Strong banks - strong Australia

Level 3, 56 Pitt Street Sydney NSW 2000 Australia +61 2 8298 0417 @ austbankers bankers.asn.au

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Secretariat
Basel Committee on Banking Supervision
Bank of International Settlements
CH-4002 Basel
SWITZERLAND

Dear Sir/Madam

Consultative document: Regulatory treatment of accounting provisions - interim approach and transitional arrangements, and Discussion paper: Regulatory treatment of accounting provisions

The Australian Bankers' Association (**ABA**) appreciates the opportunity to provide the Basel Committee on Banking Supervision (**BCBS**) with comments on the two documents 1) Consultative document: Regulatory treatment of accounting provisions – interim approach and transitional arrangements (**Consultative document**), and 2) Discussion paper: Regulatory treatment of accounting provisions (**Discussion paper**).

With the active participation of its members, the ABA provides analysis, advice and advocacy for the banking industry and contributes to the development of public policy on banking and other financial services. The ABA works with government, regulators and other stakeholders to improve public awareness and understanding of the industry's contribution to the economy and to ensure Australia's banking customers continue to benefit from a stable, competitive and accessible banking industry.

The ABA is supportive of recent changes to accounting standards requiring the use of expected credit loss models to recognise credit losses in a timely manner, thereby further strengthening the banking system by promoting robust credit risk management practices.

Consultative document – Regulatory treatment of accounting provisions – interim approach and transitional arrangements

Proposal to retain the current regulatory treatment of provisions

The Discussion paper requests comments on the regulatory treatment of provisions generally, which would be implemented over a long period. However, the Consultative document separately requests comments on whether the current regulatory treatment of provisions should be continued for a transitional period, despite the introduction of International Financial Reporting Standard (**IFRS**) 9 from the first reporting period commencing 1 January 2018 (and pending the introduction of any new regulatory treatment resulting from the Discussion paper).

The BCBS is proposing to conduct a quantitative impact study (QIS) to:

 Estimate the impacts of the accounting changes on regulatory capital requirements before concluding what regulatory changes are needed to respond to the introduction of the accounting standards; and



2) Collect evidence on the implications and potential impact of the various transitional arrangements proposed and consider whether any transitional arrangement is necessary and what form of transitional arrangement might be appropriate.

The ABA strongly supports the conduct of a QIS because various Basel III reforms and enhancements have demonstrated the importance of QIS results in assisting the BCBS to properly calibrate reform proposals. The ABA remains concerned about the number and inter-relationship between various reforms, and their cumulative impact. The ABA believes that this can only be properly tested through a comprehensive QIS. In this regard, the ABA urges the BCBS to coordinate a QIS in relation to IFRS 9 together with a QIS in relation to the Basel III enhancements to determine the cumulative impact.

The ABA notes that the European Banking Authority (**EBA**) launched an impact assessment of IFRS 9 on approximately 50 European financial institutions in January 2016, with the assessment finalised in November 2016. A second impact assessment was launched in November 2016.

IFRS 9 requires banks to complete a large multi-disciplinary project combining the skills of finance, risk and information technology professionals. This requires strong governance and internal controls to give all stakeholders confidence in the resulting financial information. For many banks, the adoption of IFRS 9 is the most momentous accounting change they have experienced, even more significant than their transition to IFRS itself.

IFRS 9 standards were finalised in 2014 and since then Australian banks have been actively implementing what is a complex change, requiring new credit impairment models and changes to processes and systems. Australian banks are currently in the model development stage of their IFRS 9 implementation projects and reliable estimates of accounting and capital outcomes are not expected to be available until the latter half of calendar year 2017. As a result, the ABA urges the BCBS to delay a QIS until such time that Australian banks are in a position to meaningfully contribute to a QIS, ideally the final quarter of 2017.

Consequently, the ABA supports continuing the current regulatory treatment of provisions until at least the time that any revised regulatory proposals have been calibrated through a comprehensive QIS.

Transitional arrangements

The ABA supports the implementation of transitional arrangements for the impact of accounting changes on regulatory capital requirements.

In our response to the Discussion paper, the ABA sets out the reasons why we believe the correct long-term regulatory response to the change in accounting standards is likely to be a symmetrical adjustment to both the capital ratio numerator and denominator, based on the conceptual framework the BCBS employed in the original design of the capital framework. However, if the BCBS does not accept our arguments for a conceptually symmetrical outcome then the impact may be significant for various banks, particularly the banks which utilise the Standardised Approach (SA). In addition to the Basel III reforms and enhancements, the amount of capital which may be required may be significant and need capital raisings or other capital actions. To ensure an orderly transition without putting stress on the banking system and capital markets, a reasonable transition period is necessary. In proposing transitional relief, the ABA recognises that banks will likely continue to face market pressure to adjust quickly to whatever long-term regulatory outcome is decided.

The transitional arrangements for IFRS 9 should be considered holistically with the long term changes to the regulatory treatment of provisions. Any existing transition arrangements in place to amortise the initial impact of accounting changes on regulatory capital requirements would potentially place undue complexity in implementing further transitional arrangements, and may require the unwinding of shorter-term arrangements. Therefore, the ABA believes the initial impact of accounting changes on regulatory capital requirements should be quarantined until after longer-term changes to the regulatory treatment of provisions, as contemplated in the Discussion paper, and with regard to the ABA's response to that paper, are finalised.



Should the BCBS not support the ABA's recommendation to quarantine the initial impact of accounting changes on regulatory capital requirements, the ABA would support the transitional arrangement proposed in the Consultative document, Section 3.3 *Approach 1: Day 1 impact on CET1 capital spread over a specified number of years*, as this approach would reduce the immediate impact on regulatory capital and is a simpler approach when compared to the other two examples of approaches noted in the Consultative document. Further, the ABA would argue against applying a materiality threshold to Approach 1, because any impact arising from changes to accounting standards cannot be quantified at this time and defining what a 'modest' change in Common Equity Tier 1 (**CET1**) capital is will be difficult to achieve across jurisdictions.

The ABA notes that the European Commission released proposals on 23 November 2016 for a fiveyear transition to recognise the impact of IFRS 9 on banks' regulatory capital. The proposals are being submitted to the European Parliament and to the Council of the European Union for their consideration and adoption.

The ABA urges the BCBS to consider transition arrangements of the same length of time, to ensure that there is an orderly implementation of capital requirements and comparability between banks. For example, if the European banks were subject to a longer transition period than the Australian banks, this would disadvantage the Australian banks in relation to their headline capital ratios when competing for capital and debt in international capital markets. The BCBS has proposed transition arrangements of three years – this would ordinarily be reasonable if not for the European Commission proposals.

Discussion paper – Regulatory treatment of accounting provisions

Regulatory issues arising from the transition to ECL

The timely recognition of, and provision for, credit losses serves to promote safe and sound banking systems and plays an important role in bank regulation and supervision. The Basel III regulatory framework published in December 2010 sought to promote stronger provisioning practices through three related initiatives¹:

- 1) Strong support for an Expected Loss (EL) approach to loan loss provisioning
- 2) Updated supervisory guidance to assist supervisors in promoting strong provisioning practices under the desired EL approach
- 3) Creating incentives for stronger provisioning in the regulatory capital framework

The BCBS stated that its goal in supporting an EL approach was to "improve the usefulness and relevance of financial reporting for stakeholders ...", but also made clear that it supported "... an EL approach that captures actual losses more transparently and [which] is also less procyclical than the current "incurred loss" approach." The impending transition to Expected Credit Loss (**ECL**) accounting for loan losses will be an important milestone in securing the BCBS's objectives.

The Discussion paper focuses on the SA and requests feedback on three defined options for how the regulatory treatment should respond to the transition to ECL accounting for loan loss and poses an open ended question on whether there is an alternative approach the BCBS should consider. The ABA considers that the proposed option to introduce Regulatory EL (REL) into the SA has merit and would probably render the other two options redundant if it were pursued. However, in considering this option, the ABA has encountered a series of issues and ambiguities related to the conceptual framework underpinning the capital framework, which needs clarification to ensure the final regulatory treatment of ECL in both the SA and IRB frameworks is consistent and coherent. The ABA also assumes that the introduction of REL into the SA would not by itself result in a net increase in capital requirements.

BCBS, (December 2010), Basel III: A global regulatory framework for more resilient banks and banking systems, Paragraphs 23-25, p 6, http://www.bis.org/publ/bcbs189.htm, (rev. June 2011)



The ABA recognises that risk weights in both the SA and IRB frameworks are being reviewed as part of the final calibration of Basel III but the potential for increased CET1 deduction associated with the introduction of a standardised REL should be incorporated into the final outcome rather than being simply additive to capital requirements.

The issues and ambiguities referred to above are set out in greater detail below and have raised the following questions, which the ABA would ask the BCBS to clarify:

- What is the nature of the credit cycle that REL is calibrated to, that is, what level of severity, duration and frequency of credit downturn is intended to be covered by the REL allowance?
- 2) How are input floors employed in regulatory capital measures intended to be reconciled with the unbiased expectation of loss prescribed by the accounting standards?
- 3) What are the ways in which capital requirements for losses beyond the "next 12 month" time horizon are measured (explicitly and implicitly) under the Internal Ratings Based (IRB) and Standardised approaches to credit risk?
- 4) In what way does the transition to ECL accounting make the capital adequacy regime as a whole less procyclical than the current incurred loss approach?

The ABA's response to the specific options proposed by the BCBS should be read in the context of these open conceptual questions. The ABA believes that further engagement between the industry and the BCBS is necessary to fully resolve these issues.

Conceptual issues associated with the regulatory treatment of accounting provisions

Key elements of the conceptual foundation underpinning the current regulatory treatment of provisions

In developing our response to managing the transition to ECL and to the specific questions posed by the Discussion paper, the ABA used the IRB Explanatory Note published by the BCBS in July 2005² as a reference point. The core elements of the conceptual framework employed in this note include:

- The distinction between Expected Loss (EL) and Unexpected Loss (UL)
- EL covered in principle by loan loss provisions and credit margins while UL is covered by capital
- The level of capital calibrated to be sufficient that the risk of insolvency is very small (i.e. the 99.9% Confidence Level represents a 0.1% probability that UL will exceed the value of required capital)
- 12-month time horizon used to calibrate the potential losses incorporated in EL and UL

Basel II recognised that there would be variations in provisioning practice and this was the basis for requiring banks to deduct from capital any shortfall between provisions and a regulatory defined measure of EL³. The BCBS also recognised that the risk of loss would be higher for exposures longer than 12 months. The IRB formula contains an explicit maturity adjustment for sovereign, bank and corporate credit exposures longer than 12 months, while the correlation assumption for retail, implicitly captures the risk of longer-term exposures.

² BCBS, (July 2005), An explanatory note on the Basel II IRB risk weight functions, http://www.bis.org/bcbs/irbriskweight.htm

In this discussion we will use the term EL to refer generically to the concept of Expected Loss, ECL to refer to the accounting for EL (both IFRS9 and CECL) and REL to refer to Regulatory Expected Loss



The expected relationship between EL and UL

The conceptual framework described above draws a simple and, most importantly, static line between EL and UL. What is not addressed, or at the very least is unclear, is how this relationship is expected to evolve over the credit cycle. This ambiguity has the potential for provisions to overlap capital requirements and must be resolved before it is possible to determine a coherent and logical regulatory capital response to the transition to ECL accounting.

The first step in resolving this ambiguity is to agree exactly what expectations are embedded in REL. Greater clarity on this element of the capital framework would in turn create a foundation for more clearly describing ex ante how ECL loan provisions are expected to evolve relative to REL over the credit cycle.

The IRB Explanatory Note refers to EL being "... the average level credit losses [a bank] can reasonably expect to experience". There are two challenges in translating this general principle into a practical and consistent measure of REL. The first is to reconcile the impact of prudential input floors with the average unbiased expectation prescribed by the accounting standards. The second challenge is to be clear about the nature of the credit cycle the expectations are calibrated to and, in particular, to recognise that general references to "the cycle" leave open the potential for very different interpretations of exactly what is expected.

In practice, for any given time horizon, any regulatory measure will tend to be more conservative⁴ than the average unbiased forecast a bank would make under an ECL framework. These choices appear to be based on an understandable mixture of prudential conservatism combined with a desire to mitigate the procyclicality of the IRB-based capital requirement. They do imply, however, that it would be reasonable to expect IFRS 9 provisions to be less than REL during the benign part of the credit cycle and equal to, or higher, during the downturn phase (as more exposures migrate from one year to lifetime expected loss). A different relationship would be expected for Current Expected Credit Losses (CECL) based loan loss provisions, given the requirement to apply lifetime expected loss to all credit exposures, but the underlying cyclical pattern would persist.

This leads to the question of exactly what kind of cycle REL is calibrated to. If we seek to define what is "expected" over "the cycle", it is apparent that there are many outcomes that could fit within that loosely expressed term. The framework does specify that expectations should be based on a long-term perspective, but there is a variety of cycles depending on the frequency, duration and severity of the downturn one expects. In some cases the economic or business cycle might be characterised by moderate severity, with short duration downturns occurring once every 7 to 10 years. It might be argued however, that the system should be calibrated to expect and be resilient against the less frequent but more severe, and longer duration downturn expected once every 25 years or more. Claudio Borio has used the term "financial cycle⁵" to distinguish the latter, but the conceptual framework documents published by the BCBS to date do not clearly spell out what its intention or expectation was or is.

Two points of design principle flow from the issues discussed above:

- The regulatory capital impact of the transition to ECL accounting should be sensitive to where a bank or banking system lies in the credit cycle at the time of transition.
- The regulatory impact should adjust for differences between IFRS9 and Current Expected Credit Losses (CECL)⁶ in order to ensure there is a level playing field between banks operating under the different accounting regimes.

In particular, the general requirement to use TTC average PDs and downturn LGDs coupled with input floors for specific asset classes

⁵ BIS Working Papers No 395, (December 2012), *The financial cycle and macroeconomics: What have we learnt?* Claudio Borio, Monetary and Economic Department, http://www.bis.org/publ/work395.pdf

US Financial Accounting Standards Board (FASB), (16 June 2016), Accounting Standards Update 2016-13, Financial Instruments - Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments, http://www.fasb.org/cs/ContentServer?pagename=FASB%2FFASBContent_C%2FNewsPage&cid=1176168232900



Differences in time horizon

The 12-month time horizon convention adopted by the IRB approach for expressing Probability of Default (**PD**) and Loss Given Default (**LGD**) introduces another area of ambiguity in the comparison of loan loss provisions with regulatory capital requirements.

One of the distinguishing features of the two approaches to ECL is the incorporation, to varying degrees, of life time losses. At face value this suggests that any increase in loan loss provisions attributable to the difference between 12-month and expected lifetime loss is capturing a new dimension of credit risk, and hence should give rise to an increased CET1 deduction. The forward looking nature of IFRS 9 results in incurred but not reported (**IBNR**) losses being recognised earlier than RWA via IFRS 9 Stage 2 (lifetime loss). Notwithstanding the nominal 12-month time horizon used to measure PD and LGD, the IRB capital requirement is in fact calibrated to capture the higher risk of loss where exposures have an expected tenor longer than 12 months⁷. REL is more clearly a 12-month measure, but even here the specified input floors and general prudential emphasis on conservatism will tend to result in a measure that is often higher than what an unbiased point in time measure of EL would generate.

This indicates that the increase in loan loss provisions associated with lifetime losses is measuring something either already captured to some degree in the REL deduction, or an unexpected loss that was incorporated into the UL capital requirement when the loan was originated. There are two options for dealing with this potential double count, one would be to add the excess provision back to capital while the other would be to reduce risk-weighted assets (**RWA**) in the same way as the capital deducted for REL is currently netted off.

Procyclicality

The BCBS has been quite explicit in its recognition of the inherent procyclicality of a risk sensitive capital framework⁸, and its desire to mitigate this where possible. Basel II sought to address this concern through a combination of measures, including the requirement to use long-term data horizons to estimate PD, "downturn" LGD estimates, the calibration of the IRB formula via stress testing that considers the downward migration of credit portfolios in a recession. Building on these measures, Basel III introduced a base Capital Conservation Buffer (**CCB**) for all banks that could be increased if desired via the addition of a Countercyclical Capital Conservation Buffer (**CCyB**) to lean against excessive credit growth.

The discussion above has highlighted the way in which EL will increase, and decrease, depending on the state of the credit cycle. It is true that the transition to ECL will result in more provisions sooner than would be the case under an incurred loss approach. Bringing provisions forward in the credit cycle will not however, make the outcome less procyclical. It is also important to recognise that the procyclicality of the IRB capital framework ultimately depends on how the CET1 deduction for any shortfall between ECL and REL evolves over the credit cycle. As it is currently defined and calibrated, REL will tend to move in sync with ECL due to rating grade migration. Through the cycle PDs and the input floors introduced by the BCBS, may have been intended to make REL less sensitive to the credit cycle, but stress testing analysis indicates that the CET1 shortfall deduction does not operate in a countercyclical manner as would be expected if this were the case. This is an issue that would benefit from more research but one of the obvious drivers of cyclicality not addressed by the existing measures is risk grade migration. The ABA believes the answer lies not in further blunting of the risk sensitivity of the IRB approach, but rather in the transparent calibration of REL to an appropriately severe level of downturn in the credit cycle.

The "M" factor in the IRB formula is an explicit adjustment for the fact that, all other things being equal, losses on longer tenor credit exposures will be higher than for short term loans. The 2005 explanatory note (s4.6) makes clear that these "... maturity adjustments can be interpreted as anticipations of additional capital requirements due to downgrades". There is no explicit maturity adjustment for retail exposures but the explanatory note (s5.3) again makes clear that "... asset correlations implicitly contain maturity effects" and "... also explain the relatively high mortgage correlations...". The use of more conservative PD and LGD than might be empirically justified for the next 12 months will also have the effect of extending the time horizon of the REL beyond 12 months

BCBS, (December 2010), Basel III: A global regulatory framework for more resilient banks and banking systems, Paragraph 20, p 5, http://www.bis.org/publ/bcbs189.htm (rev. June 2011)

In contrast to the current operation of the IRB framework, it seems likely that a standardised REL as proposed in the Discussion paper would be much less impacted by changes in the credit cycle. This poses challenges for how this standardised REL would be calibrated relative to its IRB counterpart. This in turn would appear to have implications both for how the impact of the transition to ECL would be dealt with, and for the calibration of the output capital floor that the BCBS consulted on earlier in 2016.

Regulatory treatment of "excess" provisions

The current regulatory approach gives limited Tier 2 capital credit for any excess provisions. Under the IRB approach, the extent of the excess is determined by reference to REL. Under the SA Tier 2 recognition is assigned to "general provisions".

The Tier 2 capital recognition currently assigned to "general provisions" under the SA appears to be a carry-over from Basel I which was extended to the IRB framework in the form of limited recognition of "excess" provisions relative to REL. This Tier 2 recognition (either for general or excess provisions) is however, hard to reconcile with the framework as it has evolved under Basel III in which CET1 is the primary form of going concern capital (including CET1 capital conservation buffers) and Tier 2 is much more clearly seen as gone concern capital whose primary value lies in its potential contribution to the resolution of a distressed bank⁹.

The original conceptual logic behind the Tier 2 treatment seems to be that the provisions (whether general or excess) are lesser quality capital and Tier 2 was how that lesser quality was recognised. However, the continued relevance of this Tier 2 treatment is open to debate in a capital framework that has evolved to incorporate CET1 capital conservation buffers whose function seems to overlap more directly with the same kinds of risk that the general or excess provisions are seeking to cover.

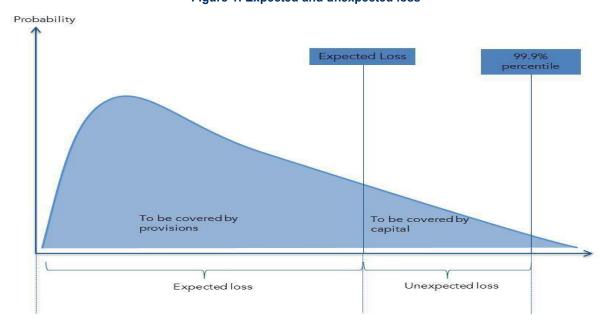


Figure 1: Expected and unexpected loss

Mapping this discussion to Figure 1 above.

• The recognition of Tier 2 capital as lower quality, gone concern capital would logically see it covering losses in the right hand side, tail risk, part of the loss distribution¹⁰.

⁹ Appendix 1 illustrates this point graphically

In practice this would tend to be confined to situations in which the bank had either failed or a Point of Non Viability event had resulted in losses being imposed on these capital instruments either by the write down of their principal value or via conversion to common equity



- However, the losses that general or excess provisions absorb in practice would more logically be situated in the middle of the loss distribution, around the intersection between EL and UL, rather than in the tail of the loss distribution.
- Under this conceptual framework, it would appear more logical that the loss absorption of provisions be seen to overlap with the roles played by the IRB REL and by the CCBs that both IRB and SA banks are required to maintain.
- A similar argument can be made for the treatment of forward looking expected loss
 provisions in SA banks, but the tension between the objectives of accounting and
 regulatory approaches to capital is more difficult to resolve in the absence of a REL which
 effectively imposes a certain minimum level of loan loss provisioning.
- REL is typically shown as a single line on the loss distribution, but the procyclicality of the
 current measurement means that REL will move within a range depending on the state of
 the cycle (closer to the LHS under the more frequent benign years and moving to the
 RHS as the credit cycle deteriorates).

Policy options for the longer-term regulatory treatment of provisions

The Discussion paper proposes three regulatory responses to the transition to ECL loan provisioning:

- 1) Retain the current regulatory treatment of provisions, including the distinction between general provisions (**GP**) and specific provisions (**SP**), as a permanent approach.
- 2) Introduce a universally applicable and binding definition of GP and SP.
- 3) Fundamentally change the current regulatory treatment of provisions remove the GP/SP distinction and introduce REL under SA.

Drawing a meaningful distinction between GP and SP has always been difficult, and the ABA believes it would not be feasible to introduce a definition that would result in consistent and comparable outcomes. The more promising line of policy development is to introduce a REL under the SA. This seems most likely to result in a regulatory capital outcome that is resilient in the face of differences in the two forms of ECL accounting being introduced, and also able to absorb differences in practice across jurisdictions and individual banks. However, the conceptual questions and ambiguities that currently exist under the IRB approach must be addressed if this policy option is to be effective. It is also important that the introduction of REL be offset by appropriate compensating adjustments to SA risk-weights.

Section 3 of the Discussion paper poses a series of questions in which the BCBS seeks feedback on issues associated with how the proposed alternatives achieve the objectives of the regulatory framework. Appendix 2 sets out the ABA's response to these questions.

We thank you for taking our comments into consideration. The ABA believes that further engagement between the industry and the BCBS is necessary to fully resolve these issues and looks forward to further contributing to that dialogue.

Yours faithfully Signed.

Aidan O'Shaughnessy Policy Director - Industry Policy 02 8298 0408 aidan.oshaughnessy@bankers.asn.au



Appendix 1: The EL/UL distinction under Basel III

Probability

Expected Loss

99.9%
percentile

To be covered by capital

Expected loss

Unexpected loss

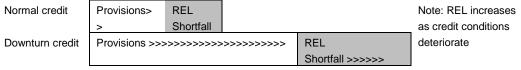
Figure 1: Expected and unexpected loss

Figure 2: Expanded conceptual framework incorporating Regulatory Expected Loss

Mapping the EL/UL distinction to a Basel III capital structure								
Pre Provision	Provisions	Provisions – Downturn				CET1	AT1	T2
Earnings	"Normal"		CET1	CCB				
			2.5%	Plus		4.5%	6 %	8 %
But IDP Bank conital is not just imported by the loyal of provisions. Any shortfall between provisions and								

But IRB Bank capital is not just impacted by the level of provisions. Any shortfall between provisions and Regulatory Expected Loss (REL) creates a CET1 deduction that will impact the buffer over CET1 requirements. This CET1 deduction can be procyclical because REL can increase by more than the increase in provisions under adverse credit conditions.

IRB – Provisions and Regulatory Expected Loss Shortfall – Basel III (Procyclical)



SA - Provisions and Regulatory Expected Loss (Proposal)

Normal credit	Provisions>	REL Shortfall	Note: REL is effectively calibrated to a defined percentile
	>		of the loss distribution and does not change as credit
Downturn credit	Provisions >>>	>>>>	conditions deteriorate



The conceptual framework developed to support Basel II draws a simple two-dimensional distinction between EL and UL, EL being identified with provisions while UL corresponds to capital. The table in Figure 1 maps this very simple conceptual distinction to the capital structure banks are required to maintain under Basel III. This illustrates that:

- The level of provisions under either of the new accounting requirements does not align neatly with the concept of an EL employed in regulatory capital measures.
- EL in practice is covered by a combination of pre-provision earnings, provisions, the REL shortfall deduction (for IRB banks) and the CCB.
- The relative contributions of each of these elements varies with the state of the credit cycle.
- The REL capital requirement for SA banks proposed in the Discussion paper would be cycle neutral and, in contrast to the operation of its IRB equivalent, the CET1 deduction for any shortfall in provisions would appear to operate in a countercyclical fashion.



Appendix 2: Discussion paper - Section 3: Request for feedback

Request for feedback	ABA response			
3.1 General and specific provisions - historically the BCBS has drawn a distinction between GP and SP				
Should the BCBS retain the distinction between GP and SP as a means to address inconsistencies in	Drawing a meaningful distinction between GP and SP has always been difficult and the ABA does not believe it would be feasible to introduce a definition that would result in consistent and comparable outcomes.			
the provisioning practices across jurisdictions and banks?	It would be simpler and more effective to employ a variation on the IRB approach which adopts a consistent regulatory definition of EL against which aggregate provisions were compared. Inconsistencies in the provisioning practices across jurisdictions and banks would be mitigated provided there is a consistent regulatory capital treatment of shortfalls and excess relative to the regulatory benchmark of EL.			
3.2 Regulatory expected loss - BCB	S is considering introducing a REL concept into the SA			
The need for an explicit REL charge in the SA.	The ABA believes that introducing a REL under the SA has merit and should be considered. This seems most likely to result in a regulatory capital outcome that is resilient in the face of differences in the two forms of ECL accounting being introduced, and is also able to absorb differences in practice across jurisdictions and individual banks. However, the conceptual questions and ambiguities that currently exist under the IRB approach must be addressed if this policy option is to be effective. It is also important that the introduction of REL be offset by adjustments to SA risk-weights such that the impact is capital neutral.			
Should EL be global by product type?	There are likely to be differences in EL across different jurisdictions (housing in particular), but arguing for different EL implies that there should be different risk-weights for a product in different jurisdictions. The desire for simplicity will weigh against pursuing this path.			
Should REL be highly granular?	The starting position is that REL should be as granular as the standardised risk-weights. Any greater granularity should be on an exception basis consistent with the desire to balance simplicity, complexity and risk sensitivity.			
Should REL be subject to ongoing review and adjustment?	Ideally REL should not require ongoing review and adjustment once the conceptual ambiguities have been addressed and a cycle neutral level of severity in its calibration has been agreed.			
3.2 IRB approach - current regulatory treatment of accounting provisions under IRB				
Are there alternatives the BCBS should consider under IRB?	At a minimum, the BCBS should clarify the conceptual questions posed in this response letter. The ABA believes this will highlight the extent to which the cyclicality of the IRB capital framework retains a potentially destabilising capacity to be procyclical. The ABA believes there is potential to enhance the resilience of the IRB framework by incorporating additional countercyclical elements. These might be pursued either via the measurement of RWA or via the definition of available capital.			



Request for feedback	ABA response		
3.3. Treatment of general and excess provisions			
GP can be included in Tier 2 (up to a	GP can be included in Tier 2 (up to a limit) under the SA		
Excess provision over REL can also be included in Tier 2 under the IRB approach (up to a limit)			
Should general and excess provisions continue to be included in Tier 2 as an incentive to make adequate provisions?	The ABA believes the correct regulatory treatment of excess provisions should be an extension of the current IRB treatment of REL in which RWA is reduced to recognise the increased level of provisions relative to REL. The rationale for this extended reduction in RWA is the same as that which currently sees IRB RWA reduced by an amount equivalent to the value of REL.		
	Recognition of excess provisions as capital is an alternative to reducing RWA, but the recognition should be CET1 not Tier 2 capital if adjusting the capital numerator is the solution adopted.		
	Tier 2 recognition for excess provisions has no logical foundation in the capital framework and plays no role as an incentive for making adequate provisions. At best it mitigates the double counting under the current arrangements, but offers no incentive as such for adequate provisioning.		
Is Tier 2 inclusion becoming less important given the increasing focus on CET1?	It is not so much that Tier 2 inclusion is less important with the increased focus on CET1, but rather that there is no logical foundation for Tier 2 treatment of provisions. The correct treatment, consistent with the conceptual foundation underpinning the original formulation of the IRB approach, would be to reduce RWA to recognise the increased level of provisioning. If RWA offset continues to be limited to the level of REL embedded in the current IRB formula then CET1 neutralisation is the logical regulatory treatment for any "excess" provisions.		
Does inclusion in Tier 2 for losses already expected weaken regulatory capital, because the provisioned amount may not be available to absorb other losses that may subsequently arise?	Tier 2 credit for provisions associated with expected losses potentially creates the appearance of weakening regulatory capital, but this is only because it is not clear that the capital recognition assigned to these provisions is offset by the fact that the capital adequacy framework does not reduce RWA as it logically should. If RWA were reduced in the same way that they are for REL under the IRB approach, then capital credit (whether Tier 2 or CET1) would not be required.		
Should general or excess provisions be recognised in other parts of the regulatory capital framework, in particular under Pillar 2?	No, the treatment consistent with the conceptual foundation of the framework is that excess provisions should be balanced by a corresponding reduction in RWA. Failing that, excess provisions should be treated as CET1 capital.		
How should the general or excess provision be recognised under Pillar 2?			
Implications for the inclusion of general and excess provisions in Tier 2 for the purposes of calculating TLAC.	The graphical representation of the loan loss distribution in Appendix 1 illustrates that general and excess provisions sit to the immediate right hand side of REL, whereas Tier 2 capital would logically be associated with the extreme right hand side of the loss distribution. The ABA's view is that the CET1 deduction for excess provisions that would result under the current framework should be balanced by a corresponding (scaled up) reduction in RWA. In the absence of an appropriate adjustment to RWA, the CET1 deductions should be neutralised.		



Request for feedback	ABA response		
3.4 Level playing field - potential for meaningful differences in provisions and capital across jurisdictions			
How best the BCBS should seek to level the impact of accounting differences.	A consistent measure of REL against which aggregate loan loss provisions are compared is the most simple and effective way to level the impact of accounting differences.		
Which approaches could level the playing field?	Calibrating the existing IRB measure of REL to an agreed level of prudence or severity that represented an expected state of the credit cycle deemed consistent with prudential prudence would offer a benchmark against which individual levels of loan loss provisioning could be compared. Ideally, this REL benchmark would be cycle invariant in the sense that it anticipated a degree of adverse rating grade migration that could be expected to manifest in the kind of credit downturn the benchmark was calibrated to. Calibrated in this way, the CET1 deduction associated with any shortfall in loan loss provisions would operate in a countercyclical fashion that would reduce the risk that the cyclical capital requirements produced adverse procyclical feedback impacts on the real economy.		
	A standardised REL developed along similar principles would extend these benefits into the SA and help maintain a level playing field between the IRB and SA.		
	Introducing a REL benchmark as described above is sufficient to achieve the BCBS's level playing field objective. The other specific proposals are not necessary (i.e. setting common minimum provisioning requirements, enhanced add-backs to Tier 2 or clarification of distinction between SP and GP are neither necessary nor desirable).		
3.5 Complexity and simplification			
The BCBS is interested in views on whether and how to simplify either the current regulatory treatment of provisions or an approach that would use REL minima.	The ABA has developed some preliminary views on this topic, but given its complexity, it will take more time to properly formulate a view representative of its membership as a whole. The ABA will continue to work on a response and would be happy to engage in further dialogue with the BCBS on this issue.		
	The ABA's ability to respond is however constrained by open conceptual issues and ambiguities identified in this response. Any feedback the BCBS can offer on these issues would be of great assistance in developing our response to the question posed here.		
3.6 Burden - efforts to simplify the tre require upfront changes	eatment of provisions could lead to a lower regulatory burden over time but may		
Would it be preferable to limit the number of changes to the regulatory treatment of provisions to reduce the immediate burden, or to introduce modifications to the treatment to achieve a less burdensome longer-term outcome?	It would be preferable to make the changes necessary to achieve the longer- term benefits of a simpler, more transparent and logical treatment of loan loss provisions.		