The voice of banking
& financial services

Comments on the EFRAG response to IASB ED

The BBA welcomes the opportunity to comment upon the draft EFRAG response to the IASB ED on financial instruments: expected credit losses. We are broadly supportive of the letter as drafted; some additional points that we would like to highlight for consideration/inclusion are:

1) **Convergence:** global convergence is important for impairment to enable a level economic playing field and for comparability for users of financial statements. The adoption of different accounting models by the IASB and the FASB does not add value to preparers or users and undermines confidence in financial reporting more generally. In this case we support convergence to the IASB model because it is a better, if not perfect, reflection of the economics of lending:

    - it does not result in such a marked day 1 loss and therefore the overstatement of an asset's performance subsequently, and

    - the performance statement reflects credit deterioration in the period which is better aligned to the purpose of the performance statement, which is to reflect economic events in the accounting period and their effects on our loss expectations making the greatest possible use of our credit risk management practices.

    We support earlier loss recognition and the attendant larger impairment provisions, but buffers that satisfy only prudential objectives should not be built into financial reporting.

2) **Foreseeable future:** we understand that alternative models such as lifetime expected losses within the "foreseeable future" at the reporting date are under discussion, mainly by the FASB and US preparers. We do not support such models because they are not based on either economics or existing risk management practices - it would be difficult to ensure consistency of application and the approach would penalise more sophisticated preparers who are capable of longer range forecasts.

3) **Scope:** The IASB &FASB should have the same scope - therefore both Boards should either consistently include or exclude financial guarantees. The pricing and initial fair value of guarantees is related to the expected credit losses at inception, and they are subject to the same risk management practices as lending and therefore it is conceptually reasonable to include them in the scope.

    However, we note that a number of constituents have raised some concerns over applying the proposals to guarantees either due to operational complexities associated with intercompany financial guarantees or because they view financial guarantees as being more akin to insurance.

4) **Discounting:** EIR is conceptually the more supportable discount rate in an amortised cost model. However much depends on operability and how materially different the results derived from alternative rates would be, and so a firm view should only be reached after field testing. Applying EIR to a far larger population than current IAS 39 will be operationally complex and therefore principles may need to be compromised to permit users to use any reasonable method that considers the time value of money as a practical expedient. Using the EIR, which is a historic rate specific to individual loans, will be harder to apply to open portfolios and collectively calculated impairment allowances for a number of users.

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We note that loan commitments and financial guarantees should follow the same measurement proposals as drawn loans, rather than what is currently proposed which appears more akin to a requirement to fair value them.

5) **Disclosures:** must be meaningful, adaptable to different credit risk management processes and products and should not introduce unnecessary detail unless clearly decision useful. We believe that the disclosures should be consistent with and better leverage existing guidance (e.g. EDTF, IFRS 7, Basel III credit disclosures) and not be additive unless clearly decision useful. The requirements to track disclosures for modified and written off assets for long periods of time after modification or write off are examples of potentially less decision useful information.

6) **Examples:** We note that in para 19 we question example 6 – the example does not seem unreasonable but would perhaps benefit from an explanation that although the rating agents have not yet downgraded but put the credit rating under review, the other factors taken together indicate that significant credit deterioration has already been triggered.

   Re example 7: We think that the illustrative example of application to credit cards where the contractual cancellation period is 1 day needs further consideration. We agree with the proposed measurement period for expected losses over the contractual life (or shorter if evidenced behaviourally e.g. by prepayments) but we would welcome an illustrative example of how to apply it to credit cards in practice. Credit card arrangements are revolving lines of credit that provide incremental extensions of credit with no set contractual payment period and optional payments with discretion provided to the borrower regarding how much to pay in a given period (subject to an established minimum payment amount). The contractual cancellation period for such facilities could be, for example 1 day, however the constructive period over which credit is offered could be longer e.g. one year. The constructive period over which credit is offered might be established by a practice of the issuer conducting an annual limit or facility review and informing the customer unless there is a credit event which may accelerate action. In this case the period over which the issuer is exposed to credit draw down on the undrawn facility is longer than the contractual cancellation period because the issuer has created a constructive expectation that credit will be extended at least annually by its behaviour and expected losses should therefore be measured over a period that is longer than contractual cancellation period. For the drawn facility the contractual life is related to approximately the period over which the minimum payments repay the drawn amount which adds further complexity.

   We think the proposals would also benefit from an example of how to calculate 12mth and lifetime expected losses on a 10 year bullet loan when no payments are due within 12mths. This example should highlight how losses will be captured before the bullet payment in year 10.

7) **Field testing:** we believe that field testing being carried out by preparers and other stakeholders at the request of the IASB and EFRAG will provide valuable insights into the operability of the significant credit deterioration trigger and consideration of forecast economic data and we encourage the IASB to consider this carefully in finalizing its proposals.

   Comparatives: We agree with the IASB proposal that comparatives should not be required to be restated because, on this occasion, a robust transitional disclosure should provide users with enough relevant and decision useful information and appropriately balances the cost of full comparative restatement and the additional implementation time delay that this would necessitate. The proposals are likely to create more volatility in results which will be explained by explanatory disclosure in any case. Some institutions may voluntarily decide to give additional comparative information on transition.

British Bankers' Association
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