



BASEL COMMITTEE ON BANKING SUPERVISION

BANK FOR INTERNATIONAL SETTLEMENTS

Chairman

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Financial Instruments: Impairment (three bucket approach)

Dear Hans and Leslie

The impairment topic is of significant importance for the global financial markets. The Basel Committee's interest in this topic is consistent with the April 2009 call by the G20 Leaders for "accounting standard setters to work urgently with supervisors to ... achieve a single set of high-quality global accounting standards" as an action to strengthen financial supervision and regulation. Moreover, in this respect the G20 Leaders requested that accounting standard setters "strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information" and "improve accounting standards for provisioning. . ."

We acknowledge the recent efforts of the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB) (collectively, the Boards) to revise their joint approach by developing a credit loss impairment model which contemplates three buckets or categories. The Committee is encouraged that the IASB and FASB are focusing their efforts on an expected loss impairment approach and that both Boards are continuing to seek convergence in this important area.

Based on our preliminary review of the draft approach and the staff papers for the July 2011 meeting, the Committee agrees with the Boards' overall direction to staff to further elaborate the approach and criteria for categorising financial assets into the three buckets and on the measurement of bucket 1. There is merit in better tying the impairment approach to credit risk management practices and credit quality. Additionally, we support further work to describe the circumstances related to when transfers between categories would occur, which would include developing a broad set of clear and well-defined "expected loss cues" (hereafter referred to as cues).¹

¹ The word "cue" is used in this context to refer to specific characteristics or factors associated with a credit information set that reflect a change in credit quality and expected credit losses and

The Committee believes that it is crucial that the proposed approach continues to reflect an expected loss model and requires the recognition of adequate levels of provisions (or allowances) on the balance sheet to absorb all expected credit losses when they occur. Not reflecting an adequate level of an allowance for expected credit losses on the balance sheet could result in overstating the related asset balances as well as the yield on those assets in any given period in the income statement. This could be potentially misleading to investors, other users, and other market participants, while also raising the safety and soundness concerns of prudential authorities.

We would also like to take this opportunity to reiterate the Committee's *Guiding principles for the replacement of IAS 39* (high-level guiding principles) that were sent to the IASB in July 2009 and published in August 2009.² These principles state that "*Loan loss provisioning should be robust and based on sound methodologies that reflect expected credit losses in the banks' existing loan portfolio over the life of the portfolio. The accounting model for provisioning should allow early identification and recognition of losses by incorporating a broader range of available credit information than presently included in the incurred loss model and should result in an earlier identification of credit losses. For the purpose of these principles, expected credit losses are estimated losses on a loan portfolio over the life of the loans and considering the loss experience over the complete economic cycle*".

As the details of the three-bucket approach are further developed, it is important to ensure that the new model is accomplishing the impairment recognition and measurement objectives identified in the joint June 2011 IASB-FASB staff paper.³ We believe this can be accomplished in a manner that is clear and consistent with the Committee's high-level guiding principles described above.

We strongly believe that any expected loss model that is developed under this refined approach should address the "too-little-too-late" problem identified with the incurred loss model by ensuring that (i) the principles for loan allocation and transfers between buckets are robust and ensure that transfers from bucket 1 to bucket 2 (or directly to bucket 3) should occur in a timely manner and (ii) the provision or allowance levels for financial assets in bucket 1 are adequate and are measured in a reasonable manner, consistent with an expected loss approach.

A key objective of this revised impairment model should be to minimise the difficulties in moving from bucket 1 to bucket 2 (or directly from bucket 1 to bucket 3).⁴ Furthermore, the overall balance of the provisions for all three buckets

result in certain kinds of behaviours (eg moving items from bucket 1 to 2 and related internal credit grades that comprise these buckets) in the refined expected loss model. These would not be incurred loss triggers.

² The high-level guiding principles are available at <http://www.bis.org/publ/bcbs161.pdf>.

³ Staff paper on the three-bucket approach for the IASB/FASB meeting the week commencing 13 June 2011 (IASB Agenda reference 8; FASB Agenda reference 99). Allocation of loans to bucket 1 in the June 2011 IASB-FASB staff paper leads to a provision for a portion of the lifetime expected losses whereas allocation to buckets 2 and 3 implies a full lifetime expected loss provisioning amount.

⁴ This is also referred to as the "cliff effect". A possible solution to address the "cliff effect" is to require bucket 1 to be measured with a full lifetime expected loss objective as with buckets 2 and 3, while at the same time recognising the use of internal credit grades within these buckets.

collectively must be sufficient to absorb credit losses on all financial assets reported at amortised cost. Thus, each impairment bucket should have clear principles associated with it that could assist in better understanding these categories, the allocation of assets to each category, and related transfers between them. Explaining the buckets in a manner that relates to the credit risk deterioration of assets and related movements through the internal credit grades of financial institutions may be useful in better linking the approach to credit risk management practices, and also in reducing the potential “cliff effect”.

Any revised impairment approach should be introduced with appropriate transitional arrangements to ensure that the allowance levels remain adequate at all times. The revised impairment approach should also be supported by robust and transparent disclosures as this will improve the comparability and consistency within and among institutions and aid in promoting financial stability. In the Committee’s view, transparent disclosures would also promote market discipline and would result in a level playing field for impairment practices around the globe over time. This would be beneficial to investors, other users, and prudential supervisors.

We offer preliminary comments in the Attachment on three areas requiring further development to ensure that the model achieves its objectives and to enhance its operationality. We are prepared to discuss the impairment approach further with the Boards or their project staff as further progress is made in elaborating the details before a new exposure draft is finalised for public comment.

These comments have been prepared by several groups within the Committee that are chaired or co-chaired by Sylvie Mathérat, Deputy Director General, Banque of France, and Jerry Edwards, Senior Advisor, Basel Committee Accounting Task Force. If you have any questions regarding our comments, please feel free to contact Sylvie Mathérat (+33 1 4292 6579), Jerry Edwards, (+41 61 280 8055), or Rob Sharma at the Basel Committee Secretariat (+41 61 280 8007).

Yours sincerely



Stefan Ingves

Attachment

Recommended improvements to the proposed Expected Loss Approach

Focus area 1: Describing the credit risk characteristics of the loans in each bucket

Overarching Objective:

The need to clearly articulate the objective and descriptors (ie principles and criteria) for each bucket or category.

Specific Observations

- We believe the credit risk characteristics used to distinguish between the various buckets need to be principles-based. Therefore, we encourage the Boards to develop principles that describe the characteristics of loans in each bucket or category. At the same time, the model should enable institutions to assign loans to the various buckets by drawing as much as possible from relevant credit risk information in their internal credit risk management and capital adequacy systems, such as through the use of credit risk grade classifications and segmentation of loans into groups with common risk characteristics.
- A principles-based model will continue to allow management to distinguish between loan types within the various buckets (e.g. commercial/wholesale and retail). This is important because the process for segmentation, credit risk grade classifications, and expected loss measurement varies by loan type and the credit risk characteristics that would drive the bucket designation may differ by loan type. For example, borrower performance and credit score changes may be important factors for retail loans in determining when loans should move from one bucket to another. For other loans (eg commercial/wholesale loans) there would generally be criteria in addition to borrower performance, such as information signaling declining prospects for a particular industry, that demonstrates an increase in potential impairment (or a worsening of credit quality) on loans to borrowers in that industry or dependent on that industry.
- It is important to note that segmentation of the portfolio into pools of loans with similar risk characteristics should first be based on loan type. Further segmentation based on risk characteristics or credit risk grade classification may be necessary. This second step results in differing expected loss measurements for loans of the same type because of their differing risk characteristics. Building on this concept, the Boards should reconsider the notion that an entire class or segment of the loan portfolio should move together from one bucket to another.
- The principle of a loan write-off or specific allowance should also be considered in describing the mechanics of the buckets. The need for a write-off or specific allowance could emerge suddenly for an individual loan in any bucket so a loan may not gradually migrate from bucket 1 to bucket 2 to bucket 3 before it, or a portion thereof, is confirmed as uncollectible and must be written off. It is important that

methodologies consider the impact of changes in forward-looking expectations as well as historical charge-off or specific allowance practices.

Possible way forward

Develop principles and cues for the three buckets⁵ based upon credit risk management practices and also credit quality. This could be applied to specific loan types along the following lines:

- Bucket 1 could be considered to address credit risk and changes in credit risk based on macroeconomic and other factors affecting “good loans” after their origination (or acquisition), but before credit deterioration is identified in portfolios, groups of loans within portfolios or individual loans consistent with loss experience over a complete economic cycle;⁶
- Bucket 2 could be considered to address expected losses when factors affecting the collectibility of these portfolios indicate credit quality deterioration on loan portfolios or groups of loans within portfolios (but where expected credit losses have not yet been identified with individual loans). This bucket would cover sectoral or geographical deterioration at a portfolio or loan group level as identified through credit risk management practices or internal credit classifications.⁷ The credit risk management or internal credit classification also reflects changes in the macroeconomic environment with a greater degree of precision.
- Bucket 3 could be considered to address expected losses when there is evidence of credit deterioration or uncollectibility of individual loans. For example, individual loans (including related loss estimates and provisions already created) should be considered for specific review when:
 - The exposures are large; and/or
 - The loans require close monitoring. This is especially relevant when, for example, there are potentially higher credit losses than typically expected, rare events occur or there is a concentration of risks (eg investment bank and corporate loans have loss distributions with “fat tails”).⁸

For instance, individual consumer loans might migrate to bucket 3 based on such factors as past due status while individual commercial loans might migrate based on such factors as specific economic conditions that adversely impact a certain geographic area or industry.

⁵ The use of buckets 1, 2 and 3 under the revised impairment approach provides more clarity regarding the concepts of the “good book” and “bad book” described in the Boards’ January 2011 Supplementary Document on impairment.

⁶ This presently occurs in some credit risk management approaches.

⁷ For example, under such a framework, delinquency is one cue that could be used for retail portfolios. For wholesale portfolios, banks could use a range of cues to identify accounts that may give heightened cause for concern. Banks will also typically operate “watch lists”. In practice, banks would be reluctant to move all such watch-list loans into the bucket 2 or 3 category from bucket 1, especially if they have exercised great care or prudence in identifying loans early for closer monitoring, as such loans may not necessarily exhibit the same severity of risk characteristics and expected credit losses as “bad loans” that belong to bucket 2 or 3.

⁸ Refer to Appendix A of the Basel Committee’s 30 June 2010 comment letter to the IASB on *Financial Instruments: Amortised Cost and Impairment*, which is available at <http://www.bis.org/bcbs/commentletters/iasb27.pdf> and at the IASB’s website www.iasb.org.

Focus area 2: Transfers between bucket 1, bucket 2 and bucket 3

Overarching Objective:

A key objective of this revised impairment model should be to minimise the "cliff effect" when assets move from bucket 1 to bucket 2 (or directly from bucket 1 to bucket 3).

A broad set of clear and well-defined cues with supporting guidance is needed to describe when to transfer assets between buckets 1, 2, and 3. The supporting guidance could include illustrations as necessary.

The overall objective should be to ensure that transfers occur in a timely manner. Although subjectivity with any set of cues is unavoidable, the cues and supporting guidance should not result in a wide range of practices worldwide and a failure to fully recognise credit losses early in the credit cycle.

Specific Observations

- We believe there are two specific ways to minimise the "cliff effect" with this revised impairment model. First, the Boards should ensure that the guidance for transfers between buckets results in timely transfers as soon as loan quality deteriorates. This aspect is explained further below in this focus area. Second, the measurement principle for the expected loss amount for bucket 1 should take into account the characteristics of a loan class. This could serve to reduce the "cliff effect" that could arise from using a bright-line approach for bucket 1 expected loss measurements. This aspect is explained further in focus area 3.
- We believe clear cues and supporting guidance, set forth as principles, should be developed to identify when loans should be moved from bucket to bucket. Without such clarity, institutions may be reluctant to move loans out of bucket 1 because of the larger expected loss measurement that applies to loans in bucket 2 ("cliff effect"). The standard setters should clarify whether all loans at origination must begin in bucket 1 or whether it is possible to place a newly originated loan in bucket 2 or 3. For example, the exposure draft should address whether a higher risk asset or portfolio whose risk characteristics at origination are representative of bucket 2 or 3 (eg pricing is reflective of the expectation at origination that contractual principal and interest will not be collected in full for a significant percentage of similar higher risk assets) should be placed initially in bucket 2 or 3.
- Paragraph 9 of the June 2011 IASB-FASB staff paper describes bucket 2 assets as those that have been "affected by the occurrence of observable events". Unless clear guidance is provided, we have concerns with the requirement for "the occurrence of observable events" as a prerequisite for moving loans to bucket 2. Terminology such as "observable events" may result in an outcome similar to what is seen today where varying interpretations of the incurred loss notion across institutions produce different allowance levels for similar portfolios and therefore do not lead to earlier loss recognition. This kind of terminology should be avoided. Grounding the approach on expected loss concepts based upon credit risk management practices that are outlined in the July 2011 IASB-FASB staff paper⁹ could be helpful in avoiding this potential problem.

⁹ Staff paper on transfer between buckets for the IASB/FASB meeting the week commencing 18 July 2011 (IASB Agenda reference 7A; FASB Agenda reference 100).

- In order for the model to reflect the progression of credit deterioration in a timely manner, we urge the Boards to clarify when macroeconomic events should lead to changes in credit loss expectations for loans in bucket 1 as opposed to migration of the affected loans to bucket 2. We believe that certain macroeconomic shocks should lead a company to move affected portfolio classes or segments into bucket 2 and provision for the expected lifetime losses on those classes or segments, especially when these transfers are tied to changes in credit risk management practices or internal credit classifications for the affected loans. We understand that Alternative C for bucket 1 was intended to capture the impact of such factors but we have significant concerns about the operationality of that alternative, as discussed below.
- Closely related to the “cliff effect” concerns, the accounting mechanism concerning the “use” of the provisions is critical, especially in the context of open portfolios. Therefore, we would encourage the Boards not to focus only on the recognition of provisions but in addition develop principles and, if needed, guidance related to their use. This could include, for instance, clarifying in the exposure draft that the revision of expected loss estimates on financial assets in bucket 1 should consider the consequences of transfers of loans out of bucket 1.

Possible way forward

A possible way forward is for the standard setters to build upon and modify the existing credit quality guidance in International Financial Reporting Standards,¹⁰ US generally accepted accounting principles and supervisory guidance on impairment¹¹ to reflect an expected loss approach instead of an incurred loss approach. It may also be beneficial to discuss the buckets in terms of credit risk deterioration that takes place and is normally tracked in banks’ credit risk management systems. For large commercial loans, for example, these include deterioration reflected in migrations to lower quality internal credit grades. For retail loans, these include, for example, deterioration reflected in delinquency status, declines in risk scores, bankruptcies, and formal workout programs.

¹⁰ See, for example, IAS 39 Financial Instruments: Recognition and Measurement (paragraph 59).

¹¹ See, for example, the Basel Committee’s guidance paper on Sound credit risk assessment and valuation for loans (2006), which is available at: <http://www.bis.org/press/p060614.htm>.

Focus area 3: Measurement of expected losses on financial assets in bucket 1

Overarching Objectives:

- (a) The accounting model for provisioning should incorporate a broader range of available credit information than is presently included in the incurred loss model and should result in an earlier identification and recognition of credit losses (based on the high-level guiding principles).
- (b) The approach used to estimate expected loss provision levels in bucket 1 should result in provisions that are adequate and measured in a reasonable manner consistent with loss experience over a complete economic cycle.¹²

Specific Observations

- We understand that the Boards are seeking an alternative that is both operational and as simple as possible. For the bucket 1 expected loss measurement, the Boards decided to pursue Alternative C as identified in the June 2011 IASB-FASB staff paper, provided an implementation approach can be developed that is both (1) operational for institutions of all sizes and complexities and (2) results in an earlier identification of credit losses than the current incurred loss model.
- We share the staff's concerns as to whether Alternative C is operational. Specifically, we are concerned about how institutions would distinguish increases in expected lifetime credit losses from original loss expectations for open portfolios of loans. At a minimum, we believe this would likely require extensive tracking of loans by vintage, which considerably increases the complexity of the overall impairment model.
- Additionally, while we find conceptual merit in Alternative C, we encourage the Boards to address two apparent conceptual weaknesses with Alternative C (which are also weaknesses with Alternative A). First, the explicit reference to at least 12 months could have the unintended consequence of being interpreted as a limit on the recognition of losses. We do not believe such a limit would result in the earlier recognition of losses for all loan types. Second, as noted in paragraph 14 of the June 2011 IASB-FASB staff paper, the effect of moving loans out of bucket 1 can be dramatic, which could impact whether financial institutions make timely transfers of assets to bucket 2. The dramatic effect of these transfers would be lessened if the bucket 1 measurement was reflective of a minimum of an average (expected) loss rate that considered an entire economic cycle for a particular asset type with the requirement that the rate be adjusted upward if current conditions and forward-looking information indicate that the worst portion of the cycle is present or on the horizon.
- We note that the approach being proposed in the July 2011 IASB-FASB staff paper¹³ does not preclude using a method that has a bright-line rule to set the

¹² Adequacy could be addressed by requiring bucket 1 to be measured with a full lifetime expected loss objective similar to buckets 2 and 3 (while at the same time recognising the use of internal credit grades within these buckets) with supporting disclosures.

¹³ Staff paper on Bucket 1 measurement for the IASB/FASB meeting the week commencing 18 July 2011 (IASB Agenda reference 7B; FASB Agenda reference 101).

allowance at an arbitrary amount due to concerns with Alternative C. We urge the Boards to anchor their final method on sound principles and consider requiring that management use an expected loss rate that makes sense given the characteristics of a loan class or segment – in particular, by considering the weighted average effective life or duration of the loans and volatility of historical losses. The use of the duration of a loan portfolio is also consistent with the risk management practices of numerous banks. For example, the 12-month loss rate for a class or segment could be multiplied by the weighted average effective life or duration of the loans or an appropriate portion thereof. For most loans (other than those with very short maturities) we expect that the result would be higher than an amount based on 12 months' expected losses but lower than the full expected lifetime losses on the loans.

Possible way forward

As a practical way forward, define the measurement model for bucket 1's expected losses generically as:

Portfolio balance X 12-month loss rate¹⁴ X Effective life (weighted average effective life or duration) defined in accordance with the characteristics of the portfolio.

Where

- The loss rate would use all available information and would be adjusted periodically (quantitative information with qualitative adjustments for current conditions and forward-looking information where necessary)
- For most banks, the effective life that best represents the characteristics of the loan class or segment (or credit risk grade) should be used. The effective life could be based upon a simple weighted average effective life or an appropriate portion thereof,¹⁵ and could include relevant supporting guidance.¹⁶ A flexible approach for the variety of banks across the globe is needed. This would ensure the varying degrees of sophistication with credit risk management systems and differences in loan products can be taken into account.
- The exposure draft could provide an example that illustrates how the credit risk deterioration in loans in bucket 1 might relate to movements within a bank's internal credit risk grades.

¹⁴ The loss rate should consider estimated expected losses and loss experience through an entire economic cycle.

¹⁵ This could, for example, use the time-proportional approach that was outlined in the January 2011 Impairment Supplementary Document as a possible method.

¹⁶ Supporting guidance could be provided with examples regarding the approximate number of years of effective life, depending on the type of loans.