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Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.

EBF COMMENT LETTER ON THE IMPAIRMENT SUPPLEMENTARY DOCUMENT

Key Points

- **Support of international convergence towards a high quality standard.**
- **Strong preference for a single model for closed and open portfolios, covering all financial instruments at amortized cost.**
- **Preference for the IASB only approach over the alternatives in the Supplementary Document (SD).**
- **Need for clarification around the usability of the "good book" provisions. Incurred losses are the crystallization of expected losses and expected loss allowances are built to be used. The standard should be clarified to better explain the objective of how the model is intended to operate in various parts of the economic cycle.**
- **The concept of a floor is not justified in the context of the IASB objective to match expected losses with interest income. A model incorporating two different concepts for an expected loss calculation and the possibility to switch between them would be misleading and lead to additional complexity.**
- **To address the specific and probably rather limited circumstances of "early loss pattern" for portfolios for which that pattern is relevant a floor may be required.**
- **Should a floor be a general requirement, as a compromise to achieve a converged solution, it should be limited to 12 months to avoid the problem that the floor would dominate the loss recognition and the time-proportional approach would be invalidated.**
- **Constituents should be given an opportunity to review the final proposal.**
- **Disclosure requirements could only be assessed when the overall proposal is available.**
- **Need for field testing before any final decision is taken.**
- **Costs of implementation need to be properly evaluated in the context of the benefits of the final proposals, for an informed decision to be possible, in the interests of users and preparers.**

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General remarks

The European Banking Federation welcomes the publication of the supplementary document and the opportunity to comment on the new proposal.

A move in the right direction to address the industry concerns

The EBF welcomes the proposed changes in addressing the operational challenges of the original Exposure Draft (ED) model. The separation of the calculation of the expected losses from the effective interest rate, the ability to use expected loss data from risk management as well as the applicability of the impairment model to open portfolios represents important improvements to the original proposal and is more closely aligned with business practices.

Scope of the SD and interaction with ED

Uncertainties remain in regard to the scope of the SD as it is not clear whether different impairment models will be applied to open portfolios, closed portfolios and individual instruments. The EBF firmly favours a single impairment model for all financial instruments at amortized cost, including financial guarantees and loan commitments, and believes the development of separate models is not desirable or justified.

Furthermore, the Federation would like to emphasize that the decoupling of effective interest rate calculation and the expected loss calculation is equally crucial for closed portfolios as it is for open portfolios. Therefore, the EBF believes the application of the original model on closed portfolios and individual assets would remain operationally challenging if decoupling was not incorporated.

Convergence

The EBF is concerned that as a result of convergence discussions, concepts with different objectives have been combined with no accounting justification undermining the original objectives for the development of the new impairment model. The EBF believes that while convergence is very important, the resulting model should be of a high quality and not distorted with conflicting concepts.

Primarily, EBF has a major concern with the concept and implications of the foreseeable future, both as an approach itself and as a floor.

Concept and implications of the foreseeable future (the floor)

The EBF believes that the introduction of the floor has no justification in the context of the IASB's objectives. The EBF supports the objective to match expected losses with interest income and believes that superimposing a floor based on a different concept would be inconsistent with the matching objective.

The EBF believes that in most circumstances, the floor will be the only determinant of the level of the provision, in particular if the foreseeable future exceeds 12 months. In practice, this would lead to the same results as if applying the FASB only model, given that the time- proportional mechanism which is the core characteristics of the IASB approach will not apply.

The EBF considers that a model that incorporates two different concepts for expected loss allowances for different portfolios on the balance sheet (time-proportional approach versus foreseeable future) and the possibility of switching between those concepts over subsequent reporting periods would be very misleading for users and therefore would not result in useful information.

Additionally, the EBF members find a lack of clear definition and understanding of the concept of the foreseeable future. Therefore, it is believed that it could result in inconsistent application across different banks, product types and portfolios, resulting in a fundamental lack of comparability and auditability. Furthermore, the future time period for which expected loss estimates are reasonably and accurately developed is highly unlikely to be constant over the economic cycle.

While the EBF does not favour the introduction of the floor, we understand that it was introduced as a result of a compromise to achieve a converged solution and in order to resolve the issue of “early loss patterns”. While the TPA is not designed to explicitly deal with near term future losses or “early loss pattern”, the EBF believes that the mechanism will in most cases provide adequate provisions to cover such pattern.

In that context the EBF believes that to address the concerns over specific portfolios where early loss patterns are observed and where the time-proportionate approach (TPA) mechanism would not provide sufficient level of provisions to cover early losses, a case could be made for a floor mechanism that would not dominate the overall loss recognition.

Should it be unavoidable to introduce the floor to achieve a converged solution, it should be fixed at a period of 12 months. This would ensure that the floor does not dominate loss recognition and invalidate the time proportionate mechanism. Such approach would also avoid unnecessary complexity, as many entities have data available for this time period.

Need of clarification regarding the usage of the provisions in practice

The EBF believes that any model replacing the current incurred loss model should be built around the following key principles:

1) Expected losses should be recognized over the life of the portfolio

2) Expected losses should be determined on a portfolio basis
3) Expected losses are the best estimates of the losses on the financial assets existing in the portfolio at balance sheet date
4) No change in the EIR calculation from the current IAS 39 (essential also for closed portfolios)
5) Impaired loans are treated as in the current IAS 39
6) Incurred losses are the crystallization of expected losses, so expected loss allowance are built to be used

The IASB proposal reflects the first five principles.

However, there is a concern regarding the last principle: "Incurred losses are the crystallisation of expected losses, so expected loss allowances are built to be used". The proposed approach does not allow the full absorption of incurred losses (the provision needed in the bad book upon transfer) using the allowance account that was established for the relevant portfolio in the good book. Only the time- proportional amount in the allowance account relating to the transferred loan provides an offset against the new loss provision in the bad book, while the remainder must be recognised immediately in the income statement. This results in a loss pattern in the profit and loss account that is similar (although less pronounced) to the incurred loss model of IAS 39, with only a limited offset from the allowance on the good book. This is not wholly consistent with the principle that incurred losses are the crystallisation of expected losses and that expected loss allowances are built to be used if and when losses are incurred.

It may not be possible to fully mitigate this characteristic of the proposed model. The only way to partly mitigate this under the proposed model in the ED is to ensure that there is a meaningful reduction of the allowance in the good book, when justified, for loans that are transferred to the bad book during an economic downturn.. This may be best illustrated by the conditions that exist at the worst point of an economic cycle. At this point many bad loans will be or have been transferred to the bad book. If management applies a positive outlook (when justified based on reasonable and supportable information on forecasts of future events and conditions) in estimating future expected losses for the good book, a meaningful reduction to the good book provision may be possible, which would provide an offset against the immediate additional provisions needed for the incurred losses in the bad book.

However, in practice it would be very difficult to accomplish this, as it would require predicting the beginning, the end and also the depth of economic cycles, which is practically very difficult and, if even possible, would always occur with a significant delay.

Given the characteristic of the IASB model, the EBF believes that it would be helpful if the standard was clarified to better explain the objective of how the model is intended to operate in various parts of the economic cycle and should better explain that the offset as explained above should arise when condition justify so (for example by providing guidance or examples that assists in making judgments in the relevant parts of the economic cycle).

This clarification should reduce the problem that the proposals would result in practice in an impairment model that is similar or equal to the existing incurred loss model with only an additional "buffer" in the balance sheet. It is not clear how that outcome would address the criticism on the current IAS 39 model.

Disclosure requirements

The disclosure requirements can only be assessed when the overall picture is available. It is not clear, how the proposed disclosure requirements will fit with the final model. Also, at this point in time, the FASB views on disclosure requirements are not known. The EBF would welcome a re-exposure of the proposed final standard as it will allow constituents to review the disclosures requirements for all assets (not only those under the scope of the SD) and how the proposed requirements link to the final model.

A very challenging comment period time for full assessment of implications

The development of a new impairment model is of significant importance for the banking industry. The Federation believes that the changes proposed to the original IASB model are significant and sufficient time should be granted to allow entities to review the proposal in details and understand its impact and all possible consequences. Unfortunately, as the short SD comment period has coincided with the period that many entities are preparing their annual financial statements, these entities have not been able to test the model using data from their actual portfolios.

The cost of implementation needs to be properly evaluated in the context of the benefits of the final proposals. It is clear, however, that the proposals are likely to entail potentially very significant levels of expenditure to implement and maintain on an ongoing basis, therefore it is essential that a proper impact study and field testing is undertaken before any final decision is made. The members of the EBF are ready to assist in the proposed field testing.

Furthermore, it is believed that for such a significant issue, field testing cannot be adequately performed on a piece-meal basis. The EBF believes that sufficient time must be granted and effort put to perform an overall field tests once all components of the impairment model are clear. Sufficient time must also be allowed to address the outcome of such field tests and the opportunity must be given to the constituents to assess the final proposal.

Question 1

Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (i.e. delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

The EBF supports an impairment model based on the expected loss model with earlier recognition compared to the current IAS 39 incurred loss model.

However, as detailed in the questions below, the EBF has some concerns regarding the common model, especially usability of provisions and the introduction of the foreseeable future (floor).

From the proposed alternatives, the EBF favors the IASB time- proportional approach without floor but believes that the usability of the provisions in practice needs to be further clarified. The EBF believes that while the provisions will be built up early and the amount will in many instances be higher than today, the lack of ability of entities to predict the beginning and the end of an economic cycle makes it difficult to ensure that sufficient provisions have been built up in advance of a crisis, and to use those provisions that have been built up, when conditions deteriorate. See question 3 for further discussion on this point.

Question 2

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

The EBF favours a single impairment model for application on open and closed portfolios and individual instruments as well. Specifically, the decoupling of effective interest rate calculation and the expected loss calculation is equally crucial for closed portfolios and individual instruments as is for open portfolios.

The EBF believes the new proposal is operationally less complex compared to the original model, although some degree of complexity remains, and it is equally applicable for closed portfolios as well as individual instruments.

Question 3

Do you agree that for financial assets in the 'good book' it is appropriate to recognise the impairment allowance using the approach described above? Why or why not?

The EBF supports the distinction between the good book and the bad book, as it believes this will provide useful information for the users of financial statements.

However, the EBF does not agree in principle with the use of a floor in recognising expected losses in the good book, as this takes the approach further away from the matching concept. The use of a foreseeable future floor is also based on a different concept of loss recognition.

Furthermore, there is a practical concern that provisions built up over time may not be available for use when credit conditions deteriorate. The difficulties that this presents may be best illustrated by the conditions that exist at the worst point of an economic cycle. At this point many bad loans will be or have been transferred to the bad book. Only if management applies a positive outlook in estimating future expected losses for the good book will a meaningful reduction to the good book provision be possible. This would provide an offset against the immediate additional provisions needed for the incurred losses in the bad book. Such a positive outlook would need to be justified using all reasonable and supportable information on forecasts of future events and conditions. It is envisaged that this would be difficult in practice and disclosures on the critical management judgments would be very important. The EBF believes that the standard should be clarified to better explain the objective of how the model is intended to operate in various parts of the economic cycle and should better explain that the offset (as explained above) should arise when conditions so justify. The clarification could be provided by guidance that would assist in making judgments in the relevant parts of the economic cycles. Paragraph B5-B7 could be amended to provide this clarification on the application of management judgments.

Question 4

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

While the time proportional basis approach is still complex as it requires tracking of the historical data and two sets of calculations (to determine the floor and the time-proportional expected credit losses), it is capable of being made operational. However, should the floor be the determinant of the level of provisions in most cases (depending on the definition of the foreseeable future) the implementation of the joint model is questionable, given the high implementation cost and results which would not differ from the model of the FASB.

Question 5

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

The EBF believes that the balance sheet under the joint model may not be clear as it could lead to a changing meaning of the allowance from one reporting period to the next. As in practice, the expected loss would either be calculated under the time-proportional approach or the foreseeable future expected loss which may be misleading to the users to understand and difficult for preparers to explain.

Question 6

Is the requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

The EBF welcomes the requirement to differentiate between the good book and bad book. The basis for this differentiation is important to understand how the impairment model will operate in practice. The EBF agrees that the differentiation should reflect internal credit risk management practices, as this should provide more useful information to users on how credit risk is being managed. However, the credit risk management process is continuous as financial assets pass through various stages of uncertainty about collection with recovery proceedings occurring relatively late in the process, and care should be taken to ensure that the point at which a loan may be classified as part of the bad book does not occur too late leaving significant amounts of loans in the good book for which losses are likely to have occurred. Paragraphs B2 to B4 could be open to a wide range of interpretation, and we believe that the principal defining the differentiation would benefit from a clearer statement that it is the degree of uncertainty about the collectability of an asset that is the key factor, and when that uncertainty is such that it is likely a given loan or group of loans will not be recoverable in full as a result of known or probable events then that loan or group of loans should be transferred to the bad book. An entity should define the bad book using the methodology which best represents this principle for the types of assets it holds, and provide clear disclosure of the methodologies used.

Notwithstanding this, the EBF believes that the requirements are consistent with the EBF paper which considers some common types of approaches used today by financial institutions to identify and recognize impaired loans and impairment allowances including both individual and collective procedures, and their implications for the identification of the bad book.

Question 7

Is the requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

Yes, the EBF believes the requirement is both operational and auditable, as long as the distinction is clear as stated in question 6.

Question 8

Do you agree with the proposed requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

Yes, the EBF agrees with the requirements, however as noted in response to question 6, further clarification is required around the distinction between the "good book" and "bad book".

Question 9

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

(a) **Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?**

The EBF does not agree. The introduction of the floor is conceptually not justified as it distorts the objective to link the EL with the revenue recognition and will not reflect the economic substance. The floor would lead to the creation of some form of day one loss that is outside the concept of the IASB model and potential disadvantages when entering new markets or growing a business.

(b) **Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?**

The existence of an early loss pattern in an open portfolio is not a clear concept and would require further analyses. While it may be present in a new portfolio, in a steady state portfolio the concept of "early loss pattern" loses its meaning.

Although the TPA is not designed to explicitly deal with near-term future losses or 'early stage' loss patterns, the EBF believes that the mechanism will in most scenarios provide adequate provisions to cover such loss patterns. This is due to the fact that although the TPA will defer an element of the near-term expected losses it will however recognise the time-proportional amount of the longer term losses immediately.

Therefore, the TPA will be sufficient for near-term losses where the deferred portion of these losses is mitigated by the mid to long term expected loss element that is recognised immediately.

In a portfolio of loans at different stages in the expected loss cycle, the cumulative amount of expected losses in the mid to long term may well be sufficient to arrive at a TPA provision that will cover those early losses. This is due to the fact that the amount of loans outside the near term/early stage loss period is likely to be larger than those in the early stage loss period in a mature portfolio and therefore the absolute amounts of expected losses in the early period versus the mid to long term is the determining factor. However, it is recognized that this may not be the case in all instances (e.g. new production or growing portfolios and therefore a floor mechanism that will not dominate the loss recognition, may be required to cover such specific scenarios.

(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

In principle, the EBF does not agree with the proposed minimum allowance amount. In many cases the foreseeable future floor will be the binding constraint should it exceed a period of 12 months. At a period of 12 to 24 months, the foreseeable future provision will often prevail over the time-proportional provision. At a period of 2 year or more the floor will probably only be exceeded in rare circumstances. In most circumstances, the time-proportional provision will be less than 2 years expected losses, and the floor will be the only determinant of the level of the good book provision.

Therefore, should the floor be unavoidable as a political compromise, it should be set at the level of 12 months. This compromise would ensure that the floor would not dominate loss recognition, and enable the use of existing data (with appropriate adjustment) for many preparers.

(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

The future time period for which expected loss estimates are reasonably and accurately is not constant in all economic conditions. This period is likely to be longer in good times than in bad times, when future economic conditions are less certain. Should the foreseeable future be required to be a fairly constant period, it would lose its meaning of the period over which the entity can develop specific projections and would become a concept close to a regulatory requirement.

(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.

The concept of foreseeable future is not clear and would lead to a lack of consistency in application across entities as well as product types and portfolios. It will be based on the practices of the institutions risk management and the level of information available in different markets.

(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

The EBF believes the foreseeable future should not be greater than 12 months to avoid that the floor would dominate loss recognition and invalidate the matching concept. However, clearly for portfolios with remaining life under 12 months the floor should be limited to the remaining life.

Question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

The EBF believes that above a foreseeable future period of 12 months, the level of provisions would prevail over the provision using the TPA. Consequently, this would mean in effect the FASB only model is applied.

Question 11

The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

(a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?

Yes, the EBF agrees with the proposed flexibility.

(b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

Yes, we agree.

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (i.e. to recognise expected credit losses over the life of the assets)? Why or why not?

The EBF prefers the IASB approach over the alternatives in the SD. However clarification to assist with the judgments around the usability of the provisions should be provided.

Question 13

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (i.e. to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

As specified in the previous question, the EBF is supportive of the IASB approach.

Appendix Z

Question 14Z

Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

Yes. This is considered one of the major improvements both conceptually and operationally. As previously discussed, it should be clear in the Standard that the decoupling applies both for open and closed portfolios and also for individual assets.

Question 15Z

Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

Yes, loan commitments that are managed the same way as loans valued at amortised cost (IFRS 9 should be subject to the same impairment requirements.

Question 16Z

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

Yes, the EBF believes it would be operational.

Question 17Z

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

Yes. We agree.

Question 18Z

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

The EBF supports the recent Board decisions to eliminate the requirements for some of the disclosures as proposed in the original ED in particular those relating to loss triangles and stress testing. Due to the limited comment period and the desire to focus on the conceptual aspects of the combined approach model the members of the EBF did not have sufficient time to undertake a detailed review of the requirements set out in the SD and how they link to all assets held at amortised cost. The EBF would therefore recommend that the Board re-expose on a limited basis the proposed final standard as it will allow constituents to review the disclosures requirements for all assets (not only those under the scope of the SD) and how the proposed requirements link to the final model.

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

Question 19Z

Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

The disclosure requirement suggest that the time- proportional amount of the allowance should be transferred to the bad book, the bad book allowance should be subsequently increased for the remaining amount needed and the good book allowance should be recalculated. While in practice the level of the good book allowance may not be affected (at least in a steady state environment), to make it more operational a transfer in the amount of 100% allowance to the bad book would be preferable.