Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

Via email: hhoogervorst@ifrs.org

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Exposure Draft (ED/2013/3) Financial Instruments: Expected Credit Losses

Dear Hans

The Basel Committee on Banking Supervision (the Committee) appreciates the opportunity to provide comments on the International Accounting Standards Board's (IASB's or Board's) Exposure Draft (ED) to establish principles for the recognition, measurement, presentation, and disclosure of expected credit losses. We recognise the challenge in developing an impairment accounting standard based on expected losses and appreciate the hard work of the Board and staff over the past five years.

We also appreciate the Board's observance of the IASB-FASB[1] Financial Crisis Advisory Group (FCAG) report[2] that highlighted the importance of the Board continuing consultations with prudential regulators given the special importance of accounting standards to supervisors, especially accounting for financial instruments. In this letter, the Committee reaffirms the importance of developing a high quality converged solution on accounting for the impairment of financial instruments by moving from an incurred loss model to an expected loss model.[3]

The Committee and the Board have the same objective regarding this project: providing users of financial statements of lending organisations with high quality information about loss expectations on debt instruments. This is consistent with the April 2009 call by the G20 Leaders for:

> "*accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning and achieve a single set of high-quality global accounting standards,*" and to "*strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information.*"

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1 Financial Accounting Standards Board (FASB).

2 Report of the IASB-FASB Financial Crisis Advisory Group, July 2009, at www.ifrs.org/News/Press-Releases/Documents/FCAGReportJuly2009.pdf.

3 Previous letters from the Committee to the IASB are available at www.bis.org/bcbs/commentletters/commentletters.htm.

Convergence is fundamental for integrated global financial markets

International convergence of accounting standards for financial instruments is fundamental to achieve comparable financial reporting for banks operating in integrated global financial markets. During the IASB's forthcoming joint redeliberations with the FASB on credit losses, we strongly encourage achieving a high-quality converged standard that improves financial reporting. To consider any converged solution on impairment to be of high quality, the Committee expects the solution to be an expected loss model that results in earlier recognition of credit losses in all jurisdictions using more forward-looking information than under the existing incurred loss model. Reflecting expected credit losses in the financial statements is in the interest of all users of financial statements and is essential to their reliance on accounting standards to properly portray a bank's financial condition.

Like the Board, the Committee has undertaken various efforts to respond to lessons learned from the financial crisis. Included in those efforts is a revised regulatory capital framework that responded to capital levels that were proven to be too low. A consistent set of accounting standards, particularly for financial instruments, is integral to the appropriate implementation of the revised regulatory capital framework, and improving worldwide banking supervision and financial stability.

Of equal importance to a single high quality impairment standard is a consistent global application thereof. The Committee believes, therefore, that any converged solution must also contain sufficient implementation guidance to drive consistent global application. The purpose of the Committee's regulatory capital framework is to achieve a stronger and more resilient banking system to form the foundation for sustainable economic growth. The Committee designed its revised regulatory capital standards to ensure that banks hold sufficient capital to absorb unexpected losses. The finalised regulatory capital framework, which starts with accounting measures to determine common regulatory minimum requirements, would greatly benefit from a consistent recognition of expected credit losses across jurisdictions.

The Committee understands the rationale of both the IASB's and FASB's proposed expected credit loss models. As a result of the efforts by both Boards, there have been robust discussions of the desired financial reporting goal and the merits of different methods of achieving that goal. It is essential that the Boards reconvene and reach a converged solution. As supervisors, we attach the utmost importance to the adequacy of the balance sheet allowance for credit losses. Therefore, a converged solution for high quality financial reporting should meet the Basel Committee minimum principles that we reiterated in our 21 December 2012 letter to the chairs of both Boards, including:

- Impairment recognition and measurement should be based on sound methodologies that reflect expected credit losses over the remaining life of a bank's existing portfolios at the reporting date.
- The new standard should require earlier provisioning than under the incurred loss approach and avoid or minimise cliff effects to the extent possible.
- The overall balance of provisions should be sufficient to absorb expected credit losses of all financial assets reported at amortised cost and fair value through other comprehensive income.

- The expected loss model should reflect the effects of any credit deterioration on collectability expectations.

Potential improvements to the Exposure Draft

The Committee believes that timely recognition of expected credit losses is a vital component of high quality financial reporting and of a safe and sound banking system. The financial condition of a bank is highly sensitive to rapid credit risk increases and credit quality deterioration, as demonstrated again in the financial crisis. Therefore, appropriately determining how, when, and in what amount to recognise credit losses should be a priority for all stakeholders in the banking industry, including bank management, investors, and other users of bank financial statements.

In considering changes to the proposal to reach a high quality converged solution, the Committee has outlined below its recommendations for improving the Board's proposed dual measurement approach. Our recommendations focus on two issues which are indispensable in resolving the flaw identified from the financial crisis that credit loss recognition under the existing incurred loss model is 'too little, too late': (i) the stage 1 measure of impairment must be adequate, and (ii) the point of transfer to stage 2 must be highly sensitive to changes in credit risk. We urge the Board to adopt the following recommendations, which could serve as a starting point in pursuing a converged solution with the FASB that meets the FCAG's recommendations and fulfils the G20 mandate. Our comments below are designed to enhance the proposed accounting model in ways that are in all respects consistent with the IASB's existing conceptual framework.

Stage 1 expected credit loss measurement

In the ED, stage 1 is comprised of financial instruments for which the measurement of expected credit losses requires an estimate of the probability of 'default' over the next 12 months. The Committee recommends:

- Replacing the term 'probability of default' with 'probability of a significant increase in credit risk.' This would ensure that the stage 1 calculation is not linked solely to a payment default, but instead captures indicators of loss expectations that precipitate eventual non-payment. The probability of a significant increase in credit risk is more encompassing than probability of default and would include indicators of possible credit losses.
- Considering moving from a 12-month time horizon to an expanded time horizon.
- Emphasising the appropriate use in stage 1 estimates of institution specific factors as well as additional macroeconomic and other environmental factors.

In our view, an expected credit loss model should be sensitive to all sources of credit risk that affect the expectation of loss within a banking institution's portfolios of debt instruments. An expected credit loss model should not exclude or ignore relevant information in developing a reliable estimation of expected credit losses considering past events, current economic conditions, and reasonable and supportable forecasts of future events and economic conditions. This should be explicitly stated in the final Standard.

Upon origination or purchase of a financial asset, a bank accepts credit risk although it cannot isolate which individual instruments, within a group of assets, will experience credit losses until later in their life cycle. We believe the reporting of loss allowances reflecting those losses that management reasonably expects at each reporting date is of primary importance to the users of financial statements. This requires at least inclusion of more forward-looking information in order to arrive at the most appropriate stage 1 measure of expected credit losses.

Although the IASB model requires some expected credit losses to be recognised in stage 1, we are concerned that changes in loss expectations since initial recognition may not be adequately recognised and measured until significant credit deterioration is acknowledged. Similarly, the model should ensure appropriate building of allowances prior to significant credit deterioration, including losses that were reasonably expected at initial recognition (but for which past loss experience reflects a pattern of default beyond 12 months), in order to mitigate the "cliff effect." We recommend that the final Standard clearly requires recognition of changes in loss expectations for all financial assets to ensure that the allowance builds to reflect increasing credit risk in banks' portfolios in stage 1 prior to any transfers to stages 2 or 3. The Committee believes this could be accomplished by means of an adequate expansion of the stage 1 horizon that is able to capture the specific loss patterns of different portfolios coupled with changing the measure of expected credit loss in stage 1. The new measure should be based on the probability of a significant increase in credit risk (rather than the probability of default), which would ensure more forward-looking elements are included in the evaluation of the stage 1 allowance.

In order for the measurement of credit losses to be sufficiently sensitive to all sources of credit risk which impact the expectation of loss within an institution's loan portfolio, it is necessary that available forward looking environmental, borrower, and instrument-specific credit indicators or risk drivers be factored into the stage 1 estimates. Paragraphs B7 and B20 in the ED provide examples of information that should be considered when determining whether the recognition of lifetime expected credit losses is required. We see these indicators as instrumental to achieving an expected loss model that is more forward-looking. We recommend that these paragraphs be included in the main body of the final Standard, and that they also apply to stage 1 measures. The final Standard also should include more thorough implementation guidance indicating how to incorporate the above indicators into the stage 1 expected credit loss estimate. Additionally, paragraph B32 describes expected cash flows for collateralised financial instruments. The Committee would suggest this paragraph also be included in the main body of the Standard.

The assessment of a significant increase in credit risk should include consideration of more macroeconomic and other environmental factors, additional institution and borrower-related information, and transaction-specific details (such as repayment schedules, collateral requirements, down payments, and loan-to-value ratios) since they drive a borrower's ability and willingness to repay the loan. Requiring consideration of these factors in stage 1 will enable allowances to build over time and better reflect credit loss expectations. If it is the Board's intention that such information and risk drivers are considered in stage 1 of the model proposed in the ED, we do not think the text in the ED makes that clear. The Committee urges the Board to make it explicit that this is the case and expand the factors listed in paragraphs B7 and B20 to include these additional factors which must be considered in the stage 1 measure.

As noted above, the Committee believes it is important to consider all available information that affects credit risk, including the early identification of excessive risk building in the financial system. Historical experience often forms the initial basis of future credit loss expectations. This would include well-established product-specific loss patterns reflective of the portfolio's credit risk and underwriting terms. Additionally, it is essential to consider changes in lending strategies and underwriting standards that impact borrowers' incentives and ability to perform. Financial instruments may have terms or other features that mask the extent of these instruments' expected credit losses until meaningful repayment performance is required under the contract. Such financial instruments may include loans structured with significant balloon payments, extended interest-only periods, or negative amortisation features as well as loans originated based on an over reliance on the collateral's appraised value at origination. However, we caution against the use of bright lines, which could cause stage 1 to fall short of capturing known loss patterns of loan products or result in ignoring impending credit losses expected to occur.

Transfer criteria based on a significant increase in credit risk

In the ED, transfers to stages 2 and 3 occur when "credit risk has significantly increased since initial recognition." The Committee recommends clarifying that a "significant" increase is earlier than waiting for non-performance by the borrower or similar borrower-specific factors related to discovery of credit deterioration, and includes broad indicators of increases in credit risk for homogenous groups of loans.

The IASB's proposed boundary between a 12-month and a lifetime expected credit loss measure may be too late in the credit life cycle of a financial instrument depending on how "significant" increase in credit risk is interpreted, which would result in allowances not building sufficiently before a payment default occurs. Determination of when to transfer loans from stage 1 to stages 2 or 3 must consider all information reflecting a buildup of credit risk in a banking portfolio. Such information includes indicators of relaxed underwriting practices, aggressive lending policies, or a shift in collection efforts to the recovery of amounts due. It is crucial to explain the term 'significant' to reflect our understanding of the Board's intention of incorporating early indicators for the transfer out of stage 1. Specifically, the Board needs to set forth a principle governing the magnitude of change in credit risk that would be considered as significant. Paragraphs B20(c) and (d) suggest considering internal price indicators of risk and comparing the instrument to the rates and terms of a newly issued or originated loan. It would be useful if the Board clarified the meaning of these paragraphs and how it relates to underwriting standards. In our understanding, all else being equal, if an institution would not make the same loan today on terms comparable to those on the loan when it was originated due to a meaningful increase in credit risk since origination, a transfer of the loan out of stage 1 and the recognition of lifetime expected credit losses would be required.

Additionally, the ED equates an instrument with an external credit rating of 'investment grade' as having low credit risk. The Committee believes the 'investment grade' category is not homogenous and cannot be uniformly regarded as 'high credit quality.' Probabilities of default vary significantly for longer maturities within the investment grade category and toward the lower end of the investment grade range.[4] For instance, the IASB proposal would continue to view a downgrade of an instrument from AAA to BBB as having low credit risk and would not require a change to the lifetime expected loss estimate despite a meaningful increase in credit risk. While we support the use of absolute measures of credit risk in an expected loss model, we believe the references to investment grade criteria in the ED are too broad and should be removed. Paragraph 6 of the ED defines 'low credit risk' in the context of default of an instrument not being imminent and at most a weakened capacity of the borrower to meet its contractual cash flow obligations on financial instruments. If these references are not removed from the ED, they could be interpreted as needing an exceedingly large increase in credit risk before transferring assets to stages 2 or 3. The Committee believes the transfer point to stage 2 should be substantially earlier than imminent default. Additionally, the Board should replace the term 'a weakened capacity' in paragraphs 6 and IE23 with 'a diminished but sufficient capacity' of the borrower to meet its contractual cash flow obligations.

The ED would also benefit from not using both terms 'significant increase in credit risk' and 'significant credit deterioration.' These terms seem to be used interchangeably throughout the draft, yet they can be interpreted to have different meanings. Significant credit deterioration can be linked to deterioration of the specific borrower's credit quality, whereas an increase in credit risk can be interpreted as also including institution-specific internal factors (such as changes in underwriting standards) and macroeconomic risks or risk drivers outside of the borrower's control (such as market interest rates, housing prices, or unemployment). The Committee suggests the IASB eliminate the term 'significant credit deterioration' and only use the term 'significant increase in credit risk.'

We note that paragraph B12 states:

> *"Generally, there is a significant increase in credit risk before a default occurs or before there is objective evidence of impairment."*

However, paragraph 9 of the proposed standard also includes a presumption that a significant increase in credit risk has occurred when contractual payments are 30 days past due. It is important to clarify the Board's intent regarding the use of such past due criterion. Otherwise, there is a potential for this concept to be interpreted similarly to the discovery of a loss event in the incurred loss model, which delays loss recognition. We are concerned that institutions will resort to using '30 days past due' as a primary indicator, without due consideration of whether other credit risk indicators are present. The Committee regards the past due reference as a backstop and not as the primary indicator. The past due reference is not in itself an appropriate indicator of significant credit deterioration. Experience has shown significant credit deterioration would have occurred well before this point, and therefore solely relying on past due status as a primary indicator would be contrary to the principles in the ED.

Lastly, pools of instruments with similar risk characteristics should be transferred to lifetime loss measurement if credit risk has increased significantly. This

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4 See table with cumulative probabilities of default in IASB Staff Paper 5B, November 2012, p.26.

determination would consider historical experience and forward-looking macroeconomic factors and should take place even though objective evidence of a significant credit risk increase is not yet observable on an individual asset level.

Choice of discount rate

The Committee does not agree that an institution should be able to select a discount rate from a range of possibilities between a risk free rate and the effective interest rate (EIR) to calculate expected credit losses, as proposed in paragraph 29(a) of the ED. The choice of a discount rate will reduce comparability amongst entities. If the Board requires discounting, the Committee suggests requiring the use of the EIR to discount estimated future cash flows as applied under IAS 39. As a practical expedient, the Board could allow the use of contractual interest rates for financial instruments issued at market rates or acquired without significant discounts or premiums.

Modifications

For modifications not resulting in derecognition of a financial asset, paragraph B22 of the ED requires a comparison of the credit risk under the modified contractual terms with the credit risk under the original, unmodified contractual terms to determine whether a significant increase in credit risk has occurred. We would caution against this approach, as we view these kinds of modifications of terms as a useful recovery tool that should not be used as a means for reclassifying loans from impaired to performing status. If the loan modification was made due to borrower financial difficulties, we would expect all such modified assets to be subject to a lifetime expected credit loss measurement. In other words, we view troubled loans as impaired financial assets, and the mere relief provided by a restructuring should not in itself be considered as an indicator of recovery in the borrower's repayment capacity.

Further, paragraph B23 implies that in the event of an asset being derecognised as a result of a troubled borrower being granted a modification, the new asset would be classified in stage 1. If that were the case, the Committee would be concerned whether the borrower's effective ability to perform was adequately considered, and would suggest that the final Standard clarify that such newly recognised asset remains subject to a lifetime loss assessment.

Financial instruments measured at fair value through other comprehensive income

The Committee supports an impairment model that is consistent for financial instruments at amortised cost and fair value through other comprehensive income (FV-OCI). However, we believe that more relevant information for users of the financial statements would be provided if the balance sheet presentation of debt instruments at FV-OCI included their related allowance for credit losses. Thus we suggest the Board consider presenting the allowance on the face of the balance sheet.

Debt securities

The ED does not provide specific guidance on how to apply the proposed impairment model to debt securities. While these securities may share common structural characteristics with loans, the credit risk of these two types of instruments may be managed in different ways, a distinction that should be recognised by and deserves clarification from the Board.

For example, guidance is needed to assess whether a significant increase in credit risk has occurred and its extent. It is particularly unclear when several blocks of the same bond (e.g. with the same International Securities Identification Number) have been acquired at different dates. Several approaches could be considered when determining the extent of any increase in credit risk: (1) separately for each block, which may be operationally burdensome, or (2) for all of the blocks of the financial instrument in the aggregate according to the average credit risk level at initial recognition. In addition, for rated debt securities, further explanation is necessary to illustrate how a change in the external rating should be factored into the credit risk analysis.

Stage 3 interest revenue

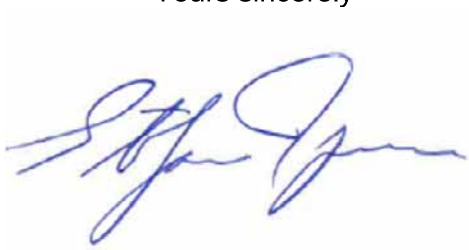
Paragraph 25(b) indicates an entity should continue to accrue interest for a stage 3 financial asset, but to base the accrual on the asset's amortised cost basis rather than its gross carrying amount. The Committee does not believe income accrual on stage 3 assets is appropriate. We recommend introducing a nonaccrual principle that requires stage 3 assets to be placed on nonaccrual (or for interest accruals to be fully reserved for) and that interest receipts be recognised on a cash basis or cost recovery basis, as appropriate in the circumstances.

Concluding comments

The Committee is appreciative of the Board's commitment to a high quality converged impairment model that appropriately addresses the issues identified during the financial crisis by the G20 and the FCAG. The Committee looks forward to continuing to work with the Board on this very important project.

These comments have been prepared by the Committee's Accounting Expert Group, which is chaired by Mr René van Wyk, Registrar of Banks, South African Reserve Bank. If you have any questions regarding our comments, please feel free to contact Mr van Wyk (+27 12 313 3601) or Xavier-Yves Zanota at the Basel Committee Secretariat (+41 61 280 8613).

Yours sincerely



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