The Clearing House
At the Center of Banking Since 1853

January 13, 2017

Via Electronic Mail

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel Switzerland

Re: Discussion Paper and Consultative Document – Regulatory Treatment of Accounting Provisions

Ladies and Gentlemen:

The Clearing House Association L.L.C.[1] appreciates the opportunity to comment on the Basel Committee's recent Discussion Paper[2] and Consultative Document[3] addressing the regulatory treatment of accounting provisions for credit losses and the implications for regulatory capital of modifications to U.S. Generally Accepted Accounting Principles[4] and International Financial Reporting Standards[5] that will replace the existing incurred-loss approaches for establishing accounting provisions with forward-looking approaches based on expected credit losses ("**ECL**").

Under the current U.S. GAAP and IFRS incurred-loss approaches, a bank or other entity generally considers only past events and current conditions in determining whether to recognize

1 The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Association L.L.C. is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C., owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by building a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly $2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume.

2 Basel Committee, *Discussion Paper – Regulatory Treatment of Accounting Provisions* (October 2016), *available at* https://www.bis.org/bcbs/publ/d385.pdf.

3 Basel Committee, *Consultative Document – Regulatory Treatment of Accounting Provisions – Interim Approach and Transitional Arrangements* (October 2016), *available at* https://www.bis.org/bcbs/publ/d386.pdf.

4 Financial Accounting Standards Board, *ASU No. 2016-13, Financial Instruments – Credit Losses (Topic 326)* (June 2016).

5 International Accounting Standards Board, *IFRS 9 – Financial Instruments* (July 2014).

credit losses on financial assets. The modifications to U.S. GAAP and IFRS replace these approaches with forward-looking methodologies that for many assets will reflect credit losses that are expected over the lives of financial assets.[6] When implemented, ECL accounting standards will require banks and other entities to establish accounting provisions for credit losses on financial assets based on past events, current conditions, and reasonable and supportable forecasts. Upon the initial implementation, banks and other entities will recognize a one-time adjustment to retained earnings and, therefore, CET1. The modifications to U.S. GAAP will take effect beginning with the first quarter of 2020 for banks and other entities that are SEC reporting companies and have December 31 fiscal year-ends, and the modifications to IFRS will take effect on January 1, 2018. Early adoption is permitted under both U.S. GAAP and IFRS.

Although the implementation of ECL accounting standards is expected to increase overall accounting provisions for credit losses and correspondingly decrease CET1, the magnitude of the impact is not presently known.[7] In light of the anticipated impact of ECL accounting standards and the attendant uncertainty, it is critical that stakeholders—including the Basel Committee, national authorities, and banks—assess the implications of these pending changes to U.S. GAAP and IFRS on regulatory capital.

Accordingly, we welcome the Basel Committee's initiatives relating to the implementation of ECL accounting standards and look forward to further consultations on the longer-term regulatory treatment of accounting provisions. In that regard, we support the Basel Committee's decision to conduct the quantitative impact studies described in the Discussion Paper and the Consultative Document, to consider potential revisions to the regulatory treatment of accounting provisions, and to seek consultation on transitional arrangements. High-quality quantitative impact studies are critical to furthering the Basel Committee's objective of making empirically based decisions. Consistent with that objective, we believe that the quantitative impact studies should proceed only when banks have further progressed in their preparations for the implementation of ECL accounting standards and are in a position to provide more meaningful estimates of the impact of ECL accounting standards, so as to ensure any data collected is of sufficiently high quality. We also support the introduction of transitional arrangements, as contemplated by the Consultative Document, to mitigate the potential "cliff effects" and "capital shock" resulting from the adjustment to retained earnings and CET1 upon the implementation of ECL accounting standards.

---

[6] Under U.S. GAAP, accounting provisions will reflect estimates of credit losses over the lives of financial assets. Under IFRS 9, the horizon for the estimates of credit losses depends on the relevant stage: for Stage 1, accounting provisions will reflect estimates of credit losses over a 12-month horizon; and for Stage 2 (applicable for financial assets that have had a significant increase in credit risk since initial recognition) and Stage 3 (applicable for financial assets that have objective evidence of impairment at the reporting date), accounting provisions will reflect estimates of credit losses over the lives of the financial assets.

[7] *See, e.g.*, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration and Office of the Comptroller of the Currency, *Frequently Asked Questions on the New Accounting Standards on Financial Instruments – Financial Instruments – Credit Losses* (Dec. 19, 2016) at 15, question 17, *available at* https://www.federalreserve.gov/bankinforeg/srletters/sr1619a1.pdf.

We recommend that any revisions to the regulatory treatment of accounting provisions take into account that, as a result of ECL accounting standards, accounting provisions are expected to increase and provide additional capacity to absorb future credit losses. As a result, a proper calibration between accounting and regulatory capital frameworks is necessary to ensure that excessive or duplicative capital requirements for credit risk do not result from the implementation of ECL accounting standards. The Basel Committee should further study the implications of ECL accounting standards using the data from the quantitative impact studies to ensure that the relationship between accounting and regulatory capital frameworks is coherent and properly calibrated.

In addition, the transitional arrangements should be finalized in the near term due to the January 1, 2018 effective date for the modifications to IFRS. We also believe that the transitional arrangements should reflect the significant uncertainty regarding the impact of ECL accounting standards, both in terms of magnitude as well as variability among banks and business models. This uncertainty is likely to remain during the time frame for developing transitional arrangements, particularly as to the modifications to U.S. GAAP, which will not go into effect until 2020, two years after the modifications to IFRS.

I. Executive Summary.

- The Basel Committee should retain the distinction between general provisions and specific provisions for purposes of determining Tier 2 capital under the standardized approach and, as to the longer-term treatment of accounting provisions under the standardized approach, revise the methodology for determining risk-weighted assets so that exposure amounts are risk-weighted net of both general provisions and specific provisions. Our recommended approach is a modified version of the first option presented by the Basel Committee in the Discussion Paper.

- The standardized regulatory expected loss framework described in the Discussion Paper (the "**SA-EL**") would represent a fundamental change to the current regulatory treatment of accounting provisions and presents substantial challenges and drawbacks, including complexity, reduced risk sensitivity, and the introduction into the standardized approach of concepts and methodologies that were developed for unique aspects of the IRB approaches.

- Banks should continue to be permitted to include accounting provisions in Tier 2 capital under both the standardized and the IRB approaches, and the limits on the maximum amount of accounting provisions that can be included in Tier 2 capital should be recalibrated to reflect the effects of ECL accounting provisions on the magnitude and nature of accounting provisions.

- The Basel Committee should conduct a comprehensive analysis of the current treatment of accounting provisions under the IRB approaches to assess whether that treatment is appropriate for ECL accounting standards and to ensure that the impact of ECL accounting standards on regulatory capital is not inappropriately adverse.

- A transitional adjustment to CET1 that is amortized on a straight-line basis over five years is appropriate to facilitate the ability of banks to absorb the uncertain and potentially material impact of the implementation of ECL accounting standards.

  - Banks should be permitted to phase in the "day one" impact of ECL accounting standards on CET1 over the transition period, and jurisdictions that have adopted IFRS should have the option to permit banks to phase in the impact of IFRS 9 Stage 1 and Stage 2 provisions on CET1 if the differences between phasing in the "day one" impact and IFRS 9 Stage 1 and Stage 2 provisions are appropriately considered.

  - The full impact of the implementation of ECL accounting standards should be subject to a transitional adjustment to CET1 that is amortized on a straight-line basis over five years, with the transition period beginning on the effective date for the applicable ECL accounting standard.

- Retention of the current regulatory treatment of accounting provisions, as applied under both the standardized and IRB approaches, is warranted until the longer-term treatment of accounting provisions is determined and any changes to that treatment are implemented.

II. The Basel Committee should retain the distinction between general provisions and specific provisions for purposes of determining Tier 2 capital under the standardized approach and, as to the longer-term treatment of accounting provisions under the standardized approach, revise the methodology for determining risk-weighted assets so that exposure amounts are risk-weighted net of both general provisions and specific provisions.

The standardized approach distinguishes between accounting provisions that are general provisions ("**GP**") and those that are specific provisions ("**SP**"). That distinction is reflected only in the regulatory capital framework; it is not reflected in accounting standards. Jurisdictions have therefore developed their own approaches to categorize accounting provisions as GP or SP. For regulatory capital purposes, GP are accounting "[p]rovisions or loan-loss reserves held against future, presently unidentified losses [and] are freely available to meet losses which subsequently materialise," and SP are accounting "[p]rovisions ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped."[8] Under the standardized approach, GP, but not SP, may be included in Tier 2 capital, up to a maximum of

[8] *See* Basel Committee, *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (December 2010, rev. June 2011) at paragraph 60, *available at* http://www.bis.org/publ/bcbs189.pdf.

1.25% of standardized credit RWAs,[9] and exposure amounts are risk-weighted net of SP but gross of GP.[10]

The Discussion Paper presents three options for the longer-term treatment of accounting provisions under the standardized approach. The first option would retain the current regulatory treatment of accounting provisions, including the distinction between GP and SP and exposure amounts risk-weighted net of SP but not GP, with jurisdictions continuing to categorize accounting provisions as either GP or SP based on their respective accounting frameworks; the second option would introduce universally applicable and binding regulatory definitions for the categorization of GP and SP while retaining the current regulatory treatment of, and distinction between, GP and SP; and the third option would fundamentally change the current regulatory treatment of accounting provisions by removing the distinction between GP and SP and introducing the SA-EL.[11]

We urge the Basel Committee to adopt a modified version of the first option ("**Modified Option 1**") in which GP (but not SP) would remain eligible for inclusion in Tier 2 capital and exposure amounts would be risk-weighted net of both GP and SP. Under Modified Option 1, the approach to determining Tier 2 capital would be consistent with the current standardized approach and the Discussion Paper's first option. Modified Option 1 would, however, eliminate the different treatment of GP and SP for purposes of determining standardized RWAs.

We believe Modified Option 1 is more appropriate than, and preferable to, the Discussion Paper's three options for the following reasons:

- First, Modified Option 1 is simple in its design and significantly less complex to implement than the Discussion Paper's second option (developing universally applicable and binding regulatory definitions for categorizing GP and SP) and third option (the SA-EL). With respect to the second option, we agree with the Basel Committee that developing detailed, prescriptive regulatory definitions of GP and SP would be challenging.[12] This challenge would be particularly acute due to differences in accounting frameworks and provisioning standards and practices across jurisdictions. With respect to the third option (the SA-EL), as discussed further in Section III below and as recognized by the Discussion Paper, the SA-EL would represent a fundamental change to the current regulatory treatment of accounting provisions, presenting significant complexity relating to both the design and implementation of the framework. Although Modified Option 1 would entail the development of a methodology to allocate accounting provisions (including GP) among standardized exposures, we believe that developing and applying that

---

9 *See id*.

10 *See* Basel Committee, *Basel II: International Convergence of Capital Measurement and Capital Standards – A Revised Framework Comprehensive Version* (June 2006) at paragraph 52, *available at* http://www.bis.org/publ/bcbs128.pdf.

11 *See* Discussion Paper, at 5-12.

12 *See id.*, at 6 ("[S]triking the right balance in defining GP and SP would be a challenge under this approach.").

methodology would be significantly less complex than implementing the second or third options presented in the Discussion Paper. A central aspect of the Modified Option 1 methodology will be how GP are allocated among exposures with varying risk weights, and we recognize the importance of not over-allocating GP to exposures with high risk weights. We would welcome the opportunity to work with the Basel Committee, national authorities and other stakeholders to develop the allocation methodology.

- Second, Modified Option 1 promotes risk sensitivity because it would adjust standardized RWAs based on all accounting provisions under ECL accounting standards, which, in turn, reflect the underlying risk characteristics in banks' portfolios. Indeed, by risk-weighting exposure amounts net of both GP and SP, Modified Option 1 would be more risk-sensitive than the current regulatory treatment of accounting provisions, which considers only SP in the determination of standardized RWAs. In stark contrast, and as discussed in Section III below, the SA-EL would reduce risk sensitivity by disregarding all accounting provisions (including SP) in determining standardized RWAs and by rigidly imposing uniform global metrics for the minimum amount of credit loss provisions to be recognized in CET1.

- Third, Modified Option 1 would eliminate the different treatment of GP and SP for purposes of determining standardized RWAs, as exposure amounts would be risk-weighted net of both GP and SP. This would reduce level-playing-field issues resulting from jurisdictions' varying approaches to categorizing accounting provisions as GP and SP. Although Modified Option 1 would retain the distinction between GP and SP for purposes of the provisioning component of Tier 2 capital, under Modified Option 1—and unlike the current regulatory accounting treatment or the first and second options in the Discussion Paper—all accounting provisions, whether GP or SP, would be factored into the determination of standardized RWAs. Accordingly, Modified Option 1 would treat all accounting provisions similarly in calculating the denominator for all standardized risk-based capital ratios, including CET1, which, as the Discussion Paper observes,[13] is increasingly the focus of stakeholders. Modified Option 1 would therefore avoid the complexity of the second and third options while promoting risk sensitivity and addressing level-playing-field issues relating to jurisdictions' varying approaches to categorizing accounting provisions as GP and SP. In addition, Modified Option 1 would promote greater consistency between RWAs under standardized and IRB approaches. Under the IRB approaches, accounting provisions do not factor into risk-weighting calculations, and the distinction between GP and SP does not affect RWAs.[14] Modified Option 1 would reduce, if not eliminate, the relevance of the distinction between GP and SP for purposes of determining standardized RWAs.[15] Modified Option 1 would also promote greater consistency between the standardized approach and accounting

[13] *See* id., at 13.

[14] *See* Basel II, at paragraph 308; *see also* Discussion Paper, at 5.

[15] If the methodology for allocating accounting provisions among exposures considered whether accounting provisions were GP or SP, Modified Option 1 would reduce, but not eliminate, the relevance of the distinction between GP and SP for purposes of determining standardized RWAs.

standards because the distinction between GP and SP is not reflected in accounting standards.

We recognize that Modified Option 1 includes an aspect of "double counting" because GP would both be subtracted from exposure amounts for purposes of determining standardized RWAs and be eligible for inclusion in Tier 2 capital. We believe, however, that any such double counting is appropriate in light of the double counting of certain credit risk elements under the standardized approach in both RWAs (through the standardized risk weights) and regulatory capital (through the recognition of accounting provisions in CET1), as discussed further below.

During the development of Basel II, the IRB approaches were redesigned to exclude "expected losses" from RWA calculations so that IRB RWAs would reflect only "unexpected losses."[16] In contrast, the standardized approach was not similarly revised in connection with the development of Basel II,[17] and, as the Discussion Paper observes, standardized risk weights may reflect both "expected losses" and "unexpected losses."[18] Accordingly, a bank's standardized RWAs may represent credit risk elements relating to both "expected losses" and "unexpected losses." Since accounting provisions are seen to cover "expected losses" under regulatory capital frameworks,[19] certain elements of credit risk—*i.e.*, those relating to "expected losses"—may be double counted in standardized capital ratios, with "expected losses" being reflected both in regulatory capital through the recognition of accounting provisions in CET1 and in RWAs through the standardized risk weights. Indeed, although the Basel Committee has stated that capital would only be needed to absorb "unexpected losses" (and not "expected losses"),[20] banks hold capital for both types of losses under the standardized approach. Moreover, to the extent that any accounting provisions recognized under ECL accounting standards cover "unexpected losses," the implementation of ECL accounting standards will increase the double counting of credit risk elements in both capital and RWAs under the standardized approach and result in double counting of credit risk elements in both capital and RWAs under the IRB approaches. Indeed, as discussed in the introduction and Sections IV and V below, this potential double counting has implications for other aspects of the regulatory capital framework, including the calibration of regulatory capital requirements, the provisioning component of Tier 2 capital, and the overall treatment of accounting provisions under the IRB approaches. As described in

---

16 *See* Basel Committee, *An Explanatory Note on the Basel II IRB Risk Weight Functions* (July 2005) at 7 ("In the end, it was decided to follow the [unexpected losses] concept and to require banks to hold capital against [unexpected losses] only."), *available at* http://www.bis.org/bcbs/irbriskweight.pdf.

17 *See* Basel Committee, *Modifications to the Capital Treatment for Expected and Unexpected Credit Losses in the New Basel Accord* (Jan. 30, 2004) at 1 ("In summary, for the IRB approach, expected losses will be removed from the risk weight functions. . . . The Committee is not intending to make any related changes to the standardised approach."), *available at* http://www.bis.org/publ/bcbs104.pdf.

18 *See* Discussion Paper, at 11 ("It is not fully clear whether or not it should be assumed that the SA risk weights already count part of regulatory expected losses in addition to unexpected losses.").

19 *See* An Explanatory Note on the Basel II IRB Risk Weight Functions, at 7 ("As explained above, banks are expected in general to cover their Expected Losses on an ongoing basis, *e.g.* by provisions and write-offs, because it represents another cost component of the lending business. The Unexpected Loss, on the contrary, relates to potentially large losses that occur rather seldomly. According to this concept, capital would only be needed for absorbing Unexpected Losses.").

20 *See id.*

Section V below, application of a methodology similar to Modified Option 1 could be applied to the IRB approaches to mitigate some of the implications of double counting credit risk elements in capital requirements.

III. The SA-EL would represent a fundamental change to the current regulatory treatment of accounting provisions and presents substantial challenges and drawbacks, including complexity, reduced risk sensitivity, and the introduction into the standardized approach of concepts and methodologies that were developed for unique aspects of the IRB approaches.

The implementation of the SA-EL, as outlined in the Discussion Paper, would represent a fundamental change to the current regulatory treatment of accounting provisions under the standardized approach. Moreover, the SA-EL would introduce into the standardized approach concepts and methodologies that were developed for the IRB approaches even though those concepts and methodologies reflect unique aspects of the IRB approaches and are not well-suited for the standardized approach. The SA-EL thus presents substantial challenges and drawbacks, as further described below. In light of those challenges and drawbacks, the SA-EL may not be an appropriate treatment for accounting provisions under the standardized approach.[21]

The development and implementation of the SA-EL would be complex and impose regulatory compliance burdens. The introduction of the SA-EL would require the design and calibration of an entirely new regulatory framework and, as the Discussion Paper acknowledges, an assessment of standardized risk weights to evaluate the potential double counting of credit risk elements in regulatory capital requirements and to determine whether adjustments to risk weights are needed.[22] The SA-EL thus presents two types of complexity: complexity relating to the development of the framework itself, and complexity relating to the need for banks to develop systems and procedures to apply the framework.

The SA-EL is also an inherently rigid framework that would reduce risk sensitivity by both disregarding all accounting provisions (including SP) in determining standardized RWAs and establishing uniform global metrics for minimum credit loss provisions to be recognized in CET1. Indeed, by risk-weighting exposures gross of both GP and SP and by prescribing specified regulatory expected loss rates that would be the basis for calculating the minimum amount of credit loss provisions to be recognized in CET1 (except to the extent banks have excess provisions), the SA-EL would eliminate *any* recognition among banks worldwide of differences in the credit quality of their exposures within a particular risk-weighting category. For example, all 100% risk-weighted commercial loans across banks worldwide would be treated identically for standardized approach capital purposes, irrespective of credit-quality differences in exposures.

Further, the SA-EL would not reduce level-playing-field issues that are likely to arise following the implementation of ECL accounting standards because the SA-EL retains the

---

21 Certain of The Clearing House's members that report under IFRS recommend further consideration of the SA-EL as the longer-term treatment of accounting provisions, as well as potential changes to the framework and areas for further analyses, in separate comment letters.

22 *See* Discussion Paper, at 9-11.

asymmetric CET1 deduction/Tier 2 inclusion framework and does not address differences in ECL accounting standards that are expected to result in higher provisions under U.S. GAAP than under IFRS.[23] The SA-EL would establish a minimum amount of credit loss provisions to be recognized in CET1; any accounting provisions in excess of that minimum would reduce CET1; and that excess could be included in Tier 2 capital, subject to a cap. Accordingly, and as the Discussion Paper acknowledges, the SA-EL would not address level-playing-field issues relating to high levels of accounting provisions,[24] nor would the SA-EL address level-playing-field issues relating to the recognition of excess provisions in CET1 and the varying levels of accounting provisions under U.S. GAAP and IFRS. Moreover, as the Consultative Document and Discussion Paper observe,[25] the implementation of ECL accounting standards is expected to result in an increase in overall accounting provisions, and these provisions will often be greater than calculations of regulatory expected losses due to the different horizons for evaluating credit risk. The SA-EL therefore would not address the level-playing-field issues that are likely to exist under ECL accounting standards—*i.e.*, issues relating to high levels of accounting provisions, the asymmetric treatment of excess provisions and the recognition of excess provisions in CET1, differences between U.S. GAAP and IFRS, and the expectation that accounting provisions under U.S. GAAP will be higher than those under IFRS.

The regulatory expected loss framework was developed and designed for the IRB approaches, which, as discussed in Section II above, excludes "expected losses" from RWA calculations so that current IRB RWAs reflect only "unexpected losses," with "expected losses" covered through provisioning. The current regulatory expected loss framework thus reflects the distinction under the IRB approaches between "unexpected losses" (which are covered through RWAs) and "expected losses" (which are covered through provisions, via recognition in regulatory capital). In contrast, the standardized risk weights do not distinguish between "expected losses" and "unexpected losses," and, as explained in Section II above, the standardized approach double counts certain credit risk elements in regulatory capital requirements. The SA-EL would introduce into the standardized approach concepts and methodologies that were developed for and reflect unique aspects of the IRB approaches—*i.e.*, a treatment of credit provisions predicated on the distinct treatment of "unexpected losses" and "expected losses." There would be two consequences to transposing such IRB-specific concepts and methodologies to the standardized approach: *first*, the SA-EL would lack conceptual coherence given the different characteristics of IRB and standardized RWAs; and *second*, the SA-EL would increase the double counting of credit risk in standardized capital requirements.

---

23 Accounting provisions under U.S. GAAP will typically be higher than those under IFRS because U.S. GAAP will require that accounting provisions reflect estimates of credit losses over the lives of financial assets, while IFRS will require a lifetime horizon for only IFRS 9 Stage 2 and Stage 3 provisions and will provide for a 12-month horizon for IFRS 9 Stage 1 provisions. *See* footnote 6, *supra*. In addition, the SA-EL would not address the fact that certain jurisdictions will not implement ECL accounting standards and will, instead, retain incurred loss methodologies. *See* Discussion Paper, at 7, footnote 13.

24 *See* Discussion Paper, at 8.

25 *See* Consultative Document, at 4 ("The Committee is aware that the transition to ECL accounting will generally result in an increase in the overall amount of loan loss provisions . . ."); Discussion Paper, at 16 ("Given the various differences, it is possible that accounting ECL could be higher or lower than regulatory EL although **the shift to a lifetime PD is expected to result in accounting ECL exceeding regulatory EL in possibly many cases**.") (emphasis in original).

Indeed, the Discussion Paper acknowledges that the SA-EL "could result in EL amounts covering some portion of credit risk that is currently already captured by the risk weights."[26]

IV. Banks should continue to be permitted to include accounting provisions in Tier 2 capital under both the standardized and the IRB approaches, and the limits on the maximum amount of accounting provisions that can be included in Tier 2 capital should be recalibrated to reflect the effects of ECL accounting provisions on the magnitude and nature of accounting provisions.

Under each of the standardized and IRB approaches, banks may include a provisioning component of up to 1.25% and 0.6% of credit RWAs, respectively, in Tier 2 capital.[27] Although we agree with the Basel Committee that stakeholders increasingly focus on CET1, inclusion of accounting provisions in Tier 2 capital remains important because banks are subject to minimum total capital requirements and, for some banks, the total capital ratio may be a binding constraint. Moreover, the provisioning component of Tier 2 capital does not introduce undue complexity into the regulatory capital framework; the component reflects straightforward calculations comparing GP (under the standardized approach) and excess provisions (under the IRB approaches) to credit RWAs. Accordingly, we urge the Basel Committee to continue to permit banks to include GP and excess provisions in Tier 2 capital, up to specified limits.

We also believe that the limits under both the standardized and IRB approaches should be recalibrated for the following reasons:

- First, under ECL accounting standards, accounting provisions will reflect estimates of credit losses over the lives of many financial assets. Accordingly, ECL accounting standards will require the recognition of accounting provisions for credit losses that have not yet occurred and may occur beyond the one-year horizon used for the determination of capital requirements under the IRB approaches. Those accounting provisions will reduce CET1 and be available to absorb losses if and when credit losses materialize. Including those accounting provisions in Tier 2 capital would appropriately reflect the loss-absorbing characteristics of accounting provisions under ECL accounting standards and would not weaken regulatory capital.

- Second, accounting provisions under ECL accounting standards may cover some "unexpected losses." To the extent such provisions cover "unexpected losses," as discussed in Section II above, the implementation of ECL accounting standards will result in the double counting of credit risk elements in regulatory capital

---

26 Discussion Paper, at 9.

27 Under the standardized approach, only GP may be included in Tier 2 capital, up to the 1.25% of credit RWAs limit. Under the IRB approaches, banks compare their accounting provisions to their regulatory expected losses for credit exposures (which are calculated as the probability of default, multiplied by loss given default, multiplied by exposure at default). If a bank's accounting provisions are greater than its regulatory expected losses, the bank may include the difference (referred to as "excess provisions") in Tier 2 capital, up to a maximum of 0.6% of credit RWAs. *See* Basel III, at paragraphs 60-61; *see also* Discussion Paper, at 5; footnote 32, *infra*.

requirements, as "unexpected losses" will be both deducted from CET1 (through the recognition of accounting provisions) and reflected in standardized and IRB RWAs.

- Third, if the limits are not increased, the proportion of accounting provisions that may be included in Tier 2 capital will decline because accounting provisions are expected to increase under ECL accounting standards. For example, if a bank has standardized RWAs of $10,000 and GP of $250 under existing accounting standards, up to $125 (or one-half) of the GP could be included in Tier 2 capital. If, as a result of ECL accounting standards, that bank's accounting provisions increase by 50% to $375, then, assuming constant RWAs of $10,000, only 33% of the GP could be included in Tier 2 capital. There is no policy reason why the proportion of accounting provisions that may be included in Tier 2 capital should decline as a result of ECL accounting standards. Indeed, as noted above, incremental accounting provisions resulting from ECL accounting standards will provide additional capacity to absorb future credit losses.

- Fourth, the implementation of ECL accounting standards may result in reductions in standardized credit RWAs. To the extent accounting provisions under ECL accounting standards are SP, the implementation of ECL accounting standards would reduce the maximum amount of provisions that may be included in Tier 2 capital under the standardized approach, because the incremental SP would reduce standardized credit RWAs. In addition, if Modified Option 1 is adopted, the implementation of ECL accounting standards would further reduce standardized credit RWAs, as exposure amounts would be risk-weighted net of both GP and SP. Accordingly, the 1.25% limit under the standardized approach should be recalibrated to reflect the reduction in credit RWAs resulting from ECL accounting standards and, if Modified Option 1 is implemented, risk-weighting of exposure amounts net of GP.

V. The Basel Committee should conduct a comprehensive analysis of the current treatment of accounting provisions under the IRB approaches to assess whether that treatment is appropriate for ECL accounting standards and to ensure that the impact of ECL accounting standards on regulatory capital is not inappropriately adverse.

The current treatment of accounting provisions under the IRB approaches was developed and designed when banks used incurred-loss methodologies to recognize credit losses on financial assets. The implementation of ECL accounting standards will require banks to use different, forward-looking methodologies to determine accounting provisions. Accordingly, we recommend that the Basel Committee analyze whether the current treatment of accounting under the IRB approaches will remain appropriate once ECL accounting standards become effective. Although we believe that the evaluation should be a comprehensive assessment of the treatment of accounting provisions under the IRB approaches, we also recommend that the evaluation focus on the following matters:

- The IRB approaches contemplate a one-year horizon for credit losses, whereas the ECL accounting standards reflect a lifetime horizon for many financial assets. As the

Discussion Paper observes,[28] accounting provisions under ECL accounting standards will likely often be greater than calculations of regulatory expected losses due to the different horizons for evaluating credit risk. ECL accounting standards will, therefore, likely fundamentally change the relationship between accounting provisions and regulatory expected loss calculations. Such a change could, among other things, result in the treatment of accounting provisions under the IRB approaches no longer being conceptually sound. Moreover, level-playing-field issues relating to the extent and treatment of excess provisions could arise.

- Accounting provisions under ECL accounting standards may cover some "unexpected losses." As discussed in Section II above, to the extent such provisions cover "unexpected losses," the implementation of ECL accounting standards will result in the double counting of credit risk elements in regulatory capital requirements, as "unexpected losses" will be both deducted from CET1 (through the recognition of accounting provisions) and reflected in RWAs.

- The accounting provisions under ECL accounting standards will have different loss-absorbing characteristics from accounting provisions under the current incurred-loss methodologies. ECL accounting standards will require the recognition of accounting provisions for credit losses that have not yet occurred and may occur beyond the one-year horizon used for the determination of capital requirements under the IRB approaches. Moreover, these accounting provisions will be available to absorb losses if and when credit losses materialize.

- Application of a methodology similar to Modified Option 1 for the standardized approach, described in Section II above, could be applied to the IRB approaches to mitigate some of the double counting of credit risk elements in capital requirements resulting from the implementation of ECL accounting standards. For the IRB approaches, such a methodology could provide that exposure amounts would be risk-weighted net of excess provisions, which represent accounting provisions in excess of regulatory expected losses for credit exposures over a 12-month horizon.

- The maximum amount of excess provisions that may be included in Tier 2 capital should be recalibrated, for the reasons discussed in Section IV above.

VI. A transitional adjustment to CET1 that is amortized on a straight-line basis over five years is appropriate to facilitate the ability of banks to absorb the uncertain and potentially material impact of the implementation of ECL accounting standards.

The Consultative Document notes that the Basel Committee has identified a number of reasons why it may be appropriate to introduce transitional arrangements for the impact of ECL accounting standards on regulatory capital. These reasons include: (i) the possibility that the impact could be significantly more material than currently expected and result in unexpected declines in capital ratios; (ii) the fact that the longer-term regulatory treatment of accounting provisions is under consideration and has not been determined; and (iii) the two-year difference

---

[28] *See* id., at 16.

in the effective dates of the ECL accounting standards under IFRS and U.S. GAAP.[29] These factors provide compelling justification for the introduction of transitional arrangements, and we urge the Basel Committee to do so.

A. Banks should be permitted to phase in the "day one" impact of ECL accounting standards on CET1 over the transition period, and jurisdictions that have adopted IFRS should have the option to permit banks to phase in the impact of IFRS 9 Stage 1 and Stage 2 provisions on CET1 if the differences between phasing in the "day one" impact and IFRS 9 Stage 1 and Stage 2 provisions are appropriately considered.

The Consultative Document provides three possible approaches for how transitional arrangements could be structured. The first approach would phase in the "day one" impact of the implementation of ECL accounting standards on CET1 over the transition period; the second approach would include a CET1 capital adjustment during the transition period based on the "day one" proportionate increase in accounting provisions; and the third approach would allow banks that report under IFRS to phase in the impact of provisions under IFRS 9 Stage 1 and Stage 2 on CET1.[30] For the following reasons, we recommend that the Basel Committee implement the first approach for all jurisdictions that have adopted ECL accounting standards and provide jurisdictions that have adopted IFRS with the option to implement the third approach if the differences between the first and third approaches are appropriately considered.[31]

- First, the first and third approaches are simple in their designs. Under the first approach, a bank would determine the impact of the implementation of ECL accounting standards on CET1 by comparing its CET1 immediately before and after implementation. Any decline in CET1, net of tax effects and any provisioning shortfall under the IRB approaches,[32] would be phased in to CET1 over the transition period. Under the third approach, a bank would treat the sum of its IFRS 9 Stage 1 and Stage 2 provisions at the applicable reporting date, net of tax effects and any provisioning shortfall under the IRB approaches, as the transitional adjustment to be phased in to CET1. The first and third approaches thus entail a limited number of straightforward calculations to determine the transitional adjustment.

---

29 *See* Consultative Document, at 4.

30 *See* id., at 4-9.

31 We note that on November 23, 2016, the European Commission proposed amendments to the Capital Requirements Regulation that would, among other things, implement the third approach in the European Union, with a five-year transition period and straight-line amortization of the entire transitional adjustment. *See* European Commission, *Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 and Regulation (EU) No 648/2012* (Nov. 23, 2016) at 264-265 (proposing to add Article 473a – Introduction of IFRS 9 to the Capital Requirements Regulation), *available at* http://ec.europa.eu/finance/bank/docs/regcapital/crr-crd-review/161123-proposal-amending-regulation_en.pdf.

32 If a bank's regulatory expected losses are greater than its accounting provisions, the bank must deduct the difference from CET1. *See* Basel III, at paragraph 73; *see also* Consultative Document, at 6-7.

- Second, it is our understanding that providing jurisdictions that have adopted IFRS with the flexibility to select the third approach may not introduce level-playing-field issues if all banks have transition periods of equal length that begin on the applicable effective date for their respective ECL accounting standard.[33] There would be no level-playing-field issues *among* IFRS jurisdictions, as each could select the third approach. In addition, as between IFRS jurisdictions and U.S. GAAP jurisdictions, the two-year period between the effectiveness of ECL accounting standards under IFRS and U.S. GAAP could mitigate level-playing-field issues relating to the ability of only IFRS jurisdictions to select the third approach. During 2018 and 2019, banks that report under U.S. GAAP will not be required to apply ECL accounting standards, so there would not be level-playing-field issues relating to the ability of IFRS jurisdictions to select the third approach during that time if IFRS jurisdictions could elect to use the third approach but U.S. GAAP jurisdictions could not. Beginning in 2020, assuming all banks have transition periods of equal length that begin on the applicable effective date for their respective ECL accounting standard (*i.e.,* January 1, 2018 for IFRS and January 1, 2020 for U.S. GAAP), the level-playing-field issues relating to the ability of IFRS jurisdictions to select the third approach could be mitigated because the proportion of the transitional adjustment added back to CET1 would be higher for U.S. GAAP jurisdictions than for IFRS jurisdictions, which would be two years further along in the transition period.[34]

B. The full impact of the implementation of ECL accounting standards should be subject to a transitional adjustment to CET1 that is amortized on a straight-line basis over five years, with the transition period beginning on the effective date for the applicable ECL accounting standard.

We address below the length of the transition period and the reasons why the full impact of the implementation of ECL accounting standards (without any materiality threshold) should be phased in to CET1, as well as the benefits of a straight-line amortization of the transitional adjustment and the reasons why CET1 is the appropriate capital metric to be adjusted.

The Consultative Document states that the Basel Committee is considering a transition period from three to five years.[35] We recommend that the Basel Committee select a five-year transition period beginning on the effective date for the applicable ECL accounting standard for the following reasons:

- First, the magnitude of the impact of ECL accounting standards on accounting provisions in the aggregate and for individual banks is currently unknown, and, as the Consultative Document observes, "the impact could be significantly more material

---

33 For example, assuming a five-year transition period, banks that report under U.S. GAAP would have a five-year transition period beginning in 2020, and banks that report under IFRS would have a five-year transition period beginning in 2018.

34 For example, assuming a five-year transition period, in 2020, U.S. GAAP jurisdictions and IFRS jurisdictions would be in the first and third years of their respective transition periods.

35 *See* Consultative Document, at 5.

than currently expected and result in an unexpected decline in capital ratios."[36] If the impact is significantly more material than currently expected, a longer transition period would facilitate the ability of banks to absorb the unexpected "cliff effects" and "capital shock" resulting from the adjustment to retained earnings and CET1 upon implementation of ECL accounting standards.

- Second, and related to the first point above, despite general awareness of the pending changes to accounting standards , there are still unresolved interpretative issues that could significantly affect the impact of ECL accounting standards, which limits banks' current ability to estimate, and perhaps adjust capital levels to prepare for, the potential "cliff effects" and "capital shock." These unresolved interpretive issues relate to a number of matters, including, for example, ways in which banks will estimate the life of loan for products such as credit cards and the methodologies used to generate the required full life economic forecasting.

- Third, a longer transition period would not meaningfully impair or delay the realization of the anticipated benefits of ECL accounting standards, nor would a longer transition period weaken banks' capital. This is because a longer transition period would facilitate a less disruptive introduction of ECL accounting standards into regulatory capital, without affecting the applicability of ECL accounting standards for financial reporting purposes or the need for banks to adhere to the new provisioning methodologies. Accordingly, the potential benefits of a longer transition period outweigh any potential drawbacks.

- Fourth, as discussed in Section VI.A above, providing all banks with transition periods of equal length that begin on the applicable effective date of their respective ECL accounting standard may mitigate potential level-playing-field issues if IFRS jurisdictions have the option to implement the third approach and allow banks to phase in the recognition of IFRS 9 Stage 1 and Stage 2 provisions.

The Consultative Document states that the Basel Committee is considering a modified version of the first approach that would include a materiality threshold and limit the transitional adjustment to the portion of the decrease in a bank's CET1 resulting from the implementation of ECL accounting standards that exceeds a specified percentage of the bank's CET1. We urge the Basel Committee not to include materiality thresholds in the transitional arrangements and believe that the full impact of the implementation of ECL accounting standards should be phased in to CET1 over the transition period.

- First, as noted above, there is uncertainty as to the magnitude of the impact of ECL accounting standards, in the aggregate and with respect to individual banks, and the inability to phase in the full impact of ECL accounting standards on CET1 could adversely affect banks' ability to absorb decreases in CET1 due to the implementation of ECL accounting standards, in particular if those decreases are significantly larger than anticipated.

---

[36] *Id.*, at 4.

- Second, as described above, there are currently unresolved interpretive issues that limit banks' ability to estimate and prepare for the impact of ECL accounting standards.

- Third, phasing in the full impact of ECL accounting standards would not meaningfully impair or delay the realization of the anticipated benefits of ECL accounting standards, nor would it weaken banks' capital. Here, too, phasing in the full impact would facilitate a less disruptive introduction of ECL accounting standards into regulatory capital, without affecting the applicability of ECL accounting standards for financial reporting purposes or the need for banks to adhere to the new provisioning methodologies.

- Fourth, a materiality threshold would result in inconsistent application of the transitional arrangements among banks, as some could be prohibited from phasing in any of the impact of the implementation of ECL accounting standards, and others would be limited to phasing in varying portions of the impact.

- Fifth, materiality thresholds would reduce the simplicity of the transitional arrangements.

We support the Basel Committee's objective to develop simple transitional arrangements and agree that straight-line amortization furthers that objective. Any other basis of amortization would introduce otiose complexity. We also agree with the Basel Committee that CET1 is the appropriate capital metric to be adjusted in the transitional arrangements because increases in accounting provisions due to the implementation of ECL accounting standards will result in decreases in CET1.

VII. Retention of the current regulatory treatment of accounting provisions, as applied under both the standardized and IRB approaches, is warranted until the longer-term treatment of accounting provisions is determined and any changes to that treatment are implemented.

As the Consultative Document notes, the Basel Committee's proposal to retain the current regulatory treatment of accounting provisions during an interim period would allow for thorough consideration of longer-term options for the regulatory treatment of accounting provisions and additional analysis of the impact of ECL accounting standards.[37] We support those objectives and the Basel Committee's proposal for the interim period. We also agree with the Basel Committee that jurisdictions should extend their existing approaches to categorizing accounting provisions as either GP or SP to accounting provisions measured under ECL accounting standards, and that regulators should be encouraged to provide guidance on the categorization of accounting provisions under ECL accounting standards. We note, moreover, that the accounting provisions under ECL accounting standards would relate to forward-looking methodologies, the incorporation of forecasts into determinations about credit losses on financial assets, and loss events that have not yet occurred. Accordingly, we agree that national authorities should not be precluded from determining that some of the accounting provisions

[37] *Id.*, at 1.

under ECL accounting standards should be categorized as GP (*i.e.*, accounting provisions "held against future, presently unidentified losses [that] are freely available to meet losses which subsequently materialise") and not SP (*i.e.*, accounting provisions "ascribed to identified deterioration of particular assets or known liabilities, whether individual or grouped").[38]

* * * * *

The Clearing House appreciates the opportunity to comment on the Discussion Paper and Consultative Document. If you have any questions, please contact the undersigned by phone at (212) 613-9883 or by email at david.wagner@*theclearinghouse.org*.

Respectfully submitted,

David Wagner
Executive Managing Director,
Head of Finance and Risk Affairs and
Senior Associate General Counsel
The Clearing House Association L.L.C.

cc: William Coen
(Basel Committee on Banking Supervision)

Scott Alvarez
Michael Gibson
Fang Du
Patrick Steiner
Joanne Wakim
(Board of Governors of Federal Reserve System)

Amy Friend
Morris Morgan
Louis A. Thompson, Jr.
(Office of the Comptroller of the Currency)

Doreen Eberley
Charles Yi
Robert Storch
(Federal Deposit Insurance Corporation)

---

[38] *See* id., at 1 and 3, footnotes 1 and 7; Basel III, at paragraph 60.