Federation of European Accountants

European Banking Authority
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Brussels, 24 October 2016

Subject: Consultation Paper on Guidelines on credit risk management practices and accounting for expected credit losses

Dear Sir or Madam,

The Federation of European Accountants[1] (the Federation) is pleased to provide you with its comments on the European Banking Authority (EBA) consultation re the guidelines on credit risk management practices and accounting for expected credit losses.

Following the publication of Guidance by the Basel Committee (BCBS) in December 2015 on the same matter, the Federation welcomes the initiative undertaken by the EBA to ensure sound credit risk management practices in the EU associated with the implementation and on-going application of the accounting for expected credit losses.

The Federation believes that one of the biggest challenges when applying IFRS is the proper implementation of financial reporting standards, especially those standards which introduce significant changes in the existing financial reporting requirements. IFRS 9's ECL introduces a new model for impairment for financial instruments. Especially, banks and other financial institutions will face specific implementation challenges as they are exposed to a wide range of different financial assets.

Overall, the Federation has expressed its support to the BCBS principles. Any alignment at EU level should stay as close as possible to the international requirements to ensure consistent interpretations of IFRS 9 and achieve a high-quality ECL model across different jurisdictions. **The Federation has the clear expectation that the EBA has not and does not intend to have the authority to establish requirements for financial statements.**

[1] The Federation of European Accountants represents 50 professional institutes of accountants and auditors from 37 European countries, with a combined membership of almost 1 million professional accountants working in different capacities. As the voice of the European profession, the Federation recognises the public interest.

The Federation would like to ask for clarifications when it comes to correlations between the prudential and accounting approaches and particularly when it comes to the following EBA reference: "[…] the well-established regulatory capital models for the measurement of expected losses may be used as a starting point for estimating ECL for accounting purposes" (§11, 75). We understand that the expected losses can be used as a starting point for calculating ECL. Nevertheless, it should indeed only work as the beginning of further guidance. **Prudential and accounting approaches cannot be similar and it should be noted that there are important differences to be further explained.** Additionally, in the future, banks may have to develop and maintain their accounting model on a "stand-alone basis" – especially as the BCBS has been recently moving to more standardised approaches. Therefore, we are not certain about the recommendation that institutions should be using common processes, systems, data etc. to measure ECL for accounting purposes and determine EL for capital adequacy purposes.

Moreover, it remains unclear what will be the prudential treatment of the expected losses impairment accounted for under IFRS 9.

Furthermore, the Federation is concerned that the scope of application of the proposed guidelines is **wider than the scope of the BCBS guidelines**. Most importantly, on the use of practical expedients the BCBS guidelines indicate that "the committee expects internationally active banks to limit their use of simplifications and/or practical expedients included in the relevant accounting standards" whereas the proposed guidelines would apply to all banks in Europe applying IFRS 9. We have also noted the same issues at a number of other instances such as in the consideration of forward looking scenarios (§23), loss allowance at an amount equal to 12-month ECL (§ 4.3.1-89), the probation period for forbearance (§ 4.2.2-41) as well as for a number of public disclosures (§4.2.8-81,83) (See replies to questions 1,3 and 6).

Finally, we would also like to express our **concerns regarding the proposed proportionality approach**. In particular, guidelines remain unclear on i) whether the proportionality approach can be applied to portfolios ii) how to apply proportionality by smaller institutions (see reply to question 3).

You may find below our replies to the consultation's questions. For any further question on this letter you may contact Eleni Kanelli, Manager at the Federation at eleni.kanelli@fee.be or via phone at: 0032-(0) 2 893 33 78.

Kind regards,

On behalf of the Federation of European Accountants,

Petr Kriz
President

Olivier Boutellis-Taft
Chief Executive

Overview of questions for consultation

1. "Is the scope of application of the guidelines appropriate and sufficiently clear?"
As stated above and at questions 3 and 6, the Federation is concerned that the scope of application of the proposed guidelines is wider than the scope of the BCBS guidelines.

2. "Is the date of application of the guidelines of 1 January 2018 appropriate?"
Considering that this is in line with the implementation date of IFRS 9, and no additional requirements are established by the EBA, the Federation considers the date as appropriate.

3. "Please provide any comments you may have on the appropriateness of the proposed proportionality approach."
The Federation expresses its concerns on the proposed proportionality approach. There is not enough clarity provided in the guidelines. In particular:

- *There is a need for further indications on how this can be applied by smaller institutions.*

- *There is a need for clarification on whether/how this can be applied to non-complex portfolios or credit activities both for bigger or smaller institutions.*

Also, the guidelines go beyond the requirements of IFRS 9 by adding restrictions on the use of practical expedients (§ 129 "[…] taking into account the proportionality principle set out in these guidelines, credit institutions which are both smaller and less complex may reasonably reply more on the use of practical expedients while meeting the objectives of these guidelines") for the "low credit risk exemption" and the "more than 30 days past due rebuttable presumption" and the "undue cost and effort" exception (§ 129 and following paragraphs). The BCBS Guidance applies to internationally active banks only. When extending to other banks (i.e. not internationally active banks) in the EU applying IFRS 9, this limitation seems to go beyond both IFRS requirements and BCBS guidelines without a clear purpose. However, we agree that ECL estimation that would be regarded as approximations to "ideal" measures (§19) should be designed and implemented to avoid bias.

4. "Do you agree with the draft guidelines which introduce the relevant BCBS Guidance in the EU regulatory framework? Are there additional issues for which the EBA Guidelines should be amended in the context of finalising the guidelines?"
Overall, the Federation has expressed it support to the BCBS principles. Any finalization of regulatory requirements at EU level should stay as close as possible to the existing framework and achieve a high-quality ECL model across different jurisdictions.

5. "Do you agree with the impact assessment and its conclusions, having regard to the baseline scenario used for this impact assessment? Please provide any additional information regarding the costs and benefits from the application of these guidelines."
A cost benefit analysis could be beneficial in order to ensure capturing possible divergences at EU level. Nevertheless, in order for the EU to remain competitive at global level, any interpretation should not deviate to a great extent from the international trends. In addition, it should be kept in mind that any intervention from regulators, market oversight bodies or any other bodies should not take the role of the standard setter or of the IFRS Interpretation Committee.

6. “Please provide any additional comments on the draft guidelines.”

6a) The Federation welcomes the role that the external auditor plays in supervision proceedings[2]. Regarding the following reference in the guidelines (Principle 2 – ECL measurement assessment, paragraph 143[3]), the Federation would like to reiterate the importance of the fundamental principle of confidentiality of the auditor which is included in the auditors' professional ethical standards. Any information obtained by the auditor in the course of an audit of financial statements cannot be disclosed to other parties (including supervisors), unless it is permitted or required by law.

6b) *The guidelines do not clearly indicate if their scope is limited to loans (as in the BCBS guidelines) or if it covers all financial instruments (as in IFRS 9). In particular, at § 7 (Scope of application) references are limited to “lending exposures” while it is not clear whether all financial instruments with impairments are also included. As least for debt securities, we do not see any reason for being excluded as per accounting at cost.*

6c) *In several instances (in addition to the restriction of the use of practical expedients- see above) the guidelines seem to go beyond the IFRS 9 requirements. In particular:*

- *In § 4.1.3-23, the guidelines seem to require that the credit institution should “clearly document”, with “robust justification” when some information has been excluded from the forward looking approach because an event has a low likelihood of occurring. We would rather request that the credit institution should sufficiently document the scenarios that have been retained in the forward looking approach.*

- *In § 4.3.1-89, the guidelines indicate that in order to define default, the credit institution should be guided by the definition used for regulatory purposes, whereas IFRS 9 requires default to be defined in a manner consistent with that used for internal credit risk management. We believe that the guidelines should not be more prescriptive than IFRS 9, even if the credit institution might choose to align its accounting definition to the regulatory one.*

- *In § 4.2.2-41, the probation period for forbearance should not be more prescriptive than IFRS 9 requirements, whereas the guidelines indicate to consider the specific regulatory definitions (minimum 2 years' probation).*

- *Finally, a number of public disclosures (§4.2.8-81,83) go beyond IFRS 9 requirements. Indicatively, we have included the following references: “the manner in which senior management's experienced credit judgement has been incorporated” or “how the senior management satisfies itself that lending exposures are appropriately grouped”.*

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[2] Provided there is a legal procedure foreseen.

[3] *“Competent authorities <u>may make use of the work performed by internal and external auditors</u> in reviewing a credit institution's credit risk assessment and ECL measurement functions”*