



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

VIA EMAIL: iasb@iasb.org

Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
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1 September 2009

Request for information 'Expected loss model' impairment of financial assets: Expected cash flow approach

Dear Sir David

The Basel Committee on Banking Supervision welcomes the opportunity to comment on the IASB's *Request for information ('Expected loss model') Impairment of financial assets: Expected cash flow approach*. The Committee has a strong interest in high quality financial reporting by banking organisations and has carefully considered this request, in particular, since in April the G20 Leaders called on "accounting standard setters to work urgently with supervisors to improve standards on provisioning and achieve a single set of high-quality global accounting standards".

Generally, the proposed approach has appealing features, such as its reliance on lenders' judgments about expected cash flows over the life of a loan without regard to limited time frames or trigger events and incorporating a broader range of available credit information. If this approach is carefully designed, soundly implemented and carefully audited, its features could strengthen accounting recognition of loan loss provisioning and lead to earlier recognition of credit losses inherent in banking activities. Furthermore, we have identified some areas that warrant the IASB's added attention, particularly as they relate to clarifying the principles of an expected cash flow approach, ensuring transparency over management's assumptions, loss trends, and providing an adequate transition period to a new model for credit loss estimates.

Our general comments and responses to three of your six questions are included in the attached Appendix, and they build upon the Committee's guiding principles for the replacement of IAS 39 that I sent to you in July 2009 and that can be found on the BCBS web site (http://www.bis.org/list/press_releases).

These comments have been prepared by the Committee's High Level Working Group (HLWG), co-chaired by Sylvie Mathérat, Director of the Banque de France and Chair of the Committee's Accounting Task Force (ATF), and Jerry Edwards, Senior Advisor on Accounting and Auditing Policy, ATF. The Committee has approved these comments and trusts that you will find them useful and constructive. Representatives of the HLWG would be open to continuing dialogue

with the IASB as it develops the exposure draft on the expected cash flow approach in the coming weeks.

If you have any questions regarding our comments, please feel free to contact Sylvie Mathérat (+33 1 4292 6579), Jerry Edwards, (+41 61 280 8055), or Xavier-Yves Zanota or Rob Sharma at the Basel Committee Secretariat (+41 61 280 8613 or +41 61 280 8007).

Yours sincerely

A handwritten signature in blue ink, appearing to read 'Nout Wellink', with a stylized flourish at the end.

Nout Wellink



Appendix

General comments on IASB's Request for information ('Expected loss model') Impairment of financial assets: Expected cash flow approach

As recommended by the G20 in their report of April 2009, accounting standard setters should strengthen accounting recognition of loan loss provisions and work together with prudential supervisors to identify solutions that are consistent with the complementary objectives of promoting the stability of the financial sector and of providing transparency of economic and financial results.

The Committee supports an expected loss approach to the impairment of financial assets and believes that the expected cash flow approach, as one type of expected loss method, has certain beneficial aspects. The main objective of the IASB's approach is to reflect accurately and in a transparent manner the credit losses embedded in assets managed on an amortised cost basis, with the result that provisions shall be built up without waiting for an incurred loss event and corresponding adjustments will be made to the recognition of income. The expected cash flow approach, as outlined in the IASB's Staff Paper 5A dated May 2009 (Staff Paper 5A) and summarised in your request for information, with the enhancements discussed in this comment letter, could result in more robust provisioning practices and earlier recognition of losses within the economic cycle, which could have the potential to mitigate pro-cyclicality. To that end, experienced credit judgement will be needed to estimate the expected losses over the life of the portfolio, considering the loss experience over the complete economic cycle.

The Committee's *Guiding principles for the replacement of IAS 39*, July 2009, include its views on the main principles of a sound provisioning and impairment approach, in line with recommendation 13 of the G20 *Working Group 1* report and the FSF's procyclicality recommendations on provisioning in April 2009, which the G20 Leaders welcomed. Our answers to your request for information on the expected cash flow approach as an alternative to the current incurred loss model are based on these guiding principles.

Based on these guiding principles, we would like to reiterate that the expected cash flow approach should not result in a fair value impairment approach (eg the effective interest rate (EIR) should be calculated based on the sole consideration of the credit risk embedded in the contractual interest rate and should not include liquidity risk premia or other risks reflected in fair value measurement).

A provisioning and impairment approach based on these principles will be able to serve the interests of prudential regulators as well as those of investors by giving more accurate information about the quality of bank loan portfolios and the cash flows expected to be received because it will result in an earlier recognition of credit losses. The feasibility of an expected cash flow approach will depend on how the principles of the new approach are clarified and how transparency is ensured. These aspects are elaborated in the Appendix – Answers to detailed questions.

Answers to detailed questions

Question 1:

Is the approach defined clearly? If not, what additional guidance is needed, and why?

Our response differentiates between (A) the calculation mechanism used in this model, (B) the expected cash flow approach considered as a whole, and (C) presentation and disclosure issues.

(A) Generally, the basic calculation mechanism behind the expected cash flow approach is reasonably set forth for introductory purposes in the staff paper. The method limits the risk of overstating interest revenues on the basis of the contractual interest rate, which includes compensation for expected losses but does not consider the effect of those losses in the interest accrual.

We consider the EIR calculation mechanism:

- Transparent since it is consistent with the credit risk embedded in the contractual interest rate;
- Suitable for bank business models used for the amortised cost category since the EIR is calculated on the basis of internal data; and
- May allow for banks to use certain internal risk management information and related systems similar to those needed for Basel II regulatory capital purposes.

(B) However, the expected cash flow approach considered as a whole could benefit from further specificity in the principles underlying the approach.

1. Principles supporting the accounting treatment

To improve the quality of information surrounding the expected cash flow approach, we recommend the IASB should require companies to distinguish between information about the built-up of provisions for expected credit losses and the use of provisions for actual credit losses (eg, loan write-downs/charge-offs or increases in specific provisions). This information should be disclosed in a manner that enhances the understanding of the quality of the financial assets and how expected loss provisions are being reduced when actual losses occur. A reconciliation of the provisions and a gross presentation of total loans and the provision account (contra asset account) could be a considerable and useful improvement.

Estimates of expected losses should consider credit loss information over a **complete economic cycle** and reflect credit loss estimates calculated **over the life of the portfolio**.¹ This estimation process would include, but would not be limited to:

- Considering a broad range of available and relevant credit information, including internal credit grades for the portfolio of loans²;

¹ This recommendation is consistent with the *Guiding principles for the replacement of IAS 39* as endorsed by the Basel Committee on Banking Supervision and developed by the Committee's High Level Working Group, which were forwarded to the IASB in July 2009. The guiding principles state that "expected credit losses are estimated losses on a loan portfolio over the life of the loans and considering the loss experience over the complete economic cycle."

- Evaluating loans on either a group basis or on an individual basis, whichever is more appropriate in the circumstances;
- Categorising loans that are evaluated on group basis by homogeneous classes of risk (which for banks could be consistent, at a high level and to the extent possible, with the Basel II risk categories);
- The process of estimating credit losses may result in either a specific amount representing the impairment estimate or a range of possible amounts. In the latter case, an entity should recognise the amount that is the best estimate within the estimated range of credit losses, taking into account all relevant information about the collectability of the loan portfolio;
- Under the model, an entity would be expected to exercise professional judgment when evaluating historical credit loss information. In particular, an entity should consider factors that would cause expected losses as of the evaluation date to differ from historical losses, including the following:³
 - Changes in lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices;
 - Changes in international, national and local economic and business conditions and developments, including the condition of various market segments;
 - Changes in the trend, volume and severity of past due loans and loans graded as low quality, as well as trends in the volume of impaired loans, troubled debt restructurings and other loan modifications;
 - Changes in the experience, ability, and depth of lending management and staff;
 - Changes related to new market segments and new loan products;
 - Changes in the quality of the bank's loan review system and the degree of oversight by the bank's senior management and board of directors;
 - The existence and effect of any concentrations of credit, and changes in the level of such concentrations;
 - The effect of external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's current portfolio;
 - Changes in the credit risk profile of the loan portfolio as a whole;
 - Changes related to collateral values or other loss mitigants; and
 - Changes in the range of possible amounts of loan losses to consider the best estimate within the range.

An entity should maintain sufficient and appropriate documentation to reasonably support its estimates for audit and other verification purposes.

² In this respect, there may be ways for the expected cash flow approach to be integrated with the loan classification practices of banks. For example, use of their historical loan classification data in the estimation of expected cash flows, with adjustments for loss expectations, could help to reduce the cost of applying the expected cash flow approach and improve banks' expected loss estimates.

³ Similar principles are set forth in the Committee's policy paper, *Sound credit risk assessment and valuation for loans*, June 2006.

(C) Comprehensive disclosures

As judgement will be an important input in the methodology used, disclosures should outline an entity's assumptions and the sensitivity of those assumptions to changes in the underlying factors that have caused expected losses to differ from historical losses. Disclosures should also summarise the entity's management processes for estimating cash flows and related governance and controls.

Staff Paper 5A mentions that one of the challenges of an expected cash flow method is that the reporting entity may be tempted to misstate the initial estimates of credit losses, which is the foundation under the expected cash flow approach. As indicated in the paper, one way to address this issue is to require comprehensive disclosures to stimulate market discipline.

Users of financial statements, including banking supervisors, require a broad array of information about risk exposures and related credit losses to understand an entity's credit risk profile and appetite. A reconciliation of increases and decreases in the provision account (eg, timing and level of provisions, confirmed losses, and loss recoveries), together with related qualitative disclosures, would contribute to this understanding and provide greater insight into an entity's write-down and collection practices as well as how provisions have covered credit losses.

Question 2:

Is the approach operational (ie capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?

With a reasonable implementation period, the underlying principles behind this method could be operational, since a number are already used in incurred loss provisioning under IAS 39, with the main exception that they do not exclude expected credit losses from future cash flows at inception. However, implementing an expected cash flow approach raises two types of issues:

- Technical issues, such as an increase in the quantity of information to be processed;
- Methodological issues, such as:
 - How to deal with revolving loans;
 - Implications of variable interest rate loans;
 - Implications of short versus long maturities, including expected renewals that will lengthen the life of a short-term loan, expected prepayments that will shorten the life of a long-term loan, and changes in these expectations;
 - Accounting for occasions when estimated cash flows are not consistent with actual outcomes, including prepayments;
 - Estimating the amount and timing of cash flows from liquidation of collateral, either by the borrower or the bank;
 - Application of expected recovery costs in cash flow estimates; and
 - Furthermore, estimating reliable and verifiable credit losses over the life of a loan will be challenging, especially for smaller, less sophisticated banks. In particular, banks must develop and implement sound and reliable estimation methodologies for future cash flows (especially in the case of long-term facilities) Also, the educational challenges resulting from a change from an incurred loss to an expected loss model for preparers (particularly for these smaller banks), auditors, and other users also should not be underestimated.

Considering these technical and methodological issues, plus the educational challenges, it will be very important for banks and other preparers to develop appropriate information systems as well as appropriate policies, procedures and corporate governance over provisioning. This will require significant lead time to implement these changes in a safe and sound manner. As such, it is important that adequate time is allotted for understanding the new model and making these changes.

Furthermore, independent verification, including by external auditors, will be required as well as the development of appropriate industry statistics and performance measures for industry and peer analysis purposes. It would be helpful if the IASB could work with industry representatives to develop more detailed examples for use in the exposure draft to address the methodological issues noted above.

Question 5:

How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:

- (a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?**
- (b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?**

The entity should be required to use the impairment approach (eg individual or group assessment) that results in the best estimate of credit loss for any individual loan or group of loans. In some cases the most reliable method would be an estimate of expected cash payments or net proceeds of transfers of assets (eg in cases of foreclosure or repossession of assets) on an individual loan basis, particularly in the case of an entity having granted a small number of very large loans to entities active in a capital intensive sector. However, for many retail loans and homogeneous small-balance commercial loans, a pooled approach may be more appropriate and representative. We recommend that the IASB avoid creating any arbitrary triggers that would compel one evaluation method over another. Instead, we suggest that an entity's management determine, based on its own credit risk management practices, whether an individual or group-basis approach would result in a better estimate of loss and apply the method determined to be more appropriate. It is also important that the credit losses identified by specific review of loans and losses on loans that are dependent upon collateral for their repayment should be carefully considered and reflected in the process of estimating credit losses under the expected cash flow approach.

Currently, banks segment portfolios into groups of loans with similar credit characteristics. The number of segments is chosen to allow sufficient granularity to provide meaningful information about the estimated loss in each segment and in aggregate. Some examples of typical characteristics that entities use to group loans for the purpose of assessing credit risk and valuation include: estimated default probabilities or credit risk grades, loan type, product type, market segment, geographical location, borrower industry, collateral type, and past-due status. The entity's plans for collection (eg work-out versus repossession/foreclosure) could also be considered when segmenting the portfolio. More sophisticated credit risk assessment models or methodologies for estimating expected cash flows, including credit risk grading processes, may combine several of these characteristics.