ESBG position paper on the IASB-FASB Supplementary Document: Financial Instruments: Impairment

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### 1. Introduction

ESBG appreciates the opportunity to respond to the Financial Accounting Standards Board's (FASB's) and the International Accounting Standards Board's (IASB's) Supplement Document Financial Instruments: Impairment.

# A step in the right direction

ESBG welcomes the proposed changes in addressing the operational challenges of the original Exposure Draft (ED) model. We support the FASB's and the IASB's efforts to align the approaches for loan loss recognition. We favour moving to an expected loss model that provides a more forward-looking approach to the accounting for credit losses, as it better reflects the economics of lending decisions. We also believe that the proposed impairment model for open portfolios of financial assets offers more operational solutions for financial institutions than the IASB's original proposal. In particular we welcome the decision to exclude expected losses from the effective interest rate, the introduction of the good-book and the bad-book concept and the flexibility related to the choice of discount rate.

Therefore, we agree with the followings approaches:

- The better alignment with internal credit risk management of entities;
- The recognition of expected loss (and changes in estimates) in profit or loss on a time proportional basis over the life of the portfolio;
- The introduction of the good book and the bad book;
- The decision to decouple the allocation of interest revenues and expected credit losses (i.e. the separation of the calculation of the expected losses from the effective interest rate); and
- The flexibility regarding the use of a discount rate for the good book.

These positive points are very important since the development of a new impairment model is crucial for the banking industry and for savings and retail banks in particular. However, there are some shortcomings in the proposal.

# A very short comment period with the introduction of new concepts

First of all, ESBG highlights that the changes proposed to the original IASB model are significant and that insufficient time have been granted to allow entities to review the proposal in details and understand its impact as well as all possible consequences. Unfortunately, as the short Supplementary Document (SD) comment period (60 days) has coincided with the period during which many entities



are preparing their annual financial statements, these entities have not been able to test the model using data from their actual portfolios.

We also note that the SD introduces new concepts (for instance the 'floor') into the debate, rather than exclusively focusing on simplification of the expected cash flow model. We further note that this separate consultation on the development of an impairment approach for open portfolios adds to the fragmentation of the deliberation process and the due process, making it all the more difficult to assess these proposals in their full context. For these reasons, we regret to stress that a 60-day comment period is insufficient and we believe that stakeholders should be given additional time to assess the proposals in detail – especially when one thinks of small savings and retail banks. We also urge the IASB to engage in field-testing these new concepts to assess their impact.

# High political pressure to converge IFRSs and US GAAPs

We understand that the IASB has to make all possible efforts to obey to the G-20 demands to converge IFRSs and US GAAPs by the end of 2011. But we also stress that this goal should not be made at the expense of the quality of future accounting rules. Indeed, we are concerned that as a result of convergence discussions, concepts with different objectives have been combined with no accounting justification and undermining the original objectives for a high quality impairment model. ESBG believes that while convergence is very important, the resulting model should be of a high quality and not distorted by conflicting concepts due to political pressure.

# A compromise proposal which can be subject to criticism

In particular, we believe that an impairment model should reflect the link between the pricing of the asset and the expected credit losses, and therefore we have a number of concerns on the use of the floor and the related concept of 'foreseeable future'.

As explained by the board in paragraph BC32 of the SD, the IASB's preferred approach was a good/bad book model without the floor (i.e. allowance equal to the time proportional amount of the remaining lifetime expected credit losses for good book loans). When loans are considered bad (i.e. the entity's credit risk management objective changes from receiving regular payments to recovery of all or a portion of the financial asset), the full amount of expected losses is recognised immediately in profit or loss. That model was considered by the board to be a simplified approach of an expected credit loss model, whose objective would be to reflect the underlying economics of a lending transaction (i.e. maintaining the link between the pricing of the financial assets and the expected credit losses). However, it appeared necessary to address the FASB's primary concern about the adequacy of the impairment allowance for losses that tend to occur early in the lives of the financial assets (i.e. front-loaded loss emergence patterns). Therefore the floor was introduced.

As a consequence, in addition to the proposals of the Expert Advisory Panel, the model represents a further compromise reached by the IASB and FASB. Two possible implications of this are that (1) the amortised cost category of financial assets will be subject to more than one impairment model and (2) the introduction new accounting concepts – resulting from the necessity to find a compromise with high time-pressure – will not be justifiable.

Against this background and while ESBG understand the reasons for the introduction of a floor, we have three reasons to criticize the floor mechanism on the good book:



- Firstly, recognising a credit loss at inception (a day one loss) is not consistent with the
  recognition of loans (at market rate) in the financial statement of position, at their initial fair
  value. We consider that the bad book allowance is the appropriate floor for the whole
  impairment model.
- Secondly, the concept of "foreseeable future" is wide and uncertain so that it could drive in most cases the allowance amount and thus undermine the time-proportional approach and lead to generalize an approach which is not appropriate.
- Thirdly, a model that incorporates two different concepts for expected loss allowances for different portfolios in 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.

# ESBG position: matching expected losses with interest income without a floor

ESBG believes that the introduction of the floor has no justification in the context of the IASB's objectives. ESBG believes that for shareholders as well as stakeholders it is important to match expected losses with interest income. Superimposing a floor based on a different concept would be inconsistent with the matching objective.

Instead, we favour one single impairment model for financial instruments measured at amortized costs and we prefer a portfolio definition that incorporates all collectively assessed financial assets for impairment, i.e. open and closed portfolios as well as large single assets.

In other words we favor a time-proportional model that takes different loss patterns into account when calculating the impairment allowance. Thus we consider that the model proposed in the SD for open portfolios (without the floor) should be extended to closed portfolios because it would improve the representation of the economic effect of credit risk on financial assets measured at amortised cost.

However, ESBG is of the opinion that banks should be able to include short term receivables in the open portfolio approach as well as for debt securities portfolios. We favour as few approaches/methods as possible, i.e. entities should not be forced to use different methods.

Finally, while ESBG 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. In that context ESBG believes that, should the floor be kept and introduced for all portfolios, then, unnecessary complexity should be avoided. This would be done by ensuring that the floor does not dominate loss recognition and invalidate the time proportionate mechanism. A field testing on this issue would be welcome.

# Further clarification and field testing are needed

Against this background ESBG believes further discussions and clarifications are necessary with regard to the concept of the foreseeable future and on how loss recognition would occur across the economic cycle. We suggest that a proper impact study and field testing be undertaken before any final decision is made.



# 2. Answer to questions

### 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?

ESBG believes that the impairment model described in the SD will achieve an earlier recognition of expected credit losses as it proposes to replace the current incurred loss impairment model with an expected credit loss impairment model. We globally consider that the impairment approach proposed in this SD deals with the weakness of the current incurred loss model in the same way as defined by the November 2009 proposals but without its operational drawbacks.

However, as already said in the introduction, we have strong concerns regarding the floor on the good book (see Question 9).

### 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.

We believe that the proposed model also is operational for closed portfolios and single assets because the main operational difficulties are those associated to open portfolios. All financial assets should have uniform impairment model.

As we support a consistent impairment model for all financial assets carried at amortised cost, we consider that there is no reason to develop two different models for closed or open portfolio. Therefore, we consider that the model proposed in the SD should be extending to closed portfolios.

### 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?

ESBG supports the distinction between the good book and the bad book because we believe this will provide useful information for all users of financial statements (potential investors, creditors etc.).

However, we strongly stress that we do not agree in principle with the use of a floor in recognising expected losses in the good book. The use of a foreseeable future floor is also based on a different concept of loss recognition.



# Question 4

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

Yes, even if it is complex. Indeed, the approach requires tracking historical data and introduces two sets of calculations (to determine the floor and the time proportional expected credit losses). Yet, it can be made operational. As said in the introduction we consider the proposed approach far more operational than the initial approach and we welcome the IASB's decision to adopt a "decoupled" approach instead of an integrated EIR approach.

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 its uncertain impact.

We believe that the floor mechanism leads to day-one loss recognition which is not consistent with the economics of loan origination mentioned above. We consider that the bad book mechanism is the appropriate floor to deal with the issue on portfolios with front-loaded loss emergence patterns; thus the floor mechanism is not necessary (see Question 9).

### Question 5

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

ESBG has some concerns on this issue as, in practice, the expected loss would either be calculated under the time proportionate approach or the foreseeable future expected loss. It may be misleading for the users 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?

We consider that the principle underlying the differentiation between the good book and the bad book is useful for decision making. As far as the short consultation period enabled ESBG's members to evaluate the proposal it appears that the distinction between the "good book" and the "bad book" is clearly described and consistent with credit risk management practices.

# 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?



The proposed approach is operational since the two groups are operationally managed in a different way based on particular and different criteria. However, we consider the diversity in credit management practices should be taken into account when including a financial asset in the bad book to achieve comparability between entities. Given the diversity in credit risk management practices, disclosures are essential to ensure a measure of comparability between entities.

### Question 8

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

Yes, ESBG agrees with the requirements.

# 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?

We understand the political compromise that led to the introduction of a floor. But we believe that it is inconsistent with the matching principle and gives a poor reflection of the performance of the entity and thus, does not provide useful information for decision-makers. The credit risk is reflected in the interest rate charged on the loan and in theory the expected credit losses are included in the interest charge. If the credit losses expected to occur in the foreseeable future are to be provided for at inception of the loan, the corresponding interest should also be recognised at inception.

Therefore we do not believe that a floor appropriately reflects the economics of lending transactions because it ignores the link between the pricing of financial assets and expected credit losses (e.g. it gives rise to day-one credit losses for newly originated financial assets and underestimates or overestimates the net return on new (older) assets in an open portfolio).

Moreover it triggers practical issues: it requires in practice two calculations for the impairment allowance.

On the basis of these two sets of arguments (the economical and the practical) we consider that there is no need for a floor mechanism on the good book, which also in practice may undermine the time-proportional approach (see Question 10).

As already said, we consider that the bad book specific impairment method is the appropriate floor of the whole impairment model.

We also point out that prudential buffers and floors designed to prevent banks from becoming insolvent is more a task for the regulators than for the IASB. We hope the IASB will continue to issue



high quality accounting standards based on the objectives as described in the Framework and leave the prudential aspects of the banking industry to the relevant regulators.

(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?

No. We believe the time-proportional amount should be adjusted to take into consideration the loss patterns. Such an adjustment would eliminate the need for a floor. We consider that the good book/bad book concept does address circumstances where 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?

No, logically ESBG does not agree with the proposed minimum allowance amount. However, should the floor be maintained by the Board, we would recommend to cap the foreseeable future at twelve months (mostly because Basel II has a foreseeable future of 12 months - see sub-questions (d) and (e) for explanations).

Last but not least we underline that requiring a variable time period in which future losses will be estimated provides no incentive to develop new models for estimating the future losses: such models would increase the foreseeable future and thus require larger reserves for the same portfolio.

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

Yes, we believe the foreseeable future changes over the economic cycle. In good times the foreseeable future is longer than in times of economic downturn. As the financial crisis showed, under bad economic conditions, the foreseeable future would be very short as this corresponds to a time of great uncertainty (it was shorter than twelve months at the peak of the financial crisis). This may lead to the counter-intuitive result that the provisions for credit losses could decrease in an economic downturn as the foreseeable future shortens and consequently the expected losses are estimated for a shorter period of time. Thus we consider also that the good book/bad book concept will address such circumstances.

(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.

No, the concept of foreseeable future is not clear and would likely 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.



Furthermore, as described in the answer to (d) above, the foreseeable future will vary over time, but also between portfolios. Basel II rules are based on Probabilities of Default (PD) on a twelve months time horizon; this is the time horizon most banks work with, especially regarding open portfolios. In general, we believe the foreseeable future will not be longer than twelve months for banks. We propose to freeze the period to 12-month in order to reflect risk management practice and the current Basel II regulations.

(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 recognized 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.

No, as explained above, we do not believe the foreseeable future is more than twelve months even if it may vary over time depending on the economic environment.

### **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.

Since ESBG members did not have time to conduct simulations because of the short deadline to answer the IASB SD it is extremely difficult to answer this question.

However, as this concept is entirely new, we believe that if the IASB were to retain this approach, it should explain what the 'floor' represents in terms of performance measurement.

Finally our position is that the time-proportional approach is more economical than the immediate recognition approach (through the floor mechanism). We are concerned that the floor, as currently proposed, could lead to approaches which are not appropriate and misleading (see also our answer to Question 3 and Question 9). Thus we would prefer an impairment model without a floor.

### **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?

Yes, we support the flexibility proposed by the Board, as it will reduce the complexity in implementing the proposed approach – not only as regards the use of discounted or undiscounted estimates but also regarding the choice of discount rates.



Although discounted estimates are theoretically more correct and in line with the concept of time value of money, we believe that a straight line allocation, i.e. the use of undiscounted estimates, is a welcomed practical expedient. Estimating the amount of expected credit losses on a portfolio level is normally based on statistical data on historical defaults, while estimating at which point in time these losses will materialize in the future is operationally very complex.

### **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 recognize expected credit losses over the life of the assets)? Why or why not?

Yes.

We support the general concept of the IASB approach as it will deal with the weakness of the current impairment model (i.e. delayed recognition of expected credit losses). In addition we welcome the proposed simplified model which implies the decoupling of the calculation of the effective interest rate and the recognition of expected credit losses as it will ensure an operational method.

We would like to stress again that for the reasons explained in our response to Question 9, we prefer the IASB approach without the floor. For portfolios with a front loaded credit loss pattern, the time-proportional amount can be adjusted to reflect this pattern.

### 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 the FASB approach (i.e. to recognize currently credit losses expected to occur in the foreseeable future)? Why or why not?

No. For the reasons explained before, we reject the FASB proposal. The proposal does not distinguish between assets according to the entity's internal credit risk management, is too much based on subjective inputs and decreases comparability across banks.

In other words this approach does not reflect the economics and the pricing of amortized cost assets and results in an income recognition that would distort the information disclosed in financial statements.



### Additional comments on unwinding and operational issues

ESBG notices that none of the IASB documents have discussed details concerning recognition of losses for the bad book. While paragraph 2(b) of the Supplement Document states that the "entire amount of expected losses" is recognized - can ESBG members thus infer that this statement implies that the impairment can be recognised on an undiscounted basis and at the level of portfolio of homogenous loans in the bad book?

Some constituents argue that the original IAS 39 requirements should be kept for the bad book. But this would mean that the time effect of the expected cash flows would be recognised as interest income (unwinding).

ESBG stresses the need the need to reflect that time value is a significant operational issue. Costly system solutions are necessary for the implementation of unwinding.

Therefore ESBG highlights that from an operational point of view the most acceptable solution would be to recognise the impairment in the bad book:

- on an undiscounted basis; and
- without estimating the timing and amount of individual cash flows. Portfolio statistics would be used for defaulted loans.

### APPENDIX Z: PRESENTATION AND DISCLOSURE

### 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. We believe the link between the pricing of contracts and the recognition of expected losses to be important. This link is retained in the supplementary document, while the operational difficulties in the original proposal have been removed.

### Question 15Z

Should all loan commitments that are not accounted for a 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. We believe all loan commitments that are not accounted for at fair value through profit or loss should be subject to the impairment requirements in the supplementary document as they are managed and evaluated on the same basis as loans at amortised cost, irrespectively of whether they are under the scope of IAS 39, IFRS 9 or IAS 37. Nevertheless, we suggest that when estimating the expected credit loss the different credit characteristics of loans and loans commitments should be taken into account.

### Question 16Z

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

Yes, as these instruments are often incorporated in the banking book and part of the assessed credit exposure.

# Question 17Z

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

Yes. ESBG believes that presenting expected credit losses outside net interest income increases the quality of information. Net interest income is an important part of the total income in the financial industry and adding expected loss will in times of changed expectations add volatility to a normally fairly stable item.

# Question 18Z

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

No. We support the tentative decision taken on the February Board meeting to remove the requirements to disclose vintage information and results from stress testing.

For open portfolios with underlying characteristics that will be dynamic over time, we cannot see the rationale behind disclosing comparative figures concerning the impairment allowance and expected losses for a longer time period than what is usually required (i.e. one or, in certain cases, two years) are of inferior value for the users.

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

We do not propose any additional disclosures.



# **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?

We understand the reason to consider the weighted average age and the weighted average life of the transferred financial asset(s) when calculating the impairment allowances as it may not be equal to the weighted average age and weighted average life of the portfolio.

However, we point out operational difficulties. As the allowances both in the bad book and the good book are based on the situation at the date of the balance sheet, we believe it is difficult to identify the amount reflecting the age of the asset to transfer and we do not believe this information to be of value for the user of the accounts. The requirement to disclose a reconciliation of the changes in the allowance account in paragraph Z7 is an adequate level of disclosure.





# About ESBG (European Savings Banks Group)

# ESBG - The European Voice of Savings and Retail Banking

ESBG (European Savings Banks Group) is an international banking association that represents one of the largest European retail banking networks, comprising about one third of the retail banking market in Europe, with total assets of € 5,972 billion (1 January 2008). It represents the interests of its members vis-à-vis the EU Institutions and generates, facilitates and manages high quality cross-border banking projects.

ESBG members are typically savings and *retail* banks or associations thereof. They are often organised in decentralised networks and offer their services throughout their *region*. ESBG member banks have reinvested *responsibly* in their region for many decades and are one distinct benchmark for corporate social responsibility activities throughout Europe and the world.



ESBG - Association internationale sans but lucratif/Internationale vereniging zonder winstoogmerk/International not-for-profit association

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