FEDERATION BANCAIRE FRANCAISE

The Director General delegate

Paris, June 30th 2010

FBF Response to ED Financial Instruments: Amortised Cost and Impairment

Dear Sir,

The French Banking Federation welcomes the opportunity to comment on the ED Financial Instruments: Amortised Cost and Impairment.

As mentioned in our comments on the IASB's request for information on expected loss model, we support the objective of the IASB to develop an expected loss model as an alternative to the current impairment model in order to meet issues raised by the G20, the ECOFIN and Basel Committee recommendations.

We agree on the criticisms of the incurred loss impairment approach as exposed in BC 11, especially regarding inappropriate revenue recognition, cliff effect following a credit event and difficulties to identify credit events, especially for incurred, but not reported losses (IBNR) The new approach to be defined should permit to assess expected credit losses on an ongoing basis at an earlier point in time in order to reflect the risk assumed by the firm and to reduce pro-cyclical effects of the impairment model.

However, we are of the view that the proposed expected losses model, as described in the ED, does not give a fully adequate answer to these concerns for the following reasons:

- Significant operational challenges are related to the use of an EIR mechanism. The implementation of the proposed model is too complex and implies operational difficulties and significant costs which could not be justified in our view by any significant improvement in financial reporting.
- The model uses a point in time approach which implies to analyse the current economic environment. Moreover a catch up method is applied and changes in estimates of future losses are recognized immediately in P&L. These proposals undermine the potential counter-cyclical benefit of an expected loss model.
- The model is based on the fundamental presumption that it is possible to accurately estimate the timing of future losses over several years. Therefore, in order to be applied, the model implies the EIR methodology to be reviewed to include expected cash flows being estimated by time period. However, besides the operational challenges mentioned above, the predicting of timing of future cash flows is far from being accurately possible.

Sir David TWEEDIE
Chairman
International Accounting Standards Board
30, Cannon Street
London EC4M 6XH
United Kingdom

18, rue La Fayette 75440 Paris cedex 09 • Tél. : 01 48 00 52 52 • Fax : 01 42 46 76 40 • Minitel : 3617 AFB1 • www.fbf.fr
A Bruxelles : rue de Trèves, 45 • B-1040 Bruxelles • Tél. : 32 2 280 16 10 • Fax : 32 2 280 30 11

- The EIR approach implies segmentation of loans into too many small portfolios as the loans should share same characteristics of parameters (contractual rate, pattern of amortization, maturity ...). This would limit an accurate calculation of expected losses as the sample of loans included in theses portfolios are limited.

Therefore we consider that the new impairment model based on an expected loss approach should meet the following features:

- The new impairment model should not change the current definition of amortised cost or the EIR calculation
- Expected losses should be determined on open portfolio level aligned with the credit risk management practices and experience, the information already available and the systems developed in order to meet the Basle II requirements.
- The expected loss provision is calculated over the life of the portfolio, i.e. the average maturity of the loans in the portfolio weighted by the outstanding balance.
- Expected loss provision at initial recognition and subsequent revisions of estimates are spread over the life of the portfolio.
- To estimate expected losses, a point-in-time approach for the coming year and a through-the-cycle approach for the rest of the remaining life of the portfolio could be adopted.
- Impairment allowances are built up to be used when incurred loss occurs.

Finally, we are not in a favour of an early adoption as we believe that all the phases of the IAS 39 revision project should be implemented at the same time in order to allow comparability among IFRS reporting entities.

We would also suggest the Board to re-expose a revised model less complex than the current ED and based on an agreed proposed approach of impairment in order to provide fully comments before publishing a new standard.

Our answers to the exposure draft are detailed in the Appendix to this letter.
We hope you find these comments useful and would be pleased to provide any further information you might require.

Yours sincerely,

Pierre de Lauzun

Appendix

Objective of amortised cost measurement

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?

We believe that the economic approach of amortised cost measurement as described in paragraph 3 to provide "information about effective return of financial instrument" is appropriate for amortised cost category as a whole and not on an individual basis

We appreciate the IASB ED on impairment overall approach. We support the development of an impairment model that is based on expected losses for the amortised cost category rather than the current incurred loss model in IAS 39.

However we have concern about the inclusion of impairment in the definition and calculation of amortised cost and Effective Interest Rate.

Amortised cost definition should remain as the current one in IAS 39 and impairment should be independently estimate from EIR calculation.

Including expected credit losses into an EIR calculation means to estimate accurately the expected value of the cash flows related to the loans portfolio. Such expected losses depend on the characteristics of the loans in relation with the financial situation of the borrowers and on the external conditions changes depending on economic conditions. So, views on the development of economic conditions are needed.

Statistical data over long periods allow calculating a default rate over an economic cycle and allow approximating expected losses. Therefore; it is impossible to determine accurately the timing of these expected losses. So it does not make sense to incorporate the loss rate in the EIR calculus. Moreover it introduces operational issues of complex implementation due to the need of completely revising the methodology of EIR. It is not obvious that the proposed combination of credit losses with interest margin would be easy to understand for users.

Measurement principles

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?

As mentioned in our comment letter related to the IASB's Request for Information, the approach proposed by the IASB is at a reasonably high level. We believe that this principles based approach should be kept since various significantly different situations may occur between entities depending on the sector or the type of credit.

The accounting provisions should only ensure that techniques used by preparers are compatible with the general principles of the Expected Cash Flows approach and provide consistent results.

Therefore, we agree with the way the ED is drafted, i.e. without any implementation guidance for example, with the exception of the application guidance of practical expedients that we consider too prescriptive and inappropriate.

However, as stated in this comment letter and in our answer to question 4, we have major concerns with the measurement principles proposed in the ED.

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?

We welcome the IASB proposals of an impairment model based on expected losses rather than incurred losses. The principle of this new approach is in line with public authorities' requirements (G20 and BIS) to allow early identification and recognition of losses

However the IASB model has several drawbacks we would like to raise:

- Conceptual and operational issues raised by the use of expected cash flows in the EIR calculation.

The IASB model is based on the fundamental assumption that it is possible to estimate accurately the timing and amounts of the expected cash flows resulting from loan portfolios, including expected credit losses.

Expected losses on such portfolios depend from two sets of factors:

- the characteristics of the loans in relation with the idiosyncratic financial situation of the financial borrowers
- the external conditions changes through the economic cycle

This second factor is decisive as economic conditions hugely impact the credit risk components such as default rates and recovery rates. In order to estimate the expected value of cash flows, it is compulsory to have views on the development of the economic cycle for the run-off time horizon of the whole portfolios. It is obvious that it is impossible to predict accurately the amounts and the timing of future losses over several years.

The key point here is the timing of the losses:

- Statistical data over long periods allow calculating an unconditional default rate over an economic cycle, which is the weighted average default rate observed over a full economic cycle and therefore not dependant from the economic conditions. Unlike equity returns or foreign currency rates which are relatively distributed symmetrically and can be well approximated by normal distributions, loss distributions are skewed and fat tailed. It is therefore highly hypothetical to assign probabilities to different levels of expected losses; the average is often the best estimate of the expected values, as assigning a loss distribution pattern is subject to considerable model risk

- It is therefore impossible to determine accurately the timing of future losses, though it is possible to approximate their amounts, based on average statistical data calculated over long periods.
- If the timing of losses is unpredictable as macro economic dependent, it does not make sense to incorporate the losses rate in the assets effective interest rate calculus. This methodology does not lead to any superior form of information and does not justify its additional operational complexity.

We consider that a method based on probability-weighted possible outcomes as proposed in the ED would not give any better financial information on the performance of a loan. We favour excluding future possible scenarios from the impairment measurement method and using historical data and statistics.

For these reasons, we are in favour of the expected losses provisions to be spread linearly over the portfolios lives.

- <u>The estimation of expected losses.</u>

The ED proposals favour a point in time approach which assesses losses considering the economic phase when related loans are granted and an immediate recognition in P&L of the revisions of the EL. This would magnify the cliff effects observed under an incurred losses model. In a recession period, all the customers do not default at the same time but within a period of two or three years so the incurred provisions are built over such a period. Conversely, changes in hypothesis about future losses made at the balance sheet date will be all the more frequent since the losses parameters are determined on a point in time basis, related to the existing economic conditions.

Therefore, we propose to

- To use PIT data only the first next year if the economic conditions can be reasonably predicted and through the cycle (TTC) data for the remaining years until the run off of portfolios.
- To spread the incidence of changes in estimates over the remaining life of the portfolios.

Contrary to what BC 23 states, applying the cycle-average of credit losses to assets with a shorter life than the economic cycle does not result in providing for credit losses that would also relate to financial assets that will be originated after the reporting date. Through-the-cycle parameters are the default rate (PD) and the LGD. As the level of these data is highly correlated with economic conditions, using through-the-cycle values avoid betting on the economic future to calibrate expected losses; obviously, these parameters are applied only to existing loans portfolios. This method does not lead to set up provisions against future lending. Again, it is coherent with the observation that economic cycles are unpredictable over a period greater than a year in most circumstances.

- <u>Recognition of changes in losses estimates.</u>

Regarding the way to account for changes in estimates, we are of view that changes are not conceptually different from initial estimations. We agree that provisioning must not lead to record for a day one loss, as the bank will collect the premium included in the pricing of the loan to cover the credit risk related to its exposure over the maturity of the concourse. In pricing a loan, banks take into account the expected losses, but also the unexpected losses, i.e. the variation of average losses over time. This is why we price a margin over the risk free rate and the credit premium, to cover changes in estimates of expected losses. This margin will be also collected over the loan's life and therefore, the changes in estimates must be recorded symmetrically.

- Determination of portfolios

The ED proposals are based on individual loans or narrow defined portfolios. Designation of portfolios through their origination date and or maturity would oblige financial institutions to distinguish and follow up a very large number of portfolios. Therefore, this approach would be very costly to implement. Moreover, maintaining the homogeneity and ensuring the appropriate use of the expected loss provisions would also raise practical issues and would be costly.

A meaningful impairment model based on expected losses should be built up on portfolios basis. As the size and the nature of the portfolios may vary within and between different entities, the definition of portfolios should be consistent with the entities' risk management practice. It should also be based on the existing systems and information already available and built for regulatory capital purposes to meet Basle II requirements. Therefore, entities should be able to classify their loans into portfolios used for their credit risk management. At a high level of aggregation, it should follow the categorisation of assets as under Basle II provisions: corporate, bank, sovereign and retail portfolios.

Moreover, in order to accurately assess the exposure to credit risk, sample of loans included in portfolios should be significant and not be limited by a narrow definition of portfolios. The implied segmentation of the EIR approach can lead to too many small portfolios that must be sum up for defaults evaluation.

- Trade receivables

Concerning trade receivables, very short-term loans, the distinction between incurred and expected losses could be difficult and costly to assess. Therefore we believe that they should be exempt from the expected loss impairment model (similarly to the exception stated in IAS 39 AG79 for trade receivables). However, this exemption does not preclude from using statistical methods for portfolio made of small individual amount of trade receivables, as currently allowed by IAS 39.

- Debt securities portfolios

The ED does not specifically address the issues of debt securities portfolios. Even if they are listed on trade markets, we believe it is not appropriate to refer to credit spread included in a market price in order to assess expected losses. As these instruments are managed on an amortised cost basis, assessment of impairment should be based on own management judgement and should refer to the losses expected by the holder of the bonds, whatever prices are on the market. Furthermore, very rare defaults have been observed on listed bonds. For these reasons, we believe that specific features of debt securities portfolios should be taken into consideration and that operational approaches adapted to bonds portfolios should be allowed.

We consider that an alternative model should be based on the following principles:

- The new impairment model should not change the current definition of amortised cost or the EIR calculation
- Expected losses should be determined on a portfolio level aligned with the credit risk management practices and the existing systems and information already available for regulatory capital purposes. Portfolio segmentation could be set at a high level of segregation : corporate, bank , sovereign and retail portfolios.

- The expected loss provision is calculated over the life of the portfolio, i.e. the average maturity of the loans in the portfolio weighted by the outstanding balance.
- Expected loss provision at initial recognition and subsequent revisions of estimates are spread over the life of the portfolio.
- To estimate expected losses, a PIT approach for the coming year and a TTC approach for the rest of the remaining life of the portfolio could be adopted.
- Impairment allowances are built up to be used. Therefore, when a loan defaults, its incurred loss is booked against existing impairment allowances. If the expected loss is not sufficient, an additional incurred provision should be recognised in the income statement. Any subsequent increases or decreases in incurred losses follow the same mechanism.
- Impaired loans are treated as in the current IAS 39.

Objective of presentation and disclosure

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 description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost as described in paragraph 11 is clear and relevant.

However, the list of disclosures as proposed in the ED is too extensive. We believe that the benefits for users of such detailed information outweigh the costs to provide it. Entities should be able to provide disclosures on credit risk which are consistent with the way they manage their credit risk exposures.

We would recommend the IASB to set out the purpose of such disclosure and to set out the principle so that the entity would be able to decide the usefulness of the information to be provided to meet the objectives for a better disclosure as stated in paragraph 11.

Presentation

Question 6

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

Under the expected loss approach, interest incomes include a credit risk premium charged to borrowers. Therefore, we consider it would be consistent to present expected credit losses as a reduction of gross revenues.

However, we believe that flexibility should be given to the way entities present their margin and the effect of credit risk. Expected losses and interests should be presented in separate lines in the income statement in order to allow users of financial statements to distinguish the interest from the credit component.

Therefore, we believe the following separate lines should be presented in the income statement:

- Gross interest revenue
- Gross interest expense
- Gross interest margin (subtotal of the items above)
- Expected losses impairment
- Incurred losses in excess of EL allowance.

Disclosure

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?

As already mentioned in our previous answers to questions above, we are concerned by the extensive disclosure requirements, their complexity and their volume. We believe that it will be confusing for users of financial statements and would not help to provide decision useful information. The costs to provide such information would exceed benefits for users.
Information provided should allow comparability between entities. Therefore stress testing is not appropriate as not standardised information and as required for entities preparing stress testing for internal risk purposes.
Vintage information as described in paragraphs 19 and 22 could be relevant on a closed portfolio basis, as closed portfolios include loans sharing the same value of parameters used in the EIR calculus (i.e.; same contractual rate, same pattern of amortization, prepayment, and residual maturity above the same credit risk exposure). Therefore vintage information is not relevant when the impairment methodology is based on an open portfolio approach over the expected life of the portfolios as these portfolios with similar credit risks characteristics are continuously renewed with matured or cancelled loans and newly granted loans.
We believe also that the IASB should stay at a principle level when defining a non-performing loan instead of giving a 90-days past due limit while different periods could be considered depending on the type of assets.

We believe that qualitative and quantitative disclosures should be consistent with the impairment methodology applied by the entity.

Effective date and transition

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 the level of work, implementing any new impairment approach requires significant time. We have mentioned in our comment letter on the IASB's *request for information* that French banks have estimated that the implementation period may require up to 3 years. So a three years period of time at least before mandatory application would be needed to allow implementation of a new impairment approach.

However, we consider that a single effective date should be defined and required for the whole of IFRS 9 in order to allow comparability among IFRS reporting entities. Therefore, we disagree with a mandatory application to the sole impairment phase. We disagree also with the ED proposals to permit any early application.

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.

As we do not support the impairment methodology based on EIR as proposed by the ED, we do not support the proposed transition requirements. They are too complex and difficult to implement in order to meet them.

As we consider a new impairment approach, the transition to the new model would consist in a change in accounting methods. Therefore, the change would be applied retrospectively for the expected loss provision related to the stock of the outstanding loans at the date of transition to the new model. The situation is similar to the one occurred when first adopting the IFRS in 2005. Therefore, we are in favour of a mechanism similar to the transition to IAS 39 for first time adopters in 2005 with a restatement of the opening balance sheet. Moreover we do not believe that comparative information should be restated as it would provide useful information due to the complexity and costs of preparing such information that would outweigh the benefit of this information.

Question 10

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

Entities should be required to provide a qualitative analysis of the effect of the initial application of a new impairment method.

Practical expedients

Question 11

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

We believe that the criterion of materiality (B15) is not appropriate as it would require calculations to demonstrate that the overall effect of using the practical expedients is immaterial and as it leads to use an individual assessment of credit risk and EIR.

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?

Instead of providing additional guidance on practical expedients, we suggest the Board should stay at a principle-based level and should propose an impairment approach based on the principles described in our answer to question 4.
Concerning small banks or banks having insufficient loss experience, they should be allowed using peer group experience for comparable portfolios.