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Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
4051 Basel
Switzerland

30 April 2015

Dear Sirs

Consultative Document - Guidance on accounting for expected credit losses

We welcome the opportunity to comment on the Consultative Document (CD), *Guidance on accounting for expected credit losses*. We support the initiative by the Basel Committee on Banking Supervision ('the Committee') to introduce key supervisory principles for sound credit risk practices and for how these will interact with the accounting for expected credit losses (ECLs) for lending practices of banks.

The introduction of accounting for expected credit losses in IFRS 9 *Financial Instruments* and the forthcoming *Accounting Standards Update* in US GAAP represents a challenge for preparers, investors, securities regulators, prudential supervisors and auditors. As auditors, we welcome efforts that encourage a more robust application of accounting standards which ultimately better serves all users of financial statements.

Our response to the CD has three broad themes. First, the scope of the proposals; second, consistency of the accounting technical requirements in the Appendix of the CD with IFRS 9; and third, some observations we have on the auditability of the eleven sound credit risk principles. We note that the CD was not written with the objective that all the principles relevant to a bank are subject to audit; however, we are aware that some prudential supervisors may choose to require such an approach, or indirectly seek comfort from auditors as to a bank's compliance with those principles. Finally, we have included an appendix with some other observations.

Scope

The CD is intended to cover the credit risk practices for lending exposures only, with an acknowledgement that for other exposures "credit risk is properly considered in developing ECL estimates". It is unclear if, and to what extent, supervisors expect the application of the CD's principles in managing banks' credit risk exposures from non-lending exposures. These would include holdings of securities not measured at fair value through profit or loss and lease receivables. We welcome further clarity on the Committee's expectations regarding the implementation of the principles to credit risk exposures resulting from non-lending activities.

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We acknowledge that footnote 3 of the CD states that representatives of the IASB did not identify any aspects of the CD that would prevent a bank from meeting the impairment requirements of IFRS 9. Given the Committee will receive comments from constituents and make potential changes to the guidance we would hope the Committee would again seek input from the IASB on the guidance before they are finalised. We also respectfully remind the Committee in finalising their guidance that interpretations of IFRSs should be limited to the IFRS Interpretations Committee and that the IASB has introduced the *Transition Resource Group for Impairment of Financial Instruments*.

We note that the guidance when finalised are intended to apply to banks applying either IFRS or US GAAP. Given the US accounting requirements on expected credit losses are not finalised it is not clear whether the Committee intends to prepare in the future an equivalent to Appendix A on IFRS for US GAAP. Also, paragraph 15 of the CD states that it expects internationally active banks to “limit their use of practical simplifications and/or practical expedients included in the relevant accounting standards.” Given the US GAAP requirements are not yet published and therefore the extent of practical expedients in US GAAP is not known, our preference is to remove this point from the body of the guidance. If the Committee continues to have concerns about the use of practical expedients reference to this should be limited to the specific expedients in IFRS, or in the future, when the relevant US GAAP is finalised, and set out in an Appendix B.

Consistency with IFRS

We acknowledge that representatives of the IASB are satisfied that the application of Appendix A would not prevent a bank from meeting the impairment requirements of IFRS 9 *Financial Instruments*. We agree with the Committee that the guidance when finalised must not be in conflict with IFRS 9. Therefore, we have included in this letter a number of comments and proposed changes to language which would more closely align the guidance with IFRS 9.

The CD’s Appendix includes guidance that may limit some of the options available to preparers that are available in IFRS 9. We do not object to the Committee preferring an approach whereby certain practical expedients offered in IFRS 9 have limited use; however, we believe this should only be the case where the Committee believes the outcome of limiting options improves the usefulness of information resulting from applying the impairment requirements. We do not support removing practical expedients merely in order simply to have a more conservative (and therefore biased) approach. Further, we recommend that the Committee consider whether limiting practical expedients will improve consistency of application across banks given banks will likely develop their own policies rather than rely on the thresholds used in practical expedients.

We highlight that paragraph 63 of the CD states that “[i]n estimating ECL, banks may determine either a single amount or a range of possible amounts” yet paragraph A2 states the estimate should “take into account the range of possible future scenarios.” Paragraph A2 could be read as requiring an entity to utilise a full probability-weighted approach reflecting all possible scenarios in all cases, which is not a requirement of IFRS 9. IFRS 9:B5.5.41 states that a range of possible scenarios must always be considered (even if those scenarios are limited only to two, being a possibility that a credit loss occurs and the possibility that no credit loss occurs). We propose that the wording in paragraph 63 and paragraph A2 should be consistent with IFRS 9:B5.5.41 so to remove the implication that an entity is required to utilise a full probability-weighted approach reflecting all possible scenarios in all cases, and also that reference to “single amount” is not construed as permitting the loss allowance be based on the most likely recoverable cash flows which would fail to recognise the risk of non-payment even when it is remote.

We agree with the guidance in paragraph A6 that a bank should not undertake an exhaustive search for information that may affect the estimate of ECL but should use information that is ‘reasonably available’. We note IFRS 9:5.5.17(c) clarifies what is reasonable by considering whether obtaining the information would lead to ‘undue cost or effort’. However, we note that paragraph 60 of the CD that states the costs for collecting data should not be avoided on the basis that a bank considers them to be excessive or unnecessary. Given the potential inconsistency between paragraph A6 and 60 our preference is to align the language with that in IFRS 9.

In paragraph A8 the CD uses the term ‘high credit risk’ when referring to certain originated exposures. Such a term is not used in IFRS 9 and does beg the question what ‘high’ is given different lending practices of banks. We believe the CD was highlighting that higher credit risk on origination leads to greater volatility of credit risk, resulting in a greater risk that the loan could move from 12-month expected losses to lifetime expected losses. Rather than introduce a new ‘high credit risk’ term our preference would be to more simply state that the higher the credit risk on origination the higher volatility of credit risk and therefore greater care is needed in monitoring changes in credit risk.

We support paragraph A3 stating that when assessing whether there has been a significant increase in credit risk that PDs are based on the risk of default over the expected life of the financial instrument (not just the next 12-months). It would be worthwhile also including the guidance in IFRS 9:B5.5.11 that consideration should be given to the remaining time to maturity when assessing whether there has been an increase in credit risk (given all other things being equal the PD reduces with the passage of time and hence a constant PD might imply a significant increase in credit risk).

Audit implications

As part of our audit approach for banks we review the design and operative effectiveness of a bank’s risk management and internal control framework and assess whether we can rely on it to determine our audit procedures. We therefore welcome guidance for banks that will foster sound risk management practices and an effective internal control system for credit risk assessment and measurement.

Our opinion as a statutory auditor is expressed by reference to an accounting framework as issued by local or international standard setters (local GAAP, IFRS or US GAAP). Because the BCBS guidance is not part of those accounting frameworks, we highlight to the Committee that there may be situations in which we issue an unqualified audit opinion on a bank where there is not full compliance with the guidance or compliance with the guidance has not been assessed as it is not part of our scope of services.

The Committee expects processes for both credit risk practices and financial reporting to be integrated and for improvements in one area to facilitate improvements in the other. We are supportive of integration in areas where the two disciplines overlap and that IFRS 9 may serve as a catalyst to facilitate a better dialogue between risk and financial departments and review by management. The Committee notes that integration should include common processes, systems, tools and data that are used in the accounting and capital frameworks including credit risk systems, estimated PDs (with adjustment), past due status, loan-to-value ratios, historical loss rates, product type, amortisation schedule, down payments requirements, market segment, geographical location, vintage and collateral type along with information of a forward looking nature. Given the history and design of financial reporting and credit risk systems we believe the Committee’s ambition of integration will be challenging particularly given the conceptual differences between the regulatory and accounting framework (through the cycle versus point in time risk estimates for instance) that remain.

We agree with the Committee that more complex banks, internationally active banks and more sophisticated lenders should strive for the highest-quality implementation. We note that the Committee also considers that supervisors may adopt a ‘proportionate approach’ for less complex banks. Proportionality is a well-accepted approach for regulatory oversight and so is materiality in the auditing of financial statements. We are concerned that the CD could be read as requiring highly sophisticated credit risk management for all lending irrespective of complexity and materiality. For example, paragraph 59 proposes that a bank must “incorporate the expected impact of all reasonably available forward-looking information and macroeconomic factors on its estimate on its estimates of ECL.” Yet principle 1 refers to credit risk practices being commensurate with the size, nature and complexity of its lending exposures. It would be helpful if principle 1 is introduced as an overarching principle that is used in the application of all the guidance.

We welcome the Committee’s initiative to introduce requirements for the validation of the banks’ internal credit assessment models. We also believe that this is directly linked to principles 9-11 of the CD where the Committee discusses the recommendations for regulators to be satisfied that the proper policies and internal controls are in place for validation of the internal credit risk assessment models. We propose though that footnote 22 is amended to remove reference to ‘non-audit services’ as the footnote presumes that review of model validation processes are a non-audit service. Whether it is an audit or non-audit service will depend on local regulatory requirements and the external audit approach applied.

The CD notes in paragraph 63 that “the Committee expects that banks will exercise prudence, defined as exercising appropriate care and caution with determining the level of ECL and the allowances to be recognised for accounting purposes”. The CDF also refers to “prudent policies” in paragraph 10 and in paragraph 14 where it states that “supervisors having a natural interest in promoting the use of sound and prudent credit risk practices”. Although the Committee refers to the exercise of prudence and neutrality we are concerned that the use of the term prudence in the CD may be interpreted as a practice of over-cautious estimation of the downside which would be in conflict with the financial reporting objective of neutrality. It could be argued that the ECL model in IFRS 9 is designed with prudence in mind given it results in the recognition of a provision for expected losses at initial recognition. Therefore, we do not see the benefit of including references to prudent practices and prudence in determining the level of ECL, particularly given IFRS 9 does not refer to prudence and the term could be interpreted in a way that would conflict with the principle of neutrality. Alternatively, the Committee may wish to consider the use the term ‘sound practices’ which will avoid any potential conflict.

We support relevant, clear and concise disclosure of credit risk exposures for banks. Given the Enhanced Disclosure Task Force has made progress in this area and the broader disclosure initiatives of the IASB, FASB and other securities regulators to streamline disclosures we question whether this is the right time to introduce further disclosures, particularly as the disclosures in IFRS 7 following the finalisation of IFRS 9 are more extensive than what is required today and banks have yet to publish on this basis. Additionally, we request clarification if the Committee expects the disclosures that are in addition to those required by accounting standards should be subject to audit or not.

Finally, an effective implementation of expected loss accounting standards requires a consistent approach within banks supported by a consistent approach from auditors, prudential supervisors and securities regulators across multiple geographies. Where national competent authorities take different views on what they consider an effective high-quality implementation, and/or require different levels of assurance from a bank’s auditors on compliance with the guidance, this runs the risk of creating geographical differences in interpretation that puts pressure on banks trying to apply a consistent approach throughout their organisation. We acknowledge that auditors across geographies must play

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their part in trying to minimise these differences, but our success with this will depend on national competent authorities taking as much of a consistent approach as they can. Following the finalisation of the guidance we would hope national supervisors work together with the Committee to promote a consistent supervisory approach. As auditors we would welcome being part of that dialogue.

If you have any questions concerning our comments, please contact Veronica Poole at +44 20 7007 0884, Mark Rhys at +44 20 7303 2914 or Andrew Spooner at +44 20 7007 0204.

Yours sincerely

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Appendix

The points that follow are in addition to those included in the covering letter and are largely requests for clarification and suggestions where the drafting of the guidance could be improved.

21, 24(j)	Paragraph 21 states that the same information and assumptions should be used consistently for regulatory and accounting purposes to "the maximum extent possible". The Committee may wish to use the term "the maximum extent supportable" given the practicalities of using potentially disparate information for two different purposes. Similarly, paragraph 24(j) proposes the use of "forward-looking information that is reasonably available" whereas IFRS 9 uses the term "reasonable and supportable". We would prefer terms that are consistent with IFRS 9.
24(f)	We do not see how qualitative adjustments due to credit concentration are consistent with the requirements of IFRS 9.
24(k)	We question whether reference to "full credit cycle" should be "full economic cycle".
29(b)	The CD acknowledges that IFRS 9 does not use the term "reasonably estimable" when determining the time horizon of the scenarios used in estimating ECL. We would prefer that this term is not used given it creates a further level of complexity in introducing a threshold of what is a reasonable (and conversely unreasonable) period in the estimation of future cash flows given the estimation of future credit losses overall is inherently a judgement.
30 & footnote 19	We agree with the need for consistency across multiple estimates but given IFRS 9 and IAS 36 are not the same we propose inserting "… to the extent required".
37	We note that the CD considers an effective credit risk rating system as one that allows a bank to "track changes in credit risk, regardless of the significance of the change…" We agree such a system would certainly be effective but do not agree that a system that does not update for every increment of credit risk is not effective.
48	Paragraph 48 could be read as requiring re-segmentation frequently given it refers to re-segmentation occurring 'whenever relevant new information is received or a bank's expectations of credit risk have changed.' We note that paragraph 44 refers to exposures being 'homogenous in terms of their response to credit risk drivers'. We would recommend the language is refined so that re-segmentation occurs only when the credit risk of the portfolio is no longer considered similar in accordance with IFRS 9:5.5.53.
69	It would be beneficial if the CD was clearer when it expects the basis for calculating ECL for regulatory purposes and financial reporting differences to be different (e.g. point in time versus through the cycle PDs). This would help implementation and encourage the use of common data and processes only where appropriate.
A2	We agree that banks should adopt an active approach to managing credit risk, but note that paragraph A2 implies the active approach relates to the timeliness of measuring 12-month expected losses. As IFRS 9 only requires measurement at the reporting date this paragraph implies measurement of 12-month expected losses needs to be more frequent

	than at each reporting period end. Similarly, paragraph A18 states that an exposure must be "transferred to LEL measurement as soon as credit risk has increased significantly" which could imply a continuous monitoring of credit risk for accounting purposes. We suggest reference in both cases to the reporting date so it is aligned with IFRS 9.
A2	As noted in our covering letter the reference to a 'range of possible future scenarios' should be reconciled with IFRS 9:B5.5.41 to reflect that the range of possible scenarios may be limited to two.
A5	The paragraph refers to supplementing the list of elements in the Basel capital framework as indications of unlikeliness to pay. It is not clear whether these indicators refer solely to accounting for expected credit losses or have a regulatory capital implication.
A6	As with our comment above on paragraph 21, we note 'reasonable' is not accompanied with 'supportable', yet 'supportable' is referred to in paragraphs A19 and A49. We doubt the difference in language is intentional and would prefer if consistent terminology was used in the final guidance.
A8	Paragraph A8 notes that loans with a higher risk have a greater volatility of credit risk and to more readily rapid decline in credit quality. We believe this is potentially confusing given the statement in IFRS 9:B5.5.9 that "a given change, in absolute terms, in the risk of default occurring will 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 default occurring."
A27	The paragraph has six other factors to be considered of which some are similar to the factors that are included in IFRS 9:B5.5.17 (a)-(p). We would prefer that the factors in IFRS 9 are listed in the guidance. Also we note that the CD states "the presence of any of conditions (…) would suggest that there has potentially been a significant increase in credit risk" whereas IFRS 9 lists factors that "may be relevant in assessing changes in credit risk". The CD could be read that the factors are presumptively an indicator of an increase in credit risk which is not the approach for the comparable guidance in IFRS 9. Our preference is align the language with IFRS 9.
A32	As the lowering of a credit rating does not necessarily equate to a significant increase in credit risk we question whether an alternative example may better illustrate the point.
A35	The paragraph refers to "the relevant group or subgroup" that needs to be transferred to LEL whereas paragraph A36 refers to the "proportion of the group". We are unsure of the relationship between these paragraphs. We question whether the proposed guidance are trying to align with the 'bottom up' and 'top down' approaches in IFRS 9:IE38 & 39.
A40	We agree that banks should be alert to the possibility of biases that would be inconsistent with the objective of IFRS 9. Yet the 30-day past due criterion cited as an example of bias is surprising given that it may be an acceptable approach in IFRS 9. We also note that correction of bias is not only the correction of under-providing, but given the principle of neutrality, so is the correction of over-providing. The examples used in this paragraph

	give the impression that the Committee is only focussed on the former.
A41	Irrespective of whether an entity assesses a significant increase in credit risk on a collective or individual basis, under IFRS 9, the measurement outcome will be the same. Consequently we are concerned that paragraph A41 states that in the Committee's view, the use of a practical expedient introduces bias by delaying the recognition of LEL and that a collective assessment could be used to "correct for identified bias". We believe that the Committee may be referring to the fact that an individual assessment may fail to recognise changes in credit risk until exposures are past due, as noted in IFRS 9:B5.5.3, and therefore a collective assessment more faithfully represents the change in credit risk. If this is the case this point could be better explained by using language in IFRS 9:B5.5.3.
A45	The paragraph notes that a borrower would have to demonstrate consistently good payment behaviour for a loan to move from LEL to 12m ECL. It may be beneficial to also include examples relating to wholesale lending where other factors may be indicative of a transfer from LEL to 12m ECL, such as recapitalisation or changes in the seniority of debt.
A50	We disagree with the proposed guidance that the low credit simplification is a practical expedient. The IASB decided to allow rather than require this simplification (IFRS 9:BC5.183) "to reduce the operational costs and make the model more cost effective" noting that such an approach should be available so it more aligned with a bank's internal credit risk systems (IFRS 9:BC5.180). Given the IASB's stated reason for introducing the simplification we do not consider the use of such an approach should be rare nor should it be associated with a low-quality implementation.
A50, A52	Paragraph A50 appears to allow the "low credit" exemption in IFRS 9 but only "in rare and appropriate circumstances". Yet paragraph A52 appears to change the threshold of the exemption compared to IFRS 9 by permitting its use only in circumstances when the credit risk is "so low that a significant increase in credit risk since initial recognition could not have occurred." We note this would appear to limit the use of the exemption not only to rare and appropriate circumstances but also to cases where in absolute terms credit risk is 'so low'. We would favour an approach that permits the use of the practical expedient in IFRS 9 as opposed to a variant thereof, particularly if that variant provides limited operational relief.