FINANSTILSYNET
THE FINANCIAL SUPERVISORY
AUTHORITY OF NORWAY

NORGES BANK

Basel Committee on Banking Supervision

OUR REFERENCE	YOUR REFERENCE		DATE
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BCBS DISCUSSION PAPER: REGULATORY TREATMENT OF ACCOUNTING PROVISIONS AND TRANSITIONAL ARRANGEMENTS – JOINT COMMENTS FROM FINANSTILSYNET AND NORGES BANK

Dear Sir/Madam,

Finanstilsynet and Norges Bank welcome the opportunity to express our views on the 11 October 2016 consultation documents discussing regulatory treatment of accounting provisions and transitional arrangements.

Our general perspective on provisions recognised under IFRS 9 or under an incurred loss model is that no such provisions should be included in banks' own funds. A lesson learned from the financial crisis was that the incurred loss provisioning rules led to provisions that were often "too little and too late", and this lesson supported a transition to expected loss models. The transition to a more prudent provisioning approach should therefore not be diluted by including a portion of the loss allowances under IFRS 9 in banks' own funds.

Specific comments on the proposal are noted below:

<u>General and specific provisions</u>

Finanstilsynet and Norges Bank prefer an approach that relies primarily upon the accounting determinations of provisions under expected credit loss (ECL) models and that reduces the differences between the SA and IRB methods[1]. However, if a universally applicable and binding definition of general and specific provisions is introduced, it should be clarified that all loss allowances under IFRS 9 and incurred loss models are considered specific provisions. This is because all loss allowances under these models are ascribed to an individual or a group of

[1] Standardised and internal ratings-based approaches (SA and IRB)

exposures; as such, the Basel III requirement for general provisions to be *"freely and fully available to cover losses which subsequently materialize"* cannot be fulfilled.

Furthermore, loss allowances under IFRS 9 and incurred loss models do not meet the requirements for Tier 2, MREL and TLAC instruments that such funding shall be able to be converted into equity in resolution. In case the bail-in tool is used, loss provisions will cover actual losses and there would most likely be no provisions remaining to cover for potential unexpected losses. If the business of a failed institution is transferred to another entity, the new entity would need to hold the same amount of provisions for the acquired exposures. It is therefore not practically possible that any provisions under IFRS 9 or incurred loss models could be converted into equity in resolution.

The 12-month ECL provisions (stage 1) under IFRS 9 would generally provide lower expected losses than the IRB models, since the IRB models would have to take into account an economic recession in the calculation of LGD and EAD estimates, cf. description of main differences in the discussion paper. In addition, the IRB approach requires conservatism and safety margins in the estimates, while the stage 1 IFRS 9 provisions shall reflect an unbiased, probability-weighted estimate of expected loss over a period of 12 months. An excess of expected losses under IRB would be deducted from capital. We therefore consider that inclusion of stage 1 IFRS 9 provisions as general provisions in Tier 2 capital under the standardised approach would not be prudent. Stage 2 IFRS 9 provisions are lifetime loss allowances for exposures where there has been a significant increase in credit risk and where the measurement of losses is based upon a neutral analysis of macroeconomic scenarios taking into account the time value of money. Accordingly, stage 2 IFRS 9 provisions should be classified as specific provisions. Under stage 3 IFRS 9, a credit event has occurred, defined similarly to an incurred credit loss under IAS 39, for which provisions should definitely be classified as specific. As such, there will be no provisions under IFRS 9 (stage 1, 2 and 3), which could be considered additional provisions that are freely available to cover losses on other exposures.

The new standard from FASB is stricter than IFRS 9 by estimating lifetime expected losses already at initial recognition. In order to achieve a level playing field, it may be argued as appropriate under the FASB standard to include a portion of the provisions for exposures where the credit risk has not increased significantly since initial recognition (stage 1 provisions) in Tier 2. This could be accomplished through a calculation where the stage 1 provisions under the FASB standard are compared with the regulatory expected losses determined for the same exposures (cf. comments in the next section 'Regulatory expected loss'). However, this is difficult to resolve through a more detailed definition of general and specific provisions.

To the extent that a Pillar II add-on has been required for the coverage of expected credit losses under an incurred loss model, there will be less need for such additional Pillar II-requirements under an expected loss model. However, the provisions under an expected loss model should not be recognised as Pillar II own funds as such provisions are not available to absorb losses that materialise elsewhere in the bank.

Regulatory expected loss

The proposal to design regulatory expected loss rates under the standardised approach would provide harmonized rules for capital calculation irrespective of the accounting rules, and more equal

rules for the standardised and IRB approaches. However, it would be burdensome for banks both to measure loss allowances under IFRS 9 (stage 1, 2 and 3) or under the new standard from FASB, and then also do an alternative calculation of the necessary provisions for capital purposes.

Finanstilsynet and Norges Bank have noted that the EBA impact assessment of IFRS 9[2] shows an excess of accounting provisions for IRB portfolios over regulatory expected losses that under current regulation would be added back to Tier 2, subject to a regulatory cap. A banks' ability to cover losses during a recession is determined by the sum of own funds and loan loss provisions. However, if a portion of the increased provisions is included in the own funds, this would dilute the desired effect of IFRS 9, and should not be allowed.

For banks using an incurred loss model, regulatory expected loss rates should be introduced under the standardised approach. This will ensure that the CET 1 capital is reduced by the difference in calculated loss provisions between the capital adequacy rules and the accounting rules.
For banks using an expected credit loss model in accounting there should be no adjustments of capital calculation for loan loss provisions under IFRS 9 stage 2 and 3 and for the corresponding provisions under the FASB standard. Specifically, provisions for lifetime expected losses for exposures where the credit risk has increased significantly are prudent if they do not affect Tier 2 capital. IFRS 9 stage 1 would likely imply lower loss provisions than both the provisions for corresponding exposures under the FASB standard and the expected loss calculation under the IRB approach. Comparisons should therefore be made between the allowances under IFRS 9 Stage 1 and the FASB standard for the exposures where the credit risk has not increased significantly, and the regulatory expected losses calculated for the same exposures. For banks using IFRS 9, such a rule would probably result in a difference to be deducted from CET 1 capital. In contrast, banks using the FASB standard would likely be able to recognize a positive difference in Tier 2 capital for the exposures where the credit risk has not increased significantly.

To keep the capital calculation consistent with the loan loss provisioning across accounting standards, one set of rules should be introduced for banks using incurred loss models and another set of rules for banks using expected credit loss models in accounting calculations. For banks using incurred loss models, regulatory expected loss rates should be employed under the standardised approach and the current IRB rules should be retained or made more stringent. For banks using expected credit loss models, adjustments should not be made for the capital calculation; under neither the standardised, nor IRB approaches for both IFRS 9 stage 2 and 3 provisions and the FASB standard for corresponding provisions. For exposures where there has not been a significant increase in credit risk (IFRS 9 Stage 1 and the corresponding exposures under the FASB standard), regulatory expected loss rates should be introduced under the standardised approach and the current IRB rules should be retained.

The level of granularity affects the risk sensitivity of regulatory expected loss rates. To be aligned with actual risks, the regulation should be more granular. However, a higher level of granularity with additional subcategories could lead to different interpretations and make the rules overly complicated. Finanstilsynet and Norges Bank therefore support that the same level of granularity as the risk weights assigned to each exposure class be used for the definition of the standard regulatory expected loss rates, even if this means that exposures with relatively low risk (within a risk-weight

[2] EBA Report 10 November 2016 - On results from EBA impact assessment of IFRS 9, page 31

category) and low accounting ECLs will require more capital. We also believe that there should not be frequent amendments in regulatory expected loss levels after they are established.

Transitional arrangements

It is essential that the rules introduced for the regulatory treatment of accounting provisions are prudent, address the issue of "too little and too late" provisions and do not add back a portion of the provisions in own funds. If the most prudent rules require transitional arrangements, Finanstilsynet and Norges Bank support a modified version of Approach 1 (Day 1 impact on CET 1 capital spread over a specified number of years). Approach 1 is the simplest approach and the approach that most clearly adjusts for a possible "capital shock" associated with new loss provisioning rules. IFRS 9 and the FASB standard were adopted in July 2014 and June 2016, respectively, and shall only come into force on 1 January 2018 for IFRS 9 and 1 January 2020 for certain banks that are public companies under the FASB standard; as such, banks have been given a long period to prepare for the new loss provisioning rules. Transitional provisions should therefore only be introduced for reductions in CET 1 capital beyond a specified percentage.

Yours sincerely,

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