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Chairman

PDC N° 21

Paris, February 3rd, 2017

Mr Stefan Ingves
Chairman
Basel Committee on Banking Supervision
Centralbahnplatz 2
4051 Basel
Switzerland

Re: Discussion paper of the Basel Committee on Banking Supervision "Regulatory treatment of accounting provisions" (documents d385)

Dear Mr Ingves,

I am writing on behalf of the Autorité des Normes Comptables (ANC) to express our views on the above-mentioned discussion paper (DP) issued in October 2016 by the Basel Committee on Banking Supervision (BCBS) on "Regulatory treatment of accounting provisions". This letter sets out the most critical comments raised by interested stakeholders involved in ANC's due process. Our Board has reviewed and approved this letter on February 3rd, 2017.

The DP (documents d385) proposes views on the long-term regulatory treatment of accounting provisions, after the transitional period starting, for IFRS applicants, with the implementation of IFRS 9 on January 1st 2018.

Preliminary comments on regulatory provisions from ANC's specific point of view

ANC expresses its view as French accounting standard setter and therefore does not directly address the banking regulation in itself. Nevertheless, ANC is concerned that regulatory treatments as regards the application of the new IFRS 9 impairment model may raise the following accounting risks and issues:

- Consistency between accounting and regulatory estimates is desirable. However, situation may arise where an accounting change in value is not symmetrically taken into account in the regulatory environment.

- From a conceptual standpoint, the new impairment model of IFRS 9 converges towards regulatory expectations, with an expected loss (EL) approach. However, ANC notes that the transition to IFRS 9 will not be neutral on capital requirement (see document BCBS d386: "interim approach and transitional arrangements"). Such situation is a concern as regards financial communication at year end.
- Level playing field issues among IFRS applicants or between IFRS and US-GAAP applicants.

Comments on the discussion paper

<u>Asymmetry of some regulatory treatments</u>

Management's estimates are key in applying the new EL impairment model under IFRS 9 (especially for the assessment of the "forward looking approach") and might have a significant effect on the banking sector's financial statements.

ANC has noticed situations where a change in accounting provisions is not treated symmetrically under the regulatory framework.

Asymmetries may result from regulatory limits (caps or floors, see appendix) regarding the extent (often expressed as a percentage of the risk weighted assets, RWA) or the nature (CET 1 vs. Tier 2) of capital requirements, depending on:
- The direction (negative or positive) of the gap between accounting and regulatory EL;
- The approach applied in assessing the regulatory framework : standard approach (SA) or Internal Ratings-Based (IRB);
- The regulatory classification of an accounting provision as general (GP) or specific (SP).

While we recognise that asymmetrical treatments result from the current regulation, we feel important to note that, considering the level of loan loss reserves that is expected under IFRS 9, such accounting reserves might more often exceed the regulatory requirements, which is seldom the case under the current accounting rules.

Some asymmetrical regulatory treatments are depicted in the two following examples:

Example 1:

In the IRB approach:

(a) An excess of regulatory EL compared with accounting EL impacts negatively the CET1
(b) An excess of accounting EL compared with the regulatory EL impacts positively the Tier 2

	On December 31st ,2017		case (a) Regulatory EL > accounting EL		case (b) Accounting EL > regulatory EL
1	Equity		1 000		997
2	Regulatory EL- IRBA		11		11
3	Accounting EL - IRBA		8		12
4	CET1	1-2+3	997	1	997
	Tier 2			3-2	1
5	Risk Weigthed Asset		10 000		10 000
	Ratio CET1	4/5	**9,97%**	4/5	**9,97%**

On transition, the change in the impairment model from incurred to EL leads to an increase in the (accounting) allowance by 2

	On January 1st ,2018		case (a) Regulatory EL > accounting EL		case (b) Accounting EL > regulatory EL
1	Equity (-2)		1000-2		997-2
2	Regulatory EL- IRBA		11		11
3	Accounting EL - IRBA (+2)		8+2		12+2
4	CET1	1-2+3	997	1	995
	Tier 2			3-2	3
5	Risk Weigthed Asset		10 000		10 000
	Ratio CET1	4/5	**9,97%**	4/5	**9,95%**

In case (a), the transition to IFRS 9 could be neutral.

In case (b), the transition leads to a negative impact on CET 1 and a simultaneous a positive impact on Tier 2, i.e. a global negative impact since CET 1 is more critical than Tier 2.

As a consequence:

On transition, applying the IRB approach to situations where accounting EL exceeds regulatory EL will be detrimental to the capital requirements (all else being equal).

Example 2:

This example could illustrate the transition to IFRS 9, related to allowances on exposures for which no significant increase in credit risk occurs since origination ((B1) exposures). Assuming allowances dedicated to B1 are treated as Specific Provisions (SP) in the regulatory framework:

(a) Regulatory treatment applying the IRB approach: as in the previous example, the transition is neutral (with regard to CET 1 as well as to Tier 2).
(c) Regulatory treatment applying the standard approach (SA): the new allowance on B1 has a negative impact on CET 1. The increase in allowances only negatively impacts the exposure (net of accounting provision), limiting the gain in capital requirement, based on the change in allowance.

	On December 31st ,2017		case (a) IRBA		case (c) SA
1	Equity		1 000		997
2	Regulatory EL		11		
3	Accounting EL		8		x
4	CET1	1-2+3	997	1	997
	Tier 2				
5	Risk Weigthed Asset		10 000		10 000
	Ratio CET1	4/5	**9,97%**	4/5	**9,97%**

On transition, the change in the impairment model from incurred to EL leads to an increase in the (accounting) allowance by 2

	On January 1st ,2018		case (a) IRBA		case (c) SA
1	Equity (-2)		1000-2		997-2
2	Regulatory EL		11		
3	Accounting EL		8+2		x + 2
4	CET1	1-2+3	997	1	995
	Tier 2				
5	Risk Weigthed Asset		10 000		10 000-2
	Ratio CET1	4/5	**9,97%**	4/5	**9,95%**

As a consequence:
On transition, the case (c) applies the standard approach (SA), which is detrimental to the capital requirements, whereas applying the IRB would have been neutral (all else being equal).

<u>Financial communication: the impact assessment of the impairment model of IFRS 9 on capital requirement</u>

The impact assessment of IFRS 9 will constitute one of the key elements of financial communication for the banking sector, which includes the effects on capital requirement. The financial communication related to the impact will need to be detailed, especially in case of an increase in capital requirement.

ANC draws BCBS attention to the regulatory treatment related to the bucket 2 (B2) risk category under IFRS 9 (exposures on which a significant increase in credit risk occurred, without being credit-impaired):

- B2 exposures are covered by accounting allowances based on a lifetime maturity of credit risk,
- regulatory EL on B2 exposures are based on a 12 months maturity of credit risk,

as a consequence, the accounting loss reserves on B2 could exceed the regulatory ones.

The regulatory treatment of allowances on B2 exposures, on January 1st, 2018, for risks beyond 12 months, will be deducted from CET 1 (and added in Tier 2, in most cases). Such situation constitutes a financial communication issue.

ANC believes that the structural excess of accounting allowance on B2 exposures should be especially addressed in the regulatory framework, and not lead to any additional capital requirement (i.e. should be neutralised in CET 1).

Level playing field issues

- The regulatory treatment of accounting provisions will not be updated before the first application of IFRS 9, and will presumably have a negative impact (as depicted above). Non IFRS applicants, such as US-GAAP applicants, will be exposed later to the effect of transition to a new accounting impairment model. This time lap may be detrimental to IFRS applicants and may raise a level playing field issue;

- The regulatory treatment makes a distinction between general (GP) and specific (SP) provisions. This classification is defined by regulatory requirements and does not take into consideration the risk classification under IFRS accounting standards (such as bucket 1, 2 or 3 in IFRS 9). As long as the US impairment model ("current expected credit loss", CECL) is not implemented, ANC believes that a linkage between accounting and regulatory provisions may raise level playing field issues.

- The DP is suggesting introducing a regulatory EL in the standard approach. Such a regulated EL model would be based on a standardised "calibration" (calculation of the risk provided for on a regulatory PD/LGD basis). The lack of granularity of the calibration could be disadvantageous for low risk activities/countries, and advantageous for high risk activities. ANC therefore suggests to carefully analyse the effects of such an approach with regard to prudence and competition issues.

ANC's view on the suggested approaches

In its consultative paper, BCBS suggests 3 approaches:

1) Status quo: no reform envisaged;
2) Regulation based on a distinction between general and specific provisions;
3) Creation of a regulatory EL under the standard approach.

ANC does not support the 1st proposition of the BCBS, which does not improve the current identified flaws relating to asymmetry (as mentioned above).

ANC does not support the 2nd proposition of the BCBS, which puts too much emphasis on the distinction between general and specific provisions:

- without correcting the asymmetric treatment of the general provisions in the current regulatory framework,
- without addressing the regulatory treatment of the allowances under the impairment model of the future US accounting framework (CECL), and consequently inducing a level playing field issue (see above) on a regulatory basis, especially as regards the treatment of the general provisions.

ANC partially supports the 3rd proposition aiming to create a regulatory EL under the SA, and permitting a regulatory treatment close to IRB exposures. This position is explained by a more symmetrical regulatory treatment for accounting provisions. Indeed, this regulatory treatment permits to maintain independency between accounting and regulatory frameworks, which seems to be understandable and consistent on many conceptual standpoints, such as the capital requirement on unexpected losses.

Nevertheless, the 3rd proposition also includes asymmetrical mechanisms. Therefore, ANC suggests to BCBS to alleviate the adverse effects of asymmetrical regulatory treatments on accounting estimates: the excess of accounting EL compared with regulatory EL could be neutralised in the CET 1 instead of the Tier 2.

If you have any questions concerning our position, we would be pleased to discuss them. Please do not hesitate to contact us should you want to discuss any aspect of our comment letter.

Yours sincerely,

Patrick de Cambourg

Appendix

Sources of asymmetries (caps or floors)

REGULATION (EU) No 575/2013

Tier 2 items and instruments

Article 62

Tier 2 items

(c) for institutions calculating risk-weighted exposure amounts in accordance with Chapter 2 of Title II of Part Three, general credit risk adjustments, gross of tax effects, **of up to 1,25 %** of risk-weighted exposure amounts calculated in accordance with Chapter 2 of Title II of Part Three;
(d) for institutions calculating risk-weighted exposure amounts under Chapter 3 of Title II of Part Three, positive amounts, gross of tax effects, resulting from the calculation laid down in Articles 158 and 159 **up to 0,6 %** of risk weighted exposure amounts calculated under Chapter 3 of Title II

Article 160

Probability of default (PD)

1. The PD of an exposure to a corporate or an institution shall be **at least 0,03 %.**

Retail exposures

Article 163

Probability of default (PD)

1. PD of an exposure shall be **at least 0,03 %.**

Article 164

Loss Given Default (LGD)

4. The exposure weighted average LGD for all retail exposures secured by residential property and not benefiting from guarantees from central governments **shall not be lower than 10 %.**

The exposure weighted average LGD for all retail exposures secured by commercial immovable property and not benefiting from guarantees from central governments **shall not be lower than 15 %.**