INTERNATIONAL ASSOCIATION OF CREDIT PORTFOLIO MANAGERS

360 MADISON AVENUE
17TH FLOOR
NEW YORK, NY 10017
tel (646) 289-5430
fax (646) 289-5429
ADMIN@IACPM.ORG

April 30, 2015

Dear Sirs,

Guidance on Accounting for Expected Credit Losses -Consultative Document (February 2015) (the Consultative Document)

The International Association of Credit Portfolio Managers (the **IACPM**) is pleased to have the opportunity to comment on the Consultative Document "Guidance on accounting for expected credit losses".[1] We support the Basel Committee's work on providing guidance around lending standards and recognize the Committee has a role in supporting oversight. While we agree on various principles presented in the Consultative Document, we have offered views and comments on a few select principles in this paper.

The IACPM's institutional member firms comprise the world's largest financial institutions, and as such overlap the membership of several other financial industry associations. Our perspective is different, however, in that the IACPM represents the teams within those institutions who have responsibility for managing credit loan portfolios. IACPM members are the group responsible for managing the bank's loan portfolio, including actively controlling concentrations, adding diversification and managing the return of the portfolio relative to the risk, and managing counterparty risk related to derivatives exposure. We are portfolio and credit risk practitioners, not accountants and our comments come from that perspective.

Specifically, we wish to address the topics of Use of Forward-looking Information, Guidance for Credit Risk Management versus Accounting, 12-month Expected Credit Loss, Significant Increases in Credit Risk, Use of Practical Expedient/Proportionality Issue, the Interaction between new Provision Approaches and Capital Treatment, Disclosure, Definition of Default and US GAAP.

1. Use of Forward-looking Information

The Consultative Document primarily addresses this topic in Principle 6, but there are significant paragraphs in Principles 2 & 3, and the term "forward-looking information" is mentioned throughout the document. This is appropriate, as the use of forward-looking information is an important concept in expected credit loss accounting rules.

Our concern, though, is that the Consultative Document seems to suggest a standard for the inclusion of forward-looking information that differs significantly from the IFRS9 standard of "reasonable and supportable information that is available without undue cost or effort" [Section 5.5.9] While the Consultative Document does use the modifier "reasonably available" in several instances when referring to forward-looking information, it does not use the terms "supportable and without undue cost or effort". Also, there are notable instances where the modifier is dropped and more expansive language is added. Examples include:

- Paragraph 30 of the Consultative Document states that banks are expected to "consider the full spectrum of information that is relevant… when developing estimates of ECL". The term "full spectrum" seems to imply an information standard well beyond "reasonable and supportable". (Paragraph 53 also uses the term "full spectrum").
- Paragraph 37 states that a credit rating system "incorporates *all relevant* [emphasis added] information, including forward-looking information and macroeconomic factors… to track changes in credit risk, regardless of the significance of the change and consequent changes in credit risk ratings". Similarly, paragraph 59 states that a bank must use credit judgment to "thoroughly incorporate the expected impact of *all* [emphasis added] reasonably available forward-looking information and macroeconomic factors in its estimates of ECL". Also, there are similar statements found in paragraph A6. We note there is a lack of "supportable" and "undue cost or effort" criteria in these references.

[1] The IACPM is an industry association established in 2001 to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. Membership of the IACPM is open to all financial institutions that manage portfolios of corporate loans, bonds or similar credit-sensitive financial instruments. The IACPM represents its members before regulatory and administrative bodies around the world, holds conferences and regional meetings, conducts research on the credit portfolio management field, and works with other organizations on issues of mutual interest relating to the measurement and management of portfolio risk. Currently there are 102 financial institutions worldwide that are members of the IACPM. These institutions are based in 19 counties and include many of the world's largest commercial wholesale banks, investment banks and insurance companies, as well as a number of asset managers. More information about the IACPM may be found on our website: www.iapcm.org.

- Paragraph 60 states that use of forward-looking information "should not be avoided on the basis that a bank considers them to be excessive or unnecessary". This seems to directly contradict the "undue cost or effort" criteria of IFRS9.

Through the language above, and in other instances, the Consultative Document seems to imply that banks must incorporate into ECL everything they know about the future, regardless of supportability, materiality, or cost to obtain.

The lack of the "supportable" criteria in the Consultative Document is an important omission, and one that we believe should be inserted. There are many instances where loss forecasts based on forward-looking information can be highly speculative. As an example of supportable forecasting, the recent drop in oil prices is an event that has relatively predictable first-order impacts on credit quality (on companies that produce oil, and companies that use oil as a primary input, for example). However, second- and third-order effects are much less predictable, and can be highly speculative and not easily supportable, even though they may be real and relevant. Other events have inherently unpredictable implications. For example, it was very difficult to understand what the loss implications were immediately following the events of September 11, 2001. While losses could be forecast based on available information, they would not necessarily be supportable, and some could be quite speculative.

The nature of some events, in a forward looking view, could increase uncertainty about the future and loss levels (and hence might cause a bank to consider a greater variance in forecast loss levels), but may not increase the mean level, which is what ECL is meant to represent. We believe that supportability is an important criterion for including forward-looking information.

Likewise, the lack of materiality as a criterion, as noted in paragraph 37 and especially paragraph 60, seems to imply that banks need to incorporate any known forward-looking information in forecasting credit losses, regardless of significance or cost. There can certainly be known information that does not materially impact credit losses in a particular portfolio, and devoting resources without regard for materiality would seem to be an unwise allocation of budget that would not enhance the effectiveness of ECL estimation. Bank resources are not unlimited, and we believe they should be applied proportionately to the places where they will be most effective (for example, to the largest portfolios, or to the riskiest portfolios).

2. Guidance for Credit Risk Management versus Accounting

Although the Consultative Document is titled "Guidance on accounting for expected credit losses", much of the document discusses general credit risk management policies and practices (especially Principles 2 and 3). While this may not be an inherent problem for this as a standalone document, it could create confusion and a lack of clarity in the context of the whole of the Basel regulations, portions of which address the same issues[2].

The Basel regulations already address standards around sound credit risk management practices, and restating them in these accounting guidelines, with slightly different wording, creates the potential for confusion, and reduces the clarity of existing rules already finalized and in use. If it is necessary to refer to these issues, it would be clearer to do so through explicit reference. However, we believe these guidelines would be clearer and more effective if discussions on general issues of credit risk management are removed, and the focus is on accounting.

3. 12-month Expected Credit Loss

In reference to assets measured at 12-month ECL, paragraph A7 states that "a bank must be able to demonstrate that these exposures have not experienced a significant increase in credit risk since initial recognition". This statement is confusing, in that it seems to create a rebuttable presumption that exposures *have* deteriorated, and that banks must show that they have not in order to keep them in the 12-month ECL bucket. This would seem to contradict the IFRS9 process, where reasonable and supportable information is used to move assets from the 12-month ECL bucket to the LEL bucket. The Consultative Document would be clearer if this statement were removed.

4. Significant Increases in Credit Risk

The Consultative Document indicates that credit pricing should be an important factor when assessing whether or not a significant increase in credit risk has occurred (Paragraph A15 and Paragraph A27(a)). In fact Footnote 33 goes even further and states that banks should "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". We are concerned that this approach can over-emphasize the amount of credit risk information in credit spreads at certain times, and could create a conservative loan loss reserve.

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[2] Basel Committee on Banking Supervision, International Convergence of Capital Measurement and Capital Standards: A Revised Framework – Comprehensive Version (June 2006), p. 19-119 (http://www.bis.org/publ/bcbs128.pdf).

It is well accepted within finance theory that there are many components of a credit spread. Credit risk is certainly one, but there is also the market price of risk (or risk premium), considerations of liquidity, and overall considerations of supply and demand for some types of assets over others. Recently, for instance, leveraged loan markets in several countries have transacted at surprisingly tight spreads. Should we assume that credit risk for these assets is low and declining? Actions of US regulators, through their leveraged lending guidelines, would seem to indicate that they do not believe this is the case. Many market observers believe that central bank actions and the overall search for yield (which affect the market risk premium and supply/demand issues) are driving current pricing. In this situation, we believe, and probably most regulators would agree, that the reduction in leveraged loan spreads is not driven by a concomitant reduction in credit risk.

There is a further problem in the Consultative Document proposals to use credit pricing in implementing ECL accounting: they only focus on *increases* in pricing, and ignore decreases. This would be a conservative bias, and if adopted would tend to overstate reserves, rather than taking a neutral approach that neither understates nor overstates, as accounting policies should. A neutral approach would incorporate decreases in spreads as well, which would imply that current leveraged loan portfolios should see a reduction in loan loss reserves. This would seem imprudent in the current environment, and many regulators would likely object.

We propose that the better solution would be to exclude credit pricing as a required factor in determining significant increases in credit risk. Of course, credit pricing can often be an important signal in understanding changes in credit risk, and banks should take that into account in their analyses, but it should be far from a rebuttable presumption (which would have to be symmetrical to avoid conservatism).

5. Use of Practical Expedient/Proportionality Issue

It is not the intention of banks to use practical expedients to mask significant credit deterioration that could be material. Practical expedients may be used for portfolios that are currently immaterial (alone and in aggregate) and where no other relevant information is available.

This Consultative Document presents a view that significant reliance on 30 days past due information (including but not limited to the 30 day past due rebuttable assumption) is considered a low quality implementation of an expected credit loss model. We acknowledge that for some portfolios this statement is true, but this is not true across all portfolios. There are portfolios where days past due (for example 5, 10, 30 or 60 days) has been demonstrated by reference to historical data as an effective credit risk measure. For these businesses, using days past due is currently an accepted standard practice. It would be notably the case for some retail portfolios (e.g. consumer finance activities or small lease portfolios where the bank does not have any current account for the customer and no customer relationship). For significant and material portfolios, the 30 days past due practical expedient will not be used as the sole driver. It is important to remember that the main drivers we have regarding credit deterioration are practical and useable. A "proportionate" response to dealing with small portfolios is desirable, and the size of a portfolio or business relative to the whole institution should be a consideration in deciding whether a practical expedient is desirable or acceptable. Practical expedients could be relevant because their use would be consistent with the way in which the portfolios are regarded and managed.

6. Interaction between New Provision Approaches and Capital Treatment

We are concerned that the interaction between the ECL accounting approach and existing regulatory capital rules creates a problem as the provisions on bucket 2 and 3 assets are to be calculated on a lifetime basis whereas the IRB framework is calibrated to one year. A consequence of this is that CET1 will be reduced by the provisions but the "provision miss" will be added back to tier 2 capital.

We believe this is a significant issue as these rules have not been significantly revised since the introduction of Basel 3 which split capital into going concern and gone concern capital. We believe that credit provisions provide loss absorbency to the bank on a going concern basis and hence the add back to tier 2 is not an appropriate treatment. While this issue exists in the existing rule set, the change in provisioning standards exacerbates the problem. Consequently we believe that the Basel Committee needs to consider changes to the regulatory capital framework as well as providing guidance on the accounting.

Potential changes to the regulatory framework might include either:

1) Introduction of a prudential filter on the accounting to adjust provisioning to a one year time horizon; or
2) (More simply) Allowing excess provisions to be added back to Tier 1 (going concern) capital rather than Tier 2 (gone concern) capital.

7. Disclosure

Disclosure is not a credit risk practice and therefore Principle 8 should not be included as part of the guidance. The current disclosure standard**,** IFRS7 Financial Instruments: Disclosure (IFRS7), already adequately prescribes financial statement disclosure requirements

and to overlay a different set of rules would only confuse and complicate disclosure. Disclosure should be looked at holistically for all risks related to financial instruments. Additional requirements from the Basel Committee do not improve the process as there is already a strong process in place with the IFRS7. It is important to note that the disclosure requirements added to IFRS7 as a result of IFRS9 took into account the needs of investors as well as preparers to provide a full comprehensive viewpoint.

8. Definition of Default

We agree with the Basel guidance that the prudential definition of default would be appropriate for accounting purposes (i.e. criteria for 90 days past due and "unlikeliness to pay"). However, paragraph A5 could be interpreted as providing another definition of the "unlikeliness to pay" indication, extending situations of transfer of loans when the default has not yet occurred. To avoid such confusion we would suggest deleting paragraph A5.

9. US GAAP

When the FASB finalizes it standard for ECL accounting practices, under US GAAP, we request that an appendix for FASB rules, similar to the one included in the Consultative Document for IFRS be circulated for comment.

The IACPM appreciates your attention to our thoughts and concerns, and we hope you find our discussion useful. We would welcome the opportunity to discuss these issues with the Basel Committee, or provide additional thoughts on any of the above recommendations.

Sincerely,

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Som-lok Leung
Executive Director
International Association of Credit Portfolio Managers