World Council

January 13, 2017

Filed electronically
William Coen
Secretary General
Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Discussion Paper: *Regulatory treatment of accounting provisions* (Oct. 2016)

Dear Mr. Coen:

World Council of Credit Unions (World Council) appreciates the opportunity to comment on the Basel Committee on Banking Supervision's discussion paper *Regulatory treatment of accounting provisions*.[1] Credit unions are cooperative depository institutions and World Council is the leading trade association and development organization for the international credit union movement. Worldwide, there are over 60,000 credit unions in 109 countries with USD 1.8 trillion in total assets serving 223 million natural person members.[2]

The implementation of expected credit loss standards including International Financial Reporting Standard 9 (IFRS 9) and the Current Expected Credit Losses (CECL) standard under United States Generally Accepted Accounting Principles (US GAAP) are de facto capital increases for depository institutions subject to these accounting rules. World Council urges the Committee to revise its regulatory capital standards to incorporate expected credit loss accounting rules without increasing overall depository institution capital requirements.

Specifically, we urge the Committee to:

- **Retain the "General Provisions" versus "Specific Provisions" Distinction:** We urge the Committee to retain the regulatory distinction between accounting "general provisions" and "specific provisions" because IFRS 9 and CECL will require significant increases in accounting loss reserves that are not allocated to specific, actual losses.

- **Include General Provisions in Additional Tier 1 Capital:** We urge the Committee to include general provisions under expected credit loss standards in Additional Tier 1 capital up to 1.25% of risk-weighted assets. Inclusion of general provisions under expected credit loss standards in Additional Tier 1 capital is appropriate because much of these funds are currently considered Common Equity Tier 1 (CET1) capital under incurred loss standards, these funds are permanent, they are not subject to any claims, and these funds will be available to absorb actual losses as they occur.

[1] Basel Committee on Banking Supervision, *Regulatory treatment of accounting provisions* – Discussion Paper (Oct. 2016), *available at* http://www.bis.org/bcbs/publ/d385.htm.
[2] World Council of Credit Unions, *2015 Statistical Report* (2016), *available at* http://www.woccu.org/publications/statreport.

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- **Allow National Discretion to Define General Provisions:** We urge the Committee to allow national discretion to define general provisions versus specific provisions because many jurisdictions follow national generally accepted accounting principles that differ materially from International Financial Reporting Standards (IFRS) and from one-another; and

- **No "Regulatory Expected Loss:"** We urge the Committee not promulgate a one-size-fits-all minimum "Regulatory Expected Loss" approach because local accounting, legal, and credit information conditions can vary considerably from jurisdiction to jurisdiction. Any effort to standardize regulatory expected loss accounting globally would be likely to create unintended consequences and increase regulatory burdens on smaller financial institutions.

World Council's Detailed Comments

1. Retaining the "General Provisions" versus "Specific Provisions" Distinction:

World Council supports continuing the currently applicable distinction between "specific provisions" (i.e. provisions allocated to a specific loss) and "general provisions" (i.e. those that are not allocated to a specific loss). Currently, "general provisions" can be included in an institution's Tier 2 capital up to 1.25% of risk-weighted assets.

IFRS 9/CECL will significantly increase institutions' loan loss and other provision requirements. This increase in loss reserves is not related to actual losses and, as an economic matter, the institution is simply transferring capital from one form of reserve account (e.g., "regular reserves") to another reserve account (e.g., the "allowance for loan losses"). The "expected losses" established by IFRS 9 and CECL are generally an estimate of what may occur in the future, and those estimates may not in fact be accurate in the long term. In other words, losses projected on an expected basis may not in fact occur as an economic matter even if accounting rules will require institutions to recognize the estimate as a loss for accounting purposes. Moreover, these general provisions have the key features of high quality capital, including being permanent, having no claims against them, taking losses before other capital items, and being available to absorb actual losses as they occur.

Retaining the "general provisions" versus "specific provisions" concept is therefore critical with respect to institutions and their prudential supervisors being able to identify what part of the institution's funds are in fact available to absorb future economic losses (i.e. general provisions) versus what provisions have been allocated to actual losses that the institution has incurred economically (i.e. specific provisions).

We urge the Committee to retain the distinction between general provisions and specific provisions.

2. Including "General Provisions" in Alternative Tier 1 Capital

World Council believes that general and excess provisions should be included in Additional Tier 1 capital rather than Tier 2 capital. General and excess provisions should be included in Additional Tier 1 capital up to at least 1.25% of risk-weighted assets because general and excess provisions are a form of capital as an economic matter. These funds are permanent, available to absorb actual losses as they occur, are not allocated to a specific loss, and do not have claims against them. In addition, the increase in loss reserves required by IFRS 9 and CECL will be provisioned for out of CET1 capital and will absorb losses prior to CET1 items.

This means that the relative capital quality of general reserves created under expected credit loss standards will be similar to CET1 capital for most intents and purposes, as the Committee recognizes in its proposal to allow these funds to be added back to CET1 as a transitional measure.[3] At the institutional level, however, to which reserve account funds are allocated can have a profound effect on the institution's regulatory capital ratios and can trigger statutory Prompt Corrective Action requirements under existing law that may be difficult to change through national legislative processes.

Including general provisions in Additional Tier 1 capital would also encourage institutions to make sufficient provisions for their loan losses. This is because Additional Tier 1 capital is included in two of the three Basel III risk-based capital ratios as well as the leverage ratio, whereas Tier 2 capital is only included in the numerator of the total risk-based capital ratio.

During or after the transition period, we urge the Committee to include general provisions in Additional Tier 1 capital because the capital quality of the general provisions under expected credit losses will be superior to the capital quality of loss reserves under incurred loss accounting standards. This increase in capital quality militates in favor of including general and excess reserves in Additional Tier 1 capital rather than Tier 2 capital.

3. Support retaining National Discretion to define "General Provisions" versus "Specific Provisions"

World Council supports retaining national discretion regarding how to define "general provisions" versus "specific provisions." Not all jurisdictions will adopt IFRS 9, meaning that globally there will continue to be significant variation in terms of accounting standards as well as significant variations in terms of local economic conditions, how loans and other financial products are structured, and so forth. World Council urges the Committee to allow national discretion with respect to the definitions of "general provisions" and "specific provisions" so that regulatory capital rules remain flexible enough that they do not create unintended consequences in jurisdictions following national generally accepted accounting principles.

[3] *See* Basel Committee on Banking Supervision, *Regulatory treatment of accounting provisions – interim approach and transitional arrangements* – Consultative Document (Oct. 2016), *available at* http://www.bis.org/bcbs/publ/d386.htm.

Cooperative financial institutions are often legally required to follow national generally accepted accounting principles. For example, credit unions in the United States of America are required by statute to follow US GAAP, credit unions in the United Kingdom and the Republic of Ireland following national Financial Reporting Standards issued by the Financial Reporting Council, and Mexican caja populares follows Mexican Financial Reporting Standards.[4]

Given such diversity in accounting standards, eliminating national discretion in this area would be likely to result in unintended consequences including higher compliance burdens related to trying to apply a one-size-fits-all definition to local conditions.

4. No "Regulatory Expected Loss" Approach

World Council does not support the Committee's proposal to create a "minimum requirement for provisioning" under the Standardized Approach that would be "similar to what exist in the [Internal Ratings Based] approaches." We urge the Committee to allow national discretion in this area in order to take into account local conditions and to limit regulatory burdens on smaller financial institutions.

We believe that creating a standardized "Regulatory Expected Loss" approach would not sufficiently consider local conditions in terms of applicable prudential supervisory law on accounting standards, how loan products are structured in a particular jurisdiction, rules on access to borrower credit information, or locally applicable laws concerning credit and debt collection. National mortgage markets, for example, vary considerably in terms of real estate price volatility, how mortgage loans are structured, underwriting criteria, and in terms of how likely it is for a mortgage loan to result in institutional losses.

Cooperative financial institutions also may not legally be permitted to recognize loan loss provisions that are not consistent with the applicable national accounting standard. In the United States, for example, the statutory requirement for depository institutions to follow US GAAP was established by the US Congress in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA).

Congress enacted FIRREA to address perceived abuses of regulatory accounting standards by savings and loan institution prudential regulatory agencies, such as the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation, during the "Savings and Loan Crisis" of the 1980s and early 1990s. The US Congress would likely need to pass legislation amending several financial institution regulatory statutes including the Federal Credit Union Act[5] in order to change these requirements for US credit unions and banks.

[4] *See, e.g.*, Federal Credit Union Act § 202(a)(6)(C), 12 U.S.C. § 1782(a)(6)(C), *available at* https://www.law.cornell.edu/uscode/text/12/1782 ("Accounting principles applicable to reports or statements required to be filed with the Board by each insured credit union shall be uniform and consistent with generally accepted accounting principles.").

[5] *Id.*

National contexts will also be different with respect to consumer protection laws, loan contract enforcement, ability to repossess collateral, the longer-term debt collection system, bankruptcy and insolvency laws, maturity of local credit bureaus and credit reporting standards, and so forth.

The World Bank Group's *Doing Business*[6] reports indicate that there is a very high degree of diversity globally in these legal and regulatory areas. The "Getting Credit" sections of the World Bank's *Doing Business* reports track national-level regulatory conditions with respect to lending activities, including the strength of creditors' legal rights, the depth of credit information, and the percentage of adults covered by credit bureaus. Regarding the strength of creditors' legal rights, for example, *Doing Business* provides 12 specific information points with a high degree of granularity, such as "Does an integrated or unified legal framework for secured transactions that extends to the creation, publicity and enforcement of functional equivalents to security interests in movable assets exist in the economy?"[7]

The high level of global diversity in terms of creditors' legal rights, etc., is illustrated by the regional-level comparisons data from World Bank Group's *Doing Business* reports included in the following table:[8]

Region	Strength of Legal Rights (0-12)	Depth of Credit Information (0-8)	Credit Registry Coverage (% of Adults)	Credit Bureau Coverage (% of Adults)
East Asia & Pacific	6.6	4.2	14.7	20.7
Europe & Central Asia	6.4	6.4	23	40.3
Latin America & Caribbean	5.3	4.8	13	41.2
Middle East and North Africa	1.4	4.4	13.5	12.8
OECD High Income	6	6.5	12.1	67.1
South Asia	4.6	3.9	4.2	14
Sub-Saharan Africa	5	2.5	6.9	7.6

[6] World Bank Group, *Doing Business* (2017); http://www.doingbusiness.org/ (last visited Jan. 13, 2017)
[7] "Getting Credit Methodology;" World Bank Group, *Doing Business* (2017); http://www.doingbusiness.org/data/exploretopics/getting-credit (last visited Jan. 13, 2017).
[8] "Getting Credit;" World Bank Group, *Doing Business* (2017); http://www.doingbusiness.org/data/exploretopics/getting-credit (last visited Jan. 13, 2017).

The strength of creditors' rights, for example, ranges from a low of 1.4 out of 12 in the Middle East and North Africa to a high of 6.6. out of 12 in East Asia and the Pacific, meaning that creditors' rights in East Asia and the Pacific are more than four time stronger than in the Middle East and North Africa. Similarly, the percentage of adults included in credit bureaus ranges from a low of 7.6% in Sub-Saharan Africa to a high of 67.1% in OCED High Income countries. There are also often high levels of diversity vis-a-vis these the regulation of credit and credit information from jurisdiction-to-jurisdiction within these regions.

We urge the Committee to allow national discretion with respect to expected credit loss standards in order to consider fully the world's diversity of local laws and regulations applicable to accounting, loans and lending.

5. Complexity and Simplification

World Council supports retaining the Standardised Approach's level of granularity with respect to provisioning for credit losses. The current level of granularity considers local conditions and allows inclusion of general credit loss provisions in regulatory capital.

Proposed "simplifications" such as standardized loss percentages, eliminating national discretion, or prohibiting inclusion of general provisions in Additional Tier 1 or Tier 2 capital would actually increase the regulatory burdens on credit unions and other community-based cooperative financial institutions. This is because these proposed simplifications would not consider local conditions, would likely have the effect of decreasing institutional regulatory capital beyond what would be required if more detailed analyses of the underlying economics were performed, and/or would be likely to result in other unintended consequences.

World Council appreciates the opportunity to comment on the Basel Committee's discussion paper on the *Regulatory treatment of accounting provisions*. If you have questions about our comments, please feel free to contact me at medwards@woccu.org or +1-202-508-6755.

Sincerely,

Michael S. Edwards
VP and General Counsel
World Council of Credit Unions