Committee of European Banking Supervisors

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Dear Madam, dear Sir,

Request for information: Expected Cash Flow Model

The Committee of European Banking Supervisors (CEBS), comprised of high level representatives from banking supervisory authorities and central banks of the European Union, welcomes the opportunity to comment on the IASB's Request for Information on the Expected Cash Flow Model.

CEBS has followed with great interest the latest work of IASB staff on the issue of impairment of financial assets, and more specifically on an expected loss model. As banking supervisors, CEBS is of the view that the current incurred loss model is too restrictive, not prudent enough and, most importantly, not fully consistent with the manner used to manage credit risk by the banks since credit risk provisions are not usually recognised until a later stage in the lifetime of bank credit.

CEBS would therefore welcome the implementation of an impairment model by the IASB that would allow for an earlier recognition of credit risk in an institution's financial accounts, thus better reflecting economic reality and, at the same time, reducing to some extent the cyclical nature of the financial reporting of credit risk. As a matter of fact, compensation for credit risk is generally charged to the borrower from the beginning of a loan through the contractual interest rate, and as such credit risk should be taken into account very early in the process.

In our opinion, it should be possible, within existing bank internal systems established to apply the current accounting requirements based on historical cost, to develop the information required to implement an expected cash flow approach. However, we acknowledge that the determination of robust credit loss expectations for the whole duration of the loans, as well as the rolling out of the approach over time, could be challenging.

For these reasons, CEBS welcomes the IASB's move to work closely with the industry in order to obtain a clear understanding of the potential operational difficulties, and work out simplifications where they are really needed. CEBS also holds the view that there is a need to carry out field testing (where possible) and an impact assessment of the new approach in order to make further informed decisions on next steps.

The comments put forward in this letter and in the related appendix have been coordinated by CEBS's Expert Group on Financial Information (EGFI) chaired by

Mr. Didier Elbaum (Deputy Secretary General, Commission Bancaire) - in charge of monitoring any developments in the accounting area and of preparing related CEBS positions - and in particular by its Task Force on Procyclicality and Accounting under the direction of Mr. Ian Michael of the UK FSA. If you have any questions regarding our comments, please feel free to contact Mr. Elbaum (+33.1.4292.5801) or Mr. Michael (+ 44.20.7066.7098).

Yours sincerely,

Giovanni Carosio
Chair, Committee of European Banking Supervisors

Appendix: answer to selected questions

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

   CEBS has identified four areas which may require further specifications:

   - The expected cash flow approach uses from the outset an entity's best estimate of expected future cash flows. From a practical point of view, the best estimate can take different forms. It can be determined using a "point in time approach" (i.e. implying a strong necessity to reassess expected losses for each generation) or using a "through the cycle approach" (i.e. on an average basis) leading to significantly different estimates. In addition, it would be useful to include the issue of the treatment of recovery costs within expected cash flows in the project.
   - On the issue of presentation, we would strongly advocate an approach that allows users to identify and assess an entity's estimates of expected losses, along with its corresponding loss experience over time. This could be achieved by means of an allowance account or by supplementing the net amounts for loans with adequate disclosures on the level of the expected losses in the notes to the financial statements.
   - Credit loss expectations are primarily determined using statistical data based on portfolios of loans with similar characteristics, although the approach may also be applied to individual loans. Some guidance could be useful with regard to the determination of these portfolios as well as on the link between the use of portfolios for statistical purposes and the application of the approach on an individual basis.
   - Further guidance should address the treatment of short-term revolving credit facilities, financial assets whose terms have been renegotiated (and that would otherwise be past due or impaired) and variable rate interest instruments (as discussed below).

   In general it is felt that the IASB needs to apply care to ensure that the approach is principles-based and supplemented with clear and sufficient application guidance that allows the determination of expected losses for all types of institutions and instruments.

   We also note that transitional provisions have not yet been clearly defined. Given the significance of impairment within financial reporting, it will be important to give careful consideration to such provisions to facilitate comparison over time and to understand how variation in impairment calculated under different models will be treated. With this in mind, combined with the role played by management judgement, we would like to emphasise the necessity of the IASB developing application guidance which will deliver robust implementation of any new model, to be used both initially and on an ongoing basis. Disclosures will also be important in this regard, so that the rationale for expectations and changes of those expectations can be understood by users.

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

The expected cash flow model is based on the effective interest rate mechanism as currently defined in IAS 39, except that it does not exclude credit losses from expected cash flows considered in the initial computation at inception. Hence, CEBS believes that banks should be able to adapt their systems to the expected cash flow approach as proposed, to the extent that the mechanism behind this approach is similar to the one that is currently used to determine the amortised cost.

CEBS acknowledges that the implementation of the expected cash flow approach and notably developing robust and reliable estimates not only of expected cash flows (an important precondition for reducing cyclical effects) but also of their timing may raise operational challenges. However, as regards expected credit losses, CEBS believes that the proposed approach could use information and parameters from the internal credit risk assessment systems that banks have developed for regulatory purposes, notably those using an ‘advanced’ internal rating based approach under Basel II. These systems should allow them to determine, to a large extent, expected cash flows even though some developments to estimate expected loss to the full maturity of the loan may be needed, with a level of complexity in line with the size of the bank.

For banks that apply the ‘standardised’ approach, the implementation of the expected cash flow approach could pose further challenges given that these banks may not have developed internal credit risk assessment systems based on an expected loss concept. CEBS encourages the IASB to work closely with the industry and regulators in order to obtain a clear understanding of the potential operational difficulties, and work out simplifications where they are really needed.

However, from a more general perspective, it is worth noticing that the information required to operate an expected cash flow approach is similar to that required for loan price setting. Therefore, banks should be able to use information from the systems that they have developed for price setting.

4. ***How would you apply the approach to variable rate instruments, and why?***

CEBS is attached to high-quality accounting standards that provide information to investors on the financial situation of an entity. This includes an appropriate impairment approach for variable rate instruments, which is consistent with impairment rules applied to fixed rate instruments. However, CEBS agrees that an excessively sophisticated approach for variable rate instruments may lead to undue cost and therefore encourages the IASB to proceed to a cost/benefit analysis before identifying areas where simplifications may be needed.

On the basis of the analysis set out in the Appendix to the Request for Information, on grounds of cost-benefit and practicality, CEBS tends to favour ‘Approach A’ to amortisation of upfront costs, and ‘Approach B’ to impairment of variable rate instruments.

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?

When the bank adopts a portfolio approach for measuring the expected credit losses of a group of loans with similar characteristics (e.g. consumer loans), we believe that this approach should be maintained throughout the lifetime of the assets included in the portfolios. A loan that would appear as impaired on an individual basis should not be removed from the loan portfolio in which it was initially included when the expected losses of the whole portfolio were estimated. If these expected losses have been reliably estimated, the incurred loss observed on a loan included in a portfolio is only a crystallisation of these expected losses. CEBS believes that this is the only way to ensure the consistency of the parameters used to establish the statistics. Otherwise, we fail to see how the regular reassessment of expected credit losses could be consistently applied. It should be stressed that a key requirement for the approach to operate properly is that banks have systems to estimate expected losses in an appropriately granular and reliable way. Banks should disclose key assumptions underlying expected cash flow estimates and the sensitivity of those estimates to changes in the underlying assumptions.

However, maintaining a collective approach for assets included in a portfolio should not preclude the provision of complete information on the amounts of impaired assets. In particular, quantitative disclosure should permit investors to:

- distinguish between expected future losses and those actually experienced;
- comprehend the amount of impaired or past due loans, regardless of whether these loans have been measured using a portfolio approach or an individual approach.

6. ***What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?***

As stated in our response to question 4, CEBS is not opposed as a matter of principle to simplifications. These should not be made, however, to the detriment of the quality of information. Only areas where real concerns have been identified, notably in terms of a cost-benefits analysis (e.g. for IT system, should be subject to simplified accounting treatment. However this issue warrants further field testing and impact assessment.

The approach should be subject to appropriate high-quality disclosure requirements to provide investors and depositors with information in a timely fashion on the accounting choices made and any related simplifications. We believe that quantitative disclosures on how actual losses compare to expected losses over short- as well as long-term periods would also be necessary. Other qualitative disclosures should cover methods and assumptions as well as parameters which give rise to changes in expectations.