ECL provisions: interim approach and transitional arrangements

Response to BCBS CP 386

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, and broadly supports, the principle of the main proposals for an interim period retaining the current regulatory treatment of provisions, and for transitional provisions to mitigate any capital shocks. We have commented in our parallel response to DP 385 that a reappraisal and redesign of the regulatory treatment of accounting provisions is now overdue, and should be done on a holistic basis to ensure any "double counting" is avoided. Such redesign cannot be rushed. So interim / transitional arrangements in some form are clearly necessary.

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.

As with any new permanent treatment, the BSA starts with an open mind as to the detail of proposed interim and transitional solutions. Bearing in mind the situation of our members, a solution should achieve as far as possible the following objectives :

(i) avoidance of "capital shock";

(ii) equitable treatment as between SA and IRB users ; and

(iii) operational simplicity, especially for smaller institutions.

Moreover, in designing transitionals, there needs to be clarity as to the end point (which necessitates final answers to the questions posed in DP 385). It is essential to avoid a "Grand Old Duke of York" experience, where institutions are launched on an initial transition path that has a more adverse interim effect on capital than would have been needed if the transition path had been drawn to arrive at what turns out to be the correct end point. Our members have already had experience of this being mishandled in the UK in the introduction of the LCR.

Interim approach

Considering first the question of retaining on an interim basis the current regulatory treatment of provisions, this does at least have the merit of relative simplicity. In itself, it does nothing to mitigate the current disadvantage that standardised users suffer relative to IRB users. The higher the increase in provisioning resulting from ECL, the sharper the disadvantage to SA users over the interim period. So (subject to transitional arrangements) it may cause the interim capital shock for SA users to be worse than is actually envisaged at the end-point.

We note the extensive and well-argued response from the German Banking Industry Committee, and we think their suggestions for an alternative interim approach are worthy of consideration.

Transitional arrangements

These are of the greatest importance as “capital shocks”-especially those that are mere artefacts of changing fashions in accounting, and do not reflect any actual changes in the riskiness of the underlying asset portfolios – should be avoided as far as possible. While our members are well-capitalised, even on Basel 3 end-point measures including all the multifarious buffers, their principal source of additional CET 1 is retained earnings, which are built up steadily, not raised overnight. So avoidable capital shocks that are mere artefacts are especially damaging to our members, and indeed to any mutual or cooperative bank. And a capital shock that is a mere artefact will, by constraining lending, nevertheless damage the real economy of households and businesses, to no purpose.

Leaving aside the detail of which transitional approach is best, the BSA rejects the BCBS’ suggestion trailed in paragraph 3.1 to the effect that since banks have been aware of IFRS 9 for some years, they *“should be prepared to absorb a modest decrease in CET1 capital (i.e. a modest capital shock) upon initial application of ECL”*. Indeed, the challenge should be thrown back to the BCBS itself : why, if ECL and IFRS 9 have been known about for several years, was their effect not taken into account in a holistic manner in either the Basel 3 reforms, or the current “Basel 4” reviews, so that any impact could form part of the calibration of those packages ?

Turning to the several options canvassed in the CP, we think there may be merit in both Approach 1 and Approach 3. We understand that Approach 3 is likely to be the route taken in Europe, but we also note the simplicity of Approach 1. Again, we commend for consideration the suggestions put forward by the German Banking Industry Committee. We also mention below some detailed points contributed by one of our members.

Detailed points

The CP’s Approach 1 will provide a degree of capital shock protection through phased implementation- however a significant part of our member societies’ IFRS 9 journeys will be through regularly improving calibration of their models over time as more and ‘better’ data becomes available.

While they will strive for an accurate estimate of ECL at 1 January 2018, the provisions they recognise (that under Approach 1 form the base of their phased CET 1 add back over the adjustment period) could need some revised calibration and adjustment over time. With much current mortgage lending in the UK involving fixed term products for at least 2 year terms, even where current credit risk across a portfolio remains relatively unchanged, provisions may vary, be it through changing macro-economic assumptions, model calibration or other factors. By 31 December 2018, the first significant date for post-IFRS 9 external capital reporting (unless quarterly reporting is approved for non-systemic institutions in the interim) the provision calculated against a portfolio of mortgages that existed at 1 January 2018 may be quite different: however the phased impact transitional is calculated against a 'fixed' 1 January 2018 provisions movement.

So, if a provision was overstated at 1 January 2018 and subsequently reduced (not unlikely during ongoing 2018 calibration) this provides an undue and beneficial CET 1 add back over the transitional period. Similarly, if 1 January 2018 provisions are considered understated after a period of further calibration, subsequent capital will reflect the hit of 'larger provisions' without benefitting from a proportional transitional add back.

We would also note that, for societies who opt to derecognise mortgage assets in the event of a product switch, spreading a day 1 adjustment over numerous future years (3 in the given example) ignores the fact that for the purposes of IFRS 9 provisions, much of the societies' mortgage assets will have been derecognised (and replaced by new assets) over this term. The same customers may exist- but they may now have new origination dates for credit risk against new mortgage assets- making the day 1 adjustment much less relevant in later years of transitional application.

Finally, there is a further source of capital shock that has not been dealt with by the transitionals. It is envisaged (paragraph 2.3 of the CP) that national regulators would provide guidance on categorising ECL provisions as GPs or SPs in their jurisdiction, and this is necessary because of the current diversity of practice, especially on what should or should not be added back to Tier 2 capital as GPs. If consistency were introduced overnight, cutting back on the amount of Tier 2 add-back, this too could create a capital shock, and maybe should also be phased-in.

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Jeremy Palmer
Head of Financial Policy
jeremy.palmer@bsa.org.uk
+44 (0)20 7520 5912

York House
23 Kingsway
London WC2B 6UJ

020 7520 5900
@BSABuildingSocs
www.bsa.org.uk

BSA EU Transparency Register No: 924933110421-64

www.bsa.org.uk

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