

26 October 2016

**Draft BBA response to EBA consultation on draft guidelines on credit risk management practices and accounting for expected credit losses**

The BBA welcomes the opportunity to comment on the draft EBA guidelines on credit risk management practices and accounting for expected credit losses. The BBA represents 200 banks from 50 countries with operations in 180 jurisdictions.

As the Executive Summary observes, the move from an incurred loss model to an Expected Credit Loss (ECL) model under IFRS 9 is intended to contribute to addressing G20 concerns about the recognition of credit losses and the setting of accounting loan loss provisions being ‘too little, too late’ by incorporating a broader range of credit information. The underlying Basel guidance made clear that the best practice set out in the Basel paper should be viewed as an over layering of IFRS 9 with Principles 17 and 18 of the Core Principles for Effective Banking Supervision.

We agree in principle with the objective of seeking to achieve a high-quality implementation of the impairment requirements of IFRS 9 and agree that the EBA has a role to play in supporting the consistent implementation of ECL frameworks to the extent possible across relevant jurisdictions. In addition to emphasising the need for high-quality and consistent application of IFRS 9, however, we believe the guidelines should also place appropriate weight on the need for proportionality.

While this is recognised, we are concerned that the guidelines do not truly capture the degree to which the circumstances across differing types of firm (and to a degree within firms) will vary considerably and believe that this is an area where the guidelines would benefit from closer attention.

We would further add that we have been awaiting the publication of the (delayed) Basel consultation on the regulatory treatment of accounting provisions to engage with members more fully on the regulatory overlap with IFRS 9 and will consider whether we need supplement this submission in light of our analysis of that document.

**Subject matter, scope, addressees and definitions**

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

The scope of appears appropriate and sufficiently clear to us.

**Implementation**

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

In broad terms, though to be clear, IFRS 9 is applicable for ‘annual periods beginning on or after 1 January 2018’.

**Guidelines on credit risk management practices and accounting for expected credit losses**

**Question 3: Please provide any comments you may have on the appropriateness of the proposed proportionality approach (please also see the additional criteria included in the section covering the use of practical expedients).**

Section 4.1.1 defines proportionality, materiality and symmetry specifically for credit risk management practices and accounting for expected credit losses in terms of credit institutions, explaining that credit institutions should comply with the guidelines in a way that is ‘appropriate to their size, internal organization and the nature, scope and complexity of their activities’ and ‘more generally, all other relevant facts and circumstances of the credit institution and the group (if any) to which it belongs’.

As cross-referred in the question, Section 4.3.3 addresses the use of practical expedients, with paragraph 129 explaining that credit institutions should make limited use of these as they have the potential to introduce significant bias and because obtaining information, given their business, ought not to involve ‘undue cost or effort’. It adds that credit institutions which are both smaller and less complex may reasonably rely more on the use of practical expedients while meeting the objectives of the guidelines. While this intuitively feels right, the document elsewhere refers to consideration being given to the ‘nature, scope and complexity’ of activities and ‘all other relevant facts and circumstances’ of the credit institution and the group (if any) to which it belongs and this also seems right.

Section 4.3.3 then addresses the use of practical expedients and paragraph 131 specifically the information set to be used. While this is caveated, the paragraph concludes, nevertheless that ‘additional cost and operational burden do not need to be introduced where they do not contribute to a high-quality implementation of IFRS 9’. We view this, together with the wording quoted from IFRS 9 itself i.e. that ‘an entity shall consider reasonable and supportable information that is available without undue cost and effort’ as offering an insight to the balance to be found on achieving proportionality noting that institutions should guard against reading this too restrictively.

**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?**

The main part of the guidance is based around eight principles on credit risk management practices and accounting for expected credit losses applicable to credit institutions, additional guidance for institutions applying IFRS 9 and three principles applicable to competent authorities in their supervisory evaluation of credit risk practices, accounting for expected credit losses and capital adequacy.

On the whole, we find the principles applicable to credit institutions and the guidance they convey to be readily understandable and consistent with the Basel guidance upon which they are based. We welcome in particular the emphasis, in various places, upon the approach being aligned with how the credit institution manages the lending exposure and the need for credit institutions to use experienced credit judgement ‘especially in the consideration of reasonable and supportable forward-looking information, including macroeconomic factors’ being essential to the assessment of credit risk and measurement of ECL. That said, there is concern over paragraph 23 in the preceding section which requires banks to provide clearly documented and robust justification where, in exceptional circumstances, information relevant to the assessment of credit risk is not reasonable and supportable. This wording or its interpretation could be read as requiring justification for not including every possible future scenario. While this cannot be the intention, the wording needs amending so as to clarify that this is not the case.

Although it looks quite innocent, the disclosures in principle 8 (section 4.2.8) and elsewhere in the draft guidelines could add significantly to the burden for banks. We see a case, in particular, for specific reference to IFRS 7.

If we have a general concern about the principles, it is about the consequence of the transposition of Basel guidance into EBA guidelines and whether this somehow turns principles into rules. Paragraphs 33, 36 and 37 of the EBA guidance, for instance, sees a change in emphasis between the texts as a result of “generally” and “could” being replaced by “in particular” and “should”. We believe that this should be reconsidered.

**Conclusion**

**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.**

Section D2 of the impact assessment sets out the options for applying proportionality, with:

* Option 2.1 described as application of the guidelines in a proportionate manner without defining specific criteria;
* Option 2.2 as developing criteria on the application of the proportionality approach and excluding smaller/less complex credit institutions in certain cases; and
* Option 2.3 as establishing proportionality on the basis of additional requirements on the part of systemically important and other credit institutions in certain cases.

The guidance explains that option 2.1 requires ‘compliance in outcome’, described as the application of sound credit risk and accounting practices by all credit institutions, providing freedom of means for achieving that according to the assessment of specific proportionality criteria. Under this, additional incremental costs of applying these guidelines would be reduced to ‘the maximum extent possible’, since application of the guidelines will be tailored to the specificities of a credit institution. This tailoring is seen as avoiding the need for thresholds or ‘bright lines’ to be mechanically applied.

Option 2.2 is described as being similar to option 2.1, with the exception that for smaller/less complex credit institutions the application of the practical expedients of IFRS 9 would be explicitly permitted, while for other credit institutions the application of the practical expedients should be limited.

The sub-section concludes that the preferred option is a mix of options 2.1 and 2.2, which, while proposing the application of the general proportionality approach, also clarifies that ‘both smaller and less complex credit institutions may rely more upon the use of practical expedients (although adjustments should be considered to avoid any potential bias arising from such use) to introduce a more proportional approach in the application of the guidelines’.

We would question whether this goes far enough. The Basel guidance was intended to only ever apply to the larger banks. These requirements are now enshrined in guidance that must be applied by all credit institutions with a relatively undefined commitment to proportionality. While the application of the EBA guidelines by credit institutions is to be according to the *‘nature, scope and complexity of their activities’,* we nevertheless see a need for a much clearer statement in the body of the guidelines that indicates that the EBA fully appreciates that differing firms will have significantly different approaches in their application of IFRS 9. In addition to the commentary already given on proportionality, we would like to see inclusion of a fuller statement more closely reflecting the statement made in the Basel guidance, namely:

“11. While ECL accounting frameworks are new and different from current accounting frameworks and their implementation will require an investment in both resources and system developments/upgrades, standard setters have given or are expected to give firms a considerable time period to transition to the updated accounting requirements. On that basis, the Committee has significantly heightened supervisory expectations that internationally active banks and those banks more sophisticated in the business of lending will have the highest-quality implementation of an ECL accounting framework.

12. For less complex banks, consistent with the Basel Core Principles, the Committee recognises that supervisors may adopt a proportionate approach with regard to the standards that supervisors impose on banks and the conduct of supervisors in the discharge of their own responsibilities. This allows less complex banks to adopt approaches commensurate with the size, nature and complexity of their lending exposures.”

Similarly, while the *‘nature, scope and complexity of their activities’* approach works to a degree, larger firms will have smaller subsidiaries, sometimes within less developed environments, and numerous smaller segments and exceptions within their overall portfolios that cannot be modelled and managed to the same high degree of compliance with the guidelines as for their mainstream portfolios.  While there will be some benefit from being within a larger group, there will be natural limitations on what can be achieved. As the guidelines provide, any by exception approach will need to be clearly documented and appropriately justified.

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

To underline our responses above:

* We see merit in explicit reference being made to IFRS 7 requirements in order to place disclosure recommendations within the guidelines into context.
* We are concerned about the consequence of the transposition of Basel guidance into EBA guidelines and whether this somehow turns principles into rules. The Basel paper is about best practice rather than minimum standards and this, to our way of thinking, stops short of mandating particular approaches and instead recognises that there may be a range of practices that could result in a particular outcome being achieved. The ‘could’/’should’ distinction therefore is an important one and should be reviewed throughout the guidance to ensure that the appropriate emphasis is used.
* We are unsure that the guidelines truly reflect the differing circumstances of different types of firm (and activity) and the extent to which it must be valid for the adoption of IFRS 9 to vary considerably where the circumstances allow.

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