Dear Sirs,


The British Bankers’ Association welcomes the opportunity to comment on the FASB’s Proposed Accounting Standards Update, Financial Instruments – Credit Losses (Subtopic 825-15).

The BBA represents over 200 banks from 50 countries on UK and international banking issues. Our members report primarily under IFRS, so we have not responded to the detailed questions in the Update. Instead we have provided our views on the key issues.

The members of the BBA acknowledge the considerable efforts made by both the FASB and the IASB in developing proposals for an accounting model for the impairment of financial assets using more forward looking information to address the shortcomings of the incurred loss model that were exposed during the financial crisis.

While there is some common ground between the FASB and IASB proposals, they start from very different conceptual positions. Furthermore, there are significant differences in current practice between existing US GAAP and IFRSs, which affects how the proposals are evaluated. There is, therefore, a very serious risk that there will be a failure to find a converged solution for impairment accounting. The consequences of two different impairment models could be profound and would include significant weaknesses in the comparability of market information on changes in the credit quality of banks’ assets, and different effects on capital regulation with consequential impacts on international competitiveness affecting market confidence in financial reporting. We are concerned that, under these circumstances, international banks may come under market pressure to provide information on both accounting models and to reconcile the results. Even if it were feasible to do so, this would increase implementation and ongoing costs very significantly and increase the complexity of information provided without necessarily increasing its usefulness. We urge the Boards to consider the serious implications that two impairment models will have for users and preparers, and make every effort to reach a converged solution.

The BBA believes that convergence towards an improved accounting standard for impairment losses should be the overriding objective. The FASB and IASB proposals represent the output from an extensive debate on different approaches, and their differences provide an opportunity for stakeholders to consider which attributes are most important in providing decision useful information on expected credit losses, at a cost which justifies the benefits. The BBA considers that the most important attributes of a new impairment model are that it should have a sound conceptual basis which reflects the economics of the business activity it purports to represent; be capable of
alignment to internal credit risk management practices; be principles based not rules based, yet
grounded on principles which are sufficiently clear to establish comparability across different
organisations in different countries; and be operational at a cost which justifies the benefit of the
improvements in information provided. In addition, it must avoid negative economic effects on
lending activity, including disproportionate impacts on particular sectors of lending activity, which
result purely from the accounting model adopted. In the sections that follow, we discuss the FASB
model under these headings.

**Sound conceptual basis reflecting the economics of the business activity it purports to
represent**

The BBA believes that the recognition of lifetime expected losses at the date of initial recognition,
and the subsequent overstatement of performance in following years, serves to distort the
economics of lending relationships as it severs the economic link between the fair value of a loan or
debt security on initial recognition and the credit quality of the instrument. We believe that the
recognition of financial assets at an amount below their fair value together with the disconnect in the
recognition of interest income and credit risk is not representative of the economics of lending and
double counts losses at initial recognition because the interest rates charged on different types of
financial instruments reflect spreads for the initial expectations of credit risk. We have in the past
supported a model that initially defers expected credit losses on initial recognition and subsequently
recognises losses as an adjustment to the effective return, such as that proposed by the Joint
Boards Supplementary Document. But we are also aware of the operational difficulties in
implementing such an approach and therefore believe that the final model needs to balance the
requirements for operability with the economics of the lending business, recognising that a diverse
range of preparers will have to implement the proposals.

We are therefore supportive of the IASB’s approach as it strikes a better balance between the
operational challenges of implementation and the economic substance of providing credit. While
neither model is perfect, both Boards have given extensive consideration to the possible alternative
proposals and we support the renewed impetus to finalise the proposals in this very significant area
of accounting.

In order to be conceptually sound, it is important for the accounting model to reflect the time value of
money and discounting in a consistent manner. This is a more significant issue for long-lived
financial assets, and carries greater significance when estimating full lifetime expected losses for
financial assets which do not exhibit any credit deterioration, when the timeframes involved in
estimating expected losses and recoveries are likely to be longer than in a significant credit
deterioration model. We disagree that the methodologies proposed in the FASB ED (825-15-55-3),
such as the loss rate methodology, inherently reflect the time value of money, indeed we believe that
this approach will lead to inconsistencies in practice, and very significant measurement differences
with the IASB model, which will be confusing for investors and other users. We believe that the
FASB model has not been sufficiently developed in this regard to permit a proper impact analysis to
be carried out.

**Alignment to internal credit risk management practices based on expected loss**

The BBA believes that any accounting model for the impairment of financial instruments must reflect
the economics of providing credit and therefore align with the entity’s credit risk management
practices. We do not believe that the FASB model in requiring lifetime losses at initial recognition,
adequately addresses the impact of credit deterioration on the incidence of credit losses.

An approach to the recognition of impairment that is founded on the credit life cycle and credit risk
management practices and which recognises increasing expected losses as credit quality
deteriorates provides a more faithful representation of credit portfolio quality and therefore of the
underlying economics. Current credit risk management practices collate and monitor data on the
credit quality of assets. Alignment of the accounting to credit risk management would therefore
enable preparers to leverage off existing data rather than having to create new data purely to meet a financial reporting requirement. Furthermore, recognising impairments as credit risk metrics deteriorate gives users of financial statements relevant information about the effects of changes in the credit quality of assets that would not be transparent in terms of loss recognition if lifetime losses are recognised at origination for all financial instruments. For financial assets which do not exhibit, and are not expected to exhibit, significant signs of credit deterioration, it is possible to adapt existing methodologies and data to estimate expected losses that may result from default events that are possible in the next 12 months. For these assets, however, extending the estimation period beyond 12 months would not be readily supported by existing credit risk management practices and methodologies.

Clear principles which establish comparability across different organisations in different countries

In seeking an approach that can be made operational by a wide range of different entities, there is a balance to be struck between permitting the use of different methods of achieving the required outcomes, and avoiding unacceptably wide diversity in practice. The BBA believes that both models require greater clarity of definition to support consistency in application.

While both models will require very significant levels of judgement, we are particularly concerned by the FASB model, where the requirement to estimate lifetime losses across all financial instruments, including those exhibiting no credit deterioration, is likely to result in an extremely wide range of possible outcomes for expected loss recognition. This may place an unrealistic burden on preparers in terms of exercising judgements around loss recognition which may be impossible to remedy through disclosures, affecting market confidence in the financial statements. While the IASB model will also involve very significant judgements, it should be possible to achieve greater comparability around the concept of credit deterioration given its relevance to existing credit risk management processes, supported by relevant disclosures.

Further work on disclosures is also needed to ensure that they provide useful insights into the credit characteristics of financial instruments in the context of the impairment model.

Operability at a cost which justifies the benefit of the improvements in information provided

Our members have carried out assessments of the operational implications of the different impairment models in as much detail as the articulation of the models permits. In general, our members found that where elements of existing credit risk management processes are capable of being adapted or enhanced to provide the inputs for the impairment accounting model, this was of significant benefit to the operability of the proposals. While both models will involve operational complexity, the IASB model’s stronger alignment with credit risk management processes is likely to be both feasible to implement and provide more relevant information. In making this assessment, the BBA notes that the IASB has made efforts to simplify the criteria for credit deterioration in order to strike an appropriate balance between the faithful representation of credit deterioration and operability.

While the FASB model is easier to describe, and may therefore appear simpler to apply, the complexity of estimating lifetime expected losses, especially for long lived performing loans, is likely to prove extremely challenging. The principal difficulty is the shortage of specific data on lifetime losses for financial assets with no signs of credit deterioration. For longer lived assets, a very wide range of possible outcomes could be estimated, and the amounts recognised in the financial statements would be highly subjective and extremely sensitive to the assumptions and forecasting models used, to the point where the reliability of the amounts would be difficult to support, and therefore open to question. These amounts would be far removed from the information used in credit risk management, and our concern is that they would most likely be used only for accounting purposes, further reducing their relevance.
Avoid negative economic effects on lending activity which result purely from the accounting model adopted

As discussed above, the upfront recognition of lifetime expected losses on all financial assets, including those which are not credit deteriorated, results in accounting which provides a distorted view of the economic effects of lending activity. This distortion may have a number of unintended consequences for the financial services industry and the broader economy, and given the fundamental role which banks play in transforming the maturities of financial assets and liabilities, these consequences could be profound. The effects on reported financial performance, and associated impacts on regulatory capital and funding costs, could constrain lending activities, particularly for longer-dated instruments and instruments with higher credit risk/higher income characteristics. Examples of such implications might include:

- Reduced availability and higher cost of loans with longer maturities or to lower-rated borrowers such as small and medium sized enterprises. The required return for these longer dated or lower rated loans may become higher than is warranted by the economic risk.
- Reduced diversification of banks’ balance sheets as banks seek to de-emphasise longer maturity and higher credit risk lending.
- Incentives for greater distortion in the structure of the financial services industry encouraged by arbitrage opportunities between banks (seeking to manage the impact of heavily front-loaded provisions) and shadow-banking market participants for whom the interplay between the accounting and regulatory factors is less significant.

These very real potential impacts on the wider economy and the financial system need to be carefully considered by standard setters and regulators. We are also concerned that a failure to converge will result in similar distortive impacts between markets internationally.

Lead-time for implementation

The BBA recognises the importance of finding a solution that is capable of being implemented in a timescale that will be acceptable to stakeholders. However, there are likely to be significant operational challenges in implementing a more forward looking impairment accounting model. In addition, there are complex interactions with regulatory capital and taxation that will require careful analysis and planning with the relevant authorities, as well as the planning of business impacts and the implementation of governance and control frameworks. It will be necessary for public companies to communicate and explain the likely effects of the new accounting standard on their business to investors and other market participants well in advance of the transition date, which will take a significant amount of the available time.

Given the significance of the changes, the BBA believes that a minimum of three years are likely to be needed from the date of publication of the final standard to the mandatory effective date in order to ensure that there is sufficient implementation time to manage the operational risk of these changes across the industry. Any shorter timescale for a project of this complexity would involve unacceptable operational risk. We consider that the FASB approach would require significantly more time to implement than the IASB approach, given the lack of alignment with existing credit risk management processes, and we question whether even in an extended timeframe it would be feasible to develop estimates of sufficient quality to meet the objectives of financial reporting.

In our view, it is important that the final requirements, including disclosures, are available by the end of 2013 so that companies can make a serious start to their implementation projects having certainty as to the requirements, which is particularly important given the potentially high costs of the implementation programmes.

We hope you find these comments are of value. Please feel free to contact us if you would like to discuss any of the points in more detail.
Yours sincerely,

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