ICAEW REPRESENTATION 165/16

Draft Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses

ICAEW welcomes the opportunity to comment on the *Draft Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses* published by European Banking Authority on 26 July 2016, a copy of which is available from this link.

This response of 26 October 2016 has been prepared on behalf of ICAEW by the Financial Services Faculty. As a leading centre for thought leadership on financial services, the Faculty brings together different interests and is responsible for representations on behalf of ICAEW on governance, regulation, risk management, auditing and reporting issues facing the financial services sector. The Faculty draws on the expertise of its members and more than 25,000 ICAEW members involved in financial services.

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MAJOR POINTS

Welcoming the initiative

1. We welcome the opportunity to comment on the Consultation Paper (CP), *Draft Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses*. The introduction of accounting for expected credit losses in IFRS 9 *Financial Instruments* represents a significant change and challenge for preparers, investors, securities regulators and the auditors of lending institutions. Prudential supervisors and the wider regulatory community have expressed significant interest throughout the course of the development of these standards. Following the finalisation of the IFRS standard we acknowledge that supervisors have valid opinions on how they expect it to be implemented and wish to make those views clear especially as they relate to the interaction between credit risk management principles and expected loss accounting.

2. We consider that a single set of authoritative guidance, that issued by the Basel Committee on Banking Supervision ("Basel Guidance"), that is applicable to banks across all geographies, is more likely to be effective in encouraging consistent implementation of IFRS 9 than similar efforts made at a national or regional level. Therefore, it would be helpful for the European Banking Authority (EBA) were to issue guidance that is entirely consistent with the Basel Guidance, subject to appropriate proportionality and materiality considerations.

3. We do not object to the EBA indicating a preference for limiting use of particular simplifications and practical expedients offered in IFRS 9, especially in circumstances where it believes that their more extensive use would result in a lower quality implementation of the standard. But we urge strongly that restrictions should be applied only where there is a clear consensus amongst stakeholders that discouraging the use of options is proportionate, i.e. very likely to improve the usefulness of information to investors resulting from applying the impairment requirements of IFRS 9 at an acceptable cost. We suggest that the EBA also considers whether limiting the use of practical expedients, particularly for less complex portfolios, will improve consistency of application across banks when they are, in practice, likely to develop their own policies rather than rely on the thresholds used in the practical expedients.

RESPONSES TO SPECIFIC QUESTIONS

Q1: Is the scope of application of the guidelines appropriate and sufficiently clear?

4. We believe that the scope is clear in setting out that the guidelines are intended to cover the credit risk practices for lending exposures only and they do not apply to non-lending exposures such as debt securities and lease receivables.

Q2: Is the date of application of the guidelines of 1 January 2018 appropriate?

5. Yes.

Q3: Please provide any comments you may have on the appropriateness of the proportionality approach

6. We agree with the EBA that credit institutions should strive for high quality implementation. We also support a 'proportionate approach' where the sophistication of credit risk management

reflects the credit institution's size, internal organisation and the nature, scope and complexity of their activities and also the size, nature and complexity of portfolios even for larger credit institutions: we do not believe this conflicts with high quality implementation. Indeed, a high quality implementation will appropriately balance cost, time and quality to ensure that the resulting financial reporting meets the accounting requirements effectively and efficiently without introducing undue operational risks.

7. The Basel guidance was intended to apply to large banks. To replicate these principles in the EBA guidelines which, as proposed, will apply to all European regulated credit institutions would mean that, despite having less sophisticated ECL programmes, many smaller institutions would face disproportionate requirements in applying the credit risk management practices outlined by the guidelines. We urge the EBA to reconsider its guidelines applicable to smaller credit institutions.

8. Paragraph 19 in the guidelines considers "approximation of ideal measures" and it also refers to the need to "avoid bias". While we recognise that the Basel Guidance also uses the same expressions, we draw the EBA's attention to the fact that IFRS 9 permits a variety of approaches and it is unlikely that there is a common, generally accepted view on what is "ideal" and therefore whether a particular approach is an appropriate approximation of such a measure.

Q4: 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?

9. The guidelines specify a series of expectations surrounding model validation that may be inconsistent with the organisational design within a bank. By prescribing an approach in this area, the paper does not appear to allow organisations to establish effective approaches that meet basic "principle" requirements, which thus may lead some organisations to dismantle existing effective structures to accommodate the requirements of the guidance.

10. Paragraph 53 requires a temporary adjustment if a portfolio cannot be re-segmented on a timely basis. The Basel Guidance suggests a temporary adjustment may be appropriate but does not require it. Different approaches may deal with new information or changed expectations of credit risk differently and the EBA guidelines should not require a specific approach. Therefore the text should be reworded to remove the "should". In general, the EBA wording in the EBA guidelines should be reviewed and the words "must" and "should" replaced where necessary for consistency with the Basel Guidance.

Q5: 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

11. We offer no views on the impact assessment.

Q6: Please provide any additional comments on the draft guidelines

12. An effective implementation of expected loss accounting standards requires a consistent approach within banks supported by a consistent approach from auditors, prudential supervisors and securities regulators across multiple geographies. Where national competent authorities take different views on what they consider an effective high quality implementation, and/or require different levels of assurance from a banks' auditors on compliance with the guidelines, this runs the risk of creating geographical differences in interpretation that puts pressure on banks trying to apply a consistent approach throughout their organisation. We acknowledge that auditors across geographies must play their part in trying to minimise these differences, but their success on this point will depend on NCAs also taking as much of a

consistent approach as they can. Following the finalisation of the guidelines we hope national supervisors will work together with the Committee to promote a consistent supervisory approach. We would welcome being part of that dialogue.