2012-260 Comment Letter No. 17A

David SchraaRegulatory Counsel

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Technical Director Financial Accounting Standards Board 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116

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INSTITUTE OF INTERNATIONAL FINANCE

1333 H Street, NW, Suite 800E
Washington, DC 20005-4770

Washington, DC 20005-4770
TELEPHONE 202.857.3600

FAX 202.775.1430
WEB iif.com

Dear Ms. Seidman:

The IIF, via its Senior Accounting Group (SAG), welcomes the opportunity to comment on the FASB Exposure Draft, Financial Instruments – Credit Losses (subtopic 825-15) (December 2012) and the IASB Exposure Draft – ED /2013/3 Financial Instruments: Expected Credit Losses (March 2013).

This letter addresses basic conceptual issues with both the FASB proposal and the IASB proposal. It is essential to consider both proposals together. We will prepare a comment letter to the IASB as well and, as we undertake further analysis of the IASB proposal, we may develop or have additional comments and views.

Provisioning and credit incentives

As background to the fundamental issues about impairment and provisioning discussed below, it is important to consider for a moment some of the business and economic implications of any proposal.

Members place a high priority on understanding the effects of a more forward-looking impairment accounting model on bank regulatory capital and on lending business more broadly. These considerations are particularly relevant to the work being undertaken by the FSB and others on incentives for longer term investment.

While it is agreed that a more forward-looking impairment model is needed, there is concern that the greater the divergence between impairment loss recognition for accounting purposes and the economic effects of lending activity and credit-risk management processes, the greater the danger that the accounting will present a distorted view of financial performance, with a risk of associated impacts on regulatory capital, or will itself affect business incentives and decisions. This is a particular danger if there were to be a requirement of full upfront recognition of lifetime expected losses on all financial assets, including those which are not credit deteriorated, as proposed in the

FASB model. This distortion may have a number of unintended consequences for the financial services industry and the broader economy.

These effects may include a restriction in the availability of longer term lending, reduced lending to higher credit risk customers (for example small businesses) and/or increasing costs of lending to these customers; less diversification in the credit risk that banks are willing to undertake; and inadvertent encouragement of incentives for arbitrage opportunities between banks and shadow-banking market participants for whom the regulatory implications of the accounting model are less significant.

Convergence

As a threshold matter, we would like to reiterate the IIF's long-standing position that convergence between U.S. GAAP and IFRS is highly desirable. And convergence is especially important and compelling with respect to impairment and provisioning. Having two different standards on provisioning would cause confusion among investors; make comparisons of international banks more difficult for users of financial statements, including investors; create complexities and possible inconsistencies in international prudential regulation; and most likely undermine confidence in both standards and perhaps in regulation as well.

Furthermore, the issues of business and economic impact addressed in the first part of this letter would be exacerbated if there is a failure to reach a converged solution, which may also result in distortive impacts between markets.

In December 2012, the SAG reaffirmed its commitment to the goal of international consistency of accounting standards and reaffirmed its strong support for a global level playing field, international regulatory consistency, and mutual recognition to avoid competitive distortions and regulatory arbitrage¹. Concern is in fact growing over the likely problems that would be created if firms are required to make impairment and provisioning disclosures that are inconsistent or unduly complex across the global industry.

Having said that, convergence on this issue is complex because of the different points from which firms enter the debate, because of the history of practice in different countries, and because of the problematic aspects identified in both the current IASB and FASB proposals. Although the Group is thus unable to state a consensus approach, it has become apparent that both the IASB and the FASB proposals are troubling to the industry, and we hope that a common solution could be found that would resolve present issues with both.

Principles

In light of the IASB proposal and the FASB proposal, the IIF SAG <u>reaffirms the following fundamental views</u>:

• the impairment and provisioning process should be more forward looking than today's IFRS or U.S. GAAP;

¹ See the letter to the IFRS Foundation of December, 2012.

- full up-front loss recognition should not be a *general* requirement as it does not reflect the economics of lending, although there are specific circumstances where it is appropriate;
- preparers must, when appropriate for a given exposure, be allowed to take more provisions than might have been allowed under previously existing standards, and any standard must result in reliably measureable and comparable provisions for reasonably estimated expected losses on a timely basis;
- the level of allowances that is calculated should reflect the economics of exposures (including macroeconomic effects); and
- the impairment model should not result in over-provisioning or create disincentives to initial lending decisions, which would have direct effects on the global economy.

Methodology

The following should be drivers of any methodology:

- The methodology should reflect the economics of lending;
- The methodology should be operational and use credit risk management processes and information;
- The methodology should require use of all available credit information; and
- The methodology should allow flexibility of segmentation to reflect risk management practices.

Because risk management has developed sophisticated techniques to assess loan losses, and operates under both specific regulatory requirements and regular supervision by banking regulators, the industry's view is that the closer the standard comes to risk management, the more useful the information will be to investors. In addition, using methodologies as close as possible to those used by risk management would be the most operationally efficient, least prone to error, and most readily understood by business personnel and senior management.

The impairment model should be driven by the credit characteristics of the financial assets being evaluated and the changes in those characteristics, determined either by economic or market events, or by credit deterioration events. It should also incorporate a forward-looking dimension, as do advanced risk-management techniques.

Neither of the proposals entirely reflects current risk management or the economic view of risk and its translation into allowances.

The worst outcome would be to have to build a parallel system only for accounting purposes. Not only would this entail systems and training costs, but there would be a constant problem of explaining the differences to risk managers and senior management. Divergences between risk or capital views and accounting views would complicate external communications and disclosures as well, especially as it can be anticipated that there will be substantially more investor attention to such issues over time. Banks are necessarily concerned about the operationality of multiple and inconsistent concepts.

Because it operates entirely on the basis of lifetime losses for loans other than those already put on non-accrual status, the FASB proposal would make no distinction between loans for which the credit environment has *not* changed since inception and loans assessed when some credit deterioration has occurred.

Furthermore, the FASB proposal as currently stated would be procyclical in ways that would be both unnecessary and hard to control. Estimating lifetime losses for purposes of the currently proposed FASB model would be likely to overestimate future losses during a crisis, as it would generally be difficult to forecast future recovery in a reliable manner, which would induce preparers, auditors, and supervisors to err on the side of excess conservatism in the inevitably subjective estimation of lifetime losses.

Existing risk systems would have to be changed substantially or new systems built to incorporate additional data and procedures, often beyond the normal horizon of credit analysis, especially to the extent that full lifetime losses would need to be analyzed for performing loans. Reliable data is not always available to permit the construction of loss curves necessary to assess a lifetime level of allowances for performing loans. In any case, lifetime estimates for "good book" assets would inevitably depend substantially on macroeconomic estimates over the life of such assets as opposed to specific information with respect to them. The FASB proposal would inevitably require a great deal of judgment and estimation, resulting in high degrees of uncertainty, a wide dispersion of stated provisions across banks (especially for longer horizons), and potentially misleading or disputable information to users. While the IASB proposal also requires full lifetime loss assessment for the second and third stages, and some systems adjustments would be required, such assessments for questionable credits is more in line with existing credit practice.

The current IASB proposal, on the other hand, raises other concerns among members, including IFRS reporters, especially regarding the potential operational complexity of the transfer mechanics from one stage to another. However, for stage one, loans which have not exhibited and are not expected to exhibit significant credit deterioration, IFRS firms generally see the twelve-month horizon as a reasonable basis for recognizing expected losses.

The IASB first stage is broadly compliant in principle with current risk management intent for banks employing the more advanced Basel III approaches. However, while IFRS banks believe the one-year measurement horizon would provide reliable results that are comparable across institutions, certain other banks, largely in the U.S., see the twelve-month horizon as too prescriptive, in a way that would have the potential to require allowances that are not appropriate to the risks. Some of them are concerned that it might result in reduction of the current level of allowances for certain exposures.

The transfer from stage one to stage two or three under the IASB proposal elicits concern, insofar as it might in some cases require transfer asset by asset. Some members are concerned under the present proposal about what might be required to develop an audit trail to demonstrate the deterioration loan by loan from stage one to stage two if the "more than significant deterioration" criterion is not clarified. This point as well could imply a need to revisit risk systems, depending on how the final rule turns out. Again, the most appropriate and operational solution for any transfer requirement, whether under the present IASB proposal or otherwise, would be to align it as closely as possible with current risk and credit management systems.

Elements of Commonality?

One way to look at the problem of impairment and provisioning is that banks' books in effect reflect a two-stage approach to impairment and provisioning that could be engaged for accounting purposes without systematically changing risk systems or approaches.

- a first stage for portfolios of assets when no credit-deterioration event has occurred since inception or is reasonably expected (the so-called good book); and
- a second stage for portfolios of assets when credit deterioration is reasonably expected or has actually occurred, corresponding to assets with increasing probabilities of default (PDs) under Basel II or increasing charge-offs in accordance with customary banking industry practice, and encompassing doubful or clearly non-performing assets (which might be thought of as the "bad book").²

For the second stage, there is no debate that, under any impairment and provisioning standard, the measurement horizon should be the estimated remaining lifetime of the assets and that estimating and providing for losses within such a horizon would be reasonably feasible on the basis of information related to such assets and yield the appropriate level of allowances for such circumstances.

For the first stage, depending on current practices and the way a credit deterioration event is interpreted, the twelve-month horizon for expected losses resulting from possible default events in that time period as proposed by the IASB is viewed by IFRS-using members as a reliable measurement, easy to assess, implement and understand, and relatively consistent with many risk-management practices. For others, the foreseeable-future approach appears more feasible and appropriate. For the reasons stated above, most firms agree that the lifetime-losses approach, at least as currently proposed, would not be the basis of a high-quality standard for the first stage or the "good book", however defined.

U.S. members believe that the assessment should, as stated above, be driven by the credit characteristics of the financial assets being evaluated and the changes in those characteristics determined either by economic or market events, or by credit deterioration events. In this view, most of U.S. members agree that lifetime recognition of credit losses for performing loans is not appropriate, while they also believe that for various types of loans, the twelve-month horizon would be insufficient. For many assets, the appropriate measurement horizon would be longer than twelve months, perhaps as much as two or three years, depending on available information, experience, and the tenor of the assets. For example, if the unemployment rate increases, the deterioration of many U.S. loan portfolios is expected to have a substantial impact only after the twelve-month horizon. As the first stage in the IASB model is understood by U.S. members to be restricted to a twelve-month horizon, the recognition of the expected credit loss would be captured later; this is a result of the allowance calculation's reflecting a twelve-month probability of default rather than a probability of default associated with the longer expected maturity or foreseeable future tenor. They conclude that

² In the IASB proposal, there is an explicit third stage generally corresponding to the "bad book". In the FASB proposal, actually non-performing assets would be placed on a non-accrual basis.

using a twelve-month probability of default would result in a lower provision given that probabilities of default generally increase as tenor increases, all else being equal.

IFRS-using members interpret credit deterioration more broadly. Any event that would have a substantial impact on a credit could be viewed as sufficient to require the bank to start the second stage for loans. In that case, the second and third stages envisioned by the IASB proposal would capture any elevated PDs, yet the twelve-month horizon for the first stage would be a way to include in overall provisioning an appropriate estimate for performing loans. This is seen as a way to ensure that the entire portfolio has been evaluated and that each loan is captured within the scope of allowances for losses on an expected-loss basis. So, under the circumstances set out in the preceding paragraph, if unemployment rates increased and that led to an expected significant deterioration in the credit quality of the loans (even outside the twelve months), then under the IASB proposals the affected loans would move into the second or third stage.

This difference of perception of the "good book" contributes to the difference of views among members; if it were possible to come to a clear and widely agreed-upon understanding of the treatment of performing loans that would contribute greatly to developing a converged solution; therefore, it would be helpful for the Boards to focus on this issue.

Time value of money

The two Boards have taken different views on how to assess the time value of money (TVM). On one hand, the FASB assumes that the TVM is implicitly incorporated in the calculation of allowances³; on the other hand the IASB wants the TVM to be explicitly calculated⁴. The two different approaches concern the industry. If not corrected, such a difference could lead to significant differences of amounts of provisions.

A divergence on this point would be especially problematic with respect to "bad book" calculations. Given that, as discussed above, lifetime losses are likely to be included in any "bad book" standard, such a standard should converge on elements of the calculation, and a divergence on TVM approaches could be especially distortive and at odds with comparability. As discussed above, divergence on the "bad book" is likely to be especially damaging to investor confidence in the accounting for impairment.

³ FASB - 825-15-25-4 An estimate of expected credit losses shall reflect the time value of money either explicitly or implicitly (see paragraph 825-15-55-3). If an entity estimates expected credit losses using a discounted cash flow model, the discount rate utilized in that model shall be the financial asset's effective interest rate.

FASB -825-15-55-3 Paragraph 825-15-25-4 requires that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly. A discounted cash flow model is an example of a method that explicitly reflects the time value of money by forecasting future cash flows (or cash shortfalls) and discounting these amounts to a present value using the effective interest rate. Other methods implicitly reflect the time value of money by developing loss statistics on the basis of the ratio of the amortized cost amount written off because of credit loss and the amortized cost basis of the asset and by applying the loss statistic (after updating it for current conditions and reasonable and supportable forecasts of the future) to the amortized cost balance as of the reporting date to estimate the portion of the recorded amortized cost basis that is not expected to be recovered because of credit loss. Such methods may include loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors. The requirement in paragraph 825-15-25-4 is met when the method used to estimate expected credit losses either explicitly or implicitly reflects the time value of money.

⁴ **IASB - 16-** An estimate of expected credit losses shall reflect: (a) an unbiased and probability-weighted amount that is determined

by evaluating a range of possible outcomes (see paragraphs 17 and B28); and

⁽b) the time value of money (see paragraphs B29-B31)

As opposed to the FASB's proposal, the IASB's proposal requires a specific TVM methodology. The proposed IASB methodology for TVM is different from that used by the Basel Committee and from other methodologies. For example, if the loss given default (LGD) as defined in the Basel Accord is used to assess allowances, the discount factors included in the LGD may already take into account TVM to a substantial degree. As a consequence, to avoid any double count of TVM, the discount factors would have to be reintegrated and the expected cash flows discounted with the "accounting" rate. A similar mechanism would have to be put in place with any other estimation methodology. A further issue here is the complexity and artificiality of overlaying any imposed methodology for TVM over other methodologies that, in the view of the Group, are likely already to take TVM sufficiently into account for these purposes.

Moreover, in the IASB approach, the choice of possible rates (between the risk-free rate and the Effective Interest Rate (EIR)) that could be used to evaluate the TVM⁵ would create unnecessary complexity and inconsistency, as defining a risk-free rate is not as easy as appears to be assumed. In some cases, particularly for emerging markets, the range between the risk free rate and the EIR would be between 2% and 20% which is excessively broad. The choice of the rate thus implies a wide range of amounts and a significant volume of divergences among IFRS banks. While the same issue comes up in a somewhat different way in the FASB proposal, it is evident that both Boards need to consider this problem further.

One specific point on the FASB proposal: The FASB clarified its position in the recently issued Q&A document stating that "An entity would not be required to prove that a method that implicitly reflects the time value of money provides the same result as (or reconciles with) a method that explicitly reflects the time value of money. The FASB approach would thus allow appropriate use of existing loss-estimation methods without adding additional complexity but without taking into account comparability across firms.

Finally, in conclusion on TVM: in devising a converged standard, or at least a consistent approach to "bad book" exposures, it is very important for the Boards to find a consistent approach to TVM. Any such approach should be as simple as possible; as convergent with current risk processes as possible; be clearly described to avoid implementation ambiguities; and avoid overlying multiple calculation methodologies insofar as possible.

Toward a Solution?

Against the background of the foregoing discussion, the distance between the two proposals may appear less dramatic than it originally seemed. We do not have a specific proposal at this time, but offer some observations that we hope may be helpful to the Boards:

- To reiterate, convergence on a high-quality standard is especially important on impairment and provisioning and should be a priority goal of the Boards.
- If convergence on an overall standard proves not to be achievable, particular effort should be given to maximizing consistency of the treatment of "bad book" assets, however defined. The main focus of users and regulators is of course on the higher

⁵ IASB - B29- Except for purchased or originated credit-impaired financial assets, when determining the discount rate used to reflect the time value of money for the calculation of expected credit losses in accordance with paragraph 16(b):

⁽a) an entity shall, at initial recognition of a financial asset, determine as the discount rate for that asset any reasonable rate that is between (and including) the risk-free rate and the effective interest rate;

- PD and actually non-performing assets, so consistency of understanding and presentation thereof is crucial.
- If the final IFRS and U.S. GAAP standards are not fully converged, narrative disclosure of the approaches used in determining impairments and provisions by each firm should of course be provided where appropriate; however, there is a strong consensus that attempting to make up for a lack of convergence by requiring multiple calculations and detailed reconciliations between the two systems would not be appropriate.
- The effects of the final standard on impairment and provisioning upon disclosure and upon capital regulation, although the province of other authorities, need to be kept in mind, especially if full convergence is not achieved.
 - Great care will be required by the standard-setters; by IOSCO and the securities regulators; and by the prudential regulators to be sure that both clear disclosure that is comprehensible to the market and a level playing field can be achieved.
 - The Boards should consult with the Basel Committee and be mindful of the effects of the outcome in this area on global bank capital requirements; any solution should be capital-neutral and not create disparities in the interpretation or application of Basel III across jurisdictions or across firms.

Transition and time needed

Whatever the solution may be and depending on the extent to which it would rely on existing risk systems, not less than three years would be required to implement the expected losses model, given the adjustments or additional developments needed in risk information system to make historical data available, to build operational and reliable curves by segment of assets, and to validate and backtest systems and methodologies. Moreover users, regulators and preparers will need to be trained and educated, especially if the Boards do not find a converged solution.

Conclusion

In conclusion, convergence on the critical point of impairment remains a priority, for the IIF as for the G20. We certainly recognize the issues the two Boards face in coming to a common conclusion, but that does not diminish the importance of establishing a converged standard that will be appropriate and readily understandable for preparers, regulators, and users alike. Please let us know if the IIF Senior Accounting Group can be of assistance as thinking progresses further.

Should you have any comments or questions on this letter, please contact the undersigned or Veronique Mathaud (vmathaud@iif.com; +1 202 682 7456). We appreciate your consideration.

Very truly yours,

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