David Schraa
Regulatory Counsel

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

RE: Discussion held on June 17 on the *Guidance on Accounting for Expected Credit Losses* consultative document

Dear Mr. van Wyk:

The Institute of International Finance (IIF), via its Senior Accounting Group (SAG), values highly the ongoing dialogue with the Accounting Experts Group (AEG) to understand and address the AEG's concerns, and shares the objective of ensuring that the final Guidance supports high-quality and robust implementation of the new provisioning requirements.

Following the highly constructive discussion held with the AEG on June 17 regarding the draft *Guidance on Accounting for Expected Credit Losses* (ECL) consultative document (the "Guidance"), the SAG would like to provide additional comments on the following selected areas of concern for both the AEG and the SAG.

1. Definition of a significant increase for low credit risk exposures
2. Transfer criteria for a homogenous groups of exposures in a situation when one or several exposures have experienced significant credit deterioration
3. Incorporation of forward-looking information and macroeconomic factors in the credit risk models
4. The use of overlays and its intersection with credit risk modeling

Definition of a significant increase for low credit risk exposures.

The SAG is particularly concerned with the circumstances in which a numerically small increase in credit risk could be regarded as "significant". The example of a "small" downgrade of a major sovereign as discussed in June illustrates the issue.

IFRS 9[1] notes that the significance of a change in the credit risk since initial recognition depends on the credit risk at initial recognition. Therefore the significance should be considered in relation to the starting point and the change considered significant will not be the same across all the risk grades.

Consequently, the SAG agrees that the absolute amount of change in the risk of a default occurring will tend to be smaller for a lower credit risk asset than for a higher credit risk asset; but the amount of change considered significant (relative to the initial credit risk) will depend on how credit risk grades are constructed and how significance is determined. The determination of what is considered significant will involve expert credit judgment.

As noted at the meeting, when a small increase in credit risk occurs for high credit quality assets, as for all assets, banks will not look at the movement in isolation, but will also consider the particular circumstances of the customer, the magnitude of the resulting management actions and the effects of considering forward-looking economic scenarios resulting in a transfer assessment process that extends beyond merely relying on a numerical movement in PDs or ratings. Overall, the process will be a combination of measurable elements and management judgment. It will be inevitably a matter of judgment depending on facts and circumstances, and information banks have available in order to understand what is going on with the credit risk. The process for higher-quality exposures will thus be no different from that for other exposures. Changes in credit assessment will, of course, also need to be assessed against the original exposure in light of forward-looking information.

Finally, the SAG notes that independently of its significance for purposes of transfer to Stage 2, a small change in credit risk reflected in the PD will result in a remeasurement of the ECL allowance even within stage 1.

Transfer criteria for a homogenous group of exposures in a situation when one or several exposures have experienced significant credit deterioration.

The SAG welcomes the AEG's intention to remove the requirement for frequent segmentation from the Guidance and to refocus on the importance of having an appropriate homogenous segmentation at initial recognition.

[1] B5.5.9

We note that model development requires lending exposures to be segmented into groups that share common main risk characteristics that are subject to a number of shared risk factors (which will be established based on empirical analysis of their relationship to past observed default events in the given portfolio). This does not mean that they have the same characteristics; in a given portfolio of assets, some will be much less risky than others, depending on individual circumstances. The model itself need not be applied to the segment as a whole but may be applied separately to sub-portfolios within the segment or to individual exposures. Therefore it should not be expected that when an exposure, that was included in a homogenous segment for model development, experiences a significant increase in credit risk, necessitates the entire segment moving into stage 2. It may be appropriate to move the entire group where it is modelled on a portfolio basis and there is no distinguishing characteristic in individual items in the group, however this is unlikely to be a common scenario.

For example, home loans in a portfolio will typically share the risk factors of loan-to-value, debt service ratio, and on a macro-economic level GDP, interest rates and unemployment rates. Within the portfolio, a rank-ordering of the exposures will be determined based on the assessment on how they are exposed to the statistically relevant risk factors. As such, the exposures with a low loan-to-value ratio, combined with a high debt coverage ratio will rank above those with the highest advance ratio and lowest debt service. The PDs are then calibrated such that the high ranking exposures are assigned a low PD and the other ones a high PD – the goal being that over the portfolio an aggregation of the individual PDs results in the estimated portfolio-average PD. The two loan types have therefore a different PD, a different LGD (because of the advance ratio) and hence a different ECL in Stage 1. Incorporation of macro-economic indicators such as expected future changes in interest rates, would not affect the two positions linearly as the top clients have sufficient cushion to absorb higher costs of financing – their rating may therefore remain unchanged as well as the ECL in Stage 1 – while the bottom ones would be expected to suffer substantially – their rating will therefore move down by a significant margin and a re-classification to Stage 2 would be the consequence with a steeply increasing ECL.

More generally, an individual exposure could experience a significant increase in credit risk as a result of specific behavior, such as missing a payment or an increase in default probability, in which case it would be moved individually. In addition, 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. In a situation where a few exposures change for reasons that do not imply a change of the analysis behind the segmentation, a move of the entire group into stage 2 would not be justified if the risk of the overall grouping as a whole were not also significantly increased.

Finally, it is important to note that segmentation based on a homogenous group of exposures does not prevent the bank from identifying issues about the credit risk of individual

exposures. Depending on the design, transfer criteria may be applied at the level of individual exposures or sub-portfolios. A significant increase in the credit risk of a specific exposure would not necessarily affect the entire group.

Incorporation of forward-looking information and macroeconomic factors in the credit risk models.

A relationship or a link is required between macroeconomic factors and changes in credit risk before macroeconomic factors can be incorporated into ECL accounting models. Banks need to identify relevant risk parameters and how they are affected by these factors. Banks can, for example, build upon the mechanisms developed for stress testing purposes to make such links.

The extent to which forward-looking and macroeconomic factors have already been integrated into existing models will need to be considered. For example, some banks might already have "point-in-time" (PIT) models that have incorporated macroeconomic factors such as GDP, interest rates, and unemployment rates.

On the other hand, some models do not incorporate forward-looking or macroeconomic factors as required by IFRS 9. In those situations, model enhancement will be required to incorporate these factors.

However, there is a distinction between factors that can or cannot be incorporated into the ECL accounting whether through the models or by overlays. There is no rationale to incorporate forward-looking information based on non-empirical estimates or guesses as to the outcome of future events for which there is no established link to credit risk and where no observed historical relationship exists with credit deterioration.

For example, a political event will rarely be predictable and its impact on economic factors will be even less certain. However, banks should be able to make judgments about the short term implications of economic events, such as the recent drop in oil prices, particularly where they are important to their business.

Overall, IFRS 9 will require judgment in evaluating a range of events based on reasonable and supportable information in order to establish a link with credit risk. If in a particular situation there is no reasonable and supportable information, such an event would not be factored into the ECL accounting. Nevertheless, as stated above, disclosures on risk factors or disclosure about risk concentrations may be a useful response to political events and other circumstances, which do not have a clear link to credit risk.

The use of overlays and its intersection with credit risk modeling.

The SAG understands the concern raised by the AEG around the use of overlays. The use of overlays should not be seen as an alternative to improvements to credit risk models or credit risk management practices, where relevant. We agree that over-reliance on overlays could indeed perpetuate the current disconnect between credit risk management and accounting. Therefore, banks should be careful that the use of overlays will not discourage the separate risk-management process of updating of models and conducting ongoing sound risk-management processes.

In response to such concerns, the SAG points out:

- The removal and remediation of overlays is already a well-established process under the current IAS 39.
- But overlays may nonetheless be required depending on the facts and circumstances including uncertainties arising from forward-looking information. For example, a change in oil prices can be a "temporary" overlay for certain portfolios where recent dramatic volatility could not have been foreseen.

More generally, implementing ECL accounting requires a multiple step process to ensure that forward-looking information is taken into account and significant increase in credit risk is recognized in a timely fashion.

Those steps can be summarized as follows:

- Understand the outputs of credit risk grading processes, information and practices as applied to a given exposure or type of exposures. For example, retail processes are more hard-coded. Wholesale processes rely more on expert judgment;
- Assess to what extent, if any, forward-looking information and macroeconomic factors are already embedded in such practices, to avoid duplication;
- Based on that analysis, decide on the approach to be taken in the context of IFRS 9. For example, take identified risk factors as a basis of credit risk deterioration and explicitly overlay them for both transfer and measurement with a forward-looking judgment when those underlying risk processes practices and factors do not completely capture forward-looking information and macroeconomic factors.

Because IFRS 9 has an important component of judgment, it is important to ensure that the risk process has been completed and that forward-looking information in the existing process has been assessed before making the necessary adjustment if those processes do not capture such information adequately. Such an approach would make sure that the implementation has been robust without significant reliance on overlays.

Conclusion

The SAG reiterates its concern about any increased divergence in the application of banks' credit risk assessments between the regulatory requirements and accounting. Obviously, for each requirement the starting point goes back to the same data and the assessment of the probability of default is used for both, even though they serve different purposes and are determined against different time horizons. On one hand the AEG supports an increased use of sophisticated models because of the forward-looking aspects of the accounting standards, while on the other hand the BCBS is debating the reliability of internal models. As the Basel Committee is well aware, the IIF and the industry strongly support the continued use of risk-sensitive measures for capital purposes, but would also be concerned about the market's understanding if the end result is a substantial divergence in the use of models between accounting and prudential regulation. The SAG believes that it would be helpful for the industry and for users if there were a common position on the use of models independently of their accounting or regulatory use.

Further discussion of audit issues.

As discussed on June 17th, the role of the auditors is important in achieving high-quality and robust implementation of the new provisioning requirements. As such, the SAG would welcome a specific meeting with the AEG and audit firms to ensure that all parties have a common understanding of the objectives of the accounting standards and a more consistent view of the means of meeting those objectives.

Finally, the SAG would be pleased to have an additional meeting or a conference call with the AEG in order to discuss the proposed suggestions further. It would also be very useful to have the opportunity to comment on a pre-finalization draft of the Guidance.

Please contact Dorothée Bucquet (202-390-8279) or me to pursue any of these issues. We also hope to hear from you with regard to the proposed audit meeting and the opportunity to discuss the Guidance before finalization.

Very truly yours,