Tel: +44 20 7893 3300
Fax: +44 20 7487 3686
@: abuchanan@bdoifra.com
www.bdointernational.com

BDO IFR Advisory Limited
Contact:
55 Baker Street
London W1U 7EU
United Kingdom

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

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Dear Sir

Consultative Document - Guidance on accounting for expected credit losses

We are pleased to comment on the above Consultative Document (the CD) that has been issued by the Basel Committee on Banking Supervision (BCBS). Following consultation within the BDO network[1], this letter summarises views of member firms that provided comments on the CD.

We welcome and support the initiative taken by the BCBS to develop guidance for supervisory requirements associated with the new Expected Credit Loss (ECL) model. The new approach introduced by the IFRS 9 ECL model brings significant challenges for banks in both its implementation and ongoing application. We believe that the high quality implementation of accounting standards is in the common interest of banking supervisors, auditors and accounting standard setters.

The guidance set out in the CD will be read and used not only by those involved in prudential and regulatory reporting, but also those involved in the preparation and audit of financial reports for the capital markets. Our comments therefore focus on points where the existing drafting might risk causing confusion, or be unclear from a financial reporting and/or regulatory reporting perspective. We anticipate that the CD will be used extensively by both supervisors and banks for many years to come and it is important that the drafting of the CD is as clear and unambiguous as possible.

In general, we agree with the 11 principles that are set out in the CD, and support the likely effect of strengthening banks' internal control environments in order to support a high quality implementation of the ECL model. However, we believe that it would be appropriate to clarify some of the drafting of the principles, and the Appendix which sets out supervisory requirements specific to jurisdictions applying IFRS, and have some concerns about the implications of certain of the statements that are made. In particular, we believe that if for some aspects it is considered that the required approach for regulatory purposes is different from IFRS 9, this must be made clear. There should also be explicit confirmation of those aspects where IFRS 9 sets out an appropriate approach.

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Alignment with IFRS 9

In certain areas, the CD is drafted in a way which is similar to, but not quite the same as, the text in IFRS 9. It is not clear whether it is intended that the approach to be followed under the BCBS guidance would be different from an accounting approach. It would be helpful if, to the extent possible, the wording is drafted in the same way as in IFRS 9 except where it is intended that there should be a difference, with this then being made clear with the associated rationale. Alternatively, if the existing wording is retained but no difference from IFRS 9 is intended, this should be stated explicitly.

Materiality

The CD does not explicitly discuss the notion of materiality and, in some places (such as paragraph A6) refers to using 'all reasonably available information'. It would be appropriate for reference to be made to materiality, because reasonably available information might include information about smaller and immaterial portfolios.

Practical expedients and proportionality

The Appendix, which sets out supervisory requirements specific to jurisdictions applying IFRS, refers to practical expedients that are included in IFRS 9, with it being suggested that if they are used by larger banks this would be a poor (or very poor) quality application of the ECL model. We do not agree that this is necessarily the case, and believe that it should instead be made clear that the practical expedients should only be used where appropriate. For example, a large bank might have a number of relatively small subsidiaries in less developed and emerging markets where detailed information might not be available; the same might apply to certain loan portfolios. In such cases, the use of practical expedients might be justified. We do, however, acknowledge that banks might need to revisit their internal systems and processes during the period up to the adoption of the ECL model.

We suggest that the guidance in the CD might explore further the circumstances in which it might be appropriate to use the practical expedients, including consideration of materiality, undue cost and ultimately the risk of significant loss.

Linked to the question of the practical expedients, it would also be appropriate for proportionality to be acknowledged more clearly. As well as larger banks having part(s) of their group which may be based in relatively less sophisticated jurisdictions, a smaller financial institution will typically (and appropriately) not have the same level of sophistication as a large global bank.

Reviews of segmentation of portfolios

In a number of paragraphs, the CD makes reference to the need for the composition of portfolios to be revisited and amended, to take account of changes in credit risk and ECL. However, it is not clear how often a bank would be expected to revisit its portfolios for accounting purposes. If it is intended that there should be frequent resegmentation, it is also not clear how it would be possible for the related accounting and regulatory provisioning to

be reconciled because the segmentation for regulatory purposes is generally not revised frequently.

Our detailed comments are set out in the attached Appendix.

We hope that you will find our comments and observations helpful. If you would like to discuss any of them, please contact me at +44 (0)20 7893 3300 or by email at abuchanan@bdoifra.com.

Yours faithfully

Andrew Buchanan

Global Head of IFRS

Appendix

Principle 1

A bank's board of directors (or equivalent) and senior management are responsible for ensuring that the bank has appropriate credit risk practices, including effective internal controls, commensurate with the size, nature and complexity of its lending exposures to consistently determine allowances in accordance with the bank's stated policies and procedures, the applicable accounting framework and relevant supervisory guidance.

We agree, and note the appropriate distinction that is made in paragraph 19(b) between allowances that are determined in accordance with the applicable accounting framework, and allowances that are determined in accordance with relevant supervisory guidance.

However, we note that elsewhere in the CD, such as in paragraph 15 (Objective and scope section), the text might be taken to imply that the BCBS believes that there is symmetry between accounting and supervisory requirements, and we do not believe that this is necessarily the case. As noted in paragraph 30 of the CD, scenarios developed for regulatory purposes are not always directly applicable for accounting purposes.

Principle 2

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

Paragraph 21 notes that banks should:

> '...maximise the extent to which underlying information and assumptions are used consistently...'

It is not clear whether this is intended to mean the consistent use of information throughout a group, or consistently to similar entities and/or portfolios within a group. We believe that the latter would be appropriate; a large multinational bank will typically have operations that vary significantly in size and complexity among jurisdictions and, because the extent to which information is reasonably available may differ, it may be impracticable (and inappropriate) for the approach followed at a major subsidiary in a well developed country to be applied to a much smaller entity in an emerging market economy.

Paragraph 23 refers to the need to use 'all relevant information affecting the assessment and measurement of ECL'. It is not clear whether this is intended to be different from, and more onerous to apply, that the guidance in IFRS 9 which refers in paragraph 5.5.9 to the consideration of:

> '...reasonable and supportable information, **that is available without undue cost or effort**, that is indicative of significant increases in credit risk since initial recognition.' [emphasis added]

Paragraph 31 notes that bank management should be able to:

> '...demonstrate...that the price at which lending exposures are granted appropriately reflects inherent risks.'

There may not always be such a precise link between risk and pricing. In some cases, provided a potential borrower passes the necessary tests, a loan will be granted which will be at the same interest rate regardless of whether the borrower only just passed the tests, or passed them by a substantial margin. A bank might also take a commercial decision to make loans available at a price that is more attractive that those charged by competitors for borrowers with a particular credit score, in an attempt to increase market share.

In the case, for example, of credit cards a bank may be able to charge interest rates that are in excess of the rate that would reflect the credit risk to which it is exposed, simply because that is market practice in that jurisdiction. Again, all credit card holders are charged the same rate, regardless of their comparative credit ratings. Incentives are also offered to borrowers to transfer balances to a new provider at very low (or 'honeymoon') interest rates that again do not reflect pricing that is based solely on credit risk.

Towards the end of paragraph 32(a), it is noted that:

> 'Subsequent to a restructuring or modification, a bank may expect full repayment of any outstanding principal and/or interest; however, delays in the expected timing of those cash flows may still evidence that credit quality has not improved , and thus the level of ECL should not decrease.'

We do not agree that this will necessarily be the case. Although the PD may not have decreased, it is quite possible (if not likely) that the LGD will be lower (particularly for a collateralised loan), meaning that it may be appropriate for the level of ECL to be reduced.

In Principle 2 and in a number of the paragraphs that follow, reference is made to 'robust' in the context of the measurement of allowances and the methodology for assessing credit risk. It is not clear whether this is intended to imply something other than the neutral approach that is required by IFRS 9, and it would be helpful for this to be clarified.

Paragraph 24(k) refers to the maintenance of 'sufficient historical loss data over at least a full credit cycle'. It is not clear whether this is intended to imply a 'through the cycle' approach which may not be in accordance with accounting requirements.

Principle 3

A bank should have a process in place to appropriately group lending exposures on the basis of shared credit risk characteristics.

Paragraph 42 notes that:

> 'Credit risk rating should be reviewed whenever new information is received or a bank's expectation of credit risk has changed. Credit risk ratings assigned should receive a periodic formal review (eg at least annually or more frequently if required in a jurisdiction) to reasonably ensure that those ratings are accurate and up to date.'

For some types of product which are managed on a portfolio basis (such as residential mortgages), it is possible that the reassessment periods for individual loans could be longer because in some cases loans are only reassessed in the event that the borrower is in obvious difficulties.

We suggest that the reference to the potential for reviews to be required more frequently than annually is expanded to refer to '...in a jurisdiction or portfolio)...'.

Paragraphs 44 and 46 refer to the need for resegmentation of portfolios, and imply that this might need to be carried out frequently. It would be helpful for an indication to be given of how frequently the composition of portfolios should be reviewed, and of the triggers that might prompt such a review (for example, a deterioration in economic conditions in a particular geographic area which might arise from macroeconomic factors, such as significant changes in commodity prices, or factors specific to the borrowers). There are also questions around the extent to which the segmentation of portfolios for accounting purposes, and for regulatory purposes, should be aligned and, if not wholly aligned, the extent to which it should be possible to reconcile that segmentation. If, for accounting purposes, frequent resegmentation is intended (which would be likely to be rather different from the frequency of resegmentation for regulatory purposes), a reconciliation between accounting and regulatory portfolios could become very challenging to produce. In that context, we note that in some jurisdictions regulatory approval is required for resegmentation.

Paragraph 47 notes that:

> 'Where it is assessed that the level of credit risk has increased on a group basis......the entire group should migrate to a higher credit risk rating, indicative of lower credit quality.'

The drafting might be taken to imply that 'group' means the overall accounting group as a whole. We assume that this is not the case, and that the intention is to refer to a particular portfolio of exposures. It would be helpful for this to be clarified.

Principle 4

A bank's aggregate amount of allowances, regardless of 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.

In a number of the paragraphs, reference is made to 'robust' in the context of the methodology for assessing credit risk and the assessment of allowances. It is not clear whether this is intended to imply something other than the neutral approach that is required by IFRS 9, and it would be helpful for this to be clarified.

In this context, we note that paragraph 54 appropriately refers to the need to estimate cash flows that a bank expects to receive without bias and within the context of the required neutrality of accounting information.

Principle 5

A bank should have policies and procedures in place to appropriately validate its internal credit risk assessment models.

Footnote 22 refers to the need for an external auditor that both audits a bank's financial statements and carries out a review of the model validation process to ensure that the performance of the non-audit service does not impair its independence. This does appears to be relevant to a bank's own approach (typically via its audit committee) to its policies and procedures for non-audit work carried out by the external auditor. The footnote might be deleted.

Principle 6

A bank's use of experienced credit judgement, especially in the robust consideration of forward-looking information that is reasonably available and macroeconomic factors, is essential to the assessment and measurement of expected credit losses.

It is not entirely clear what is intended by paragraph 61. We note that the drafting of this paragraph is somewhat different from paragraph A29 in the section that considers supervisory requirements specific to jurisdictions applying IFRS.

Paragraph 63 notes that, in estimating ECL:

> '...banks may determine either a single amount or a range of possible amounts.'

We note that this does not appear to be consistent with the requirements of IFRS 9.B5.5.41, which requires at least two possible amounts to be determined.

Principle 7

A bank should have a sound credit risk assessment and measurement process that provides it with a strong basis for common systems, tools and data to assess and price credit risk and account for expected credit losses.

Paragraph 68 notes that:

> 'Credit risk practices should not be static and should be reviewed periodically to ensure that relevant data available throughout a banking organisation are captured and that systems are updated as the bank's underwriting or business practices change or evolve over time.'

While this will be a dynamic process, it is not clear how often it is intended that those practices should be reviewed, nor whether there are any events that would normally be expected to result in a review.

Principle 8

A bank's public reporting should promote transparency and comparability by providing timely, relevant and decision-useful information.

The final sentence of paragraph 77 refers to changes in the way in which lending exposures are grouped. Linked to our comments in respect of paragraphs 44 and 46 above (Principle 3), it is not clear whether, and the extent to which, the resegmentation of portfolios for

accounting purposes is intended to be capable of being reconciled to portfolios for regulatory purposes, nor the frequency with which the composition of portfolios for accounting purposes should be reassessed.

Principle 9

Banking supervisors should periodically evaluate the effectiveness of a bank's credit risk practices

Principle 10

Banking supervisors should be satisfied that the methods employed by a bank to determine allowances for accounting purposes produce a robust measurement of expected losses under the applicable accounting framework.

Principle 11

Banking supervisors should consider a bank's credit risk practices when assessing a bank's capital adequacy.

In addition to the guidance set out in the CD, we believe that it would be appropriate to promote communications among a bank, its regulator and the external auditors.

Principle 10 refers to a 'robust' measurement. Again, it is not clear whether this is intended to support the neutral approach required by accounting standards, or an approach intended to record provisions towards the higher end of a range of possible amounts.

Appendix - Supervisory requirements specific to jurisdictions applying IFRS

Paragraph A1

It is noted that:

> '...the Committee expects that...a nil allowance will be rare...'

It is not clear why this would be the case. For example, a significantly over collateralised loan might have a PD of greater than zero but, taking the collateral into account, the LGD might be nil.

Paragraph A2

In this paragraph (and elsewhere) the term 'robust' is used. It is not clear what is intended by the use of 'robust' and whether this is intended to imply 'prudent' in a regulatory or an accounting context.

Paragraph A3

While we do not object to emphasis being given to the points noted in respect of 12 month ECL, it is not clear why particular emphasis is being given to those specific points given that they are included in IFRS 9.

Paragraph A6

It is noted that:

> 'In formulating the estimate of the amount equal to 12-month ECL, it is important to consider all reasonable available information that affects credit risk...'

and that:

> 'The Committee expects that a bank will consider all information that is reasonably available without bias...'

It is not clear whether this is intended to be applied in the context of materiality, such that information would not need to be obtained about immaterial or insignificant portfolios. It wold be helpful for this to be clarified.

A with paragraph 23 (Principle 2), it is not clear whether the reference to 'all information that is reasonably available' is intended to give rise to a different approach from the guidance in IFRS 9 which refers in paragraph 5.5.9 to the consideration of:

> '...reasonable and supportable information, **that is available without undue cost or effort...**' [emphasis added]

Paragraph A7

The final sentence notes that:

> 'In addition, a bank must be able to demonstrate that these exposures have not experienced a significant increase in credit risk since initial recognition.'

This is the opposite from the requirement of IFRS 9, which is to identify whether there has been a significant increase in credit risk since initial recognition. It is not clear whether a different approach from IFRS 9 is intended.

Paragraph A12

It is not clear how often a bank would be expected to revisit its segmentation, the triggers that would result in resegmentation, or the extent to which accounting segments should be capable of being reconciled to regulatory segments. (Also please see our comments above).

Paragraph A13

This paragraph might be interpreted to mean that any offset of exposures would be prohibited. However, because this would effectively preclude any collective provisioning approach (because even within a group of similar exposures there will be an element of offset), we assume that this is not the intention. We suggest that it is emphasised that exposures with similar credit quality should be grouped together.

Paragraph A15

It is not always the case that the ECL anticipated on initial recognition is priced with precison into the interest rate charged. In some cases, provided a potential borrower passes the necessary tests, a loan will be granted which will be at the same interest rate regardless of whether the borrower only just passed the tests, or passed them by a substantial margin. In other cases, a bank might decide to grant loans at relatively low interest rates that do not necessarily reflect ECL in full, in order to gain market share. This comment also links to footnote 33; the pricing of loans is not always quite as sophisticated as this footnote implies.

Paragraphs A23 and A28

The discussion of macroeconomic factors in these paragraphs appears to focus on their potential negative effects. However, some macroeconomic factors (for example, a 50% reduction in the price of oil) will have a negative effect on some entities, and a positive effect on others. It would be helpful to clarify that both negative and positive effects of macroeconomic developments are to be taken into account.

Paragraph A29

As noted in our comments above, the drafting of this paragraph does not appear to be entirely consistent with paragraph 61 (Principle 6).

Paragraph A40, and section 3 - Use of practical expedients

The CD appears to take the view that it will generally be inappropriate for a bank to use the practical expedients in IFRS 9, and that (for example, in paragraphs A50 and A59) their use would give rise to a (very) low quality implementation of the ECL model in IFRS 9. We do not agree. Instead, we consider that the focus of the guidance should be on ensuring that the use of the practical expedients is restricted to circumstances in which their use is appropriate.

For example, a large multinational bank might have operations in large and well developed economies, as well as in smaller emerging markets. Depending on the circumstances, it might be inappropriate for the practical expedients to be used by entities in the large and well developed economies, but entirely appropriate for them to be used by entities in the smaller emerging markets, with this reflecting the data sets and quality of information that is available to them. We suggest that a clear link is made to the requirement in IFRS 9 that:

> 'an entity shall consider the best reasonable and supportable information that is available, without undue cost or effort.'

In this context, it would be appropriate for the guidance explicitly to take into account proportionality, in order that smaller components of large banks, and relatively smaller banks, are able to comply with the guidance while at the same time following an approach which takes into account the information that is available to them and is in compliance with the requirements of IFRS 9 (including the appropriate use of practical expedients).