



## **BASEL COMMITTEE ON BANKING SUPERVISION**

**BANK FOR INTERNATIONAL SETTLEMENTS**

Chairman

**Restricted**

**VIA EMAIL: [iasb@iasb.org](mailto:iasb@iasb.org)**

Sir David Tweedie  
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30 June 2010

### **Financial Instruments: Amortised Cost and Impairment**

Dear Sir David

The Committee welcomes the opportunity to comment on the IASB's Exposure Draft (ED) *Financial Instruments: Amortised Cost and Impairment*. The Committee has a strong interest in high quality financial reporting by banking organisations and has carefully considered this proposal, in particular, since in April 2009 the G20 Leaders [...] to achieve a single set of high-quality global accounting standards".

The Committee strongly supports the initiative of the IASB to move from the current incurred credit loss model to an expected credit loss (EL) approach as this will improve the decision usefulness and relevance of financial reporting for users, including prudential regulators. An EL approach is likely to facilitate greater alignment between an institution's internal risk management approaches and incentives, its risk-taking behaviour, and the measurement of its performance in its financial statements.

The Committee is aware that the Financial Accounting Standards Board (FASB) has just issued an Exposure Draft on financial instruments that also addresses impairment. Notwithstanding this development, the Committee strongly encourages the IASB and the FASB to work together to achieve a high-quality converged impairment accounting standard for financial instruments based on expected losses and amortised cost.

Despite our support for the broad direction of the IASB's approach, the Committee has some concerns. The ED raises a number of operational challenges for most banks, including the largest internationally active banks. Also, the EL approach proposed in the ED might result in an allowance account whose balance is not adequate at all times to cover the expected credit losses in a portfolio of financial assets measured at amortised cost. Furthermore, the adjustment to the allowance account that the ED requires in response to revisions in estimates of expected

cash flows could be procyclical, which is contrary to the intent of a move from an incurred to an EL provisioning model.

The Committee has developed and approved an EL provisioning proposal in response to a request by the Group of Central Bank Governors and Heads of Supervision (GHOS), which is the Committee's governing body. The Committee's proposal builds on the *Guiding principles for the replacement of IAS 39* (high-level guiding principles) that were sent to you in July 2009 and does not expand the use of fair value accounting.<sup>1</sup> The 11 January 2010 GHOS press release stated,

*"It is essential that accounting standards setters and supervisors develop a truly robust provisioning approach based on expected losses (EL). Building on the Basel Committee's August 2009 Guiding Principles for the replacement of IAS 39, a sound EL provisioning approach should achieve the following key objectives: 1) address the deficiencies of the incurred loss approach without introducing an expansion of fair value accounting, 2) promote adequate and more forward looking provisioning through early identification and recognition of credit losses in a consistent and robust manner, 3) address concerns about procyclicality under the current incurred loss provisioning model, 4) incorporate a broader range of credit information, both quantitative and qualitative, 5) draw from banks' risk management and capital adequacy systems and 6) be transparent and subject to appropriate internal and external validation by auditors, supervisors and other constituents. So-called "through-the-cycle" approaches that are consistent with these principles and which promote the build up of provisions when credit exposures are taken on in good times that can be used in a downturn would be recognised."*

The Committee's EL proposal addresses the key objectives outlined above. The principal elements of this provisioning proposal are set out in Appendix A of this note. These principal elements have been communicated in bilateral meetings to the IASB during the ED consultation period and are designed to be integrated with the IASB's own EL proposal.

The Committee's EL provisioning proposal aims at remedying some of the concerns we have with the ED. It looks to improve the operational feasibility of the IASB's expected cash flow (ECF) model by developing an approach for banks, including appropriate practical expedients that would result in the earlier recognition of expected credit losses. In addition, it also makes greater use of a bank's risk management and capital adequacy systems to the maximum extent possible. The Committee's EL provisioning proposal also requires that provisions should always be adequate to absorb actual credit losses, and the recognition of actual losses should not be deferred.

Finally, the Committee recognises the importance of having a high-quality accounting EL impairment standard that is auditable and includes robust disclosure requirements as it depends to a significant degree on management's expectations of the future.

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<sup>1</sup> These principles can be found on the Committee's website ([www.bis.org/press/p090827.htm](http://www.bis.org/press/p090827.htm)).

The Committee's proposal is designed to be flexible to take into account developments at the Expert Advisory Panel (EAP) and to incorporate issues and possible solutions that emerge through the IASB's due process.<sup>2</sup> The Committee recognises that the IASB's EL approach may evolve in response to the work of the EAP as well as the comments that the IASB receives on the ED itself. Approaches being explored by the EAP as alternatives to the EL approach proposed in the ED may have elements that also satisfy the key objectives set forth above in the GHOS press release. Thus, the Committee also encourages the IASB to consider such alternative approaches.

The views of the Committee expressed above are further emphasised in our responses to the questions raised in the ED, which are presented in Appendix B.

These comments have been prepared by several groups within the Committee that are chaired or co-chaired by Sylvie Mathérat, Director of the Banque de France, and Jerry Edwards, Senior Advisor, Basel Committee Accounting Task Force. The Committee has approved these comments and trusts that you will find them useful and constructive. If you have any questions regarding our comments, please feel free to contact Sylvie Matherat (+33 1 4292 6579), Jerry Edwards, (+41 61 280 8055), or Rob Sharma at the Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely



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<sup>2</sup> For example, the IASB has learned from the EAP that “decoupling” could be a solution to some of the operational issues raised by the ED. This essentially means separating the ED's proposed effective interest rate (EIR) calculation so that it estimates the effective interest rate without credit losses and separately allocates expected losses within the income statement to reduce the systems burdens of an integrated calculation. The Committee's EL provisioning proposal can be applied with a decoupled EIR approach.



## **Appendix A**

### **Principal elements of the Basel Committee's EL proposal**

The following is a summary of the principal elements of the Committee's proposal that would apply to provisions<sup>3</sup> for loans and other financial assets measured at amortised cost.<sup>4</sup> These principal elements are designed to be integrated with the IASB's own EL proposal:

- Provisions are based on best estimates of expected credit losses built over the life of the loan at the balance sheet date. (This avoids the complexity of probability-weighted cash flows as set out in the IASB's EL proposal.)
- Expected credit losses are estimated losses over the remaining life of the loans considering the loss experience over the complete economic cycle.<sup>5</sup>
  - A bank's estimate of expected credit losses would include a quantitative element based on historical losses over a time period that is representative of at least a complete economic cycle. To that end, the bank could make use of Basel II parameters and portfolio segregation. A qualitative adjustment would occur when, in management's expert credit judgement, there is reasonable, objective and auditable support for a material change to the historical loss data. Qualitative adjustments to historical loss rates should seek to ensure that provisions reflect the best estimate of losses that are anticipated over the life of the loan or loan portfolio. Thus, the Committee's forward-looking estimate of credit losses is objective, robust, reliable (and auditable); it is applied over the life of the loan portfolio. The forward-looking estimate is grounded in historical loss experience, adjusted for current factors that are likely to cause the expected level of losses to differ from the level during the historical loss experience period.
  - Given the difficulty in predicting the timing and amount of expected future cash flows, banks would be permitted to assume that expected credit losses occur evenly over the remaining life of the loan portfolio.
- Provisions are generally built up progressively by allocating a share of the interest income over the life of the loan or loan portfolio to an allowance account at the time interest income is recognised.<sup>6</sup>
- When applying the Committee's proposal, it is important to ensure that at the balance sheet date the provision or allowance is adequate to cover the expected

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<sup>3</sup> The terms provision and allowance are used interchangeably.

<sup>4</sup> The IASB's and the Committee's EL provisioning approaches apply to loans and other financial assets measured at amortised cost. In this note, the term "loan" or "loan portfolios" refers to this broader category of financial assets measured at amortised cost.

<sup>5</sup> This is derived from the Committee's 2009 *Guiding Principles for the replacement of IAS 39* (Principle 12).

<sup>6</sup> One way to achieve this is to use an EIR that reflects the initial estimate of expected credit losses on a loan or loan portfolio as proposed in the IASB's ED. However, the Committee acknowledges that its EL provisioning proposal can be applied on a decoupled basis. See footnote 2.

credit losses within the upcoming period.<sup>7</sup> A forward-looking approach to implementing this principle could be helpful to avoid under-provisioning in any particular period over the life of the loan portfolio and to ensure that the concept of "earlier recognition of credit losses" is maintained.<sup>8</sup>

It should be noted that the Committee's proposal favours a portfolio approach. This approach, however, should not ignore a specific review of large exposures and related loss estimates (including provisions already created). Although some loans are evaluated on a collective basis, removal of these loans from the collective pool and evaluation on an individual basis is appropriate in some circumstances. For example, individual loans (including related loss estimates and provisions already created) should be considered for specific review when:

- The exposures are large; and/or
- The loans require close monitoring. This is especially relevant when, for example, there are potentially higher credit losses than typically expected, rare events occur or there is a concentration of risks (eg investment bank and corporate loans have loss distributions with "fat tails").

It would be beneficial for banks to differentiate between performing and non-performing loans when utilising a portfolio approach in view of the potentially significant differences in loss expectations. Non-performing loans are currently treated differently from performing loans within banks' internal risk management and Basel II capital systems. This aspect is further explained in Appendix B under Question 5 relating to disclosures.

Usually, banks continue to write new business and manage their portfolios on an "open" basis, ie adding new loans of a similar category and risks originated in different years to an existing portfolio and including in this same portfolio transactions with different maturity profiles. Under this "open portfolio" approach, the risk characteristics of the portfolio continue to change over time and, generally, this approach is more consistent with existing systems and processes used by banks. The IASB should clarify that its EL provisioning approach allows for the use of open portfolios.

The Committee also recommends expansion of the practical expedients proposed in the ED (refer to Appendix B, Questions 11 and 12). Finally, the Committee's approach would allow for subsequent revisions of the EIR under certain circumstances that will result in an adjustment to the allowance account and the income statement over the residual life of the loan.

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<sup>7</sup> Expressed in another way, the allowance account should never have a debit balance upon materialisation of losses between two assessment dates. Typically, the length of the "upcoming period" would be one year.

<sup>8</sup> This principle is a way to have a greater assurance that the provision is not inadequate in any year to cover expected credit losses (not unexpected losses), whether due to (i) certain short term loans or the characteristics of the loans whose losses are likely to emerge in earlier years and/or (ii) significant losses in early years that are due to an expected economic downturn during that period (such as might have been the case in 2007, before experiencing the higher loan losses of 2008-2009).

## Appendix B

### Responses to questions

As noted in the cover letter, the Committee's proposal and our responses to the questions below are designed to be flexible to take into account developments at the EAP and to incorporate issues and possible solutions that emerge through the IASB's due process (eg with respect to "decoupling" and other possible approaches). The Committee recognises that the IASB's EL approach may evolve in response to the work of the EAP as well as the comments that the IASB receives on the ED itself. Approaches being explored by the EAP as alternatives to the EL approach proposed in the ED may have elements that also satisfy the key objectives set forth in the 11 January 2010 GHOS press release. Thus, the Committee also encourages the IASB to consider such alternative approaches.

#### Question 1

Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?

#### Question 2

Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

The description of the objective as stated in paragraph 3 is clear but incomplete. It is acknowledged that the description includes some key points about the effective return, the allocation of interest revenues (for assets) and expenses (for liabilities), and the "over the life of the financial instrument" concept. Nonetheless, the proposed description is focused on the interest recognition over the life of the instrument only without explicitly considering the building up of provisions for credit losses.

In the ED, the description of the objective is restricted to the allocation of interest revenues (or expenses) to capture the effective return of the instrument. The recognition of interest income on a net basis by using an EIR that reflects the initial estimate of expected credit losses instead of an EIR that does not consider credit losses affects the income statement presentation. The rationale for using an EIR that reflects initially expected credit losses could be better explained, for instance, by referring to the risk premium embedded in the contractual interest rate. Referring to an effective return on a financial asset implicitly acknowledges that the use of an interest rate that ignores credit losses to allocate interest revenues over the life of the instrument is not the only relevant parameter.

**Nevertheless, the other side of measuring the effective return is recognising the building up of adequate levels of provisions on the balance sheet to absorb all credit losses when they occur.** In the ED, the allowance account seems to be a disclosure issue only. The objective of amortised cost should require consideration of the adequacy of provisions at the end of each reporting period to ensure that the allowance account could absorb losses emerging in the upcoming period.

In summary, the Committee's view is that the recognition of interest income should be appraised in conjunction with the building up of provisions over the life of the loan portfolio (or loan). If one of the primary objectives of amortised cost is the building up of provisions, then the EIR method could be considered as a means among other possible means. We note that, as a result of the work of the EAP, the IASB will be exploring alternative

approaches that do not necessarily make use of an EIR method. These observations about amortised cost and interest income recognition would continue to apply if an alternative approach is adopted.

**Question 3**

Do you agree with the way that the exposure draft is drafted, which emphasises measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why? How would you prefer the standard to be drafted instead, and why?

**Question 4**

(a) Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?

(b) Are there any other measurement principles that should be added? If so, what are they and why should they be added?

**Question 3**

The ED is drafted in an appropriate manner, as it emphasises measurement principles accompanied by application guidance. This takes into account the diversity of bank practices associated with managing instruments at amortised cost.

Nevertheless, application guidance<sup>9</sup> could include the following broad principles:

- All provisions should be booked in a separate allowance account<sup>10</sup> and the account balance should never be negative. Therefore, the allowance account should be replenished on a timely basis to avoid a debit balance. Furthermore, the use of provisions should be monitored to avoid an excess in provisions.
- Upon changes in loss expectations reflecting a sharp decrease of collectable cash flows the EIR should not have a negative value and should be limited to the risk-free rate.
- When there is an increase in collectable cash flows, the net carrying amount recalculated after changing the EIR should be limited to the amount granted at inception. Explained in another way, the revised carrying amount should not exceed the original carrying amount at inception.
- Provisions built on the basis of an open portfolio needs to occur within a well developed risk management framework that has adequate and effective controls. Approaches for building provisions on the basis of open portfolios include grouping homogeneous loans based on similar characteristics such as maturities or vintages. Furthermore, provisions for individual loans would be allowed. The way provisions will be built up will depend to a large extent on the business models of the entity.

We note that other application principles may be more appropriate should the IASB decide to pursue an evolved version of its EL approach such as an alternative that may emerge from the work of the EAP.

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<sup>9</sup> Application guidance developed by the IASB can also be supplemented by auditing and/or supervisory guidance developed by auditing standard-setters and banking supervisors.

<sup>10</sup> As noted in paragraph 15 of the ED.

#### **Question 4**

The responses to Questions 1 and 2 above address the objective of amortised cost measurement and its appropriateness. The principles in the ED focus on the calculation of the present value by using an EIR that reflects the initial estimate of expected credit losses. Nevertheless, these principles seem too restrictive. Comments on specific paragraphs in the ED are set out below:

#### **Paragraph 7**

The wording “as a cost-based measurement, amortised cost also reflects an input relating to initial measurement, which is the effective interest rate” precludes any resetting of the EIR. By considering that the EIR at origination reflects inputs available at origination (loss experience, economic environment etc.), the Committee’s view is that material or significant changes in inputs over time should result in a revision of the EIR.

A revised EIR for a financial asset will better reflect the level of interest earned by the entity. In case of adverse changes, the EIR will decrease and interest revenues will be booked at a lower pace reflecting the degradation of the entity’s profitability. Keeping the same EIR in the context of material changes would be misleading for investors since the pace of interest revenue recognition will be maintained at a rate that does not recognise important and objective forward looking information about a bank’s expected cash flows.

#### **Paragraph 8**

The first sentence states “the estimates for the cash flow inputs are expected values”.

In the Committee’s view, these estimates should be the best estimates that the entity could make drawing on objective qualitative and quantitative information that is available in an entity’s risk management and capital systems. Use of best estimates will effectively deal with estimation uncertainty relating to predicting cash flows.

The second sentence “the estimates of the amounts and timing of cash flows are the probability-weighted possible outcomes” can give rise to significant operational challenges. Estimating cash flow inputs based on probability-weighted possible outcomes appears to be too sophisticated considering the data systems available and current practice in the bank industry.

Based on bank loss experience, the Committee believes that an average loss pattern might be the starting point to calculate expected losses. Estimates of expected cash flows (and expected losses) may be derived from a bank’s internal models that utilise actual loss experience. However, there are many methods to estimate expected cash flows (and expected losses) drawing on loss rates. For example, loss rate data used for determining expected cash flows (and expected losses) may be derived from industry loss information (eg banking associations and in some countries Consumer Protection Agency statistics). Some central banks and supervisory agencies might also make such data available. Finally, loss rates such as an average loss rate based upon types of instruments may also be used.

#### **Paragraph 10**

As noted in the responses to Questions 1 and 2 above, the way the effective interest method is described is limited to the interest recognition without any links to the (i) actual cash flows

received (or paid) by the entity and the (ii) amount of provisions built up [the allowance account is only mentioned to account for credit losses]. The measurement principles should not overlook these two important components of the amortised cost measurement since they can impact the carrying amount of the instrument at amortised cost.

The realisation of cash flows implies that expected cash flows will be compared to actual cash flows. As previously stated, estimates incorporate a certain degree of uncertainty and there is a high probability that actual cash flows can differ from expected cash flows. The way that excess cash collections or cash deficiencies (in relation to expected cash flows) are dealt with may have some consequences for the allowance account and the carrying amount. Treatment of actual cash flows will impact the accumulation of provisions. Excess cash collections could be accounted for as an increase in provisions or recognised as income depending on the amount of provisions already built up in relation to actual credit losses. Management judgement will be required to assess the level of provisions in order to avoid any negative balance of the allowance account when actual credit losses arise.

The IASB's standard should reconcile actual loss experience and the realisation of expected cash flows to expected loss estimates. The Committee believes that it would be necessary to monitor the building up of provisions upon realisation of cash flows until the termination of the instrument to assess the accumulated provisions and their capacity to absorb losses when they arise. This assessment could potentially lead to the booking of additional provisions when needed or the reversal of provisions in excess.

#### **Question 5**

(a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?

(b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?

The Committee considers that the objective of presentation and disclosure as set out in the ED is clear.

It is important that any impairment approach includes high-quality disclosure requirements. That is particularly true for an approach which depends to a significant degree on management's expectations of the future.

In the past the Committee has recommended to the IASB that there be clear disclosure of loan write-downs, charge-offs (or increases (decreases) in specific provisions) and recoveries and that these be presented in a manner that can be compared with EL provisions.<sup>11</sup> This could be done via a two-line approach – showing both EL provisions and the actual loan write-downs or increases (decreases) to specific provisions – but could also be done through supplemental footnote disclosures that are all subject to verification by external auditors.

Transparency is enhanced when the level of provisions held by individual banks can be compared to key objective benchmarks by using ratios such as provisions/financial assets measured at amortised cost, provisions/risk weighted assets, and provisions/past due and

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<sup>11</sup> See the Committee's 1 September 2009 comment letter to the IASB on its *Request for Information 'Expected Loss Model' Impairment of Financial Assets: Expected cash flow approach*.

nonperforming loans. This can assist supervisors and other financial statement users in assessing an individual bank's provisioning practices over time and comparing them with other financial institutions.

Also, the presentation, disclosures and use of the allowance account should highlight when original carrying amounts increase due to a favourable revision of estimated credit losses. The difference between contractual interest income and expected interest income also needs to be appropriately disclosed. It would be beneficial for banks to differentiate between performing and non-performing loans when utilising a portfolio approach in view of the potentially significant differences in loss expectations. Non-performing loans are currently treated differently from performing loans within banks' internal risk management and Basel II capital systems. The IASB would need to ensure that the disclosures are transparent for performing and non-performing loans. Even if performing and non-performing loans are kept together for accounting purposes when measuring impairment on a group or portfolio level, non-performing loans are normally treated differently from performing loans within banks' internal risk management and Basel II capital systems. For these loans, the disclosures should include the amounts of such loans, quantification of their expected losses, and describe how such loans are treated for provisioning purposes.

The final standard also should require clear disclosures on how management judgement is applied when measuring impairment. Some disclosures are proposed in the ED on the determination of EL. However we believe that they are not sufficient given the uncertainty surrounding estimates, especially when there is a lack of historical data. For example, more disclosures should be required regarding the determination of initial estimates of EL: sources of inputs, length of historical data used, and how estimates for new products are made.

Finally, we also agree that appropriate disclosures should be made on transition to the new standard (refer to the response to Question 10) and when practical expedients are applied (refer to the response to Question 12).

**Question 6**

Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

We agree with the proposed presentation requirement to show gross interest revenue, expected credit losses and net interest revenue separately on the face of the income statement because the determinants of gross interest revenue and expected credit losses are conceptually distinct. The former typically depends primarily on the contractual interest rate (and other elements of the gross EIR, such as fees), whereas the latter is concerned with forward-looking estimates of credit losses.

As a way to enhance transparency and avoid potential earnings management arising from adjustments to estimates of expected loss, we agree that gains and losses resulting from changes in estimates should be shown on the face of the income statement.

**Question 7**

(a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?

The Committee agrees that full and transparent disclosure regarding the operation and results of an expected loss approach is essential in order for users to properly understand the outputs and to minimise the scope for earnings management and similar abuses.

### *Overarching Issues*

In our view, the most significant overarching issue concerns the level of granularity which should be used for the required disclosures. There is a 'trade off' between, on the one hand, keeping particular disclosure categories relatively homogeneous and, on the other, the risk of disclosure overload, especially in the financial statements of large diversified institutions.

A second overarching issue, which also has implications for the volume of disclosures, is what notion of materiality should be applied. This issue is well illustrated by the disclosure requirements in paragraph 17 concerning estimates. In a medium-sized or large bank, at least some portfolios are likely to exhibit changing loss estimates at any time or to have estimated future losses that are quite sensitive to certain assumptions. The question is whether the disclosures proposed in the ED would automatically have to be made for such portfolios, or only if the amounts in question were material in the context of financial performance and condition overall.

The third key issue is ensuring that appropriate information on actual losses is disclosed. In that context, we consider the definitions of 'non-performing' and 'write-off' to be too narrow.

### *Non-performing*

In order to ensure that disclosures are both meaningful and timely, it is important that the definition of 'non-performing' is aligned to the maximum extent possible with the way in which banks manage credit risk. Accordingly, it should be possible for loans to enter this category prior to becoming more than 90 days past due (or considered uncollectible). Similarly, there may be circumstances in which a loan that is more than 90 days past due is, nonetheless, substantively performing, for example because of special factors affecting the borrower.

### *Write-offs*

The IASB's ED requires an entity to disclose for each class of financial assets its "write-off" policy and a comparison between the development of the credit loss allowance over time and cumulative write-offs. The Committee has evaluated whether: (a) write-offs are a proxy for actual losses; and (b) the write-off concept itself is defined appropriately.

(a) *Write-offs as a proxy for actual losses* - Supervisors seek disclosures or information that shows actual deterioration (or improvement) in credit quality experienced by an entity.

In paragraph BC55 of the ED, the IASB "noted that it is difficult to decide what losses are 'actual' losses" and "believed that disclosure about write-offs was the best proxy for 'actual' losses." We caution that write-offs are unlikely to always be a good guide to 'actual' losses, in part because the approach to write-offs can be affected by various institutional factors. For example, in some jurisdictions, tax relief for losses is made available against *balance sheet provisions*, which creates an incentive to provide, rather than write off. In contrast, in other jurisdictions, tax relief for losses results from the determination that individual loans are uncollectible, which creates an incentive to write off. These differences in institutions' approaches to write-offs reveals the importance of the ED's proposed disclosure of an entity's write-off policy and makes it imperative that this disclosure be clear and understandable.

(b) *Definition of a write-off* - We also believe that the IASB has adopted a very narrow definition of write-off.

The ED's definition of write-off is "A direct reduction of the carrying amount of a financial asset measured at amortised cost resulting from uncollectibility. A financial asset is considered uncollectible if the entity has no reasonable expectations of recovery and has ceased any further enforcement activities."

There may be various other considerations that affect the time at which an entity (a) considers an asset to have no reasonable expectation of recovery versus (b) when it ceases enforcement activities. Considering an asset as likely to be uncollectible does not, in itself, exclude the possibility of loans continuing to be held on a bank's books because, for example, of the possibility of some receipts from a process such as liquidation of the obligor, or from possible legal proceedings. National legal specificities could lead to significant differences in practice as to when an asset is written off in line with the IASB's definition. Therefore, it would be more appropriate to broaden the definition by retaining the first part of the description of uncollectibility (ie when there is no reasonable expectation of recovery) and eliminating the second part (ie the cessation of further enforcement activities).

#### *Individual Disclosure Proposals<sup>12</sup>*

We generally agree with most of the individual disclosure proposals. In particular, we agree that:

- Information should be disclosed at least at the level of granularity of class of financial asset, and reconciled back to the statement of financial position. However, we understand that the use of the term 'class' has caused difficulties in the context of implementing other IFRS's, and we believe that Application Guidance should be provided on how the term should be interpreted. We also encourage the IASB to consider further whether or not 'class' represents the most appropriate level for disclosure.
- Credit losses should be accounted for through an allowance account.
- The basis on which expectations of future losses are formed, and factors behind changes in such expectations, should be explained.
- Information about the sensitivity of loss estimates to inputs and assumptions should be disclosed, where material.
- Disaggregation of gains and losses due to changes in estimates into those arising from changes in estimates of credit losses, and those due to other factors, is essential. However, we think a clearer articulation of the precise distinction between 'credit' and 'other' factors will be required.

However, we do not support the proposed disclosures relating to stress testing.<sup>13</sup> We have doubts about the value of disclosing information about stress tests designed by management, because these differ across entities in terms of the issues on which they are focused, and the magnitudes of stress applied. Thus, they are not comparable across entities. Moreover, as drafted, the stress testing disclosures would relate to stress tests by an entity generally, and would not be restricted to those focused on credit risk of financial assets measured at amortised cost. Institutions should carefully consider how to provide disclosures

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<sup>12</sup> Refer to pages 10-11 of the ED for a summary of these proposals.

<sup>13</sup> Refer to page 11, item (c) of the ED.

about relevant information arising from stress tests, and their implications for the bank's estimates of expected credit losses.

Turning to vintage information, the level of detail relating to classifying assets by years of origination and maturity needs to be sufficient and appropriately balanced.<sup>14</sup> As a general principle, the level of detail for routinely classifying assets based on years of origination and maturity should be sufficient and useful in evaluating whether the amount of provisions available is adequate.

Furthermore, while information on this basis has been found relevant recently in the context of 'high risk' assets such as asset-backed securities, we are not sure that such information would be useful in respect of 'vanilla' loans. We recommend that this issue be pursued with users and preparers of financial statements.

**Question 8**

Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

Given that provisions are progressively built up and banks will continue to have open portfolios, careful attention needs to be given to the transitional accounting measures when introducing the new model. The phasing in of the new accounting model should take into consideration the stage of the economic cycle to avoid procyclical effects. Ideally, provisioning according to the new model should start during an expansionary period.

**Question 9**

(a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?

(b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?

(c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 8) please describe why and to what extent.

Banks will continue to have open portfolios on their balance sheets for provisioning purposes when transitioning to the new model. Provisions for such loans should reflect expected losses associated with these loans and should continue to be held where necessary. The transition requirements in the new IFRS need to ensure that existing provisions are not easily released on first time adoption.

It is not appropriate that comparative information should be restated to reflect the proposed requirements. This is because the restated comparative information may not use a faithfully representative estimate of expected credit losses.

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<sup>14</sup> Refer to page 11, item (e) of the ED.

**Question 10**

Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

The proposed disclosure requirements in relation to transition are adequate to provide decision-useful information to the users of financial statements.

**Question 11**

Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

The Committee welcomes the inclusion of practical expedients in the ED as we find it useful in overcoming the operational challenges posed by the IASB's expected cash flow model for impairment. Applying practical expedients is a key aspect of the proposed standard as it ensures that the proposal can be applied by all sizes of entities and to all types of instruments/portfolios while still promoting adequate and more forward looking provisioning through early identification and recognition of credit losses. However the Committee believes that the guidance proposed does not fully address the need for practical expedients and should be significantly expanded.

The Committee envisions implementation challenges in applying the ECF model for impairment, especially for the large number of less sophisticated, less complex financial institutions.<sup>15</sup> These challenges are magnified by the IASB's proposed requirement to require an expected loss amount recognised through an EIR method associated with probability-weighted cash flows. We would encourage the IASB to consider simplified approaches to the ECF model that would provide practical expedients or acceptable alternatives, such as those that may emerge from the work of the EAP, to address the operational challenges with the ECF model while still achieving the objectives of timely impairment recognition. These practical expedients should be available for use in appropriate circumstances by smaller financial institutions and in smaller portfolios at larger institutions whereas alternatives to the ECF approach proposed in the ED should be available to all institutions.

The Committee notes that financial institutions with the following attributes typically have the greatest need for practical expedients to the ECF approach. This is typically representative of banks that do not follow the advanced internal ratings-based approach for regulatory capital under Basel II. For such institutions, the cost of implementing sophisticated models outweighs the benefits derived from using these models to predict cash flows. These attributes are identified below under three groupings: business model, credit risk management systems and knowledge and resources:

*Business model*

1. Fewer lending transactions and therefore less data from which to draw valid estimates of expected cash flows with reasonable confidence intervals. These financial institutions generally maintain limited performance information on lending transactions.
2. Loan portfolios primarily centered on commercial credits that exhibit significant idiosyncratic credit risk characteristics that make cash flow projections more difficult to model.

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<sup>15</sup> Entities outside the financial services sector that hold financial assets measured at amortised cost would likely also face these implementation challenges.

### *Lack of sophistication of credit risk management systems*

3. Reasonably good at estimating losses on individual loans in the short term, but challenged with estimating the timing of losses on existing loans that are expected to occur in more than 12 months.
4. Less detailed financial information available on their borrowers.
5. A less sophisticated and less granular credit risk management process with generally fewer risk grades. Although the credit risk management process allows for the estimation of gross losses, it limits the institution's ability to effectively develop more detailed cash flow projections.

### *Knowledge and resources*

6. Limited knowledge or familiarity with sources of and/or limited access to relevant market-based cash flow data for loans.
7. Limited staff resources with skill sets and experience with sophisticated models.
8. Insufficient resources with knowledge and understanding of expected value and probability weighting concepts.

The definition of smaller institution varies by country, but most countries have a volume of small local or regional institutions that would meet the above criteria.

The ED proposes a number of principles to allow for the use of practical expedients in paragraph B15 with additional guidance in paragraphs B16-B17. The Committee believes these principles need to take into account the diversified nature of banking activity. Thus, the Committee suggests an expansion of practical expedients or the consideration of alternative EL approaches as learned from the EAP process that would be more operational than the ECF model.

One such approach is the use of a simplified average loss rate which could be defined for these purposes.<sup>16</sup> The simplified average loss rate would represent expected credit losses by loan type derived from historical experience based on some measure of actual losses (eg direct write-offs, specific provisions on non-performing loans) and adjusted for current conditions.<sup>17</sup> This amount could be recognised through the allowance account. Additional disclosures could be provided to show the impact on profit or loss. This approach is currently being used in some business models as well as in some risk management, capital and reporting processes.

An expansion of the practical expedients could also address some key aspects of the proposed ECF model that present operational challenges, including the issue of closed versus open portfolios. The simplified average loss rate can be applied to open portfolios.<sup>18</sup>

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<sup>16</sup> The simplified average loss rate could be applied to determine provision amounts as follows: Simplified Average Loss Rate x Account Balance.

<sup>17</sup> As noted in the response to Question 4 above, loss rate data may be derived from a variety of sources including some banking associations and Consumer Protection Agency statistics. Some central banks and supervisory agencies might also make such data available. Finally, loss rates such as an average loss rate based upon types of instruments may also be available for use.

<sup>18</sup> A number of banks presently use a simplified average loss rate methodology on their existing portfolios. These banks continue to write new business (ie their portfolios are open).

The Committee is of the view that the above modifications to the practical expedients in the IASB's ED would improve the final standard and allow smaller banks to have an operationally feasible and forward-looking impairment model. This impairment model would allow these banks to draw from their current business models, risk management and capital adequacy systems. The Committee also encourages the IASB to emphasise that the use of practical expedients should continue to result in the earlier recognition of expected credit losses and that provisions should continue to be adequate to absorb actual credit losses as they emerge. When considering alternatives to the ECF model proposed in the ED that may emerge from the work of the EAP and the IASB's due process, the IASB should ensure that any alternative it pursues also produces these same outcomes.

**Question 12**

Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

The IASB's impairment ED provides two simplifications to the ECF model (refer to paragraphs IN12 and B15-B17):

- a) Use of a provision matrix for trade receivables; and
- b) Separate calculations of expected credit losses and amortised cost excluding expected credit losses.

While both of these simplifications are helpful (with modifications as proposed at the response to Question 11 above), the Committee believes that, in general, additional guidance on practical expedients would be useful.

As an overriding principle, the IASB's proposal requires that the overall impact of the use of practical expedients be immaterial (paragraph B15 of the ED). Whether or not the use of the Committee's proposed practical expedients will materially impact resulting impairment estimates is unknown.

As such, the Committee recommends that the overriding principle in paragraph B15 of the ED be modified to allow the use of practical expedients by banks (and other entities that hold financial assets measured at amortised cost). Such practical expedients would reduce the operational challenges associated with implementing the IASB's EL proposal, thereby ensuring a better balance between benefits and costs.<sup>19</sup>

As noted above, a simplified average loss rate approach is one such approach that may be used and complements the currently proposed ECF methodology. A loss rate can be defined in many ways but is generally based on a financial institution's historical experience with actual losses or write-offs net of any recoveries as the starting point.<sup>20</sup> There are many ways to determine loss rates from historical data, including Probability of Default and Loss Given Default statistics, migration matrices, and roll rate analyses. A simplified loss rate approach would have the following advantages:

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<sup>19</sup> Ensuring a balance between benefits and costs is a pervasive constraint in the *Framework for the Preparation and Presentation of Financial Statements* (paragraph 44).

<sup>20</sup> Refer to the response to Question 7, which outlines issues with the definition of write-offs and with write-offs being a proxy for actual losses.

- Provides objective data embedded in current credit functions and systems as a starting point for estimating credit impairment;
- Can be developed and applied to pools of assets in open portfolios which is consistent with the way most banks manage credit risk;
- Can be supplemented by net present value techniques for loans that are individually impaired;
- Can be easily updated because it is calculated based on risk rating systems, loan type, credit scores or delinquency;
- Permits the calculation of credit impairment without undue complexity and with similar estimation uncertainty as cash flow methods; and
- Incorporates a balance sheet approach to determining the adequacy and appropriateness of the allowance account.

#### *Improved Disclosure Requirements*

The current disclosure requirements proposed in the ED should be equally applicable to estimates made using practical expedients. The disclosure requirements should be improved to encourage transparency when practical expedients are applied. Furthermore, entities should be required to disclose any practical expedients that they use.