EAPB Position Paper on EBA Guidelines on credit risk management practices and accounting for expected credit losses

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About EAPB

The European Association of Public Banks (EAPB) gathers member organisations (financial institutions, funding agencies, public banks, associations of public banks and banks with similar interests) from 17 European Member States and countries, representing directly and indirectly the interests of over 90 financial institutions towards the EU and other European stakeholders. With a combined balance sheet total of about EUR 3,500 billion and a market share of around 15%, EAPB members constitute an essential part of the European financial sector.

EAPB welcomes the consultation of the European Banking Authority's (EBA) guidelines on credit risk management practices and accounting for expected credit losses (ECL) and would like to use this opportunity to submit comments of the EAPB members on the guidelines. In the following, a general comment section presents the main EAPB concerns. Subsequently, the detailed comment section offers specific EAPB feedback to the questions in the consultation paper.

General Comments

1.) Regulatory guidance should be principle-based and suitable for banks of different size, complexity, business models and risk profiles

The guidelines contain too much specific guidance and examples creating inflexibility and redundancy with existing regulatory and accounting rules. In some areas, the guidelines are written as a rule-based guidance with strict requirements that are difficult to align with the principles of proportionality and materiality considering the characteristics (e.g. size, complexity, business model, risk profile) of each credit institution. The requirements under "Principle 2 – sound ECL Methodologies" in particular contain several points which can be read as checklists rather than parts of principle-based guidance (e.g. paragraphs 33, 36, 37). The consultative document should therefore concentrate on the established principles, while specific rules and examples should be removed as they create inflexibility and redundancies. Furthermore, the requirements to demonstrate risk-adjusted pricing throughout all business segments and for all loans are viewed as critical in order to be used as a factor for determining significant increases in credit risk and consequently as an indicator for the assessment of the quality of the implementation of the ECL model (paragraphs 40, 107).

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Another requirement set out in the consultative document is the obligation to consider absolute width as measure when determining significant increases in credit risk (paragraph 109). In some cases , it may be helpful to use an absolute measure (absolute increase in probability of default (PD) as a width of the change in PD) as additional option. Nevertheless, the usage of an absolute measure should only be a voluntary option. For some entities, a mandatory application of both measures could be difficult to incorporate and in the IFRS 9 ECL model, absolute width might interfere with the relative transfer criterion.

2.) Proportionality and materiality should be understood as overarching principles

Considering large portfolios per se as material (paragraph 18) does not appear as a proper application of the materiality principle stipulated in IFRS. Moreover, a proportionate formulation of the guidelines should neither define criteria for the scope of application nor exempt some credit institutions from applying the guidelines, but simply follow a principle-based manner ensuring consistency with the overall consultation paper.

3.) Accounting should follow risk management practice

The final guidelines should not lay down specific rules for credit risk management as such. Rather, they should be based on robust risk management methodology. The consultative document contains very detailed requirements on risk management methods and processes though and the reference to existing risk management processes is not clear enough. Referring to this, the requirements under paragraph 38 regarding the consideration of different potential scenarios constitute additional requirements beyond IFRS 9 and should be due to cost-benefit considerations less detailed and more principle based. This would be in line and consistent with the credit institution's risk management practice.

In addition, the requirement that the probation period (paragraph 41) as defined in Commission Implementing Regulation 2015/227 shall now also be considered for impairment purposes does not seem appropriate. It should be subject to the assessment of the credit institution to decide which probation period to consider as appropriate from a risk management instead of using standard probation periods that are not commensurate to the underlying risks.

4.) Use of practical expedients

While the use of practical expedients does not contradict a high quality implementation as such, their use is very restricted in the consultative document. Therefore, it is questionable to conclude that the use of practical expedients set out in IFRS 9 should inevitably be limited to achieve a robust and adequate implementation of the IFRS 9 ECL model. If the objectives of IFRS 9 impairment model are not undermined and given that an appropriate level of

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allowance will be established without delays, there should be no obstacles for the use of practical expedients.

The use of the relief in IFRS 9 to avoid “undue cost or effort” should not be applied in a way that providing forward-looking information would generally be deemed as necessary unless the preparers can prove that they do not contribute to a high-quality implementation of IFRS 9. It is unclear how and to what extent banks can demonstrate that additional cost or effort to consider all reasonable and supportable information would not contribute to a high-quality implementation of IFRS 9. This may cause time-consuming discussions with regulators.

4.1.) Use of low credit risk exemption (LCRE)

The original motivation for introducing this exemption to the IFRS 9 ECL model was to achieve an appropriate balance between the benefits of distinguishing between financial instruments on the basis of changes in credit risk and the costs of making that distinction. However, the IASB noted that financial instruments of such a high credit quality were not the primary focus for the recognition of lifetime expected credit losses. In addition, empirical assessments inside the banking industry prove that assets with investment grade quality at the reporting date do not display of significant increases in PD after inception. Since the LCRE is justified from both, a conceptual and a material perspective, it is very unlikely that the use of LCRE would result in a low quality implementation of the IFRS 9 ECL model. Furthermore, it is unclear how and to what extent banks can demonstrate that the LCRE was not used “for the purpose of omitting timely assessment and tracking of credit risk” and that the risk of the respective loans was sufficiently low. This creates scope for uncertainty and misunderstanding.

The general use of practical expedients within the limitation of IFRS 9 is necessary for the retrospective application for credit exposures that are originated before the date of initial application of the ECL model. Banks should be allowed to use practical expedients for a retrospective application for credit exposures that are originated before the first application date if the actual data is not available and cannot be generated without additional cost or effort in line with IFRS 9. This should also apply to the contemplation of the time horizon and the possible use of the 12-month PD as approximation for the lifetime of the contract to determine a significant increase in credit risk.

It is necessary to avoid additional provisions that in conjunction with IAS 8 reduce CET1 capital even if over time, these provisions would decrease again with a corresponding increase in the amount of accounting and regulatory capital. This is linked to the fact that after initial application, provisions for new transactions first have to be calculated on the basis of a 12-month PD and, given that data is available for these new transactions,

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provisions amounting to the lifetime expected credit loss are not required in the absence of a significant risk increase, which is almost always likely to be the case.

5.) 30-days-past-due rebuttable presumption (30 dpd):

A reasonable use of the 30 dpd should not contradict a high quality implementation. EAPB wants to highlight that in any case 30 dpd should be eligible subject to the application of the principles of proportionality and materiality with regard to the size and inherent risks of such exposures. In example, if retail portfolios are not material in terms of exposure size or impact on the financial situation, the use of the more-than-30-days rebuttable assumption can be an appropriate implementation that is proportionate to the risk of such retail exposures. Furthermore, there could be justified cases, in which the use of the more-than-30-days rebuttable assumption may be appropriate and the best criterion available.

6. Independence of model validation from model development

In the guidelines, it should be clarified that the required independence of model validation from model development can also be achieved if validation and development of the respective models is performed in the same organisational unit by different staff and if the validation results are approved by a committee that ensures independent decisions on the validation results and on a new model development or a recalibration.

Detailed Comments

Question 1: Is the scope of application of the guidelines appropriate and sufficiently clear?

Answer: Yes, EAPB acknowledges that the scope of consolidation and application of the guidelines is clearly formulated.

Question 2: Is the date of application of the guidelines of 1 January 2018 appropriate?

Answer: The 1 January 2018 as the mandatory date of initial application of the final EBA-guidelines will only be acceptable if the consultative document guidelines do not significantly overstep IFRS 9 requirements. Otherwise, the remaining time period until 1 January 2018 would be too short for the implementation (including test activities) of additional requirements.

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

Answer: EAPB acknowledges the documentation of the proportionality principle in the present consultative document of EBA. These principles of proportionality and materiality

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are already applied in practice today and are a part of the regulatory framework, as demonstrated, for example, by the possibility of a permanent partial use in IRB, and an accounting principle for useful information in the IFRS Framework.

Furthermore, EAPB believes that considering large portfolios per se as material would not be a proper application of the materiality principle stipulated in IFRS. In case of single portfolios, the applicable materiality principle should rather follow the criteria of the proportionality principle.

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

Answer: EAPB believes that the consultative document of EBA could take into consideration the following:

- EBA mentions that credit institutions may use existing regulatory capital models for the measurement of expected losses as a starting point for estimating ECL for accounting purposes.;

- EAPB welcomes the fact that some paragraphs reproducing IFRS 9 text have been replaced by a reference to the specific paragraph of IFRS 9. However, this approach could be extended further. For example, a statement that "credit institutions should ensure that modifications or renegotiations do not obscure increases in credit risk…" (paragraph 124) relates to IFRS 9 preventing preparers from hiding credit deteriorations by modifications or renegotiations of the contractual terms and conditions and should be appropriately referenced.

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

Answer: In relation to the impact assessment for the proportionality approach, EAPB believes that Option 2.1 should be chosen, since out of the three options, it is the most principle-based one. EAPB also believes that the draft guidelines should be based on a set of principles. Such an approach is best suited for the application within the broad range of different accounting frameworks, business models and sizes of banks and as such can be adequately applied by each credit institution in the scope of the draft guidelines.

On the contrary, developed criteria on the application of the proportionality approach and introduction of specific exclusions or inclusions ("smaller/less complex" or "systematically important credit institutions") would lead to a reduced flexibility and redundancies. It will

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also be impossible to account for all of the possible cases, when specifying certain criteria. As a consequence, the costs associated with those exclusions and restrictions would outweigh the potential benefits they might bring.

Question 6: Please provide any additional comments on the draft guidelines.

Answer: In addition to the answers/remarks above, the following aspects should be emphasised:

- In paragraph 86, the EBA draft guidelines argue that banks should measure ECL for all lending exposures and that a nil allowance should be rare unless, where appropriate, for fully collateralised loans. EAPB believes that the nil allowance should not only occur in cases of fully collateralised loans but also for other cases of credit risk mitigation, in particular for the case of guarantees. This would be in line with statements made in the draft guideline's paragraph 105 and do justice to the risk-reducing character of collateral and guarantees. Moreover, for the specific case of promotional banks disposing of collateral and/or guarantees either from national, regional or municipal governments, there seems to be no reason to work with ECL given the exceptionally low-risk character of the respective governments. In case a loan has a full guarantee from one such government, it should be considered to exclude it from ECL calculations.

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

- Regarding the materiality principle, it should be emphasised that even in case of large exposures/portfolios, the materiality and sensitivity of the amount of risk provisions should be a more relevant measure than magnitude of exposure amount. As a consequence, EAPB thus recommends changing the statement in paragraph 18 in order to reflect this idea.

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