FÉDÉRATION BANCAIRE FRANÇAISE

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FRENCH BANKING FEDERATION COMMENTS ON THE BCBS CONSULTATIVE DOCUMENT: REGULATORY TREATMENT OF ACCOUNTING PROVISIONS.

The French Banking Federation (FBF) represents the interests of the banking industry in France. Its membership is composed of all credit institutions authorized as banks and doing business in France, i.e. more than 390 commercial, cooperative and mutual banks. FBF member banks have more than 38,000 permanent branches in France. They employ 370,000 people in France and around the world, and service 48 million customers.

The French Banking Federation would like to thank you for the opportunity to comment on the discussion paper on the longer-term regulatory treatment of accounting provisions.

Key messages:

Sound conceptual standpoint call for a modification of the prudential framework:

- Both accounting and prudential measures have been adopted to solve the "too little too late" issue, expected loss provisioning on one hand, contra cyclical buffers and stress test add on capital on the other hand,
- By construction, overlapping of capital requirements between accounting and prudential capital requirements as soon as one passes on an expected loss (EL) model for the former.
- Reviewing the articulation between capital, provisions and capital requirements deserves a thorough, holistic approach. Further consultation is essential.

Objectives to be achieved by the Regulatory treatment of accounting provisions

- It should be consistent with the whole prudential framework.
- It must be understandable, simple and applied whatever the accounting regime in order to ensure comparability and level playing field,
- Finally, the new system must avoid creating opportunities for regulatory arbitrage

Outline of the FBF proposal

- Excesses and shortfalls in provisions should be treated symmetrically towards CET1
- This symmetrical treatment shall be applied both under the Standard approach (SA) and the Internal Ratings Based (IRB) approach.
- Therefore, for portfolio under SA:
  - No longer distinguish between general and specific provisions
  - Introducing regulatory EL but granular enough and better calibrated in order to reflect various asset classes and inherent risk profiles.

I. The conceptual standpoint and latest prudential developments call for a modification of the current prudential treatment of forthcoming accounting expected loss provisions

While the current prudential treatment of accounting provers was compatible with the Basel RWAs and the incur loss model accounting, once the accounting model changes to an expected loss, it results from overlapping with the expected loss component of the capital requirements

Interaction between accounting and prudential measures: Need for a holistic approach.

After the financial crisis, the G20 mandated both the accounting standard setters and the prudential regulators to commit themselves to enhance the global financial regulation and to solve the "too little and too late" issue. Both - accounting standard setters and prudential regulators - took strong measures within their respective missions.

To respond to the criticism of incurred loss model as providing too little and too late provision, the IASB and the FASB, each on their own, issued accounting expected loss models requiring the recognition of expected losses on the whole portfolio and the inclusion of broader range of credit data (i.e. forward-looking information) and resulting in fundamental changes in provisioning practices of banks. The new IASB and FASB standards will apply respectively from January 1 2018 and January 1, 2020. The Basel Committee conducted the regulatory reform in parallel covering the same risks.

On the accounting side, worsening macroeconomic factors will be built into accounting provisions through the requirement to produce an 'unbiased probability weighted' provision amount. This will result in higher levels of provisions.

As far as prudential matters, own funds requirements have been strengthened in terms of level of capital ratios and in terms of quality of capital (proportion of CET1 increased). Mechanisms of capital buffers - conservation buffer and counter-cyclical buffer on top of it when needed – have been put in place. Besides, worsening macroeconomic expectations will be reflected in stress test results, resulting in the need to hold higher capital for this risk through Pillar 2 Guidance.

Back to the conceptual standpoint of capital requirement

There is also an overlap between the accounting for accounting expected losses (ECL) and capital.
Capital requirements are primarily calibrated as Tier 1 requirements. The Basel 2 capital requirements is based on the following assumptions:

- Default-based capital requirements for credit exposures. The Merton model that underpins the Basel 2 framework is designed to extrapolate PDs under normal economic circumstances into PDs under extremely stressed economic circumstances. Other significant parameters (EAD and LGD notably) are much more loosely calibrated.
- Capital requirements are calibrated so as to cover unexpected losses with a given confidence interval (originally 99.9%, or an equivalent PD of 0.1% or a A- rating, consistent with the socially acceptable level of default) over 1 year. This consistent if the margins on the performing credits are sufficient notably to cover the expected losses, or if the exposures have been provisioned so as to provide a sufficient carry,

and only works when the requirements are covered by going-concern capital (which was only required in 2009).
- Tier 2 was primarily construed as gone-concern capital, and is now part of a broader bucket of contingent capital in resolution.

Having said that, the actual capital requirements were not calibrated in full accordance with above-mentioned assumptions:

- Capital requirements for corporate exposures are explicitly subject to a maturity adjustment which is supposed to take into account the rating migration (over a 1 year horizon) and the resulting provisions.
- In other instances, maturity and LGD were implicitly taken into account when calibrating the asset correlations, notably for mortgages (that have a much higher correlation than other retail loans). Actually, the volatility of provisions, not the volatility of defaults, was used to calibrate the asset correlations.
- As a consequence, the current capital requirements actually cover at least a piece of the unexpected provisions unrelated to pure defaults.
- Unexpected losses sometimes prove to be impractical and expected losses must be taken into account, notably when dealing with securitization exposures. For both the IRB and the SA, expected losses and provisions shortfall are used to primarily adjust the capital base and to marginal extent the capital requirements (in SA, the exposures are net of provisions). For operational risk the exclusion of the EL would make no sense (capital should cover both EL and UL).

Therefore, we believe that:

- Provisions are much more related to CET1 capital (going concern capital) than they are to Tier 2 capital (contingent or gone-concern capital)
- Capital requirements actually covers a significant part of the ECL beyond the 12-month horizon. The revised contemplated regulatory framework must therefore ensure that the same potential losses are not covered by both capital and accounting provisions.

II. Proposal for a permanent solution for regulatory treatment of accounting provisions.

The BCBS discussion paper intends to be the start of a discussion process with the industry and proposes changes to the Standardised and potentially IRB approaches to credit risk. Three approaches for treatment of provisions under regulatory capital are envisaged. Approaches 1 and 2 would keep the current framework – based on General and Specific provisions - unchanged.

The approach 3 removes the distinction between General and Specific Provisions and introduces EL (and capital deduction of excess EL) into the Standardised approach framework. Therefore, as long as the excesses and shortfalls would be treated symmetrically and the regulatory EL rates would be granular enough to match asset classes, the approach 3 would enable to align the treatment of accounting provisions in IRB and in Standardised approaches, meet the objectives of the objectives of the regulatory treatment of accounting provisions and avoid overlapping of capital requirements between accounting and prudential frameworks.

Proposal for regulatory treatment of accounting provisions under the IRB approach.

- For ECL until 12 months maturity

The excesses and the shortfalls of the 12 month expected loss accounting provisions over the 12 month expected loss under prudential framework for IRB portfolios should be treated symmetrically and adjusted to CET 1. The symmetric treatment is justified by the characteristic of IFRS 9 i.e. the incorporation of expected loss on the whole portfolio, the incorporation of forward-looking information, the unbiased probability weighted scenarios, etc. alongside with the more robust capital environment resulting from the new prudential framework.

Accordingly, the current cap that applies to the excesses of provisions over expected losses should be removed, or at least recalibrated. Indeed, this cap was calibrated when an incurred loss accounting model applied and it needs to be reviewed within the context of the changes of the accounting frameworks.

- For ECL above 12 months maturity

In order to achieve the comparison of 12m time horizon for prudential EL and accounting expected losses, we suggest that the accounting expected loss provisions above the level of 12 month time horizon should be considered CET 1 capital – or alternatively counted toward capital requirements. This will require calculation of 12 months expected losses for all stage 2 assets, above the requirements of IFRS 9 but for prudential purposes only.

Proposal for regulatory treatment of accounting provisions under the standardised approach.

In order to achieve the symmetrical treatment of excesses and shortfalls in provisions between IRB and SA approaches, we believe that the current distinction between general and specific provisions for the standardised approach should no longer remain. Moreover, under IFRS 9, while provisions for impaired assets (stage 3) can easily be identified as specific provisions, provisions for unimpaired assets under stage 1 and stage 2 can be argued being general or specific likely to vary between jurisdiction and would require further clarification of their treatment as general or specific.

We advocate that the accounting provisions beyond the prudential time horizon of 12 months should be considered CET 1 capital both under standardized and IRB approaches.

As a matter of simplification, the 12 months accounting EL in stage 1 and stage 2 could be used as an approximation of the prudential 12 months for portfolios for which the standardised approach is applied and for which no prudential EL is computed. However, as prudential EL 12 months is through the cycle (TTC) and accounting ECL is point in time (PIT), there will be a difference between the two measures at the different points in time in the cycle, although the sum of the differences on an average over a cycle should amount to zero.

Therefore, we favour a standardised regulatory EL as the minimum requirement of CET 1 reduction, as well as standardised regulatory EL rates provided by regulatory authorities.
However, the BCBS proposals concerning possible regulatory EL rates raise significant issues.

The proposed standardised EL rates lack of granularity and accurate risk measurement. They are unlikely to reflect risk profiles inherent in different portfolios, various asset classes and differences across jurisdictions. In order to improve the BCBS proposals, additional granularity for the standardized EL rates should be considered. The new standardised EL rates should not result in higher capital requirements, considering there is sufficient conservatism built into the standardised approach.

The regulatory standardized EL rates and standardized risk-weights would need to be properly calibrated. The SA RW percentages should be revised downwards to account just for the unexpected loss. When calibrating the EL rates, the BCBS should not set an implicit LGD of 45% (or 75% when subordinated) for all asset classes. The LGD for residential mortgage loans would be different from LGD for auto loans. The BCBS should calibrate the regulatory standardised EL rates in such a way that the new EL rates should be sufficiently granular in order to reflect the risk differences across and underneath each asset class. When calibrating the EL rates, the BCBS should clarify how credit risk mitigation will be reflected. Currently, the use of the foundation LGD values would not adequately or consistently reflect collateral and other forms of credit protection.

We hope you find these comments useful. The above proposals are the first views of the French banking industry on a regulatory treatment of accounting provisions. The French banking industry is ready to further exchange views and elaborate on these proposals and notably on the credit risk weighted assets calibration overlaps.