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Ms. Leslie Seidman  
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### **Re: Impairment**

Dear Mr. Hoogervorst and Ms. Seidman:

We appreciated the participation of representatives of both boards at the July 13 Three-Way Dialogue (TWD) meeting, where a large part of the discussion focused on impairment. IIF Members are grateful for the opportunity to continue to contribute to the boards' discussions and to provide input from the perspective of internationally active financial institutions.

The IIF Senior Accounting Group welcomes the boards' decision to develop a revised impairment approach based on feedback received on the Supplementary Document (SD) and the boards' respective exposure drafts (EDs). Most importantly, we welcome the boards' continued efforts to develop a converged approach to impairment. As we have emphasized in our previous comment letters and discussions with the boards, impairment is a matter of fundamental importance to financial institutions, regulators, and the capital markets as a whole. The IIF has a long-standing view that the impairment allowance should be forward looking. Hence, we believe a converged, expected-loss approach such as the "three-bucket" approach being developed is a significant step forward. We also recognize that there is not a single "right" conceptual answer, and we welcome the pragmatic approach being taken by the boards.

From this perspective, the boards have made significant progress in this very challenging area of financial reporting. We understand that regulators have called for an expeditious solution, and agree that addressing impairment is a matter of priority. We urge the boards to continue their focus on operational and implementation issues as the approach is refined, and to work closely with regulators and other interested parties to ensure that regulatory and any other interactions are addressed.

Following recent developments and discussions, it is timely to share the views developed by Members, to reiterate essential concerns, and to provide preliminary views on impairment issues that the boards are currently considering.

### *Principles on impairment*

Since the publication of the IASB's first ED on impairment in November 2009, the IIF Senior Accounting Group has been developing principles for an impairment approach based on consensus views of Members. Some broad areas of agreement include:

- Any impairment approach developed should be converged
- Impairment allowance should be forward-looking and based on expected losses
- Any impairment approach must be operational and take into consideration a cost/benefit analysis of any changes to the current guidance
- Any impairment approach should be applicable to open portfolios, to reflect how credit risk is managed within financial institutions
- An impairment approach should be congruent with credit risk management by banks

We believe that the direction now being pursued by the boards is broadly consistent with the above principles, and has the potential to be developed into the global standard that is urgently needed to ensure the continuing integrity of financial reporting in the eyes of investors, regulators and others.

Moreover, we encourage the boards to ensure that the impairment model developed is principles-based. An impairment model that is underpinned by well-defined principles will assist firms when applying the model to different types of loans.

### *The three-bucket approach*

IIF Members are broadly supportive of the three-bucket approach being considered by the boards. A three-bucket approach is generally intuitive and should be capable of application in a consistent manner that reflects credit risk management practices. The boards' guiding principle to reflect the general pattern of deterioration of credit quality of loans is appropriate. Hence, we support the boards' determination further to explore the three-bucket approach. However, given the significant difference in the allowance recognized between the different buckets (a portion of lifetime expected losses is recognized for bucket 1 while lifetime expected losses are recognized for buckets 2 and buckets 3) the definition of items in each bucket and the transfer between the buckets must be carefully considered – especially because of the interaction with issues such as 'lifetime day-one loss' and the so-called 'cliff effect' of moving from a 12 or 24 month expected loss (EL) to a lifetime EL (see later comments).<sup>1</sup>

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<sup>1</sup> Although generally supportive of a three-bucket approach, some Members note a distinction between bucket 2 and 3 loans i.e. bucket 3 loans are non-performing while bucket 2 loans have emerging signs of impairment but may be performing. These Members believe that the boards should focus on the appropriate measurement methodology for inherent losses rather than defaulting to a full lifetime expected loss concept and bright line distinctions between buckets 2 and 3.

We are aware that the boards have recently made several interim decisions on more detailed aspects of the three-bucket approach including:

- to pursue an approach based on credit risk management systems, recognizing that credit risk management is a holistic process that includes evaluating all available information
- to keep the calculation of the impairment allowance for bucket 1 operationally simple
- to develop the relative credit risk model to underpin the transfer and classification of financial assets between the three buckets.

We are supportive of the direction of the first two tentative decisions. The decision to adopt an approach based on credit-risk management systems, recognizing that credit-risk management is a holistic process that includes evaluating all available information, is significant and of course consistent with the IIF's long-standing principle, stated above, that an impairment standard should be congruent with credit-risk management approaches applied by banks. This is important for efficiency and for consistency with management's view.

Moreover, we fully support an operationally simple calculation of the impairment allowance for bucket 1. As bucket 1 assets are those that are performing and for which there is no specific information on which expected losses might be identified, the amount of expected impairment should normally be small. The overwhelming amount of allowance is expected to be assigned to assets in buckets 2 and 3. Hence, an operationally complex approach is not warranted for bucket 1, given the marginal incremental allowance created.

We understand that the boards had initially considered an alternative where bucket 1 allowance would be determined as 12 months' expected losses based on initial expectations plus the full amount of any changes in expected losses. For both conceptual and operational reasons, we believe this approach is inappropriate.

*Absolute vs. relative credit risk model*

With regard to the absolute vs. relative credit risk model issue, *when* loans are transferred from bucket 1 to 2 and the issue of day one losses are crucial considerations. We understand that the boards' tentative decision is to develop the relative credit risk model to underpin the transfer and classification of financial assets between the three buckets. However, we are supportive of an approach that incorporates the operational simplicity of an absolute approach to underpin the transfer and classification of financial assets between the three buckets. We believe that an appropriately calibrated absolute credit risk approach would achieve the objective of reflecting the general pattern of deterioration of credit quality of loans and thus be consistent with the boards' guiding principle. Moreover, this approach is more operational and congruent with internal credit risk management processes than the relative credit risk model. The assessment of the Senior Accounting Group is that the relative credit risk model cannot be achieved without overcoming significant operational hurdles. The cost associated with its application would certainly exceed the benefits.

However, as discussed at the TWD meeting, some Members are concerned that an absolute credit risk approach would result in situations where a full lifetime allowance would be taken on day one for an entire portfolio; in other words, there is concern about a “lifetime day-one loss” issue for appropriately priced higher-risk loans that might be classified into bucket 2 on origination or purchase. These Members do not support recognition of lifetime day-one losses in this situation. Meanwhile, other Members take the view that some level of day-one allowances are inevitable when using a portfolio allowance approach and are concerned that using a relative approach would delay loss recognition for lower credit-quality loans.

IIF Members have not formed a consensus view on the best solution to the day-one loss issue. However, we would note that the degree of the day-one issue is largely dependent upon the threshold set for bucket 1 and bucket 2 transfers. As a result, many Members believe that it should be possible to mitigate this issue by defining the dividing line between bucket 1 and bucket 2 in a manner that recognizes that if the level at which transfers to bucket 2 occur is at a relatively high credit quality threshold then lifetime losses will be recognized for a significantly larger population than if the transfer is set at a lower credit quality threshold. We suggest that modeling will be important to understand how the transfer requirements will work in practice before any firm decisions can be made.

We understand that a hybrid “relative overlay” to the absolute approach, e.g. separate tracking of loans originated or purchased into bucket 2 until deterioration occurs, whereupon remaining lifetime expected losses would be recognized, is being discussed. Some Members are concerned about the possible operational complexity and cost that would result from such an approach with limited offsetting benefit for users of financial statements. Therefore, we encourage the boards to continue discussions with the impairment Expert Advisory Panel (EAP) and other industry groups to develop a solution, and that the boards also give consideration to the trade-off between any resulting operational complexity and information benefits created.

Moreover, although the Senior Accounting Group has not had the opportunity to discuss more detailed aspects such as expected loss estimation, we re-emphasize the importance of an approach that is operational. Some Members are concerned that there is a misplaced notion that complexity creates precision.<sup>2</sup>

#### *Bucket 1 allowance (12 months vs. 24 months)*

We are aware that the boards are currently exploring whether to determine the bucket 1 allowance based on 12 or 24 months' worth of losses expected to occur.

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<sup>2</sup> Some Members are concerned that the boards are moving in a direction that implies estimation (and discounting) of timing and amounts of cash flows. These Members are concerned about the operability of including complex calculations into the impairment process. These Members note that many existing loss estimation practices are based, in part, on historical loss performance and would still be a good proxy under the new approach. We expect to supplement these initial views with additional comments as the boards consider more detailed aspects of the impairment model.

Given that it is challenging to develop a conceptual basis for determining the number of months on which expected loss allowance should be determined, we urge the boards to work, toward determining a dividing line between bucket 1 and bucket 2 that ensures reserves are adequate, but not excessive. If this is achieved the calculation of reserves for loans in bucket 1 may be less significant to the sufficiency of a bank's allowance for loan losses and using a 12 month time horizon, which many consider to be operationally simpler (as it is more consistent with the normal financial reporting horizon and the existing Basel requirements), more sensitive to the expected life of many types of loans and better reflects loan pricing, would be appropriate. The results of modeling across different types of portfolios and different geographies will be important in making this determination.

*Other issues*

*Quantitative analysis and field-testing* – A new global standard in this area is urgently needed. However, as noted above, we encourage the boards to understand the quantum of the likely effects of the new approach and any alternatives that might be considered as part of their on-going outreach efforts. IIF Members stand ready to assist the boards in this area by participating in field-tests and providing modeled analysis where available.

*Consistency vs. comparability between firms* – Judgment will always be required in determining expected losses and impairment. Despite possible differences in details of risk management processes between firms, firms must be able to apply internal risk management practices in making judgments on impairment. Risk management is of course, closely supervised by the prudential regulators, and standards of industry practice have, as documented by the IIF, increased substantially since 2007. Hence, we encourage the boards to allow for a certain degree of flexibility in applying the impairment model. We believe that combined with robust disclosures, a flexible, principles-based model that is consistent with credit risk management practices will provide the most relevant and useful information to users of financial statements.

*Outreach and education initiatives* – Given that impairment is a complex and specialized area, we urge the boards to consider undertaking some 'education' initiatives possibly involving outside experts such as Members of the EAP before any new proposals are issued. Such efforts would help constituents better understand the issues that are being addressed. This will help inform the responses of constituents, and improve the chances of broader acceptance of any proposals.

*Terminology* – It would be beneficial to use clearly defined terminology for accounting purposes. A new set of accounting definitions for common regulatory terms, especially "default" would conflict with risk-management practices, and create operational issues and possibly damaging confusion. Important terms such as "expected losses" should also be clearly defined.<sup>3</sup>

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<sup>3</sup> We note that both "default" and "expected losses" are defined under Basel II. Some Members would encourage the boards to align accounting terminology with regulatory terminology as internal risk management practices often rely on regulatory terminology.

*Disclosures* – While the boards are in an early stage of discussions on impairment disclosures, we urge the boards to be mindful of creating additional complexities through disclosure requirements. Systems changes will be required to capture disclosure information. Hence, some possible requirements, e.g. disclosure of lifetime expected losses for all loans, could result in operational costs, particularly when the information is not already produced for accounting, regulatory or risk management purposes. The boards must balance the costs for producing disclosures with the resulting benefits for users of financial statements. Possible information overload should also be considered. It would also be helpful to aim for consistency with Pillar 3 and other regulatory disclosure requirements, where relevant.

We look forward to the forthcoming developments on the boards' impairment project. IIF Members stand ready to continue to contribute to the boards' discussions and to provide input from the perspective of internationally active global financial institutions. Should you have any questions about this letter or the views expressed, please contact the undersigned ([dschraa@iif.com](mailto:dschraa@iif.com)) +1 202 857 3312), Carol Wong ([cwong@iif.com](mailto:cwong@iif.com)) or Christina Rulfs ([crulfs@iif.com](mailto:crulfs@iif.com)) + 1 202 857 3311).

Very truly yours,



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