BSG comments on Draft Regulatory Technical Standards on the specification of the calculation of specific and general credit risk adjustments according to Article 105(4) of the draft Capital Requirements Regulation (CRR) (EBA/CP/2012/10)

- We welcome the EBA intent to specify the distinction between the general credit risk adjustments (GCRA) and the specific credit risk adjustments (SCRA) newly required by the CRR planned to enter into force in Jan. 1st 2013. Whereas this anticipation should help the institutions prepare the implementation of the required changes, given the current delay of the trilogue process and the increasing unlikelihood of CRDIV becoming effective from the Jan. 1st, we believe that it is too premature to prescribe rules based on unfinished level 1 text. This observation is particularly relevant for this RTS for two main reasons explained below.
- A technical amendment has been proposed on the level 1 in this respect which the BSG expects the EU Commission and EU Parliament to take into account in the final text. In fact, the current CRD rule allows deduction from exposure value of both GCRA and SCRA under the standardised approach for credit risk. This makes perfect sense provided that GCRA as much as SCRA are constituted through P&L accounts and therefore are already deducted from CET1. Without being explicitly required by Basel 3, the CRR limits the deduction of CRA from exposure value to the SCRA while this modification is not backed by any economic rationale. Unfortunately this proposal has not been supported by the EU council or parliament precisely in lack of clear definition of what the GCRA and SCRA account for respectively. While this RTS maintains that both GCRA and SCRA amounts are deducted from CET1, it also provides that the GCRA should not be deducted from the exposure value. This will lead to a double counting of the GCRA on the CET1 (through deduction from the numerator) and in the RWA (through their inclusion in the exposure value of the denominator). In this context, the technical amendment on the level 1 text turns out to be more relevant than ever. The amendment proposal consists in reverting back to the current CRD rules. We urge EBA's support on this. The amendments are included as the appendix of this document for EBA's consideration.
- Ideally, the prudential definition and treatment of GCRA and SCRA should be consistent and compatible with the categories defined in the accounting standards. Indeed, the reconciliation of the regulatory capital with the accounting figures is one of the core principles of the Basel framework. This RTS specifies that it has been drafted in a way that can be applied irrespective of the accounting framework. Nevertheless, it would have to be mentioned that if an institution has nothing compatible with GCRA in its accounting, there no own funds that could be presented under this item.
  - While the current IAS incurred loss model does not create any GCRA, the move to an expected loss model currently under discussion within the IASB and the FASB may result in creating a "bucket" of expected loss qualifying for GCRA. We note that the definition and criteria in the accounting project to date are not exactly the same as in the proposed RTS. Care should be taken to keep consistency in the definitions, either by waiting for the finalisation of the accounting project in 2013, or by adjusting the wording of this RTS when the IFRS accounting definitions will have been fixed. If the latter option is chosen, a legal solution will need to be found as to whether a review clause can be included in a RTS which

is supposed to be "binding". Alternatively and preferably, this RTS should be written in a way that it should not alter the prudential treatment of CRAs due to accounting standards changes. RTS should be accounting neutral, which means that accounting standard changes must not result in fluctuations in the regulatory solvency ratios.

- Institutions, which for financial reporting purposes and own funds calculation apply the national accounting rules, in a number of countries can set up a fund for general banking risks regulated in article 38 of the 86/635/EEC Directive (Bank Accounting Directive). As the total value of the fund for general banking risks is presented a separate item on the liability side and its change is shown in the profit and loss account, in 1991 the Basel Committee has recognised the fund for general banking risks as disclosed reserves, and qualified it as Tier 1 Capital. This has remained the case under the CRD, as well. Now, even the proposal of the CRR treats the fund for general banking risks (without any foreseeable) charge, as Common Equity Tier 1. Since the banks which apply the national accounting rules for the calculation of own funds, generally use the standardised approach, too, we think that the RTS should make an explicit distinction between fund for general banking risks and general credit risks adjustments, which are treated as undisclosed reserves from regulatory capital point of view. The clarification would be necessary, because the scope of the GCRA and the fund for general banking risks partly may overlap, as the fund also can be related to credit exposure items.

Q1. Are the provisions included in this draft RTS on criteria that specify which amounts shall be included in the calculation of GCRAs or SCRAs respectively, sufficiently clear? Are there aspects which need to be elaborated further?

The "evidence of credit deterioration" needs to be clarified further. In particular, it should be clarified whether it refers to a default event or to a broader concept in rating systems used by an institution subject to the CRR.

It would be worth clarifying that the provision at art 2 (5b) means that provisions on credits in watch lists or in sensitive portfolios due to past events (e.g. past due items of less than 90 days) would qualify as SCRAs, as this is not standard practice in the industry.

In Article 4 of the RTS it is assumed that the institutions have models based on statistical observation, which is not always the case in smaller institutions. However, depending on the rules in the individual Member States, it should not be excluded that smaller institutions could use a simplified approach for GCRA, e.g. a given percentage on the exposures where no specific credit risk adjustments have been set up.

The distinction between the risks covered by the GCRA and the fund for general banking risks have to be addressed (see above).

It deserves clarification too, that in Member States where national accounting rules do not permit SCRA for the "incurred, but not reported" loss category (in contrast to the IFRS), but treat them as GCRA or FGBR, how should be treated. We think where GCRA is shown separately on the liability side and its change goes through the profit and loss account, as it is done always in case of the FGBR, it should not be reclassified in any case as SCRA, since they do not decrease the size of total assets and the related items are risk weighted.

Q2: Are there any issues regarding the timing of recognition of provisions, value adjustments or impairments in profit or loss and in Common Equity Tier 1 capital?

No. There is no particular issue in this respect.

Q3: Are the provisions included in this draft RTS on criteria to assign SCRAs for a group of exposures sufficiently clear? Are there aspects which need to be elaborated further?

Yes, it is sufficiently clear, but perhaps in order to avoid misunderstanding the sub-title could be repeated in the paragraphs, as well. However, the BSG underlines that the calculations required at Art. 3 (1) of the draft RTS may be burdensome as they would imply that the calculations of RWAs should be performed twice, as this Article states that, for this purpose, the exposure values shall be determined without taking into account any SCRAs. Hence, the BSG suggests a slight modification to the drafting of Art. 3 (1) of the draft RTS: *"in the case of a SCRA that reflects losses related to the credit risk of a group of exposures, institutions shall assign this SCRA to single exposures of this group proportionally to the risk-weighted exposure* ***or to the exposure at default*** *amounts. For this purpose, the exposure values shall be determined without taking into account any SCRAs."* Otherwise it may happen, that when the group of exposures are 0 per cent risk weighted, no SCRA could be assigned to them.

Another issue we would like this RTS to address is that the upcoming accounting reforms are expected to affect the Tier 1 ratio whereas the minimum capital requirements under Basel 3 are calibrated on the current level of CRAs. We urge that EBA consider deducting GCRAs from Tier 2 instead of Tier 1.

Q4: Are the provisions included in this draft RTS sufficiently clear? Are there aspects which need to be elaborated further?

Yes it is sufficiently clear overall. However, it would be worth clarifying Art. 5 of the draft RTS by adding a 4th paragraph based on explanations provided in the explanatory note *"for institutions applying the IRB approach, all SCRAs and GCRAs calculated at points (1) and (2) need to be sum up for all exposures treated under IRB across the institution, without prejudice of Art. 3(3). The resulting sum, calculated on a solo basis, sub-consolidated basis or on consolidated basis, depending on the level of application of requirements as defined in Title II, Part I, is used to make the comparison with expected losses calculated on the same perimeter, as provided for at Art. 155 of the CRR."*

Q5: Do you support the policy proposal, in particular to the preferred policy option (3), and the EBA's assessment that its impact is relatively immaterial to the CRR text? If not please explain why and provide estimates of such impacts whenever possible.

In order to promote harmonisation and avoid regulatory arbitrage opportunities, the BSG agree with the EBA that option 3 could be the preferred option. However, option 3 is very challenging and expensive to calculate and institutions do this in different ways today. It is therefore the BSG opinion that it would be inappropriate to require all institutions to use option 3, especially in cases where institutions assign only small amounts of SCRA to group of exposures. Less sophisticated methods (option 2) should therefore be allowed for institutions. Institutions that would prefer to implement option 3 would also need time to do the implementation, why our suggestion is that all institutions should be allowed to use option 2 during a transitional period.

Q6: What is the incremental cost to your institution for the implementation of this proposal?

Any regulatory change requires a certain level of implementation efforts and change management the cost of which varies depending on institutions and jurisdictions. We consider that the only valid impact assessment can be conducted once the accounting reforms undertaken by the IASB are finalised.

Q7: What is the incremental cost for the ongoing compliance with this proposal?

No comment

Q8: What is the incremental benefit to your institution for the implementation of this proposal?

No comment

Q9: What is the incremental benefit for the ongoing compliance of this proposal?

No comment

APPENDIX: technical amendments on CRR in relation to the prudential treatment of GCRA

Text proposed by the Commission	*Amendment*
Article 59 of the Regulation *Tier 2 items* Tier 2 items shall consist of the following: (a) capital instruments, where the conditions laid down in Article 60 are met; (b) the share premium accounts related to the instruments referred to in point (a); (c) for institutions calculating risk-weighted exposure amounts in accordance with Chapter 2 of Title II, general credit risk adjustments, gross of tax effects, of up to 1.25 % of risk-weighted exposure amounts calculated in accordance with Chapter 2 of Title II of Part Three; (d) for institutions calculating risk-weighted exposure amounts under Chapter 3 of Title II, positive amounts, gross of tax effects, resulting from the calculation laid down in Article 154 and 155 up to 0,6 % of risk weighted exposure amounts calculated under Chapter 3 of Title II of Part Three.	***Article 59 of the Regulation*** *Tier 2 items* Tier 2 items shall consist of the following: (a) capital instruments, where the conditions laid down in Article 60 are met; (b) the share premium accounts related to the instruments referred to in point (a); (c) ~~for institutions calculating risk-weighted exposure amounts in accordance with Chapter 2 of Title II, general credit risk adjustments, gross of tax effects, of up to 1.25 % of risk-weighted exposure amounts calculated in accordance with Chapter 2 of Title II of Part Three;~~ (c~~d~~) for institutions calculating risk-weighted exposure amounts under Chapter 3 of Title II, positive amounts, gross of tax effects, resulting from the calculation laid down in Article 154 and 155 up to 0,6 % of risk weighted exposure amounts calculated under Chapter 3 of Title II of Part Three.
Article 105 of the Regulation *Treatment of credit risk adjustments* 1. Institutions applying the Standardised Approach shall treat general credit risk adjustments in accordance with Article 59 (c).	***Article 105 of the Regulation*** *Treatment of credit risk adjustments* **DELETED**
Article 106 of the Regulation *Exposure value* 1. The exposure value of an asset item shall be its accounting value remaining after specific credit risk adjustments have been applied. The exposure value of an off-balance sheet item listed in Annex I shall be the following percentage of its nominal value after reduction of specific credit risk adjustments: (a) 100 % if it is a full-risk item;	***Article 106 of the Regulation*** *Exposure value* 1. The exposure value of an asset item shall be its accounting value remaining after ~~specific~~ credit risk adjustments have been applied. The exposure value of an off-balance sheet item listed in Annex I shall be the following percentage of its nominal value after reduction of ~~specific~~ credit risk adjustments: (a) 100 % if it is a full-risk item;

(b) 50 % if it is a medium-risk item; (c) 20 % if it is a medium/low-risk item; (d) 0 % if it is a low-risk item. The off-balance sheet items referred to in the second sentence of the first subparagraph shall be assigned to risk categories as indicated in Annex I. When an institution is using the Financial Collateral Comprehensive Method under Article 218, the exposure value of securities or commodities sold, posted or lent under a repurchase transaction or under a securities or commodities lending or borrowing transaction, and margin lending transactions shall be increased by the volatility adjustment appropriate to such securities or commodities as prescribed in Articles 218 to 220.	(b) 50 % if it is a medium-risk item; (c) 20 % if it is a medium/low-risk item; (d) 0 % if it is a low-risk item. The off-balance sheet items referred to in the second sentence of the first subparagraph shall be assigned to risk categories as indicated in Annex I. When an institution is using the Financial Collateral Comprehensive Method under Article 218, the exposure value of securities or commodities sold, posted or lent under a repurchase transaction or under a securities or commodities lending or borrowing transaction, and margin lending transactions shall be increased by the volatility adjustment appropriate to such securities or commodities as prescribed in Articles 218 to 220.
Article 241 of the Regulation *Exposure Value* 1. The exposure value shall be calculated as follows: (a) where an institution calculates risk-weighted exposure amounts under Sub-section 3, the exposure value of an on-balance sheet securitisation position shall be its accounting value remaining after specific credit risk adjustments have been applied; (b) where an institution calculates risk-weighted exposure amounts under Sub-section 4, the exposure value of an on-balance sheet securitisation position shall be the accounting value measured without taking into account any credit risk adjustments made; (c) where an institution calculates risk-weighted exposure amounts under Sub-section 3, the exposure value of an off-balance sheet securitisation position shall be its nominal value, less any specific credit risk adjustment of that securitisation position, multiplied by a conversion factor as prescribed in this Chapter. The conversion factor shall be 100 % unless otherwise specified; (d) where an institution calculates risk-weighted exposure amounts under Sub-section 4, the exposure value of an off-balance sheet securitisation position shall be its nominal value multiplied by a conversion factor as prescribed in this Chapter. The conversion factor shall be 100 % unless otherwise specified; (e) The exposure value for the counterparty credit risk of a derivative instrument listed in Annex II, shall be determined in accordance with Chapter 6.The risk-weighted exposure	***Article 241 of the Regulation*** *Exposure Value* 2. The exposure value shall be calculated as follows: (b) where an institution calculates risk-weighted exposure amounts under Sub-section 3, the exposure value of an on-balance sheet securitisation position shall be its accounting value remaining after ~~specific~~ credit risk adjustments have been applied; (b) where an institution calculates risk-weighted exposure amounts under Sub-section 4, the exposure value of an on-balance sheet securitisation position shall be the accounting value measured without taking into account any credit risk adjustments made; (c) where an institution calculates risk-weighted exposure amounts under Sub-section 3, the exposure value of an off-balance sheet securitisation position shall be its nominal value, less any ~~specific~~ credit risk adjustment of that securitisation position, multiplied by a conversion factor as prescribed in this Chapter. The conversion factor shall be 100 % unless otherwise specified; (d) where an institution calculates risk-weighted exposure amounts under Sub-section 4, the exposure value of an off-balance sheet securitisation position shall be its nominal value multiplied by a conversion factor as prescribed in this Chapter. The conversion factor shall be 100 % unless otherwise specified; (e) The exposure value for the counterparty credit risk of a derivative instrument listed in Annex II, shall be determined in accordance with Chapter 6.The risk-weighted exposure

amount of a securitisation position may be reduced by 12.5 times the amount of any specific credit adjustments made by the institution in respect of the position.	amount of a securitisation position may be reduced by 12.5 times the amount of any s~~pecific~~ credit adjustments made by the institution in respect of the position.
Article 261 of the Regulation *Reduction in risk-weighted exposure amounts* 3. The risk-weighted exposure amount of a securitisation position to which a 1250 % risk weight is assigned may be reduced by 12.5 times the amount of any specific credit adjustments made by the institution in respect of the securitised exposures. To the extent that specific credit adjustments are taken account of for this purpose they shall not be taken account of for the purposes of the calculation laid down in Article 155. 4. The risk-weighted exposure amount of a securitisation position may be reduced by 12.5 times the amount of any specific credit adjustments made by the institution in respect of the position.	***Article 261 of the Regulation*** *Reduction in risk-weighted exposure amounts* 1. The risk-weighted exposure amount of a securitisation position to which a 1250 % risk weight is assigned may be reduced by 12.5 times the amount of any ~~specific~~ credit adjustments made by the institution in respect of the securitised exposures. To the extent that ~~specific~~ credit adjustments are taken account of for this purpose they shall not be taken account of for the purposes of the calculation laid down in Article 155. 2. The risk-weighted exposure amount of a securitisation position may be reduced by 12.5 times the amount of any ~~specific~~ credit adjustments made by the institution in respect of the position.