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Basel Committee on Banking Supervision
Bank for International Settlements

Via website submission: http://www.bis.org/bcbs/commentupload.htm

Re: Discussion Paper: *Regulatory Treatment of Accounting Provisions*

To Whom It May Concern:

The American Bankers Association (ABA[1]) appreciates the opportunity to comment on the Discussion Paper: *Regulatory Treatment of Accounting Provisions* (DP). The DP discusses the regulatory treatment of accounting provisions under the Basel III regulatory capital framework. The DP recognizes that the implementation of Accounting Standards Update 2016-13 (the CECL Standard, which is effective in 2020, with early adoption available) in the U.S. and International Financial Reporting Standard 9 (IFRS 9, which is effective in 2018) in some other jurisdictions will have a significant impact on banks' regulatory capital and may cause significant differences among banks in regulatory capital. Therefore, the existing standardized and internal ratings-based (IRB) approaches to loss provisioning for regulatory capital purposes may require significant revision. As a result, the Basel Committee is considering various alternatives to the current loss provisioning framework for regulatory capital.

Options proposed in the DP include:

- **Option 1:** Retaining the current regulatory treatment of credit loss provisions, including the distinction between General Provisions (GP, which currently qualify for inclusion in Tier 2 capital) and Specific Provisions (SP).

- **Option 2:** Introducing a universally applicable and binding definition of GP and SP, intended to produce consistent categorizations of loss provisions used for regulatory capital purposes.

- **Option 3:** Fundamentally change the current regulatory treatment of provisions by removing the GP/SP distinction and introducing regulatory Expected Loss (EL) under the Standardized Approach (SA) to loss provisioning.

ABA fully supports the Committee's efforts to review and revise this aspect of the regulatory capital rules. Below, ABA discusses various issues that must be addressed as the Basel Committee evaluates the loss provisioning framework for regulatory capital. These issues lead us to recommend that the Basel Committee explore the options presented in the DP with exposures based not only on a gross basis (as performed currently), but also on a net basis. We

[1] The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $8 trillion in loans.

believe risk weighting options that are based on net (as opposed to gross) exposures can better provide a level playing field internationally, as well as provide incentives to maintain robust accounting provisions and charge-off policies. In any event, we encourage open dialogue and further review as further consideration of and implementation of the expected credit loss accounting models continues, and we offer the following observations about the DP.

The DP provides a good starting point for discussing and reconsidering the detailed underpinnings of the regulatory capital framework and its interaction with accounting provisions. However, the options provided in the DP will not achieve what we believe should be key objectives of a regulatory capital framework. Specifically, a regulatory framework for the capital treatment of accounting provisions should be:

- Conceptually sound
- Understandable
- Operational

Additionally, the framework should:

- Encourage robust credit loss provisioning
- Provide a level playing field for banks of various sizes and in different jurisdictions

The DP appropriately discusses the weaknesses of the current framework (Option 1) and acknowledges the significant difficulty of implementing universal definitions of GP and SP (Option 2). These weaknesses will become more pronounced under revised accounting frameworks that are based on expected credit loss as opposed to incurred loss.

In order to achieve the framework objectives noted above, we strongly encourage the Basel Committee to expand the factors being considered and conduct a transparent process that is open to all ideas. With this in mind, ABA has the following recommendations:

- **Calibration of the current standardized approach Tier 2 capital add-back for the allowance for credit losses should be addressed.**

  The add-back to regulatory capital is important to many U.S. banks, and is critical to smaller community banks that rely on it in managing their legal lending limits. The current standardized approach Tier 2 capital add-back (which is limited to 1.25% of risk-weighted assets) was established with implementation of Basel I. We believe the 1.25% inherently acknowledges some interaction between accounting and regulatory capital frameworks and, thus, the loss absorbing ability of the allowance for loan and lease loss (ALLL). The current process provides sufficient incentives to maintain robust provisioning practices, and any revised long term approach should maintain these incentives. This relationship is being fundamentally altered by the new accounting regime, which necessitates a review of this relationship.

  In evaluating how to proceed, it would be useful to have a better understanding of how the current limit of 1.25% of risk-weighted assets was determined. Understanding the Basel

Committee's views about that calibration will help determine an appropriate calibration upon adoption of revised accounting standards.

The revised accounting standards are expected to increase accounting provisions as compared to the current levels. Consequently, in re-evaluating the current Tier 2 add-back, the Basel Committee should consider both the calibration of the risk-weighted asset cap and the fundamental change occurring to the loss absorbing ability of ALLL.

- **Differences in regulatory expected losses and accounting expected losses should be addressed.**

  Option 3's standardized expected loss calculation relies on the current IRB methodology, and expected losses estimated under CECL will differ from those calculated for regulatory capital purposes[2]. We believe the standardized expected loss methodology proposed in Option 3 would result in significant double-counting and under-counting of expected loss provisions in Common Equity Tier 1 (CET1) capital. An effort to neutralize these impacts will be procedurally onerous, but would be alleviated if symmetrical treatment is provided for excess accounting provisions (added-back to CET1 capital) as well as deficient accounting provisions (deducted from CET1 capital).

  We understand that there initially has been little consideration of an add-back of accounting provisions that exceed the regulatory expected loss. If that remains the case, a comprehensive and transparent review of the calibration of the standardized approach risk weights – including the underlying definitions of both accounting and regulatory capital expected and unexpected loss – will be necessary to ensure coherence between the accounting and regulatory capital frameworks. While the symmetrical treatment noted above will not shed light on the calibration of standardized risk weights, it would alleviate the pressure on the Basel Committee to justify risk weights in a detailed manner.

- **A level playing field is important, and other options should be considered.**

  The DP discusses the desire for a level playing field internationally, and ABA strongly supports this objective. Option 2 and Option 3 appear to address the current differences in practice regarding GP and SP as well as in charge-off practices. However, none of the approaches proposed in the DP, would alleviate level playing field concerns with regard to the most important measure of capital, CET1 capital. Among the proposed options, only Option 3, if symmetrical treatment of provision excesses and deficiencies were provided, could potentially address the level the playing field between IFRS 9 and CECL. Barring symmetrical treatment, the well-known differences between CECL and IFRS 9 credit loss provisioning effectively prevent any chance at a level playing field with regard to CET1

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[2] The differences generally include the time span that losses are expected to occur (12 months under the IRB method vs. remaining lifetime for CECL) and the assumed severity (through the cycle severity under the IRB method vs. remaining severity for CECL). Depending on the product, the circumstances, and the relative point in the economic cycle, CECL allowances could be higher or lower than those calculated under the IRB method. Further, charge-off practices could result in CECL allowances being relatively lower than IRB allowances, which are based on gross exposures, before charge-off.

capital. In fact, the differences will likely become greater if the current overall methodology, whereby risk weighting is based on gross exposures, is maintained (as Option 1, 2 and 3 propose).

ABA recommends, therefore, that the Basel Committee explore options that consider risk weighting on a net (vs. gross exposure) basis. Risk weighting based on net exposures (gross, less allowances and charged-off amounts) more precisely targets unexpected losses, while providing incentives to maintain robust accounting provisions and appropriate charge-off policies.

ABA acknowledges that certain operational issues must be addressed before implementing a net-basis framework for calculating risk-weighted assets under the standardized approach. For example, allocating provisions to the exposure level in order to risk-weight on a net basis will need further examination. However, from the Basel Committee's perspective, such a framework may also provide other significant benefits. It could also allow for a focused discussion on the calibration objectives of risk weighting for unexpected losses. Since risk weighting calibration will be the most challenging aspect to modifying the regulatory capital framework, focusing efforts mainly on the unexpected loss portion will enable a more focused and thoughtful discussion. With that in mind, we would be eager to address the operational challenges more at length if the Basel Committee decides to consider this further.

ABA recognizes the challenges faced by the Basel Committee in attempting to modify the capital framework to maintain coherence with the changing accounting frameworks. The process is likely to be lengthy. However, we believe that an open process that provides transparency to the objectives and calibrations will be a huge benefit to the industry for many years to come. We welcome the opportunity to work with the Basel Committee in this process.

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss our views.

Sincerely,

Michael L. Gullette