David Schraa
Regulatory Counsel

April 30, 2015

Mr. René van Wyk
Chair of the Accounting Experts Group
Basel Committee on Banking Supervision
Centralbahnplatz 2
CH-4002 Basel
Switzerland

RE: BCBS Guidelines- Guidance on accounting for credit losses

Dear Mr. van Wyk:

The Institute of International Finance (IIF), via its Senior Accounting Group (SAG), welcomes the opportunity to comment on the *Guidance on Accounting for Expected Credit Losses* (ECL) consultative document (the "Guidance"). This letter and its attachments expand and finalize the interim comments already delivered to you on April 10, 2015.

The SAG appreciates that this consultative draft was produced to a tight timetable to enable it to be finalized in time to be taken into account in implementation projects. The SAG agrees that the revised Guidance should focus on the interaction between sound credit risk practices and expected credit loss measurement for financial reporting. It also strongly agrees that banks need to achieve high quality implementations of the new accounting requirements.

However, the SAG believes that the Guidance needs to be substantially clarified in order to achieve its objectives. While more detailed comments follow in this letter and the Appendices, the SAG views the key areas for the Basel Committee (the "Committee") to consider in finalizing the Guidance are:

- The purpose of the Guidance should be clarified and the content should be more focused on that purpose. This could be achieved by giving a redrafted Principle 4 more prominence up front and better targeting the remainder of the Guidance not only on how credit risk management should underpin the financial reporting but on areas where differences are expected from the prudential treatment.
- To help focus of the content to the purpose of the Guidance, the Committee should consider removing detailed information about credit risk practices and management, and acknowledge that risk-management tools are different for retail and wholesale counterparties.
- While the Guidance acknowledges that financial reporting must be unbiased and neutral, so that gains and losses are recognized symmetrically, this point together with noting other fundamental accounting concepts such as materiality should also be clearly stated up front for the avoidance of any doubt.

- Overall, the structure of the document and its drafting should be tightened to ensure it is internally consistent and clearly defines terms, so it is understandable to its intended audience, including finance and risk personnel in banks as well as supervisors and auditors. The text below each principle should be linked with and expand on the principle, as such a focus would help reduce duplication and improve internal consistency.

Given the interim comments submitted on April 10 (which expand on points made at the March 12 meeting with the Basel Accounting Expert Group (AEG)), this final response letter is structured as follows:

- This cover letter is divided into two parts. The first part provides an executive summary of the principal issues detailed in the Appendices and submitted on April 10; the second part provides comments on additional overarching issues;
- The Appendices as submitted on April 10, with subsequent changes highlighted in *italic format*. These Appendices provide detailed analysis of the issues discussed on March 12 and propose specific drafting suggestions.

Executive Summary of Appendices

The following discussion summarizes the essential points made in the Appendices. For a full discussion, please refer to the Appendices themselves.

Appendix I: The Guidance should make clear that banks need not undertake an exhaustive search for forward-looking information but shall consider all reasonable and supportable information that are appropriate depending on the facts and circumstances in accordance with relevant accounting standards.

As explained in Appendix I, the SAG agrees that in order to achieve high-quality implementation, banks should not ignore relevant available information that could improve ECL estimations. This should involve due consideration of the information available, and selection of that information which is relevant to the ECL impairment calculation.

The SAG believes that there should be no prescriptive requirements as to the information that should be used. However, some terminology currently used in the paragraphs cited in Appendix I is not helpful because it would be read to set an unattainable standard. In particular, reference to using the "full spectrum" of information in paragraphs 30 and 53, whilst well intentioned, will have unintended consequences as it sets a target that can never be satisfied, yet would be read as an exhaustive requirement.

While we understand the Committee's concern that the accounting terminology "reasonable and supportable" could be seen from a risk management viewpoint as limiting the scope of what is required, the SAG believes that using different language from that set out in the accounting standard could create confusion both within banks and with auditors as to what is required, which might run contrary to the intent of the Committee not to modify the accounting standards. Therefore, the language of the Guidance should be set to be consistent with the standard, as suggested in Appendix I.

Appendix II: The Guidance should require the use of inputs that are responsive to the underlying credit conditions and behavior of the borrower and rely on appropriate segmentation procedures.

As explained in Appendix II, the SAG has identified two principal issues related to the current proposal under Principle 3: the use of the terminology "ratings" and the appropriate segmentation procedures.

Paragraphs 34 and 37 appear to require that assigned credit ratings include forward-looking information and macroeconomic factors; however currently assigned credit ratings typically are more in line with capital regulation requirements. It is believed that the intent is not to require banks to calculate and maintain two potentially quite different credit ratings, which would be operationally and conceptually complex at best, but rather to use ratings as the basis for ECL analysis, which might require additional information.

The effective PD for ECL measurement purposes will be different from the PD for Basel capital purposes, given the different calculation requirements, although based on the same underlying rating. Confusion may arise from the present drafting, which appears to address "ratings" as such, rather than ECL measurements. Appendix II illustrates how to avoid any unintended requirements for having two rating systems in place.

Regarding the Committee's concerns about appropriate segmentation procedure, while the SAG acknowledges that current procedures and systems do not yet match entirely the forthcoming requirements, most banks in fact do pay careful attention to the rating of risks and the appropriate grouping of exposures. This is not a new development, although the new accounting standards may require some adaptations.

SAG members believe that, rather than provide one solution defined in terms of encouraging frequent re-segmentation, the main issue is to ensure the grouping of exposures and the inputs to the accounting ECL models are risk sensitive as suggested in Appendix II. Segmentation is only one part of the overall model review and development process and frequent resegmentation should not be considered a required (or indeed desired) characteristic of high-quality implementation.

Appendix III: The SAG believes that the use of overlays by senior management may be necessary but should not be understood to be mandatory to ensure high-quality implementation of the Guidance.

SAG members strongly believe that the use of overlays should be left to the bank's determination, depending on whether use thereof would be indicated by the circumstances, and should not be made mandatory explicitly or implicitly[1] as a matter of course. To that end, Appendix III further provides specific examples on how banks would consider situations such as the drop in oil prices.

Where forward-looking information and macroeconomic factors impacts are included in models, for example, an adjustment to the modeled results would not be needed in all cases.

[1] Paragraphs 51-53 and 59-63.

However, there may be impacts that are not capable of being modeled or impacts that cannot yet be incorporated into models. Management overlays may be needed to deal with these situations, but it should be clear why they are required and when they should be removed. Whether included in the models or not, the impact of forward-looking information and macroeconomic factors on credit losses must be identifiable and reliably measureable and it must be clear what impacts are included in the models and what are included as an overlay to ensure there is no double-counting.

Such overlays may persist from period to period but if prolonged, and expected to be permanent, management will need to consider amending the underlying grading model to deal with the exogenous risk factor more effectively, or to amend the forward looking transformation function to deal with it.[2]

Therefore, the SAG recommends that the Guidance be made consistent with sound credit risk management practices and avoid any unintended interpretation of the use of overlays. To that end, Appendix III provides specific drafting suggestions for Principle 4 and paragraphs 51 and 52.

Appendix IV: The Guidance should ensure that the assessment of "significant deterioration" is left to firm's management judgment supported by appropriate procedures and well-developed definition.

As currently drafted paragraph A27 could be seen as a checklist triggering transfer to stage two. More importantly, while pricing could be one of the pieces of relevant information to be considered, it is not necessarily the most appropriate of indicators, and should certainly not dictate any action, as currently suggested by footnote 33.

As explained in Appendix IV, the Committee should expect that significant credit risk deterioration will remain a multi-factor and holistic analysis that will take into account factors the Committee suggests in the current drafting to be considered in isolation. This means in essence that there would not be an automatic transfer criterion between stage 1 and stage 2 for a specific factor. In practice, banks would use a range of factors in determining whether significant deterioration has occurred as detailed in Appendix IV.

As a result, the SAG is of the view that such price indicators should not be given a privileged or disproportionate role in the Guidance, as further explained in Appendix IV.

Appendix V: The Guidance should clarify that the application of "proportionality" should be applicable given the facts and circumstances of particular portfolios.

As explained in Appendix V, while the SAG welcomes paragraph 12, as it recognizes differences between more and less complex banks, it is important that the Guidance should also recognize that different methodologies may coexist *within* a bank, for example for certain subsidiaries or activities in specific jurisdictions. This is already acknowledged in regulation as not all portfolios are included in AIRB approaches, even for the largest and most complex banks.

[2] See also Appendix II on segmentation.

Sophisticated models should be stated to be important to high-quality implementation when circumstances permit their use, but it should not be implied that such models are synonymous with high-quality implementation. In addition, the introduction of complexity where not otherwise appropriate or consistent with risk-management applications needs to be balanced against the resulting increase in operational risk and constraints, given the need to meet reporting timetables. The project disciplines of balancing time, cost and quality are essential to achieving high-quality implementation.

As further developed in Appendix V, proportionality should be assessed neither at the financial statement level nor at the allowances level. Instead, proportionality should be assessed using a combination of relevant factors such as the number of individual contracts in a portfolio, their risk characteristics, and the comparison of similarities:

a) within portfolios, or
b) for smaller and less sophisticated banking groups; or
c) for smaller locations, viz. subsidiaries or branches of global banking groups

Appendix V provides drafting suggestions in order to achieve this goal.

Appendix V: The Guidance should be clear that it does not override the concept of materiality as it relates to all accounting frameworks.

Reference to materiality is currently missing from the Guidance. However, materiality is a fundamental principle underpinning all financial reporting, and materiality decisions should not be seen as contrary to 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, as further explained in Appendix V, contributes to assurances that resources will be allocated at the right time to the risks that need to be monitored most closely.

Appendix VI: The Guidance should focus on how ECL accounting models should build upon credit risk management practices and processes instead of repeating or adding to guidance on the credit risk management practices themselves.

As explained in Appendix VI, SAG members strongly believe that the Guidance should *not* focus on credit risk management practices themselves – which are subject to many other regulatory and supervisory forms of oversight – but on how banks will leverage those practices in order to implement ECL models.

In addition, the Guidance should not be capable of being seen as a checklist for risk management practices for auditors or supervisors, while the current drafting could be seen as such.

Finally, the SAG understands that it is not the intention of the Committee to change regulatory definitions such as "unlikeliness to pay", which is ambiguous in the current drafting.

To that end, the SAG provides specific drafting suggestions in Appendix VI on areas where the Guidance should be amended to clarify these issues.

Additional issues to be considered

In addition to the issues discussed above, the SAG would like to draw the Committee's attention to the additional overarching issues introduced at the beginning of this letter and the discussion below.

The Guidance should focus on achieving the overarching objective of an ECL accounting model, which is to ensure that credit losses are recognized in accordance with accounting standards.

The main objective of an ECL accounting model is, as mentioned in the principal points raised at the head of this letter, to ensure that expected credit losses are recognized considering all reasonable and supportable information, including forward-looking information.

However, the proposed Guidance introduces this main concept only in Principle 4. SAG members strongly believe that the Guidance should start with that principle, which should drive the whole document. Principle 4 in its current drafting is, however, unclear and can be read in different ways. To achieve appropriate focus, Principle 4 should be amended as suggested in Appendix III, and moved upfront to underscore its importance.

To help focus the content on the purpose of the Guidance, the Committee should consider removing detailed information about credit risk practices and management, and acknowledge that risk-management tools are different for retail and wholesale counterparties. In paragraphs 19, 24, 27, 28, 31, 58, 72-81, and elsewhere, requirements, principles, or procedures are covered in detail that are appropriately (and for the most part extensively) covered by other bodies of regulation or supervisory guidance.[3]

This duplication will, if maintained in the final version, cause difficulties when firms, auditors, and supervisor's attempt to implement the Guidance. Not only does it make it more difficult for the specific Guidance directly relevant to the recognition of expected credit losses to be identified and understood, it also risks becoming out of date as other documents are updated.

Appendices VI and VII provide a number of suggestions to avoid such duplications.

In accordance with accounting standards, the Guidance should clearly state that any faithful representation of ECL implies that the depiction of credit losses is neutral and free from bias, including bias resulting from prudential regulatory requirements.

As stated in the *Conceptual Framework*[4], accounting statements should be neutral and unbiased. This is a major difference from a regulatory perspective, which explains in part why regulatory indicators such as PD or LGD can only be a starting point for the purpose of the accounting ECL implementation, as acknowledged in paragraph 8 of the draft Guidance.

Given the importance of this point, this fundamental difference should be given more prominence and should be better reflected throughout the entire document, especially in Principles 2, 3 and 5.

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[3] See also discussion in Appendix VI.
[4] IFRS 9 - BC5.86.

It is acknowledged that an ECL accounting model should be implemented consistently with credit risk management practices and Basel II/III processes insofar as possible. However, it is unclear how far the Guidance seeks consistency with regulatory Expected Loss (EL) calculations and the underlying PD, LGD and EAD models, given the different underlying principles acknowledged in paragraph 8[5] as well as the IFRS 9 requirements with regard to the use of forward looking information and assumptions, which are included differently in the one year horizon of the regulatory EL calculations.

As acknowledged in the Guidance,[6] differences in EL and ECL could be substantive. As a result, SAG members recommend that the Guidance set out as a matter of fact that regulatory input can *only* be a starting point for the purpose of an accounting ECL model and EL and ECL calibrations will be different as a result of fundamental differences between the regulatory and accounting concepts. It should be noted that changes under consideration for the advanced Basel modeling approaches, including possible floors, new sector standards, or other requirements, may increase the distance between the ECL model and capital standards, making it all the more important to note this important fact.

Clarification of the interaction of ECL accounting with capital adequacy calculations and rationalization of the references throughout the Guidance would be helpful. Paragraph 7 suggests that the same credit risk practices should provide the basis for ECL accounting models and capital adequacy measures. Paragraph 21 suggests that the banks should maximize the extent to which the underlying information and assumptions are used for both accounting and capital adequacy purposes. Paragraph 41 expects that banks will seek consistency between credit risk ratings assigned[7] and suggests that the rationale for differences in credit ratings between regulatory capital and financial reporting should be documented. Paragraph 69 suggests that the processes for obtaining forward-looking information and macroeconomic factors should be leveraged and integrated to the extent possible. Paragraph 78 suggests that similarities and differences between ECL for accounting purposes and regulatory capital adequacy purposes should be disclosed.

We suggest that the content of these paragraphs be rationalized so that it is clear that credit risk management practices are expected to form the basis for ECL accounting models and capital adequacy measures; that underlying PD, LGD and EAD models and their model development, review and validation processes may be a suitable starting point for developing ECL models; but such modeling is not the only appropriate method, and that any method for determining ECL used must adequately reflect accounting requirements.

The SAG understands from its March 12 meeting with the AEG that it is not the Committee's intention to require that loss allowance *must* follow a PD/LGD/EAD type calculation. As further discussed in Appendix I, if the intention is that these processes can be used as a starting point,

[5] "The measurement of expected losses for regulatory capital purposes may be a starting point for estimating ECL for accounting purposes; however, adjustments will be required due to fundamental differences between the objectives of and inputs used for each of these purposes. For example, the Basel capital framework's expected loss calculation for regulatory capital, as currently stated, differs from accounting in that the Basel capital framework's probability of default is through the cycle and is always based on a 12-month time horizon. Additionally, the Basel capital framework's loss-given-default reflects downturn economic conditions."
[6] Paragraph 8.
[7] See also discussion in Appendix II on credit ratings.

then it should be clear that adjustments are required, particularly as the Basis for Conclusions clearly states that regulatory indicators are not appropriate.[8]

For example, the Guidance should be clear that:

- The removal of regulatory floors and downturn adjustments, subject to materiality principles, is consistent with high-quality implementation of the ECL accounting models.
- Forward-looking information and macroeconomic factors are included in the accounting framework but not generally in the regulatory requirements.
- ECL accounting models may be necessary even where internal models are not allowed or closely limited by certain regulatory defined parameters.

A further related point comes up in Paragraph 63, which refers to "prudence" in a way that may cause confusion among users and preparers alike, given the rather fraught and sometimes politicized use of that term in accounting discussions. The present paragraph seems to set up a tricky problem of exercising "prudence" (which will inevitably have some ambiguity despite the attempt in the draft to define it) consistently with neutrality and freedom from bias. As indicated in Appendix VII, the likely unintended consequences of using the term "prudence" could be avoided by deleting that term, which would put the focus on "appropriate care and caution."

The Guidance (IFRS appendix) unduly limits the use of the practical expedients of IFRS 9

The IFRS 9 appendix[9] aims to set out the requirements for high-quality implementation, including limited use of practical expedients and simplifications, without contradicting the accounting standard. However, the Guidance neglects the utility of the practical expedients and appears to make overly categorical assumptions about their use and potential abuse.

The SAG is also concerned that in places the Guidance could be interpreted as being inconsistent with the requirements of IFRS 9, particularly where different language is used from that used in the standard. These instances are noted in Appendix IV.

In particular, the draft Guidance unduly limits the use of the "days-past-due" (dpd) indicator as a backstop in specific circumstances. It is understood that the 30 dpd indicator is not forward looking. Nevertheless its use as a backstop can be appropriate, especially in the context of retail portfolios.

The SAG understands that the Committee has higher expectations of the implementation efforts of internationally active banks than those of less complex banks and has the expectation that costs should not be factor in determining implementation effort for complex banks. As explained in Appendix I, existing Basel and other current kinds of behavioral scoring provide sound basis for analysis, but banks recognize that further development will be required to make sure such techniques are fully adapted to IFRS 9 requirements. Moreover, the 30 dpd backstop will sometimes provide a fail-safe for retail or other portfolios where major changes reflected in forward-looking information or macroeconomic factors do not necessarily capture

[8] IFRS 9 Basis for Conclusions BC5.178 and BC5.179.
[9] Starting at page 24 of the BCBS d311 Guidelines.

consumer behavior. This is not to say that banks could avoid forward-looking information or macroeconomic factors analyses, but rather that the nature of retail portfolios may mean that the "dpd" indicator is still appropriate and consistent with high-quality implementation given market and economic limitations.

SAG members agree with paragraph 52 that all loans should be monitored for credit deterioration regardless of their classification as low credit risk or less than 30 days past due. Therefore the SAG agrees that the fact that a loan is considered to have low credit risk is not a reason not to monitor its credit risk and transfer it to Lifetime Expected Loss (LEL) measurement if it experiences a significant increase in credit risk. However, the notion of low credit risk is not "merely an operational simplification" but is inherent in determining what is considered to be a significant increase in credit risk.

As set out in IFRS 9 B5.5.9 the significance of a change in the credit risk of an obligation since initial recognition depends on the risk of a default occurring as at initial recognition. If the origination credit risk were not considered, a change in absolute terms in the risk of a default occurring could be more significant for a financial instrument with a lower initial risk of a default's occurring compared to a financial instrument with a higher initial risk of a default's occurring. It should be clear that banks making such a distinction in determining significant deterioration are properly applying IFRS 9 requirements. In thus applying the accounting requirements, banks would not be relying upon the "low credit risk exemption" as discussed in the Guidance. While the Guidance can confirm that the Committee expects that all loans with a significant increase in credit risk should be transferred to LEL measurement, regardless of their initial credit risk, to impose a higher burden of proof on what is considered significant for low credit risk loans would be inconsistent with IFRS 9. Suggested drafting to address this issue is set out in Appendix VII.

As also stated in the December 1, 2014 letter, 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 dpd.

Since the Guidance does not apply to debt securities, it is understood that the low credit risk exemption may be available in appropriate circumstances in appropriate cases to manage implementation of the standard for debt securities, for example, for sovereigns.

More broadly the SAG understands that all types of transactions related to securities (including outright purchase, reverse repo, SFT, margin lending, etc.) are outside the scope of the Guidance, pursuant to footnote 8 and paragraph 13. To that end, Appendix VII includes a drafting suggestion.

Disclosure

As stated in the Basis for Conclusions of IFRS 9, the model should ensure that the amounts that an entity reports are "comparable, timely and understandable."[10]

[10] BC5.83.

IFRS already requires ECL disclosures.[11] More generally, paragraphs 72-81 of the Guidance largely restate disclosure principles and requirements that are amply covered in other aspects of accounting or regulation. It is difficult to see what such general statements can add. If considered necessary, the final Guidance should only address any very specific disclosure requirements that relate to its subject-matter.

Where specific disclosures are suggested, the current draft suggests a level of granularity that may be beyond what would be useful to users of financial statements. For the most part, these issues would be better left to be determined through the usual disclosure processes. To the extent specifics are thought necessary, it would be preferable to allow them to be determined by a group such as the FSB's Enhanced Disclosure Task Force, which would allow users, and banks to determine their appropriate scope and granularity.

For example, Paragraph 75 seems to call for an ongoing sensitivity analysis to justify the ECL. To be useful to users, sensitivity analyses need to be developed with an eye to users' needs and interests, and to avoiding information overload or unduly voluminous disclosures that users might ultimately ignore as not being decision-useful information. For this reason, it would be more appropriate to refer the appropriate scope of disclosure of assumptions behind ECL estimates, grouping of exposures, and of sensitivity analyses to a group such as the EDTF, which can take into account the views of all stakeholders. Paragraph 78 could be read as requiring bridging disclosures between sets of PDs and sets of LGDs used for accounting and regulatory capital purposes. This Guidance is not the appropriate location to determine such possible disclosures. Given that such disclosures would be complex to both operationalize and to disclose in a way useful to investors (given the fundamental differences between the accounting and regulatory concepts), as noted above if such disclosures are appropriate their scope, focus and dimensions, should be worked out through a group such as the EDTF.

Similar considerations would apply to paragraphs 77, 79, and 80 if they were to be retained.
Principle 8 should be adapted accordingly.

Conclusion

The SAG values highly its ongoing dialogue with the Committee, which is very useful for banks to understand and address regulators' concerns, and to exchange views on accounting developments, and shares the objective of ensuring that the final Guidance should support high quality and robust implementation of the new provisioning requirements.

The SAG strongly believes it is critical to ensure that, the Committee and the industry find common understanding of what is meant by high-quality implementation of the ECL accounting models. The drafting suggestions made in the Appendices are intended to contribute to achieving this goal.

The SAG also believes that a common understanding of the Guidance will enhance the consistent understanding of principles across jurisdictions and thus will avoid national "gold plating".

[11]Changes to IFRS 7 due to IFRS 9 paragraphs 35 to 42 under C13.

The SAG would be pleased to have an additional meeting or a conference call with the Committee in order to further discuss the proposed suggestions if you would find it helpful. Should you have any comments or questions on this letter, please contact the undersigned or Dorothée Bucquet (dbucquet@iif.com; +1 202 682 7456).

Very truly yours,

NB: In the Appendices, items added since the early submission of April 10 have been indicated in *italic format.*

Appendix I

Key Topic: Use of forward-looking information

Reference to SAG-AEG meeting: AEG presentation – question 1

> "How will banks apply the forward looking concept in practice? We understand that banks believe their behavioral scoring approach to retail lending exposures can be used for ECL. We would like to explore how this information, which is based on past due status and historical information, would be adapted to adequately consider forward looking and macroeconomic factors?"

Sub-topic: Forward-looking information in the context of behavioral scoring

Objective of the Guidance:

Principles 2 and 6 require that banks must have sound methodologies that address policies, procedures and controls for assessing and measuring the level of credit risk on all lending exposures, especially in the consideration of forward looking information that is reasonably available, including macroeconomic factors.

Discussion of "behavioral scoring":

The term "behavioral scoring" appears to be used in question 1 as quoted above in a broad and generic way, and there may be somewhat different practices by that name in different banks and markets. In its broadest interpretation the term implies using past internal indications of behavior of accounts to predict future behavior (default, roll rate, etc.). In retail portfolios, some banks use this term separately from application scoring, which is for new accounts. Scores that banks use internally for purposes of developing their Basel PDs and even many operational or "collection"[12] scores can be considered as behavioral scores.

Many major banks are currently using Basel PDs as a starting point for models for portfolios where banks have such Basel PDs. Banks may need to modify them to bring in lifetime-loss dimensions in order to meet the requirements of the new accounting provisioning standards. Most behavior scores, including Basel scores, predict on a fixed performance time horizon, which is different from the lifetime horizons of IFRS 9 or the US GAAP equivalent (as expected when finally proposed[13]). Macroeconomic factors are also usually not brought into current behavior scores in this sense, especially in a forward-looking way, but such information and other macroeconomic factors would need to be incorporated to accommodate IFRS 9 or future US GAAP requirements. One way to bring these in is to adapt current logistical functions that

[12] Terminology varies, but "collection scores" refers in certain banks to the performance of the portfolio after inception through to final collection of amounts owed (or default).

[13] The FASB tentatively decided to introduce a single, lifetime ECL measurement approach under the proposed Current Expected Credit Loss mode.

define PDs to allow addition of forward-looking risk elements some banks are prototyping. Alternatively, another way is to leverage existing tools such as stress-testing methodologies, which are designed to capture the relationships between macroeconomic variables and PD.

The other point to note is that existing Basel and other monitoring models are complicated and need time and effort to develop. Banks, for example may need to build new or revised transition matrix approaches as appropriate for more complex portfolios to ensure efficient incorporation of information required for ECL measurements, correction of likely information delays, etc.

Time is necessary between a model's development and its application, especially in the context of incorporating forward-looking information. Banks are working diligently on the necessary developments, but it will still be some time before full clarity on where each bank's procedures will end up can be achieved.

In short, existing Basel and other current kinds of behavioral scoring provide sound basis for analysis, but banks recognize that further development will be required to make sure such techniques are fully adapted to IFRS 9 requirements.

Description of the issue:

Paragraph 24(b) explains that the assessment and measurement of ECL goes beyond considering historical and current information and should include all relevant factors that affect repayment, whether related to the borrower or the environment within which the lending is made. Paragraph 29 summarizes the need to develop and document a bank's process to cover appropriate scenarios used in the estimation of ECL. Paragraph 30 expressly states that firms are required to consider the "full spectrum" of information that is relevant to the product, borrower, business model, or economic and regulatory environment. Principle 6 (paragraphs 59-64) further elaborates on the consideration of forward-looking information that is essential to the assessment and measurement of ECL.

Paragraphs 51, 52 and 53 provide additional commentary on the extent to which forward-looking information should be used, our understanding of which is summarized below.

ECL estimates should always incorporate the expected impact of all reasonably available forward-looking information and macroeconomic factors.

All methodologies should require appropriate adjustments to historical loss estimates for changes in the factors that affect repayment, in particular due to forward-looking information and macroeconomic factors.

Banks must use their expertise to consider the "full spectrum" of reasonable information relevant to the group or individual exposure, to ensure that allowance estimates incorporate timely recognition of changes in credit risk.

Furthermore, paragraph A23 introduces a requirement for firms to demonstrate "clear linkage" between macroeconomic factors and borrower attributes supported by "persuasive analysis",

which seems to indicate a higher standard than that required by IFRS 9, and one that would be very hard to meet if interpreted exactingly.

IFRS 9 Requirements:

Paragraph 5.5.4 states "The objective of the impairment requirements is to recognize lifetime expected credit losses for all financial instruments for which there have been significant increases in credit risk since initial recognition — whether assessed on an individual or collective basis — considering all reasonable and supportable information, including that which is forward-looking". Moreover, paragraphs B5.5.49 to B5.5.54 explain what is meant by "reasonable and supportable". For example, as stated in B5.5.51, an entity need not undertake an exhaustive search for information but shall consider all reasonable and supportable information that is available without undue cost and effort and that is relevant to the estimate of ECL.

Consequences of the Guidance as drafted:

Some terminology currently used in the paragraphs cited above is not helpful because it would be read to set an unattainable standard. In particular, reference to using the "full spectrum" of information in paragraphs 30 and 53, whilst well intentioned, will have unintended consequences as it sets a target that can never be satisfied, yet would be read as an authoritative, exhaustive requirement.

The IIF SAG supports and strongly endorses the link to a firm's risk management, which provides a disciplined basis of analysis and well-developed information, and will include identifying the drivers of ECL and incorporating to the extent possible a forward assessment of the likelihood that these may change. In addition, firms will seek to leverage the forward-looking economic and business model attributes as used defined for stress-testing[14] purposes.

Banks will use existing, well-defined risk-management structures to assure a fundamental link to policy. Such structures will include procedures and governance established to ensure sufficient oversight, transparency and assurance that results are soundly based, appropriate in context and explainable internally and externally.

For example, banks have procedures to identify which forward-looking information should be considered for inclusion in a model; the second stage would be to look at the historical sensitivity of those factors and integrate them into the model based on those sensitivities and calibrate historic sensitivity into the model.

Processes will also require extrapolation if a sensitivity level has not been observed in the past but appears to be justified now. Banks are still looking at how models will take into account forward looking information and how such extrapolations from past sensitivities can be backtested.

The SAG believes that governance and discipline are key issues. To that end, processes will need to be adapted and extended to meet the new requirements. Models are based on

[14] See also the discussion in Appendix III on application of forward-looking information to collective or individual assessment.

historical observations, relationships and sensitivity analysis; adding forward-looking information and extrapolation will require discipline to assure that a bank manages all available information correctly and consistently, both for collective and individual assessment.

The AEG well understands that firms do not have a crystal ball and that it is impossible to predict the future, especially extreme events, with any degree of confidence. The SAG believes that the focus of the Guidance should remain on the means to identify expected losses, emphasizing the importance of proactive and ongoing monitoring to pick up any signs of credit deterioration.

Proposed Drafting:

While we understand the AEG's concern that the accounting terminology "reasonable and supportable" could be seen from a risk management viewpoint as limiting the scope of what is required, the SAG believes that using different language could create confusion both within banks and with auditors as to what is required, which might run contrary to the intent of the Committee not to modify the accounting standards. Therefore, the language of the Guidance should be as consistent with the standard as possible. We also understand from our discussion that "full spectrum" intends to indicate that the issue is not about an exhaustive search for macro-economic factors on a standalone basis but how macro-economic factors affect the bank's credit risk based on its business model and on the portfolio.

The SAG therefore agrees with the Committee's concern that the use of "reasonable and supportable information" should not be narrowly interpreted. If thought necessary, commentary can be added to the Guidance that makes it clear that "reasonable and supportable" should not be construed narrowly and should not diminish the obligation to seek all reasonably available information and assess its appropriate impact on ECL.

However, the SAG is concerned about how auditors and supervisors might interpret "full spectrum". As such, we believe it is important to modify the reference to "full spectrum" in paragraphs 30 and 53 and to align it with the accounting standard and make it clear that the requirement is to align the use of forward-looking information to individual risk drivers to the extent possible, based on a requirement to obtain information that is fact-based and realistically obtainable, rather than "information" that is assumption-based or remote, recognizing the need for management judgment where a particular circumstance or event has not manifested itself previously.

Paragraphs 30 and 53 should therefore be modified as follows, which would provide a demanding yet realistic standard and avoid modifying the requirements as expressed in IFRS9:

> 30. While a bank need not necessarily identify or model every possible scenario through complex scenario simulations, the Committee expects it to consider the full spectrum of <u>reasonable and supportable</u> information that is relevant to the product, borrower, business model or economic and regulatory environment when developing estimates of ECL~~. In developing such estimates for financial reporting purposes, a bank should consider the experience and lessons from similar exercises it has conducted for regulatory purposes, although the Committee recognizes that stressed scenarios developed for regulatory purposes are not intended to be used directly for accounting~~

~~purposes~~ and to be able to demonstrate the internal governance and discipline applied to ensure that such relevant information is used. Forward-looking information and related credit quality factors used in regulatory expected loss estimates should be consistent with inputs to other relevant estimates within the financial statements, budgets, strategic and capital plans, and other regulatory reporting [footnote 19 unchanged].

53. Robust methodologies and parameters should consider different potential scenarios and ~~not~~ rely on fact-based, reasonably obtainable information, avoiding reliance purely on information or assumptions that are excessively subjective or known to be based on biased or overly optimistic considerations. Banks must use their expertise to consider the full spectrum of reasonable and supportable information relevant to the drivers of credit risk of the group or individual exposure, to ensure that allowance estimates incorporate timely recognition of changes in credit risk.

In addition, the final Guidance should delete paragraphs A23 and A24. The wording of paragraph A23 suggests a degree of foreseeability that could not be realistically supported, and the use of historical data that will often not exist or in any case cannot be extrapolated with the suggested degree of accuracy.[15] Paragraph A24 suggests that analysis at such a standard of accuracy could be performed at the individual exposure level, which is unrealistic.

~~A23. For example, within retail portfolios adverse developments in macroeconomic factors and borrower attributes (such as the sector from which they earn their primary income) will generally lead to an increase in the objective level of credit risk long before this manifests itself in lagging information such as delinquency. Thus, the Committee believes that, in order to meet the objective of IFRS 9 in a robust manner, banks will need to have a clear view – supported by persuasive analysis – of the linkages from macroeconomic factors and borrower attributes to the level of credit risk in a portfolio. This will be obtained through analysis of data for the past, adjusted using experienced credit judgment for differences between historic, current and forward-looking information and macroeconomic factors.~~

~~A24. The Committee expects analyses of this kind to be also performed for large, individually managed exposures. For example, for a large commercial property loan, banks must take account of the considerable sensitivity of the commercial property market in many jurisdictions to the general macroeconomic environment, and use information such as levels of interest rates or vacancy rates to determine whether there has been a significant increase in credit risk.~~

[15] If paragraph A23 were to be retained in some form, it would be important to delete the statement that banks must have "a clear view – supported by *persuasive analysis* – of the linkages from macroeconomic factors and borrower attributes to the level of credit risk in a portfolios." This sentence appears to create an unreasonably exacting standard that would be very difficult to meet (and to audit), which appears to go well beyond the "reasonable and supportable information" standard of IFRS9. Thus the reference should be to "… supported by *reasonable and supportable information* …" if the paragraph is revised but retained.

Appendix II

Key Topic: Principle 3 - segmentation or grouping of lending exposures

Reference to SAG-AEG meeting: AEG presentation - question 2

> "How do banks see re-segmentation working in practice to meet the objectives of an ECL model?
>
> We have heard banks question whether assessments of changes in credit risk are needed each financial reporting period, to determine if exposures should be re-segmented out of a group when some exposures have increased in credit risk.
>
> For a retail portfolio, how will a bank incorporate changing macroeconomic factors (such as an unanticipated decrease in house prices in a region) on a timely basis? Does this require formation of a new group that could migrate through stage 1 (as the credit risk increases) and transfer into stage 2 in a manner different from the rest of the group of which they were previously a part?"

Sub-topic: Definition of appropriate segmentation to reflect riskiness and drivers of credit risk for lending exposures.

Objective of the Guidance:

A bank should have a process in place to appropriately group lending exposures on the basis of shared credit risk characteristics as stated in Principle 3 and paragraph 51 of Principle 4.

Description of the issue:

Frequent re-segmentations is not viewed by the SAG as the main instrument for assigning proper risk measures to lending exposures; rather, proper initial segmentation in the model building phases and stringent regular review of the model thereafter as further detailed in the following discussion would be the most robust and generally applicable approach. Moreover, unnecessarily frequent re-segmentation, being inconsistent with credit risk management practices, would often be inconsistent with high-quality implementation of the accounting framework. Re-segmentation may occasionally be necessary, but should not be presumed to be frequent, nor should re-segmentation that would not be required by normal risk management be forced for accounting purposes.[16]

Before addressing appropriate segmentation procedures per se, it is necessary to discuss the current draft's use of the concept of "ratings".

While the SAG acknowledges that the current procedures and systems do not yet match entirely the forthcoming requirements, most banks in fact do pay careful attention to the rating

[16] See also the discussion in Appendix III on application of forward-looking information to collective or individual assessment.

of risks and the appropriate grouping of exposures. This is not a new development, although the new accounting standards may require some adaptations.

Paragraphs 34 and 37 appear to require that assigned credit ratings include forward-looking information and macroeconomic factors; however currently assigned credit ratings typically are more in line with capital regulation requirements. It is believed that the intent is not to require banks to calculate and maintain two potentially quite different credit ratings, which would be operationally and conceptually complex at best, but rather to use ratings as the basis for ECL analysis, which might require additional information. Banks expect to build ECL measurements using existing internal ratings as a point of departure and as an important source of information; however, it is recognized that complying with ECL accounting requirements may require additional information such as including the lifetime horizon or forward-looking information.

The effective PD for ECL measurement purposes will be different from the PD for Basel capital purposes, given the different calculation requirements, although based on the same underlying rating. Confusion may arise from the present drafting, which appears to address "ratings" as such, rather than ECL measurements.

Paragraph 35 appears to be out of the scope of the Guidance, read literally; it seems to set independent requirements for conducting the internal rating process. Among other things if retained, it might create confusion about the appropriate role of front line and credit-risk management staff.

Paragraph 38 appears to require that the risk of individual exposures needs to be captured specifically: if interpreted literally this would imply that collective risk assessments would not be allowed under the new regulations, which as we understood is not to be the intent of the Committee. Paragraph 38 needs to be revised to reflect the issues of retail and other portfolios where the basic risk management is generally on a collective basis.

Paragraph 40 requires banks to take into account the financial condition and payment capacity of borrowers: while for certain portfolios these are certainly among the main risk drivers, a literal interpretation of the article would similarly lead to the necessity of individual risk assessments and appear to preclude collective risk assessments, although, as the Guidance clearly recognizes, use of collective assessments is often vital to incorporation of forward-looking information into the process. As with paragraph 38, this point should be clarified.

Paragraph 41 requires that the rationale for differences in "credit ratings" for regulatory capital and accounting purposes be documented. Because, given the different requirements for the two purposes, it can be expected that differences between regulatory credit ratings and ECL measurements will be frequent despite the goal of overall consistency, we read this paragraph to indicate that such documentation is not required on a case by case basis but should reflect procedural and methodological basis for such differences in each bank.

Paragraph 46 requires that grouping of exposures should not mask the increase in credit risk of a sub-portfolio within such group. Taking the language of the second sentence of paragraph

46[17] literally would similarly require constant updating of the grouping of the collective assessment of exposure groups, which is technically impossible. Instead, in line with Paragraphs 43, 44 and 47, normal risk management requires the identified main shared risk characteristics to determine the grouping of exposures and potentially collective assessment as also stated in IFRS 9 BC5.142. As discussed elsewhere in these comments, the identified main shared risk characteristics and changes therein would normally be used to assess whether there is need for the migration of a whole group of exposures into a higher or lower risk assessment.

Equally, paragraph 48 appears to require regrouping much more frequently than would be consistent with sound credit risk management as currently applied for regulatory and other purposes or required by IFRS 9.

General observation: paragraph 46 and other parts of the draft Guidance seem to be driven by concern that portfolios could deliberately be grouped to "mask" appreciable increases of credit risks for some obligors, to avoid increasing the ECL allowance, or, conversely, that portfolios could be sliced into small, immaterial portions to avoid rigorous application of forward-looking assessment. Both of these concerns are already addressed by risk management and independent review thereof. To the extent that there are concerns that internal governance and methodological discipline might not adequately address such potential problems, then it would be more appropriate to address them through specific governance requirements or supervisory standards such as in Principle 7, rather than by in effect modifying the risk-management standards on which the new ECL accounting is intended to be built.

IFRS 9 Requirements:

The basis for conclusions for IFRS 9 BC5.140 provides the possibility to group exposures with shared credit characteristics:

> "The IASB noted that in some circumstances the segmentation of portfolios based on shared credit risk characteristics may assist in determining significant increases in credit risk for groups of financial instruments. The IASB considered that individual financial assets could be grouped into segments on the basis of common borrower-specific information and the effect of forward-looking information (ie changes in macroeconomic indicators) that affect the risk of a default occurring could be considered for each segment. As a result, an entity could use the change in that macroeconomic indicator to determine that the credit risk of one or more segments of financial instruments in the portfolio has increased significantly, although it is not yet possible to identify the individual financial instruments for which credit risk has increased significantly. The IASB also noted that in other cases an entity may use reasonable and supportable information to determine that the credit risk of a homogeneous portion of a portfolio should be considered to have increased significantly in order to meet the objective of recognizing all significant increases in credit risk."

[17] "Where changes in credit risk after initial recognition affect only some exposures within a group, those exposures must be segmented out of the group into relevant subgroups, to ensure that the ECL allowance is appropriately updated."

BC5.142 notes that grouping may change in order to reflect that within a portfolio the risk of default between exposures may change over time:

> "The IASB observed that, although an entity may group financial instruments in a portfolio with similar characteristics to identify significant increases in credit risk, ultimately, information will emerge that may enable an entity to distinguish between instruments that are more likely to default from instruments that are not. As the passage of time reduces the uncertainty about the eventual outcome, the risk of a default occurring on the financial instruments in the portfolio should diverge until the financial instruments either default or are collected in full. Consequently, the appropriate level of grouping is expected to change over time in order to capture all significant increases in credit risk. The IASB concluded that an entity should not group financial instruments at a higher level of aggregation if a subgroup exists for which the recognition of lifetime expected credit losses is more appropriate."

It may be noted that the IASB in this context appears to accept groupings as generally conducted for risk-management purposes, but, as BC5.142 notes, changes that create differences in the propensity to default of certain identifiable types of exposures (or instruments) may justify a change of grouping. It may be noted that this is different from being aware that the overall propensity to default in a given portfolio might change over time, though it is not possible to identify which exposures would be more likely to default (hypothetically, for example, a subprime portfolio might rise from 20% to 25% PD, increasing overall risk, but without creating any basis for regrouping).

It is important to note that the IASB clearly anticipated that the appropriate level of grouping is expected to change over time; however, there is nothing to indicate that it would be expected as frequently as currently drafted in the Guidance.

Consequences of the Guidance as drafted:

Paragraphs 44 and 45 already capture the existing and meaningful process for how to address Principle 3 of the Guidance very well. In general, it is expected and necessary for meaningful risk management that lending exposures be segmented in the course of model development into groups of exposures that share common main risk characteristics. By applying risk-management models, lending exposures at origination and over their respective lifetimes will receive differentiated and updated risk assessments based on the previously identified risk drivers.

As understood by all involved stakeholders, models can never capture all risk drivers but need to focus on the most relevant ones, which are generally expected to be reasonably stable over time with respect to calibration, sensitivity and performance. As a result, it can be expected that well-built models will capture the riskiness of exposures and changes in riskiness using previously identified primary risk drivers (including but not limited to forward looking information and macro-economic factors).

However it can also be expected that there will always be risk drivers and risk events that are not captured a priori in models and therefore subsequently need to be dealt with according to their materiality and temporal persistence. For example, if in a residential mortgage portfolio

house prices move inconsistently across geographic locations, it needs to be decided on grounds of materiality and proportionality whether the incorporation of geographic location as a distinctive risk driver or a split in segmentation is merited or, on the contrary, whether the ECL measurement on the basis of existing segmentation overall can still be considered to be appropriate. Too-frequent revision of segmentation would introduce excessive granularity, which could lead to over-fitted models, which in turn would typically lead to less robust models and decreased model performance. In many cases, a specific change of risks affecting a portfolio would be better dealt with by a management overlay, as discussed in Principle 4[18], or by refinement of the model without re-segmentation, rather than by re-segmentation.

Therefore there always needs to be a balance between what can be expected to be built into robust models that can be subjected to normal methodological controls and validation, and what needs to be addressed potentially by more ad-hoc qualitative overlays. Re-segmentation would depend on the duration and significance of the changes.

The Guidance as currently formulated could be interpreted to make collective risk measurement effectively impossible, because of the implied extent of individual assessment for all types of exposures in order to assign individual credit ratings. Especially in various retail segments this is and will not always be possible and would introduce an unrealistic operational burden of the necessary granularity of available information in order to make individual assessments.

Proposed Drafting:

> 33. As part of its credit risk assessment process, the Committee expects that banks will ~~develop~~ have in place ~~and implement~~ comprehensive procedures and information systems to monitor the quality of their lending exposures. These include an effective credit risk ~~rating~~ measurement system that captures the varying level, nature and components of credit risk that may be manifested over time, in order to reasonably ensure that all lending exposures are properly monitored and that ECL allowances are appropriately estimated.
>
> 34. With regard to ~~rating systems~~ ECL risk measurement, the procedures should clearly specify the key factors, including forward-looking information and macroeconomic factors, that form the basis for assigning ECL credit risk ~~ratings~~ measures and thus help support the monitoring, assessment and reporting of ECL for all lending exposures across the entire credit risk ~~rating~~ measurement system.
>
> ~~35. The credit risk rating process should include an independent review function. While front-line lending staff may have initial responsibility for assigning credit risk ratings and ongoing responsibility for updating the credit rating to which an exposure is assigned, this should be subject to the review of the independent review function.~~
>
> 37. The design of the credit risk ~~rating system~~ measurement system should ensure that a bank incorporates all relevant information, including forward-looking information and macroeconomic factors, into its ~~credit risk assessment and rating processes~~ ECL credit risk measurement both upon initial recognition and over time. In this context, an

[18] See also discussion in Appendix III.

effective credit risk ~~rating~~ measurement system will allow a bank to track changes in credit risk, regardless of the significance of the change, and consequent changes in credit risk ~~ratings~~ measures.

38. The credit risk ~~rating~~ measurement system must capture all lending exposures to allow for an appropriate differentiation of credit risk and grouping of lending exposures within the credit risk ~~rating~~ measurement system, reflect the credit risk of all underlying ~~individual~~ exposures and, when aggregated across all exposures, the level of credit risk in the portfolio as a whole.

Redrafting is proposed to ensure that paragraph 38 allows individual and collective assessment.

39. In describing elements of its credit risk ~~rating~~ measurement system, a bank should clearly define each credit risk ~~rating~~ measurement and delineate the personnel responsible for the design, implementation, operation and performance of the system as well as those responsible for periodic testing and validation.

~~40. Credit risk rating systems should take into account a borrower's current and expected financial condition and payment capacity over the expected life of the lending exposure or portfolio of exposures. This includes expectations of impacts from forward-looking information and macroeconomic factors such as interest rates and unemployment rates. In this context, the rating of guaranteed or collateralised exposures on the basis of credit risk should consider the bank's expectation of the debtor's paying capacity.~~

41. Both accounting and regulatory frameworks recognize credit risk ~~rating~~ measurement systems as tools for accurately assessing the full range of credit risk. Where a credit risk ~~rating~~ measurement ~~system~~ methodology is used for both regulatory capital calculations and financial reporting, the Committee expects banks to seek consistency between credit risk ~~ratings~~ measures assigned to a lending exposure, or portfolio of lending exposures. Where ~~credit rating assigned~~ credit risk measurement outcomes differ for regulatory capital and financial reporting purposes, the rationale should be documented.

46. Exposures must ~~not~~ be grouped ~~in such a way that an increase in the credit risk of particular~~ on the basis of shared credit risk characteristics so that the credit risk of a significant part of exposures is not masked by the performance of the segment as a whole. In general, it is expected that a bank's normal credit risk management and independent review functions will review and, as necessary, revise models and ECL applications, among other things to ensure that the ECL allowance is appropriately updated from initial measurement. Where changes in credit risk after initial recognition affect a significant part of exposures ~~only some exposures~~ within a group persistently over time, those exposures must be segmented out of the group into relevant subgroups, to ensure that the ECL allowance is appropriately updated.

48. The grouping of exposures should be re-evaluated in connection with a bank's ongoing review of credit risk models as stated by IFRS 9 BC5.142; consideration should

be given whenever necessary as to whether new information received or the bank's expectations of credit risk have changed in such a way that re-segmentation would yield the most appropriate basis for ongoing risk management in response to such new information or change in expectations ~~and exposures should be re-segmented whenever relevant new information is received or a bank's expectations of credit risk have changed~~. The group of exposures assigned should receive a periodic formal review (eg at least annually or more frequently if required in a jurisdiction) to reasonably ensure that those groupings are accurate and up to date.

A34. For exposures managed on a portfolio basis ~~(such as retail)~~, the definitions of portfolios must be reviewed regularly in connection with a bank's ongoing review of credit risk models as stated by IFRS 9 BC5.142 ~~to ensure that the exposures within them remain homogeneous in terms of their response to factors affecting credit risk~~. Changing economic conditions may require re-grouping. ~~Exposures must not be grouped in such a way that an increase in the credit risk of some individual exposures could be masked by the performance of the portfolio as a whole~~. Financial instruments should not be grouped in order to measure expected credit losses on a collective basis in a way that obscures significant increases in credit risk on individual financial instruments within the group.

A35. IFRS 9, paragraph B5.5.1, requires that, in order to meet the objective of recognising lifetime expected losses for significant increases in credit risk since initial recognition, assessment be performed on a collective basis by considering information that is indicative of significant increases in credit risk in a group or subgroup of financial instruments even if evidence of such significant increases in credit risk at the individual instrument level is not yet available. Accordingly, the Committee expects that, in instances where it is apparent that one or more exposures in a group have experienced a significant increase in credit risk, the ECL measurement of the relevant group or subgroup will ~~transfer to~~ reflect LEL measurement of ECL ~~even though it is not possible to identify this on an individual exposure basis~~ in connection with a bank's normal credit risk procedures, including ongoing review of credit risk models as discussed by IFRS 9 BC5.142.

Appendix III

Key Topic: Adequacy of allowances whether assessed on a collective or an individual basis

Reference to SAG-AEG meeting: AEG presentation - question 3

> "Can banks apply forward-looking information and macroeconomic factors on both a collective or individual basis?"

Sub-topic: Ability to incorporate forward-looking information on an individual or collective basis

Objective of the Guidance:

Banks must use all reasonably available forward-looking information to their assessments of credit risk whether this assessment is applied collectively or individually (see Guidance paragraphs 49 to 55 and A11 for thematically-related connected supervisory requirements).

Description of issue:

The AEG asked for examples of the application of macroeconomic and forward looking views where loan assets are assessed collectively. The Guidance as drafted appears to assume that assets will either be individually assessed or collectively assessed and does not fully recognize that, in addition, adjustment by way of collectively assessed overlays may be necessary from time to time to deal fully with expected credit conditions. Such adjustments may be needed whether the loans are otherwise assessed individually or collectively. The standards to be applied to such overlays are not identified expressly, leading to concern that the standards which are otherwise described for general model development and re-segmentation could be applied inappropriately or read too strictly to such temporary adjustments.

The AEG is concerned about how firms are applying forward-looking information. It is important to note that many internationally active firms are likely to use the PD, LGD and EAD regulatory capital models as the basis of their ECL calculations for both wholesale and retail portfolios. As well as adjusting these models to deal with differences in approach between accounting and regulatory concepts, such as downturn biases and conservatism in construction, firms are also planning to leverage stress-testing methodologies to adjust the resulting model outputs when needed for different macroeconomic indicators.

For example, behavior scores typically do not today include forward-looking economic factors; therefore PD estimates based on the behavior score need to be adjusted to capture the potential impacts of future economic expectations. Stress-testing methodologies aim to capture the relationships between macroeconomic variables and PD. Typically a range of economic indicators is assessed and statistical techniques are used to identify which indicators are relevant and to quantify the impact of changes in the relevant indicators on PD. Stress testing approaches can be leveraged to apply appropriate forward-looking adjustments to PD estimates. The parameters in the stress testing model can be applied to the bank's internal

estimates of the relevant indicators to calculate the appropriate adjustments to individual PD estimates.

The same broad approach is being actively explored for non-retail exposures, which are generally risk-approved individually and subject to fundamental credit analysis. For both retail and wholesale, there is also a need to consider how future risk factors, which are in some way exogenous to the current estimation framework, should be considered. For example if a forward adjustment approach of this kind does not deal specifically with the effect of a sudden *and sufficiently prolonged* event, such as an oil price shock, firms will need to consider how their frameworks should accommodate that event.

Although they *frequently assess* such matters through validation reviews, most firms do not recalibrate or rebuild their models frequently, and do so only when it is clear that it is necessary as data over time indicates that the default or loss pattern represents a *permanent* shift in the population which the model no longer appropriately predicts.

Certain events may or may not be accommodated either in the underlying models or in the forward adjustment. Firms need to consider if and how such events are accommodated in their frameworks, as a whole, and even if they are, whether the framework is making sufficient allowance for the event. Where it is apparent that the framework as a whole does not suggest outcomes which are now expected, firms are likely to consider whether centralized adjustments should be made to the framework-derived ECLs. In contemplating such overlays firms will consider the degree to which idiosyncratic adjustments have already been made to the PD and LGD characteristics of individual obligors where they are assessed and approved individually. For example, this can depend upon the proximity of the event to the present, as most models which firms intend to leverage are focused on anticipated credit events over a shorter-time horizon (typically 12 to 18 months), rather than a lifetime assessment of the obligor's fundamental credit condition. Proximate expectations are thus likely to have been taken into account by way of idiosyncratic grade override.

For example in an oil price shock scenario it may be appropriate to consider whether an overlay is required to reflect the fact that neither models nor the adjustment framework includes the effect of the current price, or its secondary consequences. If the models do not already take account of such factors dynamically, firms might stimulate immediate portfolio reviews to adjust the assessment of PD for each obligor or certain group idiosyncratically by way of grade override. If the event occurs within the normal horizon of the grading models to allow this to happen fully, and to the satisfaction of management, no other adjustment may be required. However some events happen so close to a reporting period that portfolio review and grade reassessment cannot be undertaken fully. In such cases a management overlay calculated on whatever data is available will be required.

Such overlays may persist from period to period but if prolonged, and expected to be permanent, management will be considering the necessity for the underlying grading model to deal with the exogenous risk factor more effectively, and/or to amend the forward looking transformation function to deal with it.[19]

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[19] See also Appendix II on re-segmentation.

IFRS 9 Requirements:

IFRS 9 B5.5.1 establishes that in order to meet the objective of recognizing lifetime expected credit losses for significant increases in credit risk since initial recognition, it may be necessary to perform the assessment of significant increases in credit risk on a collective basis by considering information that is indicative of significant increases in credit risk on, for example, a group or sub-group of financial instruments.

> IFRS 9 B5.5.4 states "In some circumstances an entity does not have reasonable and supportable information that is available without undue cost or effort to measure lifetime expected credit losses on an individual instrument basis. In that case, lifetime expected credit losses shall be recognised on a collective basis that considers comprehensive credit risk information. This comprehensive credit risk information must incorporate not only past due information but also all relevant credit information, including forward-looking macroeconomic information, in order to approximate the result of recognising lifetime expected credit losses when there has been a significant increase in credit risk since initial recognition on an individual instrument level."

Basis for Conclusions IFRS 9 (BC5.137)

> "In considering the feedback received, the IASB confirmed that the objective of the impairment requirements is to capture lifetime expected credit losses on all financial instruments that have significant increases in credit risk, regardless of whether it is on an individual or a collective basis."

Consequences of the Guidance as drafted:

The AEG asked for examples, which might be helpful. Without making clearer the basis on which forward-looking information can be applied collectively, users of the Guidance may be uncertain regarding the acceptability of certain practices, or the standards to be applied to their application.

Proposed drafting:

> **Principle 4: A bank's aggregate amount of allowances, regardless of the model implemented ~~whether allowance components are determined on a collective or an individual basis~~ should be adequate as defined by the Basel Core Principles, which is an amount understood to be consistent with the objective of the relevant accounting requirements.**
>
> 51. Individual assessments of credit risk may be appropriate in many circumstances, such as ~~when an exposure is closely monitored or~~ for large-value loans, or where obligor-specific behavioural characteristics are assessed. Regardless of the nature of the assessment, ECL estimates should always incorporate the expected impact of all reasonably available relevant forward-looking information and macroeconomic factors. This might require exposures (even those that are initially assessed individually using primarily historical and current information) to be placed in a group with shared credit risk characteristics and assessed collectively using a top-down approach to consider

forward-looking information and macroeconomic factors that could not be assessed on an individual basis. Such collectively assessed~~ment~~ adjustments (which some firms may reflect in additional "overlays") could allow identification of relationships between risk factors, as affected by forward-looking information and the ensuing cash shortfalls, that may not be apparent at the individual exposure level. When exposures are assessed both individually and collectively in this way, banks should be careful to ensure that there is no double-counting.

52. In addition to historical information and current conditions, forward-looking information and macroeconomic factors are also critical when estimating future cash shortfalls, for a group of exposures or an individual exposure. Methodologies for the determination of the cash flow shortfalls may start with simple averages of a bank's net loss experience on loans with shared credit risk characteristics over a relevant credit cycle, progressing to more complex techniques, such as migration analysis or models that estimate ECL. All methodologies should require appropriate adjustments to historical loss estimates for changes in factors that affect repayment, in particular due to forward-looking information and macroeconomic factors. Care should be taken, from period to period, to consider carefully whether the macroeconomic adjustment performed fully reflects future expectations of credit performance. For example, should a firm apply macroeconomic adjustments which do not reference a particular indicator which is now rapidly deteriorating, and is expected to affect the credit risk of particular obligors significantly, an overlay to reflect the impact of that factor should be considered. The extent to which the effect of the indicator is already considered specifically in the underlying assessments (for example by way of individual obligor PD overrides) should also be considered in making such further adjustments. Firms should review the need for such adjustments from period to period and should take care to ensure that their use is not prolonged beyond the period for which there is reasonable and supportable information to support the adjustments.

Appendix IV

Key Topic: Assessment of significant increases in credit risk

Reference to SAG-AEG meeting: AEG presentation - questions 6

> "Can banks indicate their current thinking on how a "significant" increase in credit risk will be defined in a manner consistent with IFRS 9 and the Basel Committee's expectations?"

Sub-topic: Changes in pricing of loans, and other information, indicating significant increases in credit risk

Objective of the Guidance:

Banks must have processes in place to enable them to determine on a timely and holistic basis when to transfer to Lifetime Expected Loss (LEL) measurement as soon as credit risk has increased significantly (see Guidance paragraph A18[20]).

Description of issue:

"Significant deterioration" is not defined but appropriately left to firms' management judgement. There is no commonly agreed standard that can be universally applied as this necessarily is a relative term in the absence of actual default. However if it is to be defined by firms in a meaningful way, it will need to be based on risk management practices to identify credit deterioration at each point in time and in accordance with the requirements in IFRS 9 to compare to credit risk at origination.

The Guidance seeks consistency in approach and application across entities within a group (see paragraph A17) as well as timely recognition (stated all through the Guidance, for example in paragraphs 10, 14, 29 and A18). Specific criteria to be considered are listed under paragraphs A27 and A28, which include reference to pricing (see separate note) as well as macroeconomic or exogenous factors.

Accepting that there is no "one size fits all" approach, paragraph 27(c) states "a downgrade of a borrower by a recognized credit rating agency, or within a bank's internal credit rating system" should be considered.

Paragraph A25 specifies the need for each bank to have a clear policy, including well-developed definitions, of what constitutes a "significant" increase in credit risk for different types of lending exposures.

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[20] A18. The IFRS 9 objective stated above means that the timely determination of whether there has been a "significant" increase in credit risk subsequent to the initial recognition of a lending exposure is crucial. Banks must have processes in place that enable them to determine this on a timely and holistic basis, so that an individual exposure, or a group of exposures with similar credit risk characteristics, is transferred to LEL measurement as soon as credit risk has increased significantly, in accordance with the IFRS 9 impairment accounting requirements.

However, Paragraph A27 lists six conditions which would *potentially* suggest a significant increase in credit risk, to which banks should pay particular attention. IFRS 9 B5.5.17 also includes a non-exhaustive list of information that may be relevant in assessing changes in credit risk, which includes 16 items and appears to include all the items in A27, although with differences in articulation.

The list in paragraph A27 includes:

> "(a) a discretionary decision by management such that, were an existing loan newly originated at the reporting date, the element of the price of the loan that reflects the credit risk of the exposure would be higher than it was when the loan was actually originated as a result of the change in credit risk since inception."
>
> Footnote 33 states a supervisory expectation that "Where management is unable to distinguish this element of pricing from others, such as the general price of credit risk or changes in gross margins charged due to other factors such as changing capital requirements, the Committee expects banks to adopt a rebuttable presumption that any increase in the credit spread that would be charged for a particular loan is due to an increase in the bank's assessment of the credit risk of that exposure."

Banks' pricing methodologies typically consider a range of factors, such as general price of credit or other factors such as economic, commercial or regulatory factors. These factors are considered holistically when arriving at the price. Credit risk is only one factor that influences pricing. An increase in credit spread for new loans is an expression of changing general credit risk appetite and strategy, but does not necessarily provide any information on the credit quality of loans originated in the previous period.

Furthermore, where pricing is changed to reflect a change in credit risk appetite caused by deterioration in past credit performance, more forward-looking indicators of the increase in credit risk for the existing portfolio will already have been considered and will have been reflected in the ECL. This is because, under these circumstances, a change in credit risk would first have been identified through other methods, e.g. PD, before being factored into the credit spread within the pricing. Under these circumstances a change in pricing would therefore be a secondary indicator.

For example, changes in underwriting policies which affect pricing may occur for business reasons, such as wishing to increase or decrease lending, with the effect that changing expected credit loss based on pricing per se would result in changes to the recognition of expected credit losses on existing financial instruments irrespective of changes in actual credit risk.

It is therefore not appropriate for footnote 33 to assume any change in the credit spread element of pricing is due to a change in credit risk of the existing portfolio. This could result in lifetime expected loss being recognized where there is no significant increase in credit risk, producing an outcome that would not be compliant with IFRS 9.

While pricing could be one of the pieces of relevant information to be considered, it is not necessarily the most appropriate of indicators, and should certainly not dictate any action.

As a result, the IIF SAG is of the view that such price indicators should not be given a privileged or disproportionate role in the Guidance.

IFRS 9 Requirements:

IFRS 9.B5.5.17 sub-paragraph (a) suggests that following information may be relevant in assessing changes in credit risk:

> "[S]ignificant changes in internal price indicators of credit risk as a result of a change in credit risk since inception, including, but not limited to, the credit spread that would result if a particular financial instrument or similar financial instrument with the same terms and the same counterparty were newly originated or issued at the reporting date."

It should be understood that changes in prices can be often independent from increases in credit risk; therefore pricing cannot be used as an automatic backstop as suggested by footnote 33. However, in cases where pricing changes are clearly determined to reflect increase in credit risk, as opposed to other business drivers, they should be evaluated in considering the ECL measurement as potential indicators of increase in credit risk.

Consequences of the Guidance as drafted:

Given the multiplicity of factors that are taken into account it would not be operationally feasible to rebut the presumption stated in the footnote. As a consequence, any general increase in pricing, which may or may not be the result of credit factors and which may or may not provide information about the credit quality of existing loans, will move large volumes of loans into stage 2. This would result in an outcome that would be inconsistent with the objectives of IFRS 9.

While the other points in paragraph A27 are of less acute concern, some are unclear (e.g. what is "an internal credit assessment summary indicator" or "deterioration of relevant factors"?) and they appear to add nothing to the existing guidance in IFRS 9. It is also unclear why these particular points, which are included in the list in IFRS 9, have been singled out for particular attention. We are concerned that the selection and articulation of the other points in paragraph A27 will incentivize users of the Guidance to place greater emphasis on these points rather than fully considering other guidance in IFRS 9 that could be of equal or greater significance in particular cases or types of lending. It would be more consistent with high quality implementation if banks were advised to consider all relevant information including without limitation the indicators in IFRS 9 in the particular circumstances of each loan or group of loans.

Moreover, taken literally, and especially in paragraph A27(c), the Guidance can be misinterpreted by auditors and others as a form of check list triggering transfer to stage 2, rather than requiring transfer based on significant increases in the likelihood or risk of default occurring since initial recognition in compliance with IFRS 9 (B5.5.7).

In practice, firms will incorporate a range of factors in determining whether significant deterioration has occurred. Banks are currently considering how best to define their internal procedures to determine significant deterioration. For example, in wholesale portfolios, this

may require a combination of (1) exposures identified in accordance with standard procedures for inclusion in the internal "watchlist," (2) changes in rating beyond a specified threshold (to be determined relative to customer type, a firm's use of internal or external ratings, and the degree of rating change[21]) and (3) a 30 days' past due backstop (more relevant in mass market portfolios where individual monitoring generally does not occur and where more macro-monitoring may not identify individual defaults).[22] Any additional "checklists" will only complicate, and possibly cause confusion in, the processes.

Internal policies and procedures already define the applicable criteria and the procedures to assure ongoing monitoring, and will be modified as necessary, and external disclosure will summarize the basis to assist user understanding on general principles.

Finally, the Guidance is not obviously symmetrical in its approach. Explicit reference should be made to reflect the intent that the treatment is intended to be symmetrical; in other words, where an exposure, or group of exposures, no longer meets the "significant deterioration" criterion, it may be transferred back to stage 1 under IFRS 9.

Proposed revised drafting:

Given the banks' broader concerns about the list of factors in paragraph A27, the Guidance would be more consistent with a high quality outcome if paragraphs A27 and A28 were refocused as follows:

> A27. While it is neither possible nor desirable for universally applicable criteria to be developed, the Committee emphasizes that ~~the presence of any of conditions (a)–(f) below would suggest that there has potentially been a significant increase in credit risk.~~ banks should take particular care to avoid the risk of a significant increase in credit risk not being acknowledged promptly when it is, in fact, present. In forming their assessments Banks should pay particular attention to the factors ~~listed below~~ in IFRS 9 B5.5.17.
>
> ~~(a) a discretionary decision by management such that, were an existing loan newly originated at the reporting date, the element of the price of the loan that reflects the credit risk of the exposure would be higher than it was when the loan was actually originated as a result of the change in credit risk since inception; [33]~~
> ~~Footnote 33~~: ~~Where management is unable to distinguish this element of pricing from others, such as the general price of credit risk or changes in gross margins charged due to other factors such as changing capital requirements, the Committee expects banks to adopt a rebuttable presumption that any increase in the credit spread that would be charged for a particular loan is due to an increase in the bank's assessment of the credit risk of that exposure.~~
> ~~(b) a decision by management to strengthen collateral and/or covenant requirements for new exposures that are similar to exposures already advanced because of changes in the credit risk of those exposures since initial recognition;~~

[21] For example, a change from AAA to AA or AA to AA- should be noted but would not normally indicate "significant" credit deterioration.
[22] 30 dpd will necessarily be amongst the factors because it is a rebuttable presumption in IFRS 9.

~~(c) a downgrade of a borrower by a recognised credit rating agency, or within a bank's internal credit rating system;~~
~~(d) for performing credits subject to individual monitoring and review, an internal credit assessment summary indicator that is weaker than upon initial recognition;~~
~~(e) deterioration of relevant factors (eg future cash flows) for an individual obligor (or pool of obligors); and~~
~~(f) expectation of forbearance or restructuring.~~
~~A28. In addition, the assessment of whether there has been a significant increase in credit risk of a lending exposure should take full account of the more general factors below:~~
~~(a) deterioration of the macroeconomic outlook relevant to a particular borrower or group of borrowers. Macroeconomic assessments must be sufficiently rich to include factors relevant to sovereign, corporate, household and other types of borrower. Furthermore, they must address any relevant regional differences in economic performance within a jurisdiction. See principle 6 in the main section of this guidance for additional considerations for forward-looking information and macroeconomic factors; and~~
~~(b) deterioration of prospects for the sector or industries within which a borrower operates.~~

A28. Such evaluation should not be wholly internally driven, and consideration should be given to external factors relevant to a particular borrower or group of borrowers, including deterioration or improvement of the macroeconomic outlook or deterioration or improvement of the prospects for the sector or industries within which a borrower operates.

Finally a new paragraph is suggested to be added the better to reflect the symmetrical nature of the accounting framework:

NEW XX: The Committee recognizes the intention of IFRS 9 that the recognition and de-recognition of significant deterioration should be symmetrical as stated in Basis for Conclusions paragraphs BC5.210 to BC5.213. That is, assets may "cure" and therefore may be reclassified to stage 1. Firms should develop policy criteria against which a consistent approach to such judgments can be assessed. Such criteria should reflect firms' overall risk management policies and procedures.

Appendix V

Key Topic: How banks propose to approach materiality vs proportionality

Reference to SAG-AEG meeting:

Overarching topics presented by the SAG related to sound methodology for assessing credit risk and measuring the level of allowances.

Objective of the Guidance:

The Guidance is supposed to be equally applicable under all accounting frameworks for all supervised banks.

Description of the issue:

While recognizing that for less complex banks, supervisors may adopt a proportionate approach with regard to the standards (Paragraph 12), the Guidance does not recognize that proportionality should apply when assessing the Expected Credit Losses process within a bank, even within a complex, internationally active bank.

The Guidance should also be clear that it does not override the concept of materiality as it relates to all accounting frameworks.

Proportionality

No difference is made in the Guidance as to whether one methodology or another should apply within a complex bank depending on the availability of data necessary to achieve a robust determination of statistical model. The ability to collect a sufficient level of data for the specific entity or portfolio in scope is key to having a statistically sound data set for building models. When Basel II/III was implemented there was acceptance that global models would be used and that local data can be enriched by global data and that such a methodology was acceptable also in host locations. Basel requirements also allowed for default to standard models when appropriate.

Such possibilities are not contemplated as such within IFRS 9. Instead, practical expedients[23] are provided for and it is recognized that all information that is available without undue cost and effort should be collected. As long as the Guidance states (paragraphs A46 and A49) that the use of practical expedients is viewed as low-quality implementation and cost should not be an excuse for avoiding developing IT systems, it is difficult to see how use of proportionate techniques will be accepted by regulators if for a specific entity or portfolio the internal or external data are not numerous enough to build a statistical model.

It may also happen that a portfolio may not have enough individual contracts to enable a bank to build a model to obtain reliable PDs, LGDs, and therefore the provision for such a portfolio

[23] IFRS 9 5.5.10 and 5.5.11.

may need to be assessed on an expert-risk basis. This does not mean that the assessment is low quality. In such a case, expert judgment will be more robust than if the portfolio were merged to others purely to meet the goal of using models. The SAG agrees with the AEG that the artificial breakdown into small portfolios for the sole purpose of avoiding building models is *not* acceptable. The SAG also believes that grouping portfolios inappropriately or building models without the sufficient level of data or with inaccurate data would lead to inappropriate results in allowances.

IFRS 9 does not preclude any methodology and calls for the leverage of all credit management practices. The Guidance lists in paragraph 24 what a robust approach shall be. It is unclear how such requirements would be read by auditors or supervisors when all conditions are not or cannot be met, because of lack of data or loss experience. There is a risk that they will turn this list into a checklist, with negative assurance having to be demonstrated, which would be unproductive for all concerned.

Proportionality should be assessed neither at the financial statements level nor at the allowances level. Instead, proportionality should be assessed using a combination of number of individual contracts in a portfolio, their risk characteristics, and the comparison of similarities:

a) within portfolios, or
b) for smaller and less sophisticated banking groups; or
c) for smaller locations, ie subsidiaries or branches of global banking groups

General observation: The draft Guidance seems to be driven by concern that portfolios could deliberately be grouped to "mask" appreciable increases of credit risks for some obligors, to avoid increasing the ECL allowance, or, conversely, that portfolios could be sliced into small, immaterial portions to avoid rigorous application of forward-looking assessment (albeit such an approach would contradict the notion that amounts are expected to be immaterial in aggregate as well as individually). Both of these concerns are already addressed by risk management and independent review. To the extent that there are concerns that internal governance and methodological discipline might not adequately address such potential problems, then it would be more appropriate to address them through specific governance requirements or supervisory standards, rather than by in effect modifying the risk-management standards on which the new ECL accounting is intended to be built.

Materiality

Materiality is generally applied to financial statements.[24] As already stated in its letter of December 1, 2014, the SAG agrees that materiality should not be used to justify low-quality implementation. However, materiality is a fundamental principle underpinning all financial reporting, and materiality decisions should not be seen as contrary to 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 contributes to assurances that resources will be allocated at the right time to the risks that need to be monitored most closely. It would be inconsistent with high-quality implementation if resource allocations could

[24] IAS 1 paragraphs 29 and 30A.

not take into account materiality. It would also be inconsistent if complexity and increased operational risk were introduced that did not contribute to a better quality implementation, as would be the case if normal materiality considerations had to be disregarded.

The Committee concludes in paragraphs A49 and 60 that "the long-term benefit of a high-quality implementation far outweighs the associated costs, which should therefore not be considered undue". The SAG could agree with this statement if it were to apply to the concept of high-quality implementation itself; however, high-quality implementation should be understood to be subject to materiality and to proportionality in the application of models as stated above. Materiality analyses serve many purposes in addition to allocation of resources and are integral to high-quality accounting generally.

Therefore materiality assessment should apply similarly to occasions where very small portfolios or exposures are concerned. Furthermore, even if credit risk will be monitored and assessed regardless of materiality (i.e. a portfolio with many individual contracts that leads to very low allowances should be assessed whatever the level of allowances is), it should be recognized by the Guidance that a materiality assessment should be applied to the resources allocated to smaller portfolios. This allocation of resources may vary over time depending on facts and circumstances.

Requirements of Basel II and Basel III:

In many parts of the requirements, materiality is mentioned as a criterion to apply to manage exposures that are not material. Paragraph 256 below is given as an example of how the concept of materiality is used.

> *3. Adoption of the IRB approach across asset classes*
>
> 256. Once a bank adopts an IRB approach for part of its holdings, it is expected to extend it across the entire banking group. The Committee recognises however, that, for many banks, it may not be practicable for various reasons to implement the IRB approach across all material asset classes and business units at the same time. Furthermore, once on IRB, data limitations may mean that banks can meet the standards for the use of own estimates of LGD and EAD for some but not all of their asset classes/business units at the same time. (Excerpts from: International Convergence of Capital Measurement and Capital Standards A Revised Framework - Comprehensive Version - June 2006)

Note, however, that in the Basel framework, proportionality and materiality are used without clearly distinguishing the two concepts.[25] While this may be workable for prudential-regulation

[25] 259. 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, subject to supervisory approval. Capital requirements for such operations will be determined. according to the standardized approach, with the national supervisor determining whether a bank should hold more capital under Pillar 2 for such positions.
260. Notwithstanding the above, once a bank has adopted the IRB approach for all or part of any of the corporate, bank, sovereign, or retail asset classes, it will be required to adopt the IRB approach for its equity exposures at the same time, subject to materiality. Supervisors may require a bank to employ one of the IRB equity approaches if its equity exposures are a significant part of the bank's business, even though the bank may not employ an IRB approach in other business lines. Further, once a bank has adopted the general IRB approach for corporate exposures, it will be required to adopt the IRB approach for the SL sub-classes within the corporate exposure class.

purposes, the two should be clearly distinguished for financial-reporting purposes, as discussed in these comments.

IFRS Requirements:

Materiality is defined in IAS 1 *Presentation of Financial Statements*, IAS 8

> For example, IAS 8.5 states that omissions or misstatements of items are material if they could, by their size or nature, individually or collectively; influence the economic decisions of users taken on the basis of the financial statements.

This principle should apply to the Guidance, subject to the understanding that a sizable portfolio should be subject to analysis under the Guidance for provisioning purpose even if the current P&L impact of any provisioning would be immaterial in the financial statement.

Consequences of the Guidance as drafted:

The proportionate approach is only recognized for less complex banks. It does not address smaller locations or smaller portfolios of global banks. For both, the level of expectation in terms of developing models factoring in forward looking information, transforming standardised LGD is unclear. The Guidance, as written, may not allow auditors or host regulators to adopt a proportionate approach to smaller locations or smaller portfolios of larger firms.

The Guidance in this area should be broader to make clear that host regulators would be expected to accept the home assessment subject to exceptions that would need to be well justified.

Proposed drafting

For "materiality"

NEW XX: This Guidance does not override the concept of materiality as applied in accordance with accounting standards.

For "proportionality"

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, or the size, nature and complexity of entities (such as smaller banks, subsidiaries or branches of banking groups); in so doing, banks should consider the availability of robust data, especially for smaller portfolios or entities.

24. At a minimum, a bank should adopt and adhere to written policies and procedures detailing the credit risk systems and controls inherent in the methodology and the

separate roles and responsibilities of the bank's board and senior management. Though not an all-inclusive list, a ~~robust and~~ sound methodology for assessing credit risk and measuring the level of allowances, where relevant (subject to appropriate and proportionate application pursuant to paragraph 12), will: (...)

60. The Committee understands that it is challenging and costly to incorporate forward-looking information and macroeconomic factors into the estimate of ECL and that ECL estimates will inherently have a significant degree of unavoidable subjectivity. Nevertheless, in the Committee's view, consideration of forward-looking information and macroeconomic factors is essential to the proper implementation of an ECL accounting model subject to the proportionality principle as explained in paragraph 12, and therefore these costs should not be avoided on the basis that a bank considers them to be excessive or unnecessary. The Committee does not, however, expect additional cost and operational risk to be introduced where they do not contribute to high-quality implementation of accounting standards.

A49. IFRS 9 states that "an entity shall consider the best reasonable and supportable information that is available, without undue cost and effort" and that "an entity need not undertake an exhaustive search for information" [footnote 34 unchanged]. The Committee expects that banks will not read these statements restrictively. Since the objective of the IFRS 9 model is to deliver fundamental improvements in the measurement of credit losses, the Committee expects banks to develop systems and processes to use all relevant reasonable and supportable information needed to achieve a high-quality, robust and consistent implementation of the approach subject to the proportionality principle as explained in paragraph 12. This will potentially require costly upfront investments in new systems and processes but the Committee considers that the long-term benefit of a high-quality implementation far outweighs the associated costs, which should therefore not be considered undue. Nevertheless, the Committee does not expect additional cost and operational risk to be introduced where they do not contribute to high-quality implementation of IFRS 9.

Appendix VI

Key Topic: Scope of the Guidance on credit risk practice and regulatory capital methodologies

Reference to SAG-AEG meeting:

The overarching topic presented by the SAG was related to the objectives and scope of the Guidance, including credit risk practices affecting the assessment and measurement of allowances - linkage to lending risk assessment, underwriting practices and pricing.

Objective of the Guidance:

As stated in Principle 2, "A bank should adopt, document and adhere to sound methodologies that address policies, procedures and controls for assessing and measuring the level of credit risk on all lending exposures. The robust and timely measurement of allowances should build upon those methodologies."

Description of issue:

The issue concerns the extent to which the Guidance should focus on how ECL accounting models build upon credit risk management practices and processes instead of repeating or adding to existing guidance on the credit risk management practices themselves, which are already covered in specific Basel frameworks[26] and prudential supervision. The issue of scope is primarily seen in Paragraphs 27 (factors to consider in credit risk assessment), 31 (sound underwriting practices and pricing) and 58 (validation of internal credit risk models). *For example, in paragraph 58, it is unclear if there are specific points relating to ECL.*

The SAG believes that the Guidance should rely as much as possible on existing frameworks[27] and indicate specific features arising from the demands of the new ECL accounting models, where deemed necessary. An example would be the additional governance considerations for model validation related to the incorporation of forward-looking information and macroeconomic factors.

A further question of scope arises as to regulatory capital measurements under the Basel capital framework. The IIF SAG understands that it is not the intention of the Basel AEG to redefine those measurements using this Guidance, and agrees with that intention. However, paragraph A5 could be interpreted as redefining the "unlikeliness to pay" criterion to reflect significant credit deterioration on a more forward-looking basis. Such an outcome would undermine the use of regulatory measurements by effectively aligning the definition of default with a significantly increased risk of a default occurring. This would introduce circularity into PD measures used as the basis for ECL accounting, and render these methodologies inoperable.

[26] BCBS 239 and Basel Core Principles.
[27] Such as the OCC Guidance on model validation.

IFRS 9 Requirements:

IFRS 9 refers to credit risk management practices for the purpose of assessing increases in credit risk. For example, the Basis for Conclusions[28] explains why a change in underwriting practices should not be the sole criterion for assessing increases in credit risk. IFRS 9 does not provide any requirements or recommendations on how banks should conduct credit risk management or underwriting practices themselves.

It is important to point out that credit risk practices vary for many legitimate reasons and cannot easily be described by a "one size fits all" approach. Risk management practices differ depending on the product, client segment, market, legal and regulatory context and other factors. This is also recognized by IFRS 9, which states that there is no mandatory methodology for implementing the ECL accounting model:

> "The IASB noted that it did not intend to prescribe a specific or mechanistic approach to assess changes in credit risk and that the appropriate approach will vary for different levels of sophistication of entities, the financial instrument and the availability of data."[29]

The Guidance should focus on how ECL accounting models should build upon credit risk management practices and processes instead of repeating or adding to guidance on credit risk management (or related underwriting) practices themselves. It would be anomalous if accounting-related supervisory guidance were interpreted as requirements for credit risk-management and underwriting practices, as opposed to accounting.

The SAG understands the AEG's concern that banks should assess, among other factors, how changes in underwriting practices could provide information that might affect ECL measurements; however that concern should not require specifying the elements currently listed under paragraph 31. The analysis of changes in pricing and other underwriting practices in ECL assessment is explained in Appendix IV.

Consequences of the Guidance as drafted:

As drafted, the Guidance appears to prescribe credit risk management and underwriting practices by providing a list of tasks and factors for consideration that risk managers should include in their due diligence. Although this may not be the intent of the Committee, the SAG is concerned that both internal risk and control staff and internal and external auditors may interpret the current draft (especially but not only paragraphs 27 and 31) too literally in their efforts to demonstrate compliance with supervisory requirements. Even if appropriate caveats were added, the current version could all too easily be used as a checklist for assessing ECL models.

Given the variety in lending portfolios, some of the factors listed are relevant for some but not for other portfolios. There is further the risk that other relevant factors may be missing, or that new risk factors will emerge as a consequence of new lending practices or changing contexts. This would mean that the Guidance would soon become outdated, and if it continued to be used as a checklist, would have the effect of reducing the ongoing quality of application.

[28] BC5.163 to BC5.165.
[29] BC5.157.

Proposed revised drafting:

Paragraph 27 includes aspects of credit risk management that are governed by other bodies of regulation and are generally closely supervised by prudential authorities. In addition, many of the factors noted are not directly related to provisioning or to financial reporting and so seem unnecessary and possibly confusing in this context. We recommend focusing the language on the need to consider lending policies, procedures and underwriting standards at the time of origination when assessing and measuring the level of credit risk for ECL purposes.

> 27. In assessing and measuring the appropriate level of credit risk for ECL purposes, with respect to factors related to the character, capacity and ~~capital~~ financial resources of borrowers, the terms of lending exposures and the values of assets pledged as collateral, or other credit risk mitigants, a bank should ~~assess~~ consider~~:~~
>
> ~~(a)~~ its lending policies and procedures, including its underwriting standards and lending terms, that were in effect upon initial recognition of the borrower's loan, and whether the loan was originated as an exception to this policy. A bank's lending policy should include details of its underwriting standards, and guidelines and procedures that steer the bank's lending approval process, for the purposes of making this assessment.
>
> ~~(b) a borrower's sources of recurring income available to meet the scheduled payments;~~
>
> ~~(c) a borrower's ability to generate a sufficient cash flow stream over the term of the instrument;~~
>
> ~~(d) the borrower's overall leverage level and expectations of changes to leverage;~~
>
> ~~(e) unencumbered assets the borrower may pledge as collateral in the market or bilaterally in order to raise funds and expectations of changes to the value of those assets;~~
>
> ~~(f) one-off events and recurring behaviour that may affect the borrower's ability to meet contractual obligations;~~
>
> ~~(g) the extent of a bank's adherence to best practices with respect to loan underwriting;[17]~~
>
> ~~Footnote17: See footnote 9~~
>
> ~~(h) timely evaluations of collateral value and consideration of factors that may impact the future value of collateral (bearing in mind that collateral values directly affect estimates of loss-given-default); and~~
>
> ~~(i) all other relevant information.~~

Paragraph 31 requires banks to adhere to sound underwriting practices and price appropriately to reflect risk, which are already required by other statements such as the FSB Principles for Sound Residential Mortgage Underwriting Practices.[30] Furthermore, it sets out examples of potential inadequate underwriting practices which, however, are amply covered by other bodies of regulation and prudential supervision. Rather than focus on linking underwriting with pricing, which is general risk management practice, the Guidance might better focus on the analysis of the link between credit deterioration and accounting requirements so that the accounting faithfully reflects the levels of credit risk that have been accepted by the bank.

[30] http://www.financialstabilityboard.org/wp-content/uploads/r_120418.pdf.

31. For the purpose of assessing increase in credit risk in accordance with the new accounting standards, a bank ~~management~~ should consider ~~should be able to demonstrate~~ its ~~adherence to sound~~ underwriting practices in light of the applicable sound underwriting practices[31] and ~~that~~ the price at which lending exposures are granted ~~appropriately reflects inherent risks~~. Post-initial recognition increases in credit risk require a bank to reassess ECL and re-measure the amount of the allowance that should be recognized in accordance with the applicable accounting framework. ~~Examples of fact patterns potentially showing inadequate underwriting practices may include:~~

~~(a) the granting of debt to borrowers based on fragile income streams (that could become non-recurrent upon a downturn) or with no documentation or limited verification of borrower income sources;~~

~~(b) high debt servicing requirements as compared with the borrower's net available expected cash flows;~~

~~(c) flexible repayment schedules, including payment vacation, interest-only payments (eg bullet loans) or negative amortisation features;~~

~~(d) for real estate financing, lending of amounts equal to or exceeding the value of the financed property or otherwise failing to provide a margin of collateral protection;~~

~~(e) increases in troubled debt restructurings and other concessions or modifications to lending exposures;~~

~~(f) circumvention of the classification and rating requirements, including rescheduling, refinancing or reclassification of lending exposures;~~

~~(g) undue increases in the volume of credit, especially in relation to the increase in the volume of credit by other lenders in the same market; and~~

~~(h) increasing volume and severity of delinquent, low-quality and impaired credit.~~

Both for paragraphs 27 and 31, although the SAG does not consider it necessary, if more specificity were required, appropriate reference to the relevant existing regulatory standards or guidance would be preferable to introducing new language as in the current draft.

In addition, paragraph 58 appears to reproduce the existing guidance on model validation (for example, Articles 188-191 in CRDIV Regulations). As a result it is unclear if there are specific points relating to ECL. This paragraph could be deleted and replaced with a cross reference to the existing guidance. Any ECL specific commentary could then be added and it would clearly stand out; perhaps these might relate to forward looking perspectives in point (c) and (c)(ii).

~~58.~~ [Owing to its length we have not shown paragraph 58 shown as deleted, but recommend its deletion.]

We suggest that paragraph A5 be deleted, as it is outside the scope of ECL accounting, and risks the circularity of definition discussed above.

~~A5. In accordance with the Basel capital framework, a default event occurs when either of the criteria in paragraphs A4 (a) and (b) is met or both are met. In this context, the "unlikeliness to pay" criterion of the debtor is regarded as a primary indicator, while the 90-days-past-due criterion is a backstop. Furthermore, the list of elements provided in~~

[31] such as the FSB Principles for Sound Residential Mortgage Underwriting Practices.

the Basel framework as indications of unlikeliness to pay should be supplemented with other elements that affect the borrower's ability or willingness to meet the contractual obligations, as identified on either an individual or a collective basis, and adjusted to incorporate current conditions and forward looking information. The inclusion of those other elements is aimed at capturing indicators of credit risk that precipitate eventual cash shortfalls.[29]

Footnote 29: The concept of default applies to other aspects of IFRS 9 ECL model, including the assessment of significant increases in credit risk.

Appendix VII

Key Topic: additional drafting suggestions

As stated on page 9 of this letter, the SAG recommends amending paragraph 63 as follows:

> *63: In estimating ECL, banks may determine either a single amount or a range of possible amounts. In ~~the latter~~ any case, the Committee expects that banks will exercise ~~prudence, defined as exercising~~ appropriate care and caution when determining the level of ECL and the allowances to be recognised for accounting purposes to ensure that the resulting estimate is~~ appropriate (ie~~ consistent with neutrality and neither understated nor overstated~~)~~.*

As stated on page 10, the scope of the Guidance should be clarified to be clear that it covers the same instruments as IFRS 9, except for debt securities that are excluded; therefore, the SAG suggests amending paragraph 13 as follows:

> *13. This paper covers the credit risk practices for lending exposures that are subject to the recognition of allowances [footnote 8 unchanged] under ECL accounting frameworks. While credit risk practices for other bank exposures, such as debt securities and securities-related transactions (e.g.: repos), are outside the scope of this paper, banks should ensure that sound credit risk practices are in place in these areas and that credit risk is properly considered in developing ECL estimates for these other exposures.*

As stated on page 9, it should be clarified that it is only the use of the "low credit risk exemption" as an operational simplification that is of concern to the Committee, and not a bank's consideration of whether a loan is low credit risk at initial recognition in determining whether an increase in credit risk is significant. It also appears that paragraph A52 requires an assessment of credit risk to be made in all situations so that 12 month ECL allowance can be determined regardless of whether there is a significant increase in credit risk. This implies that the Committee considers that the operational simplification of not using tracking is never appropriate. If this is the intention, SAG suggests amending paragraph A51 and A52 as follows, and further urges consideration of whether much of paragraphs A53 – A58 is necessary; if tracking is always required, then the additional guidance and disclosure requirements would never apply.

> *A51. The Committee regards the low-credit-risk exemption as merely an operational simplification to eliminate the need to track credit quality for financial instruments that remain of low credit risk. The Committee expects banks to continue to assess all exposures covered by this Guidance for changes in credit risk and recognize changes in 12-month ECL through the allowance where there is not a significant increase in credit risk. However, the Committee recognizes that the initial credit risk of a loan is important in determining the significance of any increase in credit risk since, if this is not considered, a change in absolute terms in the risk of a default occurring could be more significant for a financial instrument with a lower initial risk of a default occurring compared to a financial instrument with a higher initial risk of a default occurring which would be contrary to IFRS 9 B5.5.9. ~~that should be used by banks only in cases where it~~*

> *~~is evident that its use would have a minimal effect on the timing of ECL recognition and the measurement of ECL, as compared with when the expedient is not used. Nonetheless, some banks may consider that certain classes of exposures exist that are of such high credit quality that they will not exhibit significant increases in credit risk.~~*
>
> *A52. ~~In that context, the Committee expects that a significant increase in credit risk will always result in an exposure moving to LEL measurement, and for good-quality implementation of IFRS 9 any rare use of the low-credit-risk exemption must be accompanied by clear evidence that credit risk as of the reporting date is so low that a significant increase in credit risk since initial recognition could not have occurred. Accordingly, despite the exemption that exists in IFRS 9 for low-credit-risk exposures, the Committee expects that, even when a bank assigns a low credit risk rating to an exposure (or group of exposures), management should still assess whether credit risk has increased significantly. Even when a bank concludes that credit risk has not increased significantly for an individual exposure or group of exposures, it must continue to assess those exposures for changes in credit risk and recognise changes in 12-month ECL through the allowance.~~*

As also stated on page 10, the 30 dpd indicator might not be relevant for wholesale but may be an important backstop for retail credit risk management; as such, paragraph 59, which refers to "very low-quality implementation", should be moderated accordingly.

> *A59. The Committee agrees with the view expressed in IFRS 9 that delinquency is a lagging indicator of significant increases in credit risk. Banks should have credit risk assessment and management processes in place that are sufficiently robust to ensure that credit risk increases are detected well ahead of exposures becoming past due or delinquent. ~~The Committee would view significant reliance on past-due information (such as using the more-than-30-days-past-due rebuttable presumption as a primary indicator of transfer to LEL) as a very low-quality implementation of an ECL model.~~*

Finally, the SAG would like to provide two additional drafting suggestions as proposed below:

- *Use of "requirements" instead of "expectations"*

  The term "requirement" to define the objective of the Guidance is used throughout the Guidance (eg: paragraphs 1, 4, A13). The SAG understands that the shift in the use of terminology to "requirements" as compared to the previous document (Sound Credit Risk Assessment and Valuation for Loans (SCRAVL)) is made on purpose by the Committee. Nevertheless, the SAG is concerned about how this term this will interact with the standard setting process and audit requirements because, read literally, "expectations" and "requirements" have different legal and practical meanings. The Guidance needs to be clear to avoid misinterpretation and unintended consequences. Therefore the SAG would suggest replacing "requirements" by "expectations".

- *Concentration vs ECL - paragraph 24(f)*

Paragraph 24(f) refers to concentrations of credit risk as a factor of adjustment that may have an impact on ELC calculations. It is the SAG's understanding that there is no correlation between concentration and EL. Concentration of credit risk is supposed to be dealt with via large-exposure limitations and possibly capital assessments under Pillar 2. Therefore, the SAG suggests amending paragraph 24 as follows:

> *24(f): document the inputs, data and assumptions used in the allowance estimation process (such as historical loss rates, PD/LGD estimates and economic forecasts), how the life of an exposure or portfolio is determined (including how expected prepayments have been considered), the historical time period over which loss experience is evaluated, and any qualitative adjustments. Examples of factors that may require qualitative adjustments are the ~~existence of concentrations of credit risk and changes in the level of such concentrations,~~ increased usage of loan modifications, changes in expectations of macroeconomic trends and conditions, and/or the effects of changes in underwriting standards and lending policies.*