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Dear Madam, dear Sir,

**Supplement to ED/2009/12 Financial Instruments: Impairment (File Reference No. 2011-150)**

The European Banking Authority (EBA), which has come into being as of 1 January 2011 welcomes the opportunity to comment on the IASB's Supplement to Exposure Draft Supplement to ED/2009/12 Financial Instruments: Impairment.

The EBA has a strong interest in promoting sound and high quality accounting and disclosure standards for the banking and financial industry, as well as transparent and comparable financial statements that would strengthen market discipline.

We welcome the joint effort by IASB and FASB in developing a common impairment model that provides a more forward-looking approach. In particular, the move towards a converged expected credit loss (EL) approach for impairment will improve the decision usefulness and relevance of financial reporting for users, including prudential regulators.

Like the original ED, the Supplementary Document (SD) appropriately continues to address one of the important weaknesses that has been identified with respect to the current impairment models under IFRSs and US GAAP, which is delayed recognition of credit losses associated with financial assets (i.e. the too little too late problem).

We support the time-proportional approach to recording expected credit losses for the reasons explained by the Board.

We recognize that the proposed approach incorporates a broader range of credit information than under IAS39 and is more likely to draw from banks' risk and capital management (e.g. with the introduction of the distinction between good and bad loan books).

We also acknowledge that the proposed model, including decoupling of expected credit losses from the effective interest rate is likely to reduce the operational difficulties of the original IASB proposal.

Further simplification could actually be reached. As indicated in our 30 June 2010 comment letter on the original ED, another source of complexity was that the proposed approach requires estimates of the amounts and timings of expected cash flows to be probability-weighted possible outcomes. To simplify this, entities should be enabled to use more widely average loss rates, in line with their risk management systems (so not only in the case indicated in Para B7).

We note that the proposed model does not satisfactorily address the issue of pro-cyclicality raised in our 30 June 2010 comment letter on the original ED.

As indicated in that letter, estimates may have to be revised frequently depending on management's ability to accurately forecast changes in credit risk factors. This potentially gives rise to pro-cyclical effects and therefore remains a source of concern under the supplementary ED model.

In addition, the introduction of the "floor" concept and of the requirement to replenish the provisions when transferring loans from the good to bad book raises new questions in that aspect.

We see merits in the concept of a floor which promotes earlier recognition of credit losses, when the expected pattern of loss emergence warrants it, and acts as a "back-stop" supporting the adequacy of annual impairment allowances. However, the requirement to reconstitute the good book allowance immediately in case of a transfer of loans from the good book to the bad book, raises some concerns, especially during an economic downturn.

Our concerns also relate to the "foreseeable future" mechanics which is not clearly defined in the SD. These aspects are further developed under questions 9 & 10.

The supplementary ED is limited in scope which adds to complexity in terms of process and it is unclear how it interacts with the previous ED. Also a number of issues are still open as acknowledged by the Board (see par. IN20). We would appreciate having a full picture of the future impairment model and information on future steps before the finalisation of the standard.

The EBA has in general a preference for a single impairment model - based on the supplementary ED's general approach - for all financial instruments carried at amortised cost. Considerations for simplifications (e.g. for quoted debt securities) should be consistent with the principles as those for the general approach for open portfolios.

Finally, we do not support the proposed free choice regarding discounting. We would rather support a model where discounting is applied where relevant and likely to result in reliable information (i.e. essentially for the bad book). Regarding the discount rate, we believe that using the effective interest rate of the asset is the only reasonable solution in an amortised cost model.

Other more specific issues are described in our response to the different questions.

If you have any questions regarding our comments, please feel free to contact Mr. Elbaum (+33.1.4292.5801) in his capacity as Chairman of the EBA Expert Group in charge of monitoring developments in the accounting area or Mr. Colinet (+ 32.2.220.5247) in his capacity as Chairman of the technical group that coordinated this comment letter.

Yours sincerely,



Andrea Enria  
EBA Chairperson

## **Answers to the detailed questions**

### **General**

#### **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?

Yes. We believe that the ED would address one of the important weaknesses that has been identified with respect to the current impairment models under IFRSs and US GAAP, which is delayed recognition of credit losses associated with financial assets (i.e. the “too little, too late” problem).

The proposed approach would likely promote more forward-looking provisioning; incorporate a broader range of credit information and draw from banks’ risk management and capital adequacy framework.

### **Scope – Open portfolios**

#### **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 EBA has in general a preference for a single impairment model - based on the supplementary ED's general approach - for all financial instruments carried at amortised cost. We are of the opinion that the proposal is potentially as operational for closed portfolios and other debt instruments as it is for open portfolios.

Inevitably, simplifications (e.g. for quoted debt securities) will be considered, but they should be developed using consistent principles as those under the general approach developed in the SD.

For instance, additional guidance on the application to single large assets with unique characteristics and circumstances (e.g. some leveraged loans, commercial real estate loans, and large commercial loans) would be useful. Loss distributions for such assets follow different and more ‘lumpy’ patterns than homogenous populations of smaller loans. Their inclusion in a given portfolio might actually bias the statistical features of this portfolio and reduce the relevance of probabilities built on this portfolio. We note that the current proposal does not set out how lifetime expected losses should be calculated and how, for instance, prepayments and extensions should be dealt with under the model.

## **Differentiation of credit loss recognition (paragraphs 2, 3 and B2–B4)**

### **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?

### **Question 4**

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

### **Question 5**

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

The EBA agrees that, for the purpose of determining the impairment allowance, financial assets managed on an open portfolio basis should be split into two groups, based on how the loans are managed. Such a distinction is reflective of the risk management practices applied by many banks.

The EBA considers that the calculation of weighted average age and weighted average life on an ongoing basis could prove burdensome but expects it to be operationally feasible as this information should normally be used by credit risk managers already.

Estimation of future expected losses obviously requires a significant amount of judgment. Indeed, the proposals suggest that the management's best estimates should include "forecasts of future events and economic conditions" (B5) and "current and forecast economic events and trends to evaluate and project the set of circumstances that will prevail in the future" (B12).

For this approach to provide decision-useful information the basis of these estimates must be understood by the users. Since the estimates seem to incorporate scenario analyses based on management's outlook for market/macro-economic variables, disclosures about assumptions and inputs are important (as proposed in para. Z10). We also suggest that for any guidance developed in this area, concepts are drawn from prudential loan loss assessment methodologies (as suggested in further detail in our response to questions 6-8) insofar as this is commensurate with the general principles set out in the standard.

The decision-usefulness of the information depends on the accuracy of the expected credit loss estimates.

In the comment letter CEBS (the EBA's predecessor) provided on the original ED, we noted that to determine point in time estimates, an entity needs to assess in which phase of the economic cycle the related loans are granted. This assessment is difficult to do with sufficient certainty. Therefore, forecasting future losses on the basis of current and foreseeable economic conditions will be challenging and increasingly unreliable as time horizons increase. This may affect the reliability of the estimates.

The EBA therefore suggested relying on statistical average loss rates over an economic cycle as a starting point to forecast future credit losses with a long-run perspective rather than estimating loss rates adjusted to current and foreseeable economic conditions. Management would be required to adjust those estimates

whenever there is material evidence of factors that are likely to cause loan losses to differ structurally from historical loss experience (e.g. shift in cycles).

**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?

**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?

**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?

Subject to the concerns raised below regarding the 'floor', the EBA broadly agrees with the differentiation between the two groups (the 'good book' and the 'bad book') for the purpose of determining impairment allowances.

However, while the principle is clear in theory, the reliance on entities' credit risk management objectives could give rise to a wide range of practices among entities.

Risk management practices may be interpreted in a way that minimises the assets to be included in the bad book (with the effect of reducing the impairment amounts). We acknowledge that the balance is difficult to find in setting reporting standards, between the business and economic view and the quest for consistent and comparable treatments. To this end, the IASB could consider specifying a number of basic criteria that should be considered in order to determine whether the management objective has changed.

For the development of such additional guidance, the IASB could take inspiration from the Basel criteria and/or definitions to the extent commensurate with the general principles set out in the standard. Although these criteria and definitions, strictly speaking, only apply to banks and financial institutions, guidance based on these regulations could help reducing the reliance on judgment and make the application of the requirement more operational and enforceable.

Moreover, the transfer to the bad book should be made at the latest when the borrowers' status is considered as non performing or has evidenced a sensible deterioration within the entity's internal credit risk grading system (e.g. classification in the so called "watch list").

**Minimum impairment allowance amount (paragraph 2(a)(ii))**

**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?

(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?

(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?

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

(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.

(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.

### **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.

We see merits in the concept of a floor which promotes earlier recognition of credit losses, when the expected pattern of loss emergence warrants it, and acts as a "back-stop" supporting the adequacy of annual impairment allowances, i.e. ensuring that impairment allowances are always adequate to cater for the whole amount of losses expected to occur in the foreseeable future.

However, we note some shortcomings in the proposal as it stands.

The current definition of the floor is based on the notion of "foreseeable future" which is not clearly defined in the SD. This flexible concept is not based on clear and objective criteria, and as such may permit earnings management and hinder comparability.

We are concerned that the floor as currently defined could in many cases prevail over the expected losses calculated by the time-proportionate approach and hence could significantly decrease the use of the time-proportionate approach. As such, the mechanics of the floor as featured in the ED (notably the foreseeable future notion) introduces an element whose consistency with the expected model can be challenged. In addition, a floor could have a pro-cyclical impact during an economic downturn as it would likely lead banks to increase their expected losses in the foreseeable future, without permitting them to use existing allowances to cover increased and their incurred losses at the same time.

With that in mind, we believe that the Board should further explore the application and implications of this concept and, if the Board were to maintain the floor on the good book, we would recommend ring-fencing the “foreseeable future” of the floor in a way that works in practice and meets the objective of having an overall sufficient loan loss provisioning at each reporting period.

**Flexibility related to using discounted amounts (paragraphs B8(a) and B10)**

**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?

(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?

According to the proposal, time-proportional expected credit losses in the “good book” can be determined either by multiplying the entire amount of the estimated lifetime expected losses by the ratio of the portfolio’s age to its expected life (straight-line approach) or by converting the amount into annuities (annuity approach).

By definition, the calculation of annuities would require discounted estimates of the lifetime expected loss, whereas the straight-line approach would theoretically allow for the use of either discounted or undiscounted estimates of expected losses.

EBA acknowledges that financial statements must convey information that allows users to assess an entity’s cash flow prospects, and that this main goal of financial reporting is best achieved through the use of discounted amounts. For instance, in the case of financial assets with basic loan features (i.e. held with an aim to collect contractual cash flows which are solely composed of principal and interest payments), amortised cost provides measurement of the pre-set cash flow structure that reflects conditions on the initial recognition of the financial instrument (i.e. expected cash flows discounted at the effective interest rate).

However, in the context of an open portfolio assets are added to or removed from the portfolio throughout its life, and therefore it would be very difficult (if not impossible) to determine a single rate that reflects conditions existing upon initial recognition of each of the assets that make up the portfolio. Additionally, even if such effective interest rates could be calculated, determining the timing and amount of specific credit losses for assets in the “good book” over its expected life would seem impracticable<sup>1</sup>.

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<sup>1</sup> On the other hand, even if it were possible to determine such variables (timing and amount of expected losses and an effective interest rate capable of discounting the aggregated cash flow structure of the portfolio at each reporting date), the fact that some entities would be using undiscounted amounts while others would use discounted expected losses would introduce serious comparability concerns, which would be exacerbated by the additional option to use any discount rate between the original effective interest rate and the risk-free rate.

Accordingly neither the straight-line approach using discounted estimates nor the annuity approach would be feasible in practice for open portfolios, and we therefore disagree with the flexibility provided by the proposal.

We would rather support a model where discounting is applied where relevant and likely to result in reliable information. This would essentially be applicable to (to the more active and individually monitored assets included in the “bad book” where identification of expected credit losses on a case by case basis and the ensuing calculation of discounted expected loss figures is possible.

Discounting should in any case be achieved using the original effective interest rate as it is difficult to justify using any other rate appropriate to the risk and cash flow profile of the asset/portfolio.

**Approaches developed by the IASB and FASB separately**

**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?

Not applicable. (See our previous comments.)

**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 (ie to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

Not applicable. (See our previous comments.)

**IASB-only appendix Z**  
**Impairment of financial assets**

**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?

In contrast to the IASB’s original exposure draft that proposed an integrated approach (including the initial estimate of expected losses in the cash flows used to determine the effective interest rate), the supplementary document proposes to ‘decouple’ the credit loss estimate from the cash flows used to determine the effective interest rate.

The EBA is in favour of this “decoupled approach”, as it addresses the complexity concerns many respondents – including the Expert Advisory Panel (EAP) – had with regard to the integrated effective interest rate approach.



## **Scope – Loan commitments and financial guarantee contracts**

### **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?

### **Question 16Z**

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

The EBA considers that the same impairment principles should apply to loan commitments not accounted for at fair value through profit or loss (i.e. commitments to provide a loan at a below-market interest rate) and financial guarantee contracts. Credit institutions manage credit risk in the same or similar manner for these contracts as they do for funded or drawn-down loans.

While we do not express a view on whether financial guarantees should be treated as insurance contracts or as financial instruments, we would nevertheless like to stress – as already set out in the comments CEBS provided on the Insurance contracts ED – that the accounting model for financial guarantees should be such that it (i) reflects economic substance, (ii) results in robust and relevant measurement and (iii) ensures consistency at an appropriate level.

More generally, we acknowledge that distinguishing between products is challenging in a principle-based framework and determination of the relevant applicable standard can therefore be arbitrary in certain cases (e.g. for financial guarantees). It is therefore our view that ensuring consistency in treatment and language throughout the standards is far more important and will eliminate the risk of arbitrage between standards through inventive structuring of financial products.

In that respect it is important that the treatment for impairment for the instruments in question is applied consistently. The EBA strongly encourages the IASB to pursue the revision of impairment for financial assets (under IFRS 9), the measurement for provisions (under IAS 37) and the treatment of comparable instruments under IFRS 4 based on a concept of expected losses that achieves comparable outcomes for comparable instruments/contracts.

## **Presentation (paragraph Z5)**

### **Question 17Z**

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

Yes, provided it is supported by adequate disclosure (see below). The proposed presentation requirements reflect the decoupling approach and provide transparency on the sources of profit or loss from lending activities.

## **Disclosure (paragraphs Z6–Z15)**

### **Question 18Z**

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

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

As noted in the comments CEBS provided on the original ED, it is essential that any impairment model, especially one which relies so critically on management judgements, is accompanied by high quality disclosures to enable users to understand how the model is being implemented and the entity's key underlying assumptions.

The EBA supports most of the individual disclosure proposals in paragraphs Z6-Z15. With regard to some of the proposals we would like to make the following comments:

- The breakdown of impairment losses into losses on the good book and losses on the bad book should reflect the different risk management approaches to good book loans and bad book loans, allowing users to compare interest revenue with impairment losses on loans that are managed to earn interest revenue.
- In addition disclosure on the movement between the two books, with information on the transfers, non-performing loans and write-offs, allows users to assess the quality of the loan book and also the risk management policy of the entity.

In that context, it is however important to clarify some of the important concepts used, such as 'write-offs' and 'non-performing loans'. Disclosure of a comparison of the minimum impairment allowance amount and the time-proportionate allowance would be useful as this will allow users to discern management's expected loss pattern of portfolios. To avoid divergent implementations that could impair the usefulness of this information, we propose to clarify that the difference between those amounts should be calculated, first, by "portfolio" and, afterwards, aggregated by classes of financial assets; if the difference is calculated after the aggregation by classes, the impact of the "floor" could not be properly assessed.

- The level of granularity to be used for the required disclosures is a concern, to the extent that there is a trade off between keeping particular disclosure categories relatively homogeneous and the risk of disclosure overload, especially in the financial statements of large diversified institutions<sup>2</sup>.
- Whilst we support the disclosures required in paragraph Z8<sup>3</sup>, we believe that the usefulness of this information would be greatly enhanced by requiring this disclosure to be provided at least at class level (to be clearly defined), as this would provide users with a better understanding of the credit quality of the portfolio and changes in credit quality.
- Paragraph Z12 requires entities to disclose information about how previous estimates of expected credit losses compare with actual outcomes and sets out that this disclosure may be quantitative or qualitative depending on whether an entity performs back testing. Given that the outcome of the

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<sup>2</sup> The notion of 'portfolio' should conceptually follow a 'through the eyes of management' approach – need guidance but not a 'definition'. The examples of classes used in paragraph BZ20 raise, for example, the question whether the 'corporate' class, for many banks a big part of their business, should be further disaggregated (Z6).

<sup>3</sup> Paragraph Z requires entities to disclose information enabling users to compare the nominal amount of the financial assets, the total amount of expected credit losses and the amount of the impairment allowance.

proposed loan loss provisioning model is highly dependent on estimates of future losses and that estimation of such losses will require significant judgement, this disclosure is crucial for users of the financial statements to assess the reliability of estimates made. We believe that any qualitative analysis should also involve a discussion of relevant data. Qualitative information, on its own, would not be sufficient.

- Disclosures of internal risk management policies and practices (paragraph Z14), should be consistent with the information provided by the IFRS 7 requirements.

Other disclosures that the EBA believes should also be required include the following:

- Disaggregated information on impairment losses that are recognised in profit or loss. We are aware that users of the financial statements can derive some disaggregated information on the impairment losses recognised in profit or loss from the reconciliation required in paragraph BZ22 of the application guidance. However, adequately disaggregated information on the impairment losses recognised in profit or loss should be a disclosure requirement in the standard.
- Information about the sensitivity of loss estimates to key inputs and assumptions should be disclosed, where material.
- A clear policy for transfers of loans between the good book and the bad book, given that the timing of such transfers impacts provisioning levels.

#### **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 guidance in paragraph BZ25 proposes to transfer the time-proportionate amount for the allowance on the financial asset, using the weighted average age and weighted average life of the financial asset or assets.

The EBA shares the IASB's view that all approaches should result in the same impact on profit or loss. For transfers between the good book and the bad book, it would therefore follow that the allowance amounts for both books need to be recalculated, i.e. both allowance amounts must be adjusted to the appropriate levels. Indeed, in case of a transfer of losses from the good book to the bad book, the SD requires a reassessment of the good book to the appropriate level. This means that the model proposed in the SD does not allow a real mutualisation of the losses between the two books as should be the case in an expected loss model. As prudential regulators we believe this is important in this part of the model and the boards should investigate further the interactions between the good book and the bad book.