maturity adjustment to derive a time structure of the probability of default.[14]

[10] See BCBS, Basel III, paragraph 61.
[11] Regulatory EL is defined as the product of PD and LGD, where PD is the "probability of default (PD) per rating grade, which gives the average percentage of obligors that default in this rating grade in the course of one year", see BCBS, *An Explanatory Note on the Basel II IRB Risk Weight Functions* (July 2005), Section 2 at 3.
[12] See id.
[13] See id., Section 5.1 at 11.
[14] See id., "Moreover, risk premia observed [to determine the Basel maturity adjustment] in capital market data have been used to derive the time structure of PDs", Section 4.6 at 10.

The outcome is that current RW calculations require higher capital for exposures with maturity greater than one year. In addition, the Committee's explanatory note makes clear that retail "… asset correlations implicitly contain maturity effects."[15] Consequently, we are deeply concerned that upcoming lifetime ECL will measure credit risk that is already incorporated in the regulatory EL but also in the regulatory UL.

The Associations therefore strongly believe that the Committee should carefully assess the appropriateness of the current framework in light of the new accounting provisions, in particular as to the extent to which it would, as discussed above, excessively affect banks' CET1 capital ratios, which remain the most meaningful indicator to stakeholders.

Furthermore, the extent of the interaction of the accounting and prudential capital frameworks appears likely to create undue and potentially destructive volatility, especially over short periods in a crisis, which could have highly negative systemic-risk effects, as further discussed in the next section.

2. Increased volatility of capital and undesirable potential for procyclicality

The Associations are highly concerned that, under certain circumstances, the interaction of the current prudential capital requirements and the new ECL accounting standards could have significant and potentially dramatic procyclical effects that need to be addressed. By "procyclical" for this purpose, we mean that the short-term translation of the new provisioning into capital in a severe downturn would undermine banks' apparent capital condition, contributing to macro financial instability and impeding recovery of both banks and the real economy from a sharp dip.

Formerly, incurred-loss models required that a credit event occur before recognition of credit losses, which could delay loss recognition, potentially leading to too-small loan loss reserves to cover credit losses when economic downturns materialized.[16] While the Associations support the introduction of the new ECL provisioning as it addresses the G20's concerns about "too little, too late", they are concerned that the potential new and volatile procyclical effects of the interaction of the new ECL with regulatory capital have not yet been fully analyzed. The Committee acknowledged in the Working Paper published in January 2015 on the interplay of accounting and regulation that research on that subject was missing.[17] The Associations believe this still constitutes a major blind spot that stakeholders must overcome in order to ensure a sound and consistent regulatory capital treatment of ECL accounting provisions.

While the Associations firmly believe that the principle of risk sensitivity should be applied to capital

[15] See id., Section 5.3 at 15.

[16] See BCBS, Working Paper on *The interplay of accounting and regulation and its impact on bank behaviour: Literature review* (January 2015) - at Section 3.2 "Provisioning and the business cycle".

[17] See id., Conclusions at 14 "there is no research available yet on the interaction with the excess/shortfall mechanism under the Basel IRB capital requirements. Lastly, a very useful and relevant extension of previous work would be an explicit analysis of the expected loss model, which has frequently been referred to in the literature but has not been subject to any formal examination".

adequacy requirements, they also believe that it is important for the measure of available capital not to be affected abruptly by cyclical changes in risk. Volatility of ECL provisions – which are intended to be and will be more risk-sensitive and will appear earlier in the cycle than incurred-loss provisions – will already have provided much of the necessary and appropriate risk sensitivity; however, it does not follow that such risk sensitivity of provisions should flow immediately into the capital calculation in a manner that would result in undesirable and costly short-term volatility of capital, especially in downturns.

The issue is all the more significant in that, for banks under IFRS, significant portions of assets are likely to be shifted from Stage 1 "12-month ECL" to Stage 2 "lifetime ECL" at economic downturns. In a situation where adverse economic conditions lead to significant shifts (which would also affect CECL calculations, albeit in a somewhat different way), banks would consider reviewing their lending policies, among other options, in order to meet capital requirements as a result of the steep jump in provisions, if the increased volatility effects of ECL provisioning were not corrected for in some manner. It is at the least very possible that the result could be reduced corporate and SME lending at exactly the wrong time from stability and macroeconomic viewpoints. The extent to which such effects would magnify cyclical downturns in the real economy still has to be determined. We provide in Annex 1 a stylized example to illustrate what might be at stake.

Both US GAAP and IFRS standards will require banks to measure expected credit losses by considering relevant information about past events and current conditions but also forecasts of future economic conditions. Such estimates are per se volatile because they are designed to reflect changes of macroeconomic conditions as they occur and necessarily require judgment and managerial discretion as to anticipated coming changes of conditions. Although incurred-loss provisioning also had volatility effects because it followed the business cycle, most observers expect volatility to increase with the forward-looking inputs required for ECL provisioning. Should new accounting ECL directly and immediately flow into regulatory capital, it would mechanically increase the risk of excessive volatility of capital ratios, especially in a sharp downturn.[18]

As a separate but related point, at a time when it is increasingly recognized that, at least in certain jurisdictions, post-crisis regulations have had the unintended effect of draining liquidity from corporate bond markets, especially during times of stress. A further de-facto increase of capital requirements in a volatile manner by failure to adjust for the increased provisions is likely to exacerbate such effects and, thereby, contribute additionally to systemic risk.[19]

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[18] For impact of IFRS in the EU, see EBA, *Report on impact assessment of IFRS 9* (November 2016), "75% of the banks included in the survey anticipate that IFRS 9 impairment requirements will increase volatility in profit or loss" at 6.
For US GAAP, FRB, FDIC, NCUA, and OCC, *FAQs on the New Accounting Standard on Financial Instruments – Credit Losses* (December 2019), "Upon initial adoption, the earlier recognition of credit losses under CECL will likely increase allowance levels and lower the retained earnings component of equity, thereby lowering common equity tier 1 capital for regulatory capital purposes", see question 18.

[19] As an example see *The Volcker Rule and Market-Making in Times of Stress* (September 2016), "Our main finding is that the Volcker Rule has a deleterious effect on corporate bond liquidity" at 29:
at https://www.federalreserve.gov/econresdata/feds/2016/files/2016102pap.pdf;

Therefore, the Associations recommend that the Committee assess thoroughly the regulatory implications of new accounting ECL over time, looking in particular at potential increased volatility of capital and resulting procyclical effects. This assessment should cover the transition phase to full implementation of both IFRS 9 and CECL and, even more importantly, how the capital standards (both SA and IRB) will perform over the business cycle, including stress events, when interacting with new ECL accounting. The Committee should carefully weigh the eventual findings of such study and, accordingly, take any necessary measures to make adjustments to mitigate procyclicality and therefore avoid untoward effects on financial stability that, in a crisis, would undermine the credibility of the prudential capital standards.

3. Overall assessment with other regulatory changes

These significant changes of banks' provisioning for credit risk need to be considered in light of the many modifications of regulatory requirements since Basel II. Indeed, although some of the timelines and phasing-in periods still need to be specified, in particular at jurisdiction levels, it is clear that between 2019 and 2021 the new TLAC requirements, the new Standardized Measurement Approach (the "SMA") for operational risk, changes to the IRB approaches, the new SA for credit risk, the new framework for market risk (the "FRTB"), and possible output floors will come into effect. These changes need to be assessed in conjunction with the effectiveness of the new accounting ECL in 2018 for banks under IFRS and in 2020 for banks under US GAAP.

It is unclear at present whether or how the new accounting ECL provisions have been factored into the upcoming revised Basel III measures. We are concerned that neither the RWA nor ECL consultations provide comfort that the overall design and interaction of the frameworks have been considered. It is especially important to consider features of the new ECL with respect to the revised rules relating to credit risk and the output floor. Regarding the former, it is crucial to consider how the new accounting will interact with revised calculations of credit risk RWAs because the new accounting ECL equally intends to address banks' future credit losses. Regarding the latter, as highlighted in the BCBS consultative document on capital floors[20], differences in the treatment of provisions between the SA and IRB approaches suggest the need to provide the capital floor framework with an adjustment for the effects of accounting provisions on capital.

This – along with the ongoing developments in methodologies for calculating ECL for accounting purposes – engenders great uncertainty as to the resulting capital impacts. As a result, we strongly encourage the Committee to assure that the planned quantitative impact study of the new accounting ECL on banks' capital ratios encompasses the impact of all other regulatory changes. If need be as a result of such quantitative impact study, the Committee should contemplate

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See also the response to the EC's call for advice on the EU regulatory framework for financial services, section 3.2 at http://ec.europa.eu/finance/consultations/2015/financial-regulatory-framework-review/docs/summary-of-responses_en.pdf.

[20] See BCBS, *Capital Floors: The Design of a Framework Based on Standardized Approaches* (December 2014), "The Committee is of the view that this differential treatment [of accounting provisions] is sufficiently material to warrant an adjustment when calculating the capital floor" paragraph 20 at 7.

recalibrating any current or upcoming risk-weights to achieve appropriate capital requirements, without significantly increasing overall capital requirements.

4. Consistency across frameworks

The longer-term approach -- but also possible transitional arrangements -- should aim at addressing the level-playing-field issue, in particular between banks under US GAAP and banks under IFRS given the different implementation timelines and specifics of the two standards. We understand that achieving such an objective was likewise a major concern of stakeholders when the Committee was designing the IRB framework.

With the upcoming accounting standards, it is highly likely that, in most cases, accounting provisions will be greater than regulatory EL, especially given lifetime ECL of non-default portfolios. For such portfolios, the balance intended to be created by the regulatory EL parameter would appear to be no longer effective, and instead there would arguably be duplication of provisions and capital coverage.

The challenge could be even more crucial than it was then insofar as – beyond different accounting practices, which will remain a salient issue – differences in accounting *provisions* could be magnified by greater differences between accounting *standards*. Although US GAAP and IFRS pursue the same objective, they include notable differing features. For instance, IFRS and US GAAP consider different scopes and different time horizons (12-month PD for IFRS Stage 1 under versus lifetime horizon for all assets under US GAAP); the way forward-looking information is considered under the two standards may vary as IFRS 9 is more prescriptive than US GAAP; treatments of intra-group exposures differ[21]; and the maturity conventions required for revolving facilities differ. That could lead to materially different estimates, which might flow through capital requirements.

The considerations of this general review will, of course, need to be taken up in the longer-term effort sketched out by the Discussion Paper, which is considered in the next section.

[21] US GAAP provides scope exceptions for some intragroup transactions. See US GAAP, *Financial Instruments—Credit Losses (Topic 326)*, paragraph 326-20-15-3 "The guidance in this Subtopic does not apply to the following items: … (f) Loans and receivables between entities under common control".
On the contrary, as IFRS 9 does not scope out intragroup transactions, banks under IFRS will have to report in reporting on a standalone basis ECL for intragroup transactions like loans, financial guarantees, and loan commitments. See *IFRS 9 Standard,* Chapter 2.

II. BCBS Discussion Paper "Regulatory treatment of accounting provisions"

1. General comments

Introduction: Comments are preliminary. The Associations commend the Committee for launching a debate on what might be the appropriate regulatory treatment of new accounting provisions. As the preceding section explains, the review and analysis envisioned by the Discussion Paper will have to address a number of fundamental issues to arrive at an appropriate and balanced result.

Nevertheless, they believe that the proposals laid out in the Discussion Paper focus too much on the SA. The detailed and complex analysis that is necessary should not be prejudiced by the a-priori decision not to consider the IRB approaches explained at page 3; rather, full consideration should be given to the implications of the new provisioning for all approaches.

The Associations encourage the Committee to continue the iterative process of consultation and to broaden the scope of the discussion, giving close consideration of the issues highlighted earlier in Section I.

Current views. At this point, the Associations do not have definitive views agreed by all banks as to the best solution to the issues that need consideration; therefore, their reflections will also be subject iterative analysis and development and the present discussion should be considered to reflect preliminary views.

At this stage, we consider the best course is to state a range of possible options for consideration by the Committee as part of the full examination discussed above.

General Preference. As stated at several points in this discussion, the Associations are increasingly convinced that, subject to fuller study, the best solution, and thus their first preference, would be to include excess provisions in CET1 capital under both the SA and IRB approaches. By "excess provisions" for this purpose, we refer to the excess of ECL provisions over regulatory capital requirements for credit risk. In practice this treatment could be applied by either adding back those excesses to CET1 capital or through an adjustment to credit risk RWAs. This option (the "preferred option") is set out in more detail in Annex 2, with suggestions on how to introduce appropriate regulatory treatments through CET1 capital or credit risk RWAs.

In addition to the Associations' preferred option, at this stage of their thinking, it is clear that it is appropriate to consider all other options as well, to be sure of arriving at the optimal final result. We review briefly here below the current alternatives (with no particular hierarchy of preferences). All options have pros and cons that need careful consideration.

The Committee's First Option. The Associations agree with the Committee's assessment of the pros and cons of the Committee's first option as set out in Section 2.1 of the Discussion Paper.

If ultimately, the Committee decides not to adopt the Associations' preferred option, further options could be considered including a modified version of the Committee's first option, as proposed by our colleagues at The Clearing House (TCH), pursuant to which the exposure amount would be risk-weighted net of the entire provisioning allowance under the SA (as opposed to just SP) and net of the excess provisions over the one-year regulatory EL under the Advanced approaches, while the Tier 2 add-back rules would continue to be consistent with the current SA and IRB approaches.[22]

See the further discussion of the SP/GP issues raised by the Committee's first option as proposed by the Committee, in Section II.2 of this response.

The Committee's Second Option. The second-option proposal on GP and SP set out in Section 2.2 of the Discussion Paper (laying down common and binding definitions to distinguish GP from SP), could in theory promote consistency and assist in standardizing the impact of different accounting regimes, for so long as the GP/SP distinction is maintained. Some banks question the relevance of maintaining such a distinction as, under upcoming accounting standards, provisions would be taken on a spectrum defined in the accounting. Without direct roots in the accounting (as acknowledged in the Consultative Document at p.1), maintaining the significance of purely prudential GP and SP concepts could, in their view, not resolve issues of variability across jurisdictions, add potential confusion to the analysis and perpetuate unnecessary complexity in financial reporting. At the least, drawing the GP/SP line in ECL provisions would be somewhat arbitrary. Other banks, however, believe that, as the accounting and prudential frameworks have different purposes, maintaining the distinction would be an appropriate way of managing the interaction of accounting and prudential requirements, especially, if as anticipated, final Basel III requirements push more exposures into the SA. The latter group believe that maintaining the approach would be preferable to the third option (discussed in the next paragraph), subject to whether that option would incorporate full recognition of the effects of the new accounting.

The Committee's Third Option. Regarding the introduction of some form of regulatory EL for purposes of provisioning under the SA, as proposed in Section 2.3 of the Discussion Paper, the Associations agree that such a methodology would merit study especially as an approach to solving the "overlap" issue arising from ECL provisioning, in conjunction with the potential treatments outlined in Annex 2. But they are concerned that they do not have sufficient information at this stage to come to a full conclusion. For some banks, this might be a fallback option, though other banks have increasing doubts that this would be an appropriate solution, in part because of its complexity. There is also concern that regulatory EL as proposed would lead to systematic and inappropriate double counting, given that (as stressed in Section I.1 of this letter), current standardized RWs are understood to cover both excepted and unexpected losses. Be that as it may, the proposal should be assessed in light of the calibration of the standardized EL rates after finalization of the current (final) Basel revisions to Basel III, and the broader conceptual analysis advocated above.

This option is discussed further in Section II.2 of this response, below.

[22] This proposal is developed in detail in the comment letter being prepared by our colleagues from The Clearing House.

2. Responses to the Committee's Questions

The following comments discuss in detail specified topics for with the Committee seeks comments as expressed in Section 3 of the Discussion Paper, and are subject to the Associations' overall preferred approach, as discussed above.

a) General and Specific Provisions

Definition of GP and SP: As discussed above, banks have somewhat differing views on the appropriateness of retaining the GP/SP distinction, if the preferred option is not taken up. This section develops further considerations regarding GP and SP in an ECL world.

The regulatory concepts of GP and SP are not directly grounded in accounting standards. These notions arose from the very beginning of the discussion around capital adequacy. Indeed, from the first accord reached in 1988, regulators acknowledged that some of the accounting provisions for loan loss reserves should be somehow eligible to banks' regulatory capital. That is why the Committee authorized banks to include in the Tier 2 capital provisions that "are created against the possibility of future losses"[23], such provisions being qualified as GP by opposition to other provisions that are designated as SP. Those notions have persisted in subsequent accords, and banks under SA can still include GP in their Tier 2 capital to a certain extent.

At that stage, regulators already recognized (as mentioned in the Discussion Paper) that "in practice, it is not always possible to distinguish clearly between general provisions [...] which are genuinely freely available and those provisions which in reality are earmarked against assets already identified as impaired. [...] This means, inevitably, that initially there will be a degree of inconsistency in the characteristics of general provisions or general loan-loss reserves included by different member countries within the framework."[24] We believe that this statement would still be valid under the new accounting ECL. So we support any approach that would promote consistent and universal regulatory treatment of accounting provisions for capital purposes, including GP and SP, if those concepts are retained.

Nevertheless, SP and GP are not directly linked with the new ECL and the introduction in the accounting framework of an expected loss concept. As stated in the 1988 Accord, it is rather reflective of the "diversity of accounting, supervisory, and, importantly, fiscal policies in respect of provisioning."[25] Such diversity is a challenge stakeholders have faced since the introduction of capital requirements. Therefore, looking for a binding and universal definition of GP would be arguably a sensible reflection to address consistency issues of the current regulatory and accounting frameworks, but it would not deal with the specific and prominent questions that new ECL provisions raise.

[23] See BCBS, *International Convergence of Capital Measurement and Capital Standards* (July 1988), paragraph 18.
[24] See id., paragraph 19.
[25] See id.

More fundamentally, from a conceptual perspective, under current IFRS and US GAAP incurred loss models, banks have to assess whether there is any objective evidence that a financial asset or group of financial assets (such as a loan or a group of loans) is impaired. On the contrary, under upcoming IFRS and US GAAP ECL models, banks will have to recognize expected loss provisions prior to loss events, since initial recognition. Against that background, the current delimitation of GP and SP, which was shaped in an environment where incurred loss models prevailed, itself requires examination in light of the quite-different accounting. Pursuant to the new accounting standards, banks will have to estimate expected losses that could occur, considering a representative range of available information, including past events, current conditions and forecasts of future economic conditions. It will require careful analysis to identify along that spectrum of information what does not constitute an "identified deterioration in the value of any asset or group of subsets of assets."[26] As already discussed, such line-drawing is likely to be somewhat arbitrary and to perpetuate or even increase complexity both of substance and of disclosure.[27]

Treatment of GP: As mentioned earlier in Section I, under the current SA, SP are removed from the exposure at default (EAD) and GP are eligible only for adjustment of Tier 2 capital up to 1.25% of credit RWA. So the current treatment would not provide any meaningful adjustment for accounting provisions with regard the CET1 capital ratio.

That means (as already discussed) that a significant increase of accounting provisions, as will likely occur, would automatically lead to significant impacts on CET1 capital ratios, which remain the most important metric to most stakeholders. If such impacts flowed through in a highly volatile manner in a severe downturn, they would contribute to financial instability and possibly create undue concerns about the resilience of individual banks and quite possibly the sector as a whole. Such a result would also be contrary to the Committee's desire to reduce undue variability of capital requirements.

The Associations believe that such unmitigated capital impacts would be artificial and inappropriate as banks' risk profiles have not been altered in any way that the change of accounting reflects.[28] So, should the current delimitation between GP and SP be maintained, they urge the Committee to give consideration to the regulatory status of GP. Indeed, it would be appropriate to consider that all or part of new ECL provisions would be "created against the possibility of future losses" and should be eligible as capital. Furthermore, some of the original reasons that explained regulators' reluctance to include GP in Tier 1 capital will no longer exist under new accounting standards. For

[26] See BCBS, Basel II, paragraph 49(vii).

[27] The Committee recognizes the challenge of defining GP and SP. See Discussion Paper, "However, striking the right balance in defining GP and SP would be a challenge under this approach", Section 2.2 at 6.

[28] The argument is made that the prudential standards should simply accept and accommodate any changes in accounting standards. While such argument has some validity for many or most accounting changes, the change to ECL accounting is quite different. This change reflects the same broad G20 mandate that motivates most post-2009 regulatory changes, including all the Basel III changes, the FSB's *Key Attributes of Effective Resolution*, etc. As is widely recognized, accounting standard setters took a somewhat different and independent path in responding to the G20 mandate, so it is appropriate that prudential implementation of this particular accounting change take into account the potential for overlap and duplication in achieving the separate but parallel goals of the accounting and prudential frameworks.

instance, the Committee limited the benefits from GP in terms of Tier 1 capital "because such balances are often either not disclosed or are shown as a deduction from assets."[29]

This will no longer be the case as the new accounting ECL will come with a full-fledged disclosure framework, requiring banks not only to disclose but to explain their expected loss estimates. In addition, senior management, and internal and external auditors, will review the whole process very closely. In addition to being subject to audit, the new ECL provisions will be subject to supervision pursuant to the Committee's Guidance on Credit Risk and Accounting for Expected Credit Losses ("GCRAECL").[30] The triple layer of management, audit and supervisory controls, plus public disclosure, should assure that ECL provisions will be appropriately taken and, contrary to the inference in the Discussion Paper, capital requirements need not be levered artificially by measures such as the floor to create unnecessary further incentives for banks to appropriate provisioning under the new standards.[31]

b) Regulatory Expected Loss

We have already discussed briefly the Discussion Paper's third option, which consists of dropping the distinction between GP and SP in favor of a new regulatory EL under the SA.[32] Such an approach may have some merit because it would assist in achieving greater consistency between accounting and regulatory frameworks and between the SA and IRB approaches. On the other hand, some banks have reservations about it that are still being developed, so what follows are merely preliminary observations.

As discussed in Section II.1 of this response, the Associations believe that there is a robust argument for treatment of any excess of provisions over regulatory EL for prudential capital purposes in accordance with one of the solutions discussed in Annex 2, although more study is required before reaching a definitive solution.

Therefore, we discuss the potential merits of the third option as proposed in Section 2.3 of the Discussion Paper, without prejudice to appropriate consideration of the preferred option. In this discussion, it is important to stress that banks that believe the third option could be an acceptable fallback do so only on the assumption that it would be calibrated in such a way as to be broadly capital neutral.

As highlighted above, the current regulatory notions of GP and SP are not well grounded in accounting concepts, so that breaking down accounting provisions in GP and SP is likely to create awkward and arbitrary classifications (see Section 2.2 of the Discussion Paper). The Committee's

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[29] See BCBS, *Proposals for the Inclusion of General Provisions/General Loan-Loss Reserves in Capital* (February 1991), paragraph 8.
[30] See BCBS, *Guidance on Credit Risk and Accounting for Expected Credit Losses* (December 2015), at https://www.bis.org/bcbs/publ/d350.pdf.
[31] See Discussion Paper, "the shortfall would be deducted from the bank's CET1 capital, which would incentivise robust provisioning" at 8.
[32] See id., Section 2.3.

proposal is intended to remedy that shortcoming. As stated in the Discussion Paper, "this approach also aims to align the SA with IRB approaches."[33] Nevertheless, we share the Committee's view that adopting such an approach would fundamentally change the current regulatory framework. Consequently, the Committee should carefully ponder several issues before specifying the ultimate treatment. Although it is difficult to evaluate the point without knowing the outcome of the discussions intended to finalize Basel III, there is concern that attempting to align the SA and IRB approaches further may create more complexity than the contrary.

The rationale of the proposal draws on the premise that such "a scheme [regulatory EL under IRB approach] has already been introduced and successfully operated."[34] We can agree with the Committee that the introduction of the regulatory EL under the IRB approach contributes to dealing with accounting provisions under current accounting regimes up to a point. But there is no evidence at this stage that the same would be the case with the upcoming accounting ECL provisions. As mentioned in Section I of this letter, there are significant conceptual issues that require close examination in light of the change of accounting provisions (and the subsequent evolution of the Basel requirements). An important message of this response is that the system could be improved by clarifying these issues, thereby providing a firmer foundation for analyzing how to deal with excess provisions. Particularly important is the misalignment of time horizon between accounting ECL and regulatory EL, and its implications for regulatory capital over time.

In addition, as set out above in Section I.1, the current standardized RWs cover both expected and unexpected losses, and therefore adding a further capital requirement under the form of a regulatory EL appears inappropriately to give way to systematic double-counting of expected loss. So, if any version of this option is pursued, we invite the Committee to examine carefully the calibration of standardized RWs to prevent any "double-counting of a Pillar 1 credit risk element between standardized regulatory EL rates and relevant risk weights under the SA."[35]

More fundamentally, although we share the Committee's objective of reducing the variability of capital charges, we note that a similar debate already occurred for the banking book when the Committee launched the recent consultations on the SA and IRB approaches for credit risk[36], and any further initiative should be considered in light of all other revised rules. Therefore, we further invite the Committee to examine carefully the outcome of these recent consultations, particularly as they relate to the modified SA and IRB risk weights, and proposed parameter floors.

In particular, the concept of addressing provisioning variability by introducing regulatory "floors" via standardized regulatory EL needs further debate and raises many similar issues to the "floors" issue as debated for capital. Any floor would be somewhat arbitrary and would tend to confuse rather than

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[33] See Discussion Paper, at 12.
[34] See id., Section 2.3.1 at 8.
[35] See id., Section 2.3.2 at 9.
[36] See BCBS, *Revisions to the Standardized Approach for Credit Risk - Second Consultative Document* (December 2015) and *Reducing variation in credit risk-weighted assets - constraints on the use of internal model approaches - consultative document* (March 2016).

clarify the relationship between capital and provisions. In particular, the industry is concerned with the statement that "the Committee is more concerned about low levels of provisions than the converse"[37]: given that most observers (including apparently the Committee[38]) expect increases, probably substantial, in provisioning, concern about "low levels" should not be the primary design consideration for the future world of ECL provisioning (much as that may have been a consideration hitherto); on the contrary, the artificiality of floors in a context where banks will already be coping with complex accounting and regulatory guidance is highly concerning. Floors in this instance would tend to increase capital requirements in an arbitrary and rigid manner that would be questionable for the same reasons that unmitigated flow-through of new ECL provisions to CET1 capital is questionable, as discussed above.

c) Excess provisions

We have already discussed the treatment of GP above (see Section II.2). Regarding the treatment of excess provisions, the Associations are especially concerned given the misalignment of the time horizon between regulatory EL and new accounting ECL. Against that background, we invite the Committee to consider the regulatory status of new accounting ECL that go beyond the regulatory 12-month requirement.

The Associations are very concerned that there might be significant unintended consequences not to add back all or part of new ECL provisions to CET1 capital. This point was already discussed at Section I above, but it is important to reiterate the importance of examining the way upcoming accounting and regulatory regimes will interact. Indeed, this is a prerequisite to assessing the appropriate regulatory status of excess provisions as it will shed light on the very nature of accounting provisions and the scope capital requirements are supposed to cover. After such assessment, including going back to first concepts, stakeholders will be able to determine precisely to what extent there may be overlaps between the two regimes, and what adjustments would be necessary to correct them.

As an important related point, should the Committee ultimately decide to maintain the current treatments of provisioning excess and of GP, we believe that it should review the current caps that limit the inclusion of accounting provisions in Tier 2 capital in both the SA and IRB approaches. If retained, any caps should be recalibrated in light of the revised Basel III and TLAC. Over all, the new caps should ensure that, all other things being equal, the entry into force of new accounting ECL does not alter banks' total capital ratios.

A fuller discussion of what we consider an appropriate approach is set out in Section II.1 above and in Annex 2 hereafter.

[37] See Discussion Paper, Section 2.3.1 at 8.
[38] See Consultative Document, "The Committee is aware that the transition to ECL accounting will generally result in an increase in the overall amount of loan loss provisions" at 4.

d) Level playing field and excess provisions

The longer-term, permanent treatment of new ECL provisions should ensure a level playing field insofar as treatment of provisions is concerned between institutions subject to different accounting standards, especially US GAAP and IFRS, and insofar as possible between SA and IRB portfolios. This issue is directly connected to the treatment of excess provisions discussed previously. Under both standards, it is likely that excess provisions will unduly affect banks' CET1 capital ratios negatively if the regulatory requirements stay unchanged. But, as mentioned in Section I, there are material differences between the two standards that could lead to significant measurement differences, although the extent of such differences cannot as of yet be evaluated with full confidence. Put basically, however, that could mean, all other things being equal, that banks with the same risk profiles would have significantly different CET1 capital ratios. So it is necessary that the longer-term treatment appropriately address excess provisions while looking closely at the material differences between IFRS and US GAAP accounting ECL. See Annex 2 for a proposed way to deal with excess provisions.

e) Complexity, simplification, and burden

Simplicity should be a major feature of the ultimate regulatory treatment, but the goal of simplicity should not solely define the longer-term treatment, which should strike a good balance between simplicity, risk sensitivity and comparability. It is equally important that the longer-term treatment not entail unnecessary operational burden for banks as issuers, that would come in addition to the numerous projects underway or to come that are necessary to implement new accounting and regulatory standards.

The issues discussed with respect to the Discussion Paper are for the most part equally applicable to the discussion of the Consultative Document in the next section.

III. BCBS Consultative Document "Regulatory treatment of accounting provisions – interim approach and transitional arrangements"

1. General comments

As stressed in the Consultative Document[39], the entry into force of new accounting standards will significantly change accounting practices and is likely to have deep implications for banks. Regarding the effects on capital, there has been no assurance to date that the current regulatory framework will interact adequately with the new accounting ECL. In addition, different timelines between IFRS and US GAAP raise serious issues regarding the level playing field. For these reasons, the Associations are firmly convinced that transitional arrangements are warranted and we are grateful the Committee is consulting the industry on that subject.

The main objectives of transitional arrangements should be to prevent new accounting ECL from altering capital ratios mechanically, especially CET 1 capital ratios, before the final treatment is decided upon. They should ensure a level playing field during the interim period while only banks under IFRS will be subject to the new ECL between 2018 and 2020. Furthermore, it will be important to provide for ongoing transitional arrangements if the period of decision on the ultimate treatment of ECL provisions extends past the final implementation of CECL under US GAAP. In structuring such transitional arrangements, the Associations share the Committee's view that they should be simple and their implementation should not entail undue operational burdens.

We are aware following preliminary discussion with the TFELP that the Committee would be reluctant to adopt a transitional approach that would fully "neutralize" the impact of new ECL on CET1 capital. But the Associations wish to emphasize that merely phasing in new ECL as a transitional measure would not fully address the level playing field issue, but at best would only mitigate the temporal discrepancy. In addition, investors and analysts would look through phase-in arrangements and, thereby, would tend to price in the full effect of current regulatory treatments, which might turn out to be inappropriate. Therefore, the Associations encourage the Committee to weigh the merits of neutralization as part of the assessment of appropriate transitional measures.

It is important to note that by neutralization, we do not intend to establish a new prudential filter that would remove from regulatory capital the effect of accounting provisions. We rather have in mind an approach that would reverse the effect of upcoming ECL on CET1 capital, to the extent necessary to keep within current bounds. Such neutralization of the marginal effect of new ECL provisions on CET1 capital compared to current provisions would merely allow continuation of current levels of capital requirements, for which the interaction of accounting and regulatory is relatively well understood by all stakeholders, during the transition period. As discussed above regarding the Discussion Paper, we also advocate a related but importantly differing approach to treatment of ECL provisions as a long-term solution.

[39] See id., Section 3.1 at 4.

The Associations strongly believe that neutralization would have the advantages of avoiding capital impacts from new ECL accounting until their overall implications are well understood, and then allowing appropriate adjustments to create an appropriate running business-as-usual result, including for stress events. Neutralization as proposed would not negate the desire to deal with "too little, too late" provisions as financial statements will provide full, audited, disclosure of provisions. It would also have the merit of fully addressing the level-playing-field issue before the scheduled implementation of CECL in 2020. If the definitive regulatory treatment is not finalized by such date, as already stated, the Associations recommend extending the neutralization period as long as necessary to allow for full study.

Hereafter we provide more detailed comments on specified portions of the Consultative Document.

2. Comments on the Committee's proposals

a. Section 2.3 of the CD - Proposal to retain the current regulatory treatment

Until the longer-term regulatory treatment is defined, we agree with the Committee's view that regulators should, if necessary, provide guidance on categorizing new ECL provisions as GP or SP in their jurisdictions. Nevertheless, such guidance, arguably helpful as a transitional matter for so long as the GP/SP distinction is retained, would not be sufficient. While it could promote consistency within a given jurisdiction it would not deal on its own with any of the salient issues (see below and in the comments on the Discussion Paper above) that will arise when the new accounting ECL comes into effect. So the Associations advocate that, during the interim period, any such guidance be considered part of appropriate transitional arrangements specified at the Committee level.

b. Section 3.1 of the CD - The Committee's primary considerations

Reasons for transitional arrangements. The Associations believe that the considerations set out in Section 3.1 of the Consultative Document are of paramount importance and warrant the introduction of transitional arrangements. They discuss each of them below.

- *'The impact could be significantly more material than currently expected and result in an unexpected decline in capital ratios'*

Even though the impacts of new accounting standards are still some distance from being quantified precisely and rigorously, banks and other stakeholders expect that the main issue to address would be substantial increases of provisions and what to do about their implications for capital. Hans Hoogervorst as chairman of the IASB expected very substantial increases of provisions as a result of the new IFRS 9[40], which is consistent with banks' and most observers' expectations. The report published by the EBA in November 2016 confirmed such expectations, as the estimated increase

[40] "First indications are that this model will lead to a very substantial increase in the level of provisioning, in the order of around 35 per cent". Hans Hoogervorst's speech 'Preparing for the expected: implementing IFRS 9' (September 15, 2015).

was "on average 18% (and up to 30% for 86% of the respondents)"[41], which would lead to decrease "on average by up to 59 basis points (bps) (and up to 75 bps for 79% of the respondents)."[42]

Nevertheless, the Associations wish to point out that they deem unwarranted the statement that banks should be "prepared to absorb a modest decrease in CET1 capital upon initial application of ECL accounting."[43] This assessment ignores the fact that accurate and reliable predictions of new accounting provisions have not been possible to date, before methodologies, policies and procedures have been able to be put in place to manage the major changes implied by new accounting ECL, especially the incorporation of forward-looking information and, for IFRS 9, the development of multiple scenarios by each bank. While presumably the expected initial impact will be better understood at a general level by early next year for IFRS 9, day-one impacts will not be known or understood in full by the time comments on these consultations are due (and of course actual day-one impacts will be unknowable in advance given that forward-looking information will change between any preliminary estimates and the first estimates actually used for provisioning). Furthermore, to achieve a comprehensive assessment of the impact of new ECL, stakeholders should still examine, in addition to day-one impacts, interaction of accounting ECL and regulatory capital over time (see Section I.2 of this letter).

- *'The fact that the Committee has not yet reached a conclusion on what should be the permanent interaction between ECL accounting and the prudential regime'*

Under the current framework, the impact of new accounting standards would flow into banks' capital, especially for banks under the SA and with no or little provisioning shortfall under the IRB approaches. Until the Committee has reached a conclusion on the longer-term treatment there is no assurance that current rules of the prudential regime would deal appropriately with the new accounting metrics. Please refer to Section I of the letter for more details on issues raised by new ECL.

- *'The two-year gap between the effective dates of the ECL accounting standards under IFRS 9 and CECL'*

Under current regulatory treatments, the impact of accounting provisions flows directly into CET1 capital ratios of banks under the SA and of banks under the IRB approaches with provisioning excesses. Consequently, without supplementary adjustments, the differences in IFRS and US GAAP implementation timelines would de facto introduce different capital requirements for credit risk between banks under IFRS and US GAAP, and more broadly between banks under IFRS and banks under accounting standards that keep incurred loss models. The more significant the impact of new accounting standards, the more it would unlevel the playing field. Given that new ECL affects accounting for lending activity, there could be deleterious impacts on banks of disadvantaged

[41] See EBA, press release relating to *Report on impact assessment of IFRS 9* (November 2016), at https://www.eba.europa.eu/-/eba-provides-its-views-on-the-implementation-of-ifrs-9-and-its-impact-on-banks-across-the-eu.
[42] See id.
[43] See Consultative Document, Section 3.1 at 4.

jurisdictions, undermining their ability to finance growth in the real economy.

Design of transitional arrangements. Regarding the design of transitional arrangements, we discuss below required features of possible approaches:

- *The capital metric to be referenced*

Metrics such as Tier 1 and Total capital ratios are important, all the more so in light of upcoming leverage ratio minimum requirements and new standards for TLAC. As a result, transitional arrangements should consider the consequences of the new ECL provisions for these metrics. However, the Associations firmly believe that transitional arrangements should first focus on CET1 capital. CET1 capital ratio is still the most prominent metric that all stakeholders – regulators, investors, and credit analysts – look at first. Thus, as set out in Section I above, unmitigated mechanical impacts on CET1 capital metrics may be undesirable, as current regulatory treatments may result in excessive volatility and create systemic risk, especially in sharp downturns.

- *The period to be allowed for transition*

As already mentioned, given the timelines of IFRS and US GAAP, it seems inevitable that the transition period should at least cover the gap between the different effective dates of the two standards. Furthermore, should the ultimate regulatory treatment not be finalized by the latter date, the period should be extended beyond, for as long as necessary.

Especially if the Committee ultimately adopts a phase-in approach rather that a transition approach that would neutralize capital impacts, the Associations advocate a transition period of at least five years. Indeed, the Committee proposes in the Consultative Document a transition period from three years to five years. We believe that, given the potential magnitude of the changes, the period should be long enough to smoothen as much as possible the transition and to allow for mitigating the consequences of different timelines between IFRS and US GAAP. Regarding the latter, a period of three years would clearly not be enough as banks under IFRS would be subject to 75% of the effect of new ECL when banks under US GAAP would only start the transition period in 2020. In this regard, a transition period of five years would be advisable. A five-year period also appears to be the minimum time necessary to allow banks to adjust their capital planning, to project the impacts on their capital ratios, and to make other necessary changes. Furthermore, a five-year period would allow the banks, the auditors and the regulators to become familiar with ECL provisioning mechanisms. It is at the time of writing quite uncertain how the models will react, taking into account current practices, needs for consistency, and market adaptations to the information provided by the new ECL accounting. All the tentative ideas that banks are working with now are only conceptual and are not necessarily grounded in how users' reactions to the new ECL provisioning will develop.

- *The advisability of amortizing the transitional adjustment*

The question here is whether transitional adjustment should aim at smoothing the impact of the new accounting ECL, that is phasing in the impact to allow banks to absorb any potential capital shock. As already explained, the Associations favor an approach that would not amortize the transitional adjustment, but would neutralize the effect on capital of the new ECL. If the Committee ultimately adopts a phased-in approach, however, the Associations favor a simple approach that would apply a linear amortization over the transition period, preferably over five years.

- *The frequency of calculation of the transitional adjustment*

As highlighted in Section I.2 of this letter, when the new ECL comes into effect, banks and regulators will enter uncharted territory with respect to the way accounting will affect regulatory requirements over time, the main issue being how much capital ratios would be altered when the business cycle enters a recessionary period. We believe that this issue is serious enough to require close study for periodic update of the transitional adjustments depending on the progress of the analysis.

In addition, we support the Committee's statement that "any transitional arrangement would also need to address how accounting provisions that are not recognised (ie neutralised) in CET1 capital would be treated in other aspects of the regulatory framework "as highlighted in Section 3.1 of the Consultative Document. The examples provided by the Committee include the need to reverse any deduction or risk weighting of deferred tax assets ("DTA") arising from temporary differences associated with the neutralized ECL provisions. We understand it refers to the reversal of any impact on CET 1 capital and RWAs arising from the operation of the 10% individual and 15% aggregate threshold limits resulting from both the reduction in the CET1 capital base (following the increase in new ECL provisions) and the increase in associated DTAs arising from temporary differences and, in addition, that this includes the reversal of any associated impact on the treatment of significant investments in the common shares of unconsolidated financial institutions that form part of the threshold limit calculation. In other words, where new ECL provisions have not been in effect deducted from CET1 capital pursuant to the application of a transitional arrangement, the impact on the threshold calculation (and any other regulatory impact) of such provisions should be fully neutralized.

Overall, the Associations also share the Committee's view that the approach should be as straightforward as possible and that it should not entail undue operational burdens for banks. Thus, it would be unrealistic to ask banks to run current accounting and forthcoming processes in parallel run to produce two sets of accounting provisions. So the approach eventually adopted should strike a good balance between simplicity and sufficient leeway for dynamic adaptation as needed.

Finally, we note that there is no reference to TLAC in Section 3.1 of the Consultative Document, a significant omission. Given the overall challenges banks face in implementing TLAC and related requirements, and the market effects thereof, consideration of the TLAC implications of the new accounting at the very least argues for a more protracted implementation period (at least five years).

c. Sections 3.3 to 3.5 of the CD – Comments on proposed approaches

The following discussion provides comments on approaches proposed in the Consultative Document and is entirely subject to the above discussion indicating the industry's preference for full neutralization during the transition period. Should the Committee adopt one of the three proposed approaches, the Associations recommend a 100% "transitional adjustment" during the transition period, until the strategic solution is implemented; that is, the transitional adjustment would be calculated according to the specified method but there would be no amortization during that period.

i. Approach 1: Day 1 impact on CET1 capital spread over the interim period

Approach 1 has the merit to be simple and its implementation should not entail excessive operational burden. But, on the other hand, it exclusively relies on the first-day impact to determine the amount of adjustments. Thus, it presents the major shortcoming of not addressing the issues of increased volatility and potentially significant effects over the business cycle.

It follows from the remarks above that the Associations cannot endorse the modified version of Approach 1 using a materiality threshold. This variant seems to be predicated on acceptance of a "modest" decrease in CET1 capital, which is contrary to prior expectations and inconsistent with the general view that new accounting standards and current regulatory changes to finalize Basel III should not substantially increase capital requirements.

ii. Approach 2: CET1 capital adjustment linked to Day 1 proportionate increase in provisions

If Approach 2 is a bit less straightforward than Approach 1, we nevertheless consider that it is simple enough to be implemented without entailing excessive operational burden. Approach 2 consists in applying a percentage to the stock of accounting provisions at the reporting date. Thus, unlike Approach 1, Approach 2 has the merit of being somewhat dynamic and addressing the fact that accounting provisions would likely vary (volume effect) from the amount recognized at the transition date. In addition, if the percentage applied to accounting provisions at reporting dates is fixed (if calculated once at the transition date), the methodology should still be relevant provided that accounting provisioning rates are steady over time (an assumption that may or may not be correct). Nevertheless, should the Committee ultimately adopt this approach, we invite the Committee to consider applying it separately for SA and IRB exposures. Otherwise, we give in Annex 3 an illustration of possible unintended consequences.

iii. Approach 3: Phased prudential recognition of IFRS 9 Stages 1 and 2 provisions

For banks under IFRS, Approach 3 has the advantage of being fully dynamic and, thereby, would address appropriately some of the effects of the new ECL over time. We reiterate however, that one of the major drawbacks of this approach is as noted in the Consultative Document, namely that some provisions maintained today for incurred but not reported losses will be allocated to IFRS 9 Stages 1 and 2. As such, the assumption that all Stage 1 and Stage 2 provisions are "new" is not justified. This drawback, however, may be something the Committee is willing to accommodate over a transitional phase for the sake of ease of simplicity and implementation.

We do not share the Committee's view, however, as stated in respect of the other drawback asserted in the consultative document, that this approach can only be applied to institutions under IFRS. We believe that the underlying principles of Approach 3 might suit as well banks applying US GAAP CECL since, under both standards, the salient issue would be to identify provisions for non-impaired assets (i.e. performing loans) and both standards require identifying and distinguishing impaired from non-impaired assets.

Annex 1: Illustration of possible cliff effects of new ECL in severe downturns

Hereafter we give a stylized example to illustrate the increased volatility of capital requirements that appears likely to arise from new accounting standards.

Say bank A grants a loan to a corporate borrower. Bank A is under IFRS and uses IRB to calculate capital requirements for credit risk.

Accounting ECL is calculated by using a 12-month PD Point-In-Time (PD_PIT_12M) for Stage 1 and Lifetime PD Point-In-Time (PD_PIT_LT) for Stage 2. IRB RWA are calculated using 12-month PD TTC. For both purposes, we assume a 45% LGD.

- **Chart 1,** without pretending to full scientific accuracy, gives an example of how the various PDs could vary over time. Point D is the turning point; that is, beyond that point we consider that Bank A faces severe economic conditions. For simplicity purposes, we assume here that the Lifetime PD PIT is twice the 12-month PD PIT.

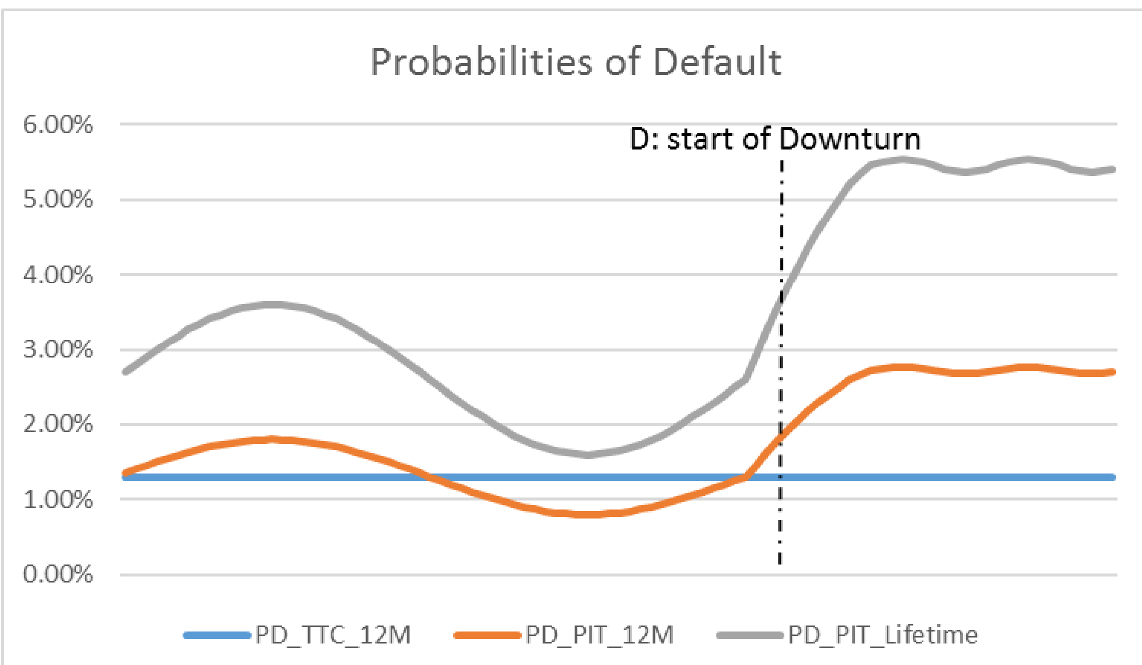

Chart 1

- **Chart 2** illustrates that the regulatory EL is stable over time since it is calculated using a stable PD TTC: REG EL = LGD * PD_TTC_12M = 45% * 1.30% = 59bps. On the other hand, the accounting EL varies with PD PIT, and there is a 'cliff-effect' because at point D the loan switches from Stage 1 to Stage 2:
  - From Origination until D: ACC EL = LGD * PD_PIT_12M
  - Beyond D: ACC EL = LGD * PD_PIT_LT

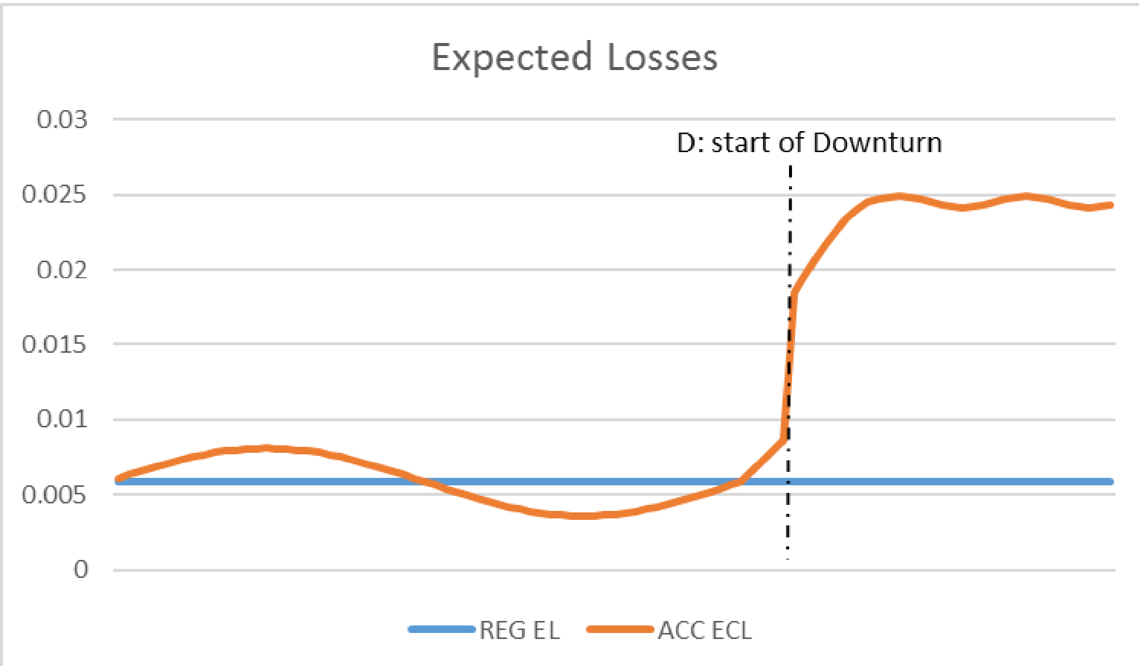

Chart 2

- **Chart 3** compares current and upcoming capital requirements. We calculate capital requirements as follows:
  We consider that RW is equal to 100% for a loan to a corporate with a PD of 1.3%, an LGD of 45%, and a maturity of 2.5 years.[44]
  We calculate the total capital requirement by converting deduction to CET1 capital into RWAs. So the total capital requirement can be expresses as follows:

  EAD * [RW+12.5 * Max(REG EL, ACC ECL)]

[44] See BCBS, International Convergence of Capital Measurement and Capital Standards. Annex 5, Illustrative IRB Risk Weights.

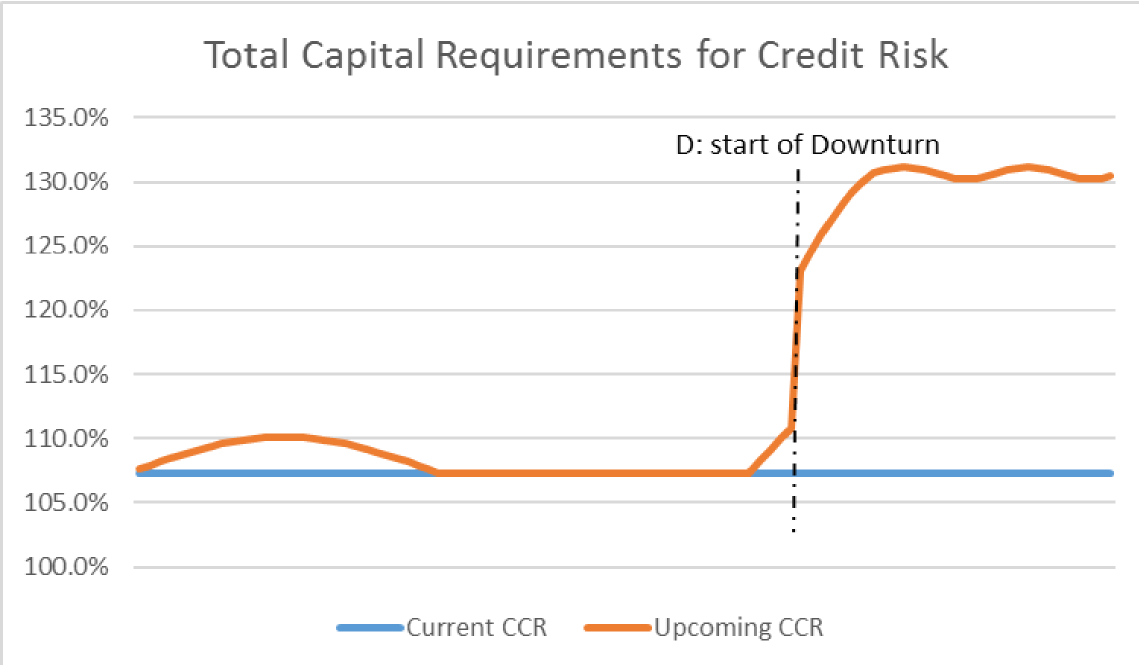

Chart 3

Conclusion This very basic example illustrates that under the assumed revised regulatory regimen, the new accounting standards could lead to cliff effects that would flow into capital ratios. The example shows that under normal conditions the new accounting would make capital requirements significantly more sensitive to the cycle. Importantly, in case of a downturn, the effect on capital requirements would dramatically increase, thereby illustrating the potential cliff-effect banks might face. Such effects would not "just" affect bank capital but could lead to immediate and potentially dramatic effects on lending. In a severe downturn (such as the worst moments of the 2007-8 crisis), the impact would be sufficient to render many banks apparently insolvent, thus contributing in a very tangible way to systemic risk at the worst possible moment.

Annex 2: Associations' preferred option to treat excess provisions

The Associations believe that the way to deal most appropriately with the issues highlighted earlier in the main body of this letter is to include in some manner excess provisions in CET1 capital. Although there are several potential manners to implement such treatment, that either adding back provisioning excess to CET1 capital or adjusting accordingly the related credit risk RWA values would be the most advisable. As already mentioned earlier, by "excess provisions", we refer here to the excess of ECL provisions over regulatory capital requirements for credit risk.

Adding back to CET1 capital. Adding back excess provisions to banks' CET1 capital would be an appropriate way to deal with the implications of the new ECL given that:

- The original formulation of the Basel II IRB capital requirements did not distinguish between requirements relating to expected and unexpected losses, but generated a VaR-type requirement.

- As a result, there was a question of how to recognize the fact that some of the resulting capital requirement would already be covered by loan-loss provisions.

- For provisions beyond regulatory EL, current limited Tier 2 adjustments were provided for, although the appropriateness of an adjustment via Tier 2 rather than CET1 can be questioned in light of subsequent prudential requirements and accounting changes; moreover, under current prudential requirements and market expectations, Tier 2 is much less relevant than it was originally and, conceptually, Tier 2 has different purposes.

- The Basel III framework introduced new CET1 capital requirements "designed to ensure that banks build up capital buffers outside periods of stress which can be drawn down as losses are incurred."[45] Given such objective and the nature of new the ECL provisions, it would be relevant and appropriate to recognize that the accounting and prudential frameworks here are aiming the same goal, and to allow recognition of the new accounting ECL for prudential purposes.

Adjusting credit risk RWAs. Another alternative to take into account provisioning excess might be to adjust RWA-based capital requirements. This alternative would adapt the adjustment for provisions to a Basel III and ECL world by removing the partial recognition of provisions through Tier 2 of the current regime, introduced under Basel II and incurred-loss provisioning.

The new adjustment could reduce credit risk RWAs by applying one of the following:

i. An offset to RWAs on the exposures associated with excess provisions, in effect, reflecting the fact that the risk is already capitalized through the numerator of the capital ratio (CET1 capital resources are net of ECL provisions). Thus, credit RWAs on each item would be equal to:

MAX{0; Current RWAs — 12.5 * Remaining provisions on the exposure that have not

[45] See BCBS, Basel III, paragraph 122.

already been offset against Regulatory EL}

or

ii. A scalar to RWAs, to be applied in the **same way** to both the regulatory EL if adopted for the SA and, importantly, to the IRB approaches as well. Such a scalar would meet the Committee's stated intention not to increase capital requirements significantly, either generally or by introducing a Regulatory EL. The scalar would be appropriately calibrated to recognize the additional levels of provisions available to absorb credit losses.

This option is somewhat akin to the scaling adjustment discussed at the end of Section 2.3.2 of the Discussion Paper and its footnote 20.

Of course variations are possible for each approach, depending in particular whether the adjustment puts emphasis on risk-sensitivity or on simplicity. The Associations would be pleased to work with the Committee on working out the details of any such possible adjustment.

Annex 3: Illustration of the use of the BCBS Approach 2 of the Consultative Document

Say Bank A is under a IRB approach and also makes use of the SA to calculate its capital requirements for non-significant business units and asset classes.[46] In this example, Bank A applies IFRS and shifts from IAS 39 to IFRS 9, but what follows would be equally valid for US GAAP and new CECL.

We assume here that:

- At T0 (the transition date), there is a Day 1 impact of 300 on CET1 capital due to a 20% increase of IFRS provisions.

Table 1 below gives the figures for each portfolio.

	IRB Portfolio	SA Portfolio	Total
IAS 39 Prov.	20,000	1,000	21,000
IFRS 9 Prov.	22,000	1,200	23,200
Reg. EL	21,900		21,900
CET1 Day 1 Impact	100	200	300

Table 1

In order to apply transitional adjustments pursuant to BCBS Approach 2 laid down in Section 3.4 of the Consultative Document, we express the CET1 Day 1 impact as a percentage of accounting provisions as follows:

DAY1_PC = 300 / 23,200 = **1.29%**

Note: Pursuant to the Consultative Document, the Day 1 impact should be expressed as a percentage of the accounting provisions in the closing balance sheet (21,000 in our example).[47] But as this percentage would be applied to new accounting provisions at subsequent reporting dates, we deem more advisable to express it as a percentage of the accounting provisions in the opening balance sheet (23,200 in our example) as we do above. If not, it would however not affect the conclusion hereafter.

- At subsequent reporting dates Q1 (first quarter of Year 1) and Q2 (second quarter of Year 1), the level of credit risk is unchanged; that is, provisioning and regulatory EL rates are steady so that changes in provisions and regulatory EL are exclusively attributable to volume effects (change in the size of Bank A's portfolios):
  - At T0 and Q1, portfolios have the same size.

  ➔ Q1 and T0 accounting provisions and regulatory EL are identical.
  - At Q2, there is an increase of 100% of the size of the SA portfolio and of 5% of the size of

[46] See BCBS, Basel II, "Some exposures in non-significant business units as well as asset classes (or subclasses in the case of retail) that are immaterial in terms of size and perceived risk profile may be exempt from the requirements in the previous two paragraphs [IRB requirements], subject to supervisory approval. Capital requirements for such operations will be determined according to the standardised approach", paragraph 259.

[47] See Consultative Document, "[CET1 Day 1 impact] would be expressed as a percentage of provisions in the closing balance sheet at the point of transition", Section 3.4 at 8.

the IRB portfolio. The 100% increase of the SA portfolio is excessively high on purpose to illustrate the asymmetrical effects on CET1 capital of accounting provisions under the SA and IRB approaches.

➔ On these portfolios accounting provisions and regulatory EL change in due proportion: +100% for the SA portfolio; +5% for the IRB.

Table 2 below illustrates the figures at each reporting date.

	Q1			Q2		
	IRB Portfolio	SA Portfolio	Total	IRB Portfolio	SA Portfolio	Total
IAS 39 Prov.	20,000	1,000	21,000	21,000	2,000	23,000
IFRS 9 Prov.	22,000	1,200	23,200	23,100	2,400	25,500
Reg. EL	21,900		21,900	22,995	-	22,995
CET1 Impact	100	200	300	105	400	505

Table 2

Chart 3 and Chart 4 illustrate the impact of IFRS 9 on CET1 capital post adjustment calculated pursuant to Approach 2. To calculate the transitional adjustment pursuant to Approach 2, we apply DAY1_PC (see above) to accounting provisions and we add back 75% of this amount to CET1:

- At Q1, Bank A could add back to CET1 capital: 75% * 1.29% * 23,200 = **225**
- At Q2, Bank A could add back to CET1 capital: 75% * 1.29% * 25,500 = **247**

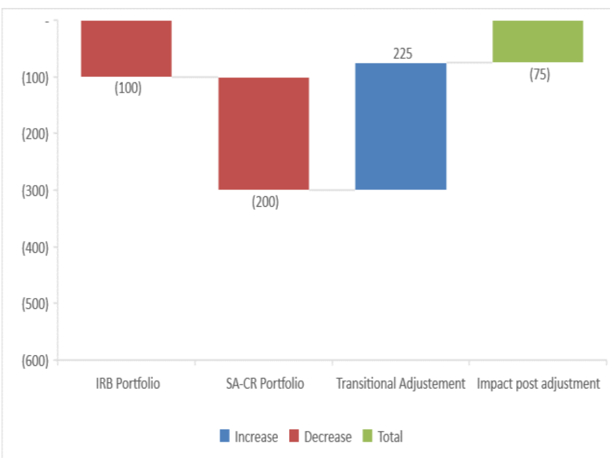

Chart 3: Reporting Date Q1

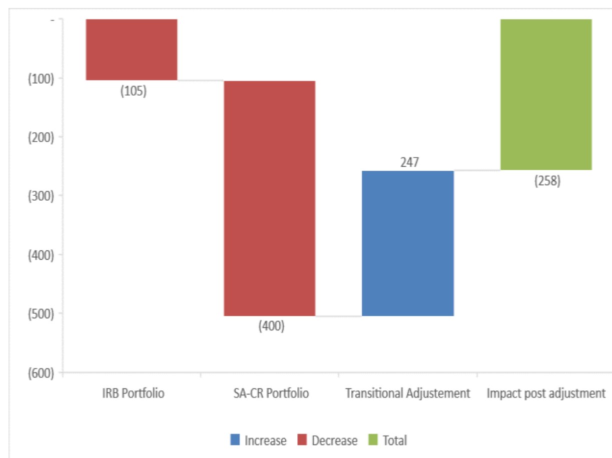

Chart 4: Reporting Date Q2

Conclusion: Increase in accounting provision may affect portfolios under the SA and portfolios under the IRB approaches in a different manner. This example shows that, for a bank that calculates its capital requirements using both SA and IRB, application of Approach 2 can result in inappropriate transitional adjustments:

- Q1 transitional adjustment mitigates 75% of the impact of IFRS 9 provisions on CET1 capital as intended (225 out of 300);
- Q2 transitional adjustment mitigates less than 50% of the impact of new ECL (247 out of 505).

We believe that this shortcoming could be remedied by applying Approach 2 separately to portfolios under the SA and portfolios under the IRB approaches.