Regulatory treatment of accounting provisions

Response to BCBS DP 385

January 2017

Building Societies Association

Introduction

The Building Societies Association (BSA) represents all 44 UK building societies. Building societies have total assets of over £364 billion and together with their subsidiaries, hold residential mortgages of over £282 billion, 21% of the total outstanding in the UK. They hold over £260 billion of retail deposits, accounting for 18% of all such deposits in the UK. They employ approximately 40,000 full and part-time staff and operate through approximately 1,550 branches.

BSA's 44 member societies, though none would qualify as a "Basel bank" – i.e. a large, *internationally active* bank, are all subject to the current Basel frameworks as mediated through the EU's Capital Requirements Regulation. Out of the 44 societies, 4 of the largest use an IRB approach, and the remaining 40 currently use the Standardised Approach (SA). In our response, we are therefore particularly concerned to avoid introducing, aggravating or perpetuating any unfair disadvantage for standardised users in the interaction of accounting provisions and capital requirements. Most of our members are, moreover, small institutions by Basel standards, with limited specialist resources, so operational simplicity is also very important.

The BSA is a member of the European Association of Co-operative Banks and supports the more detailed response of the EACB.

General observations

The BSA welcomes the recognition that the move to IFRS 9, and ECL provisioning generally, has finally triggered an overdue reappraisal and redesign of the regulatory treatment of accounting provisions. We particularly welcome the realisation that standardised users are at an unfair disadvantage compared with IRB users in terms of the impact of accounting provisions on regulatory capital. Given that IFRS 9 ECL provisioning is expected to drive a substantial increase in provision numbers, this unfairness is all the more reprehensible and should be eliminated.

Moreover, the introduction of regulatory ECL is connected with a significant additional effort for institutions using the standardised approach for credit risk. This is mainly due to the fact that these institutions do not necessarily have either a developed modelling capability, or sufficiently precise and statistically-adequate data for their receivables, to calculate an expected credit loss.

The BSA starts in principle with an open mind as to the detail of proposed solutions. To safeguard our members' interests, a permanent solution should achieve as close as possible to the following four objectives :

(i) a level playing field between SA and IRB as to the impact of provisions on capital;

(ii) avoidance of any "double counting";

(iii) avoidance of capital shocks and mitigation of any increased procyclicality; and

(iv) operational simplicity, especially for smaller institutions, and avoidance of sequential changes.

Much will depend on materiality. Were ECL provisioning to cause only minor increases, the operationally simplest solution might have much to recommend it. Our members using the SA might put up with some modest continuing disadvantage, if the administrative burden is lower. But the early indicators are that the increase caused by ECL provisioning will be pretty substantial. That means it is probably worth some extra complexity to avoid any double counting, eliminate the unfairness to standardised users, and reduce any extra procyclicality.

Double counting

To avoid "double counting" - i.e. *addressing the same risk independently through both accounting and prudential frameworks, with an additive effect* - what is required is a holistic approach, that takes account of where and why potential double counting and overlaps arise. The current prudential capital rules were calibrated on incurred loss models. So, it is not necessarily correct to move over to an expected loss model, generating higher provisions, while simply assuming that the existing calibration of capital rules remains valid.

The DP mentions the potential for double counting at paragraph 2.3.5 but is inconclusive on the matter. The area of potential double counting lies in the overlap between the concepts of lifetime ECL and "unexpected losses". We commend the analysis provided in the response by the German Banking Industry Committee on the whole question of double counting.

Preferred solution

The ideal solution would both avoid double counting and eliminate the SA/IRB unfairness. The BCBS's proposal (in paragraph 2.3 of the DP) to introduce regulatory EL under the SA, while adding some complexity for SA users, seems to us to come closest to meeting the objectives set out above, but does not yet address the issue of double counting. But we would also be prepared to go along with an alternative, simplified approach based on using regulatory EL minima, as canvassed in paragraph 3.5. We think the use of regulatory ELs could mitigate to some extent the procyclical volatility that the impact of ECL on capital would otherwise create. We also mention below points of detail raised by one of our members that should be borne in mind in finalising the treatment.

Detailed points

The purpose of IFRS 9 is to ensure that asset specific ECLs are recognised in a manner that provides for lifetime expected credit losses. Many UK building societies are facing the current challenge that low historic provisions lead to a dearth of modelling data- but the loss data they could purchase externally do not reflect their own actual risk profiles. For instance, a regional building society with a prominent concentration in, say, the North East of England, would not look to supplement its current data with ‘ UK average industry data’, particularly when the same society might well be disclosing on an annual basis how well its prime mortgage books are performing vs. industry average data with respect to default and arrears.

As such, the proposal to include capital provisions calculated against a set of ‘one size fits all’ average risks won’t fairly reflect their specific characteristics and discounts the efforts currently focused towards robust IFRS 9 provisioning models - that should already provide the best view of ECLs for each society embarked on that journey.

Burden

Our sense is that the dimensions of the higher provisioning numbers that will be driven by IFRS 9, and therefore the sharper impact of the unfairness for SA users, justify an arguably more radical overhaul of the treatment of provisions. There will be a one off implementation burden, and possibly slightly higher recurring administrative costs. But the overriding imperative is that there should be only one set of changes (including transitionals). Once any new treatment is agreed, it should not be changed for the foreseeable future.

January 2017

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The Building Societies Association (BSA) is the voice of the UK's building societies and also represents a number of credit unions.

We fulfil two key roles. We provide our members with information to help them run their businesses. We also represent their interests to audiences including the Financial Conduct Authority, Prudential Regulation Authority and other regulators, the Government and Parliament, the Bank of England, the media and other opinion formers, and the general public.

Our members have total assets of over £345 billion, and account for approximately 20% of both the UK mortgage and savings markets