David Schraa
Regulatory Counsel

December 1, 2014

Mr. René van Wyk
Chair of the Accounting Experts Group
Basel Committee on Banking Supervision

RE: Discussion held on November 13 on the proposed revised guidance for Sound Credit Risk Assessment and Valuation for Loans

Dear Mr. van Wyk:

The Institute of International Finance (IIF), via its Senior Accounting Group (SAG), welcomes the opportunity to comment on the discussion held with the Basel Accounting Expert Group (AEG) on the proposed revision of the guidance for Sound Credit Risk Assessment and Valuation for Loans ('SCRAVL' guidance or 'the guidance').

The SAG agrees with the AEG that a high-quality, robust implementation of the Expected Credit Loss (ECL) impairment accounting standards, is a key priority.

The purpose of this letter is to share with the AEG the thoughts of the SAG members on how best to achieve a high-quality, robust implementation of the ECL impairment accounting standards, following the highly constructive meeting of the 13th November. Much of the discussion at that meeting necessarily focused on IFRS 9, because IFRS 9 has been published, and the Basel AEG is in the process of drafting an appendix to the SCRAVL guidance which specifically addresses IFRS 9 (we understand that the main part of the SCRAVL addresses credit risk management practices that affect impairment, and is therefore intended to be applicable irrespective of which accounting standard applies). Some of the concepts discussed in this letter are specific to IFRS 9, for example the 'significant credit deterioration' transfer criteria. However, many of the issues discussed are also relevant in the context of the US GAAP Current Expected Credit Loss ('CECL') approach currently under development, for example those issues relating to forecasting the effect of forward looking factors on loan portfolios. For the purposes of this letter, references to the ECL impairment model and the 'standard' refer to IFRS 9, except where specified to the contrary, but the matters raised are not intended to be relevant only to IFRS 9, unless the context makes this clear. The present document is based on the views expressed during the November 13 meeting and may not necessarily fully represent the views of some members of the SAG who were not able to be present.

General Comments

The SAG believes that a high-quality implementation of the ECL impairment accounting standards should reflect banks' credit risk management practices, in order to provide meaningful information to general users of the financial statements, and to be achievable in a realistic timescale. While we acknowledge that credit risk management and application of economic forecasting practices are likely to need to be further developed to support the high-quality

implementation of the standards, we do believe that the ECL impairment accounting model would lack relevance if it were to exist purely as an accounting process, so banks will need to ensure that the ECL model is aligned with the credit risk management and business management and planning disciplines, which will have to contribute the necessary tools to carry it out. It is particularly true if, as a result of the guidance, banks effectively have to develop additional credit-rating systems.

The SAG agrees with the AEG that the guidance will be helpful in establishing consistency ***within*** banks across similar portfolios and loan types, and between reporting periods. However, if consistency means close equivalence, achieving consistency between banks on ECL recognition and measurement will not be a relevant objective, except to the extent that consistent framework for implementation across banks is established. This is particularly true in the context of forward looking information, where it could be contrary to the requirements of the standard if banks could not use their own views of future economic and credit conditions. Reasonable differences of application of the standard will also be the result of differences in business models, credit risk management practices, credit risk appetite, legal and regulatory requirements, systems and processes.

The SAG understands that the guidance is not intended to contradict the principles of the accounting standards, but we are concerned that it may inappropriately restrict the range of permissible practice within the standards for internationally active banks. While we understand the desire to improve comparability and enhance credit risk practices, the SAG is concerned about the possible unintended consequences of restricting the available approaches as this could work against high-quality implementation by creating disconnect with bank' existing credit risk management processes.

The SAG agrees that materiality should not be used to justify low quality implementation. However, we note that materiality is a key principle underpinning all financial reporting, and materiality decisions should not be seen as contrary to a high quality implementation if they are appropriately justified. Of course, sound credit risk management practices should continue to operate independently of the exercise of materiality judgments in financial reporting. But the proper assessment of materiality means that the right resources will be allocated at the right time to the risks that need to be monitored closely. It would be inconsistent with a high quality implementation if resource allocations could not take into account materiality and relevance.

We understand that while the updated document will include an Appendix for IFRS preparers, there will be no SCRAVL appendix for US GAAP. US Regulators are working on separate supervisory guidance to accompany the FASB impairment standard, but the timing will necessarily reflect the later timing of the issuance of the FASB standard, the co-ordination of US regulators, and the diversity of institutions addressed by US guidance. The US regulators are participating in the drafting of the SCRAVL guidance, including the IFRS appendix; however the US supervisory accounting guidance will necessarily reflect the final FASB accounting standard, the conceptual basis of which will differ significantly from IFRS 9. Banks that must report under both standards, notably Foreign Private Issuers with US subsidiaries, have concerns about the disconnect in the timeline between the issuance of the IFRS 9 appendix and the corresponding US GAAP guidance, which will create additional operational challenges.

We understand that the SCRAVL is intended to be used by national regulators to ensure a globally consistent understanding of a high quality implementation and ongoing application of ECL. It is therefore very important that national 'gold plating' of the Basel guidance be avoided, as this would work against the consistent understanding of principles across jurisdictions.

While the different purposes and objectives of regulatory supervision and general- purpose financial reporting are well understood by all parties involved in the preparation of the guidance, the SAG believes it would be useful for the guidance to acknowledge this fundamental point and confirm the context in which the guidance is intended to be used, for the benefit of the wide audience the guidance is likely to attract.

The SAG would like to make specific comments in the following areas:

- Forward-looking information, including macro-economic factors
- Significant increase in credit risk
- Use of practical expedients
- Level of aggregation for the use of forward-looking information/macro-economic factors
- Disclosure

Forward-looking information, including macro-economic factors

The SAG agrees that in order to achieve a high-quality implementation, banks should not ignore relevant available information that could improve the ECL estimation. This should involve due consideration of the sources of information available, and selection of factors that are most relevant in driving ECL impairment. There should be no prescription as to the information that should be used, but guidance as to which factors should be considered in identifying appropriate information, depending on the facts and circumstances. The following considerations are relevant in designing guidance that supports high-quality implementation:

- It is essential that the forward looking information selected be demonstrably and strongly linked to the credit risk of given portfolios and loan types to meet the requirement in the standard for 'reasonable and supportable information' that is relevant to assessing significant increases in credit risk and ECL measurement. We believe that this is one of the most challenging parts of the ECL model. Many potential factors can be identified for a given portfolio; however, their links to credit risk should be analyzed carefully to avoid under- or over-estimation of their impact on credit risk deterioration and ECL measurement, and any potential double-counts. As a result, the guidance should not encourage overlays or buffers that cannot be validated. It should be accepted that certain forward-looking factors may or may not have a measurable link to credit risk for a given portfolio.

- Unlike, for example, modelling market risk in a portfolio of bonds, banks cannot apply changes in expected interest rates directly in the case of loan portfolios. Relevant indicators (for example, interest rates, GDP, unemployment rates) must be transformed into factors such as PD, LGD and EAD estimates. Whilst banks may already use such transformation models, for example for pricing purposes or stress testing, they require careful management for model risk and may not respond equally well under all economic conditions.

- In addition to model risk, there is also a risk relating to the selection of assumptions, linked to the forecasting of macroeconomic factors, which can be challenging even for a few quarters, let alone longer periods (even if at some stage, practical expedients, such as mean reversion, are used). After the event, forecasts may be shown to have been materially different to actual experience in terms of both magnitude and direction. This is one of the reasons why specific model parameters and assumptions should not be prescribed: different banks using somewhat different

approaches or assumptions are more likely, over time, to come to better average results in an area where no forecasting approach can be perfectly reliable.

- It should not be made a requirement to collect detailed forward looking information for which no link to underlying credit quality exists. This does not mean that banks should not monitor credit conditions and markets to identify new information that becomes relevant to credit deterioration because of material economic or other changes.

- When an item of forward-looking information has been identified as credit-risk linked, it should be used symmetrically to assess increases or decreases in credit risk. The guidance should acknowledge that credit risk can decrease as well as increase, and that it is important to apply judgment symmetrically, identifying both credit deterioration and improvement on a timely basis.

- The guidance should not over-state the relevance of macroeconomic factors in driving ECL. The effect of macroeconomic factors on ECL is likely to depend on myriad inter-related contributory factors, and may well be of only relatively marginal significance to many portfolios and types of loans.

- It is acknowledged that an external event that is rare or hasn't happened before could have an impact on credit risk. Banks should apply judgment as to whether any such event is likely to have a significant effect.

These challenges are implicit in the forward-looking approach that the standard setters have adopted. Unquestionably, the industry will need to develop experience over time to incorporate macroeconomic factors in the model methodology and to find ways to validate them (including in differ economic conditions) and to manage the inherent model risk in this complex process. There should be no illusion about the complexity of this challenge.

A high-quality implementation of the standards may therefore not yield a "perfect" outcome in terms of modelling or forecasting accuracy. The SAG strongly suggests that the AEG acknowledge these points and put greater emphasis on the quality of the process, noting the inevitable variability of outcomes. The SAG believes that banks will have met their obligation to put in place a high-quality implementation of the standards if they have sound processes and governance that acknowledge the inherent challenges of applying the forward-looking approach required in the standards.

Significant Increase in Credit Risk

The 'significant credit deterioration' transfer criterion is a key part of the IFRS 9 ECL model.

Credit risk assessment should remain a multi-factor and holistic analysis for purposes of determining significant deterioration. In order to reflect credit risk management in practice, the multi-factor analysis of reasonable and supportable information should include both current credit risk assessment and available relative measures of credit risk exposure. For example, a downgrade in an internal rating may or may not be seen as significant depending on the level of the initial rating of the borrower, on the number of credit grades the bank may use to assess credit risk, and other aspects of credit analysis.

The holistic analysis of credit risk factors means that there would be no automatic triggers if all relevant factors were taken into account. It is important that the significant credit deterioration

transfer criteria developed have meaning in a credit risk management context. 'Hairline' triggers (for example a 'one notch' downgrade in a finely differentiated scale of credit grades designed to pick up small movements in credit risk) would not faithfully reflect the credit risk management process and could result in an exaggerated volume of movements back and forth between stage 1 and stage 2. Defining hairline triggers for prudential purposes would not be consistent with the concept of "significant credit deterioration" under IFRS 9, and could potentially create misleading information about credit volatility in the market if they generated frequent transfers not reflecting fundamental credit analysis.

We understand the concern of the AEG that methodologies should be sufficiently sensitive to detect credit deterioration in stage 1 before the point of transfer to stage 2 is reached. It should be considered that the allowance in stage 1 will not be analytically static anyway because of the continuous monitoring of credit risk, which is the precondition to determination of whether credit deterioration has been significant in the terms of the standard. Thus, although the transfer itself is a specific, point-in-time event, and the move to lifetime expected loss is likely to have a significant impact on the measurement of impairment allowances, this does not imply that the analysis of credit risk itself creates a cliff effect.

Use of practical expedients

As mentioned in the preliminary comments, we fully support high-quality, robust implementation. At the same time, we believe that an appropriate use of practical expedients, for example those permitted by IFRS9, should not be judged a-priori as synonymous with poor-quality implementation. The quality of a bank's implementation should not be judged on the sole criterion of the use of practical expedients.

- The appropriate use of practical expedients can be achieved consistently with high-quality implementation because all loans are monitored for credit deterioration regardless of their classification as low credit risk or less than 30 days past due. Use of the low credit risk exemption in appropriate cases will not delay or mask the identification of significant credit deterioration.

- It is acknowledged that larger banks should not rely solely on days-past-due information, which is a lagging indicator of credit deterioration. To be compliant with IFRS 9 a bank's transfer criteria for significant credit deterioration must use more forward-looking information where available. However, past-due information is a necessary part of a bank's data set, particularly for retail exposures, and the 30-days past-due presumption may represent a relevant backstop measure in many cases. In any case, past-due information has to be used in conjunction with other information in order to reinforce the quality of the implementation. Moreover, there will be cases where, as IFRS 9 explicitly foresees, adequate statistical evidence may rebut the presumption. It should also be noted that delinquency data is likely to play a more significant role in the allowance estimation process of smaller, less sophisticated institutions and the SAG would recommend that the AEG acknowledge that in their final guidance.

- There are some specific occasions when practical expedients are consistent with a high quality implementation, for example, where the aggregate exposure is not material, or, for very high credit-quality obligors or portfolios, when the amount of impairment allowance would not be materially different even between stage one and stage two.

Level of aggregation for the use of forward looking information/ macro-economic factors

We understand the concern of the AEG that significant credit deterioration may in some cases be missed on an individual assessment basis, and in these situations collective assessment should take place. However, we do not believe that an individual assessment is necessarily more backward looking than a collective assessment. To that end, we believe that the following implementation guidance would be compliant with the principles of IFRS 9:

- When the relationship of forward-looking factors, including macroeconomic factors, can be established at the individual exposure level, there should be no need to apply a collective adjustment.

- Banks should consider whether a higher quality implementation or a more operable solution would be achieved by reflecting these factors at an individual level where possible, and whether there is a risk of double counting if collective adjustments are also made.

- When forward-looking factors, including macroeconomic factors, cannot be reflected at an individual level, they should be reflected at a collective level, subject to demonstrating adequate linkage with credit risk deterioration as discussed above.

- When sufficient linkage is demonstrated, a given factor should be implemented at the appropriate level of aggregation.

- Dynamic re-segmentation of portfolios may be important in specific circumstances, but should not be a blanket prerequisite for the assessment of high-quality implementation. It should be required when considered necessary to capture ECL using reasonable and supportable information. For example if the segmentation for credit risk characteristics has been carried out robustly, it is not clear why frequent re-segmentation would be necessary in the ordinary course. It may not be feasible to generate sufficient reliable data for ongoing monitoring for significant deterioration when segmentation is changed frequently. Moreover, frequent re-segmentation would undermine the clarity of disclosure. Thus, re-segmentation should be understood as required when but only when some material change in the economic facts and circumstances requires it.

Disclosure

The SAG believes that disclosures will play a key role in facilitating understanding of a bank's impairment allowances and related methodologies, as well being a point of comparability between banks. We believe that disclosures will need to be high quality, particularly given the judgmental nature of the ECL impairment model.

Banks need to develop the capability to provide disclosures lock-step with their methodologies and governance processes. The timely design of disclosures is critical to the implementation timeline, and needs to be included in the design-phase of implementation project.

The SAG welcomes the input of users on disclosure requirements as a general principle, and expects that the EDTF's forthcoming work on disclosure recommendations following the April 2015 roundtable planned by the FSB will make a useful contribution to the development of disclosures that meet users' needs. However, members are concerned about the timing of the EDTF's work in the context of their implementation projects, particularly if the recommendations involve the further development of systems and data as a result of additional disclosure requirements or changes in the specification of existing IFRS 9 disclosure requirements. As a

practical matter, therefore, it may be necessary to consider banks' IFRS 9 project implementation timeframes when considering the timescales for the implementation of recommendations. We also note that disclosure practices are likely to evolve beyond 2018, as preparers' and users' familiarity and experience with the new standard grows, given the very significant differences in the systems, processes and data requirements and levels of judgment involved, compared to existing accounting practices.

Timing and Conclusions

The SAG appreciates the AEG's efforts to finalize and issue the guidance as quickly as possible to give clarity to banks on the characteristics of a high-quality implementation. We understand that as a next step a consultative document will be issued. In light of the tight timeline for the implementation of the design phase of the project, we support early finalization of the SCRAVL. The SAG envisages that a consultation period beginning as early as possible, and limited to 60 days, would meet this objective.

The SAG understands that the regulatory capital implications of the ECL impairment model are under consideration by a separate Basel working group, and that the SCRAVL guidance is not intended to address this aspect. However, the SAG wishes to reiterate that investors and other stakeholders are starting to take a keen interest in understanding the possible regulatory capital impacts, and banks will need to identify and plan for the business implications of these possible impacts as early as possible. In conclusion it would have been useful if the timing of the two prudential guideline components (SCRAVL and capital) was similar. Ideally, they would be issued at the same time but if, as it appears, this is not feasible, guidance as to capital impacts should follow on as soon as possible, recognizing that users of banks' financial statements will focus increasingly on the broader impacts of the new standards as the implementation projects progress.

The SAG values highly the ongoing dialogue with the AEG to understand and address regulators' concerns, and shares the objective of ensuring that the guidance supports a high quality and robust implementation.

Should you have any comments or questions on this letter, please contact the undersigned or Dorothee Bucquet (dbucquet@iif.com; +1 202 682 7456).

Very truly yours,