January 13, 2017

Comments on the Consultative Document and the Discussion Paper: *Regulatory treatment of accounting provisions*, issued by the Basel Committee on Banking Supervision

Japanese Bankers Association

We, the Japanese Bankers Association ("JBA"), would like to express our gratitude for this opportunity to comment on the consultative document and the discussion paper: *Regulatory treatment of accounting provisions*, issued on October 11, 2016 by the Basel Committee on Banking Supervision ("BCBS").

We respectfully expect that the following comments will contribute to your further discussion.

I. Comments on the consultative document

<<General comments>>

We support the introduction of expected credit loss (ECL) models in accounting provisioning given that it will help us achieve risk recognition at an early stage. Nonetheless, the following points would need to be taken into account with regards to the introduction of ECL models: (i) introduction of ECL models will vary depending on accounting standards; (ii) even where ECL models are to be introduced, the timing of introduction will be different across jurisdictions; and (iii) assumptions and methodologies used under the ECL models will also be different. Based on these differences between each jurisdiction's GAAP, the BCBS should carefully consider areas to be harmonized in their regulatory treatment and those to be allowed for adjustments in line with each jurisdiction's circumstances.

Furthermore, it is hard to say that sufficient surveys and analyses have been performed to identify the level of changes in provision amounts within the entire banking sector resulting from the transition to ECL models. As sufficient factors are unavailable to make decisions for reviewing the regulatory treatment of accounting provisions, we therefore support the BCBS's proposal to "retain the current regulatory treatment of accounting provisions for the interim period". Nonetheless, as the BCBS is aware of, it is important to sufficiently assess the potential impact on the entire banking sector by conducting a comprehensive quantitative impact study and other related exercises.

If, as a result of such studies, it turns out that the introduction of ECL models will cause a significant impact, an appropriate transitional arrangement should be implemented as proposed in the consultative document. The transitional arrangement should be as simple as possible in order to minimise the calculation burden on banks and supervisors and to enable market participants to readily observe the impact of the transitional arrangement. The BCBS should also pay attention to differences between accounting standards and allow national discretion to make adjustments if deemed necessary.

<<Specific comments>>

1. Proposal to retain the current regulatory treatment of provisions

We support the BCBS's proposal, "for an interim period, jurisdictions would extend their existing approaches to categorising provisions as general provisions ("GP") or specific provisions ("SP") to provisions measured under the applicable ECL accounting model".

Furthermore, to ensure consistency within jurisdictions, it would be useful if regulators provide guidance, as appropriate, on categorising ECL provisions as GP or SP in their jurisdictions, as mentioned in the consultative document.

2. Transitional arrangements

As stated in the general comments, it is preferable to implement a simple transitional framework so that market participants will be able to readily observe the impact of the transitional arrangement.

Among the approaches presented in the consultative document, Approach 1 (Day 1 impact on CET1 capital spread over a specified number of years) is practically simple and is considered to be optimal.

The transitional arrangements described in the consultative document intend to reduce only the effect of ECL models when they are initially applied. However, after the initial application, it is likely that the amount of provisions will change considerably due to changes in economic environments or other factors, resulting in more volatility in the amount of regulatory capital. Taking these factors into consideration, the BCBS should consider allowing some adjustments even after ECL models are initially applied.

3. Others

A flexible approach should be taken with respect to the introduction of transitional arrangements by giving discretion to national regulators. As accounting standards differ between jurisdictions, application and implementation date of transitional arrangements to those jurisdictions not adopting IFRS or USGAAP are not determined yet at this point in time. Given the differences in accounting standards or varied practices across jurisdictions, application and implementation date of transitional arrangements should be determined at the discretion of each jurisdiction.

II. Comments on the discussion paper (DP)

<<General comments>>

In our understanding, the incorporation of ECL models into accounting standards, particularly IFRS 9, intends to allow banks to apply internal models (e.g. internal ratings-based (“IRB”) approach) for calculating loan loss provisions with a view to improving consistency with the regulatory capital framework. The BCBS, however, is considering constrains on the use of internal models for credit risk measurement, which may result in less consistency between accounting standards and the regulatory capital framework. Inconsistencies between the two will not only increase banks’ practical burdens but also may lead to inconsistency in disclosure and may mislead market participants. Given this, when discussing the regulatory treatment of accounting provisions, it is important to assess both the accounting standards and the regulatory framework entirety in order to ensure consistency between them.

Furthermore, as mentioned in our comments on the consultative document, it is likely that the introduction of ECL models might lead to considerable changes in the amount of provisions in each period, and it might cause more volatility in the amount of regulatory capital. As such, the BCBS should sufficiently analyse the potential impact that such volatility in the regulatory capital may have on the bank’s financial intermediary function and also on macroeconomy and the financial market. If deemed necessary, the comprehensive review of the regulatory treatment of provisions should also be considered.

In addition, in discussing the introduction of ECL models in accounting provisioning, the following points would need to be taken into account with regards to the introduction of ECL models: (i) introduction of ECL models will vary depending on accounting standards; (ii) even where ECL models are to be introduced, the timing of introduction will be different across jurisdictions; and (iii) assumptions and methodologies used under the ECL models will also be different. Based on these differences between each jurisdiction’s GAAP, the BCBS should carefully consider areas to be harmonized in their regulatory treatment and those to be allowed for adjustments in line with each jurisdiction’s circumstances.

<<Specific comments>>

1. Policy options for the longer-term regulatory treatment of provisions

We support the option to "retain the current regulatory treatment of provisions as a permanent approach" ("option to retain the current treatment") on the basis that this option will impose the least burden on banks and be capable of taking a flexible and appropriate approach that reflects differences in accounting standards and business practices across jurisdictions.

With respect to the approach to "introduce a universally applicable and binding definition of GP and SP," this approach may rather give rise to practical burdens or undue confusion and is unlikely to produce benefits justifying costs, since definition of provisions and provisioning practice are different among jurisdictions. We support the option to retain the current treatment, but if the BCBS would decide to introduce a universally applicable definition of GP/SP, it would be reasonable to treat accounting provisions recognised for impaired loans as SP and all other accounting provisions as GP, respectively, under the Basel regulatory regime.

Although we support the option to retain the current treatment as described above, if regulatory expected loss ("EL") is to be introduced under the standardised approach ("SA"), the BCBS should carefully consider the following points:

① Sufficient and appropriate calibration (e.g. application of downward-scaling factors) should be considered in order to avoid the increase in regulatory capital relative to the current SA framework.

② The BCBS should also consider reviewing the calculation method for credit risk weighted assets ("RWAs"), the denominator of capital adequacy ratio, along with the treatment of partial write-offs and the definition of EAD, because the amount equivalent to EL needs to be deducted from such credit RWAs under the SA in order to ensure consistency between the SA and the IRB approaches.

③ Applying the capital floor based on the SA to RWAs calculated under the IRB approaches is currently under consideration. The BCBS should revisit the regulatory approach in terms of the impact on both SA and IRB banks once the final rules is set for the capital floor.

④ The discussion paper proposes to calculate the regulatory EL amount for defaulted exposure as the higher of: "the standardised regulatory EL rate multiplied by the gross exposure values defined in Basel II, paragraph 308"; and "accounting provisions related to credit losses for the defaulted exposure under accounting standards" (see paragraph 2.3.3.2). Since this proposed rule does not allow the inclusion of excess provisions into regulatory capital, the treatment is overly conservative relative to the IRB approaches. Given this, this rule should be removed.

2. Treatment of general and excess provisions

We propose that both (i) GP under the SA and (ii) eligible provisions under the IRB exceeding EL should be eligible for the inclusion in CET1.

In the first place, loan loss provisions are capable of absorbing loss on a going-concern basis. Given this, it would be reasonable to include in CET1, instead of Tier 2, for both the above-mentioned (i) and (ii).

In addition, with the upcoming introduction of ECL models in some accounting frameworks (e.g., IFRS and USGAAP), ECL models and incurred loss models will co-exist at a global level. Furthermore, IFRS and USGAAP are applying different provisioning methodologies. It is therefore expected that the level of accounting provisions will significantly vary across jurisdictions and banks going forward.

If the current regulatory treatment is retained under such circumstances, it will give an inappropriate incentive for the jurisdictions and banks where accounting standards require earlier recognition and a higher level of provisions. Given the fact that these jurisdictions and banks apply more sound measures, they will have less CET1 although they determined to adopt these measures in response to the criticism "too little too late" during the global financial crisis. Considering increased recognition of CET1 as one of significant indicators in recent years, regulatory treatment should be reviewed from the perspective of promoting the use of ECL models as well.

Furthermore, there is a problem in terms of comparability because the CET1 ratio may vary across banks having the same portfolio, depending on whether they use ECL models or not, and depending on the nature of ECL models, if they employed.

In view of the above and also from the perspective of ensuring a global level playing field, it is important to neutralise the effect on CET1 arising from whether ECL models will be introduced in accounting standards or not.

3. Others

We support the inclusion of general provisions and excess provisions in Tier 2 for the purposes of calculating Total Loss-Absorbing Capacity ("TLAC") (paragraph 3.3). Since both general and excess provisions are deemed as loss-absorbing capacity at the time when a bank falls into bankruptcy, it would be reasonable to include them into the numerator for calculating the TLAC ratio.