



EACB Comments on IASB Exposure Draft on Financial Instruments: Amortised Cost and Impairment (ED/2009/12)

30 June 2010

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EACB AISBL – Secretariat • Rue de l'Industrie 26-38 • B-1040 Brussels

Tel: (+32 2) 230 11 24 • Fax (+32 2) 230 06 49 • Enterprise 0896.081.149 • lobbying register 4172526951-19

www.eurocoopbanks.coop • e-mail : secretariat@eurocoopbanks.coop



Introduction

The European Association of Cooperative Banks recognises the importance of the work of the IASB on “Financial Instruments: Amortised Cost and Impairment” (ED/2009/12).

Therefore, the European Association of Co-operative Banks (EACB), the European Banking Federation (EBF), the European Saving Banks Group (ESBG) and the European Association of Public Banks (EAPB) have developed an alternative approach to IASB expected cash flow model. You will find in annex a joint document highlighting the basic features of our proposed “Expected Loss over the Life of the Portfolio (ELLP)” approach. This industry model reflects the business and risk management practices and addresses both the conceptual and operational drawbacks of the IASB model.

Furthermore, in this paper, we have laid down the comments of the EACB members to the questions of the exposure draft (ED/2009/12).



General Comments

IASB Expected Losses Model

The members of EACB agree that this ED is an important step to meet issues raised by the G20, the ECOFIN and the Basel Committee. We conceptually support the development of an impairment model that is based on “expected loss”, rather than the “incurred loss” model that currently exists under IAS 39 *Financial Instruments: recognition and measurement*. Any new approach to be defined should permit to assess expected credit losses on an ongoing basis at an early point in time in order to reflect properly the risk assumed by the entity and to reduce procyclicality of the impairment models.

However, our members believe that the proposed expected losses model as described in the ED does not provide an acceptable solution and leads to additional problems, especially:

- The ED proposes that the initial expected loss estimate is recognised over the life of the related assets, whereas (positive and negative) changes in the expected loss estimate must be recognised immediately in P&L. Our members fear that this proposal would result in significant additional volatility and pro-cyclicality.
- Significant operational changes are related to the use of an Effective Interest Rate mechanism. EACB members assessed that the implementation of the ED proposals would imply significant costs. Moreover, those proposals seem to be very complex to be applied in practice and would not provide any significant improvement in financial reporting.
- We fear that users would not properly understand the IASB’s proposals (e.g. due to the proposed combination of credit losses with interest margins and the lack of transparency in regard of incurred losses/impairments). Similarly, preparers would have strong difficulties in implementing those proposals (e.g. due to the need to develop a completely revised methodology for the calculation of additional effective interest rates and the need to define expected cash flows by time periods) when entities manage expected losses.
- Moreover, the EIR approach would imply segmentation of loans into too many small portfolios as the loans should share some characteristic parameters (e.g. contractual rate, pattern of amortisation, maturity etc.). This would limit an accurate calculation of expected losses as the samples of loans included in these portfolios are limited.
- Furthermore, the model is based on the presumption that it would be possible to accurately estimate the timing of future losses over several years. Therefore, to be applicable, the IASB model would imply a review of the EIR methodology in order to include expected cash flows being estimated by time period. However, besides operational challenges mentioned above, we doubt that predicting the timing of future cash flows would be reliable and relevant enough given insufficient modelling capabilities.



The European Banking Industry Alternative Model

To address these shortcomings, EACB has been working together with the European Banking Federation (EBF), the European Saving Banks Group (ESBG) and European Association of Public Banks (EAPB) to identify a number of sources of complexity as well as conceptual issues.

An alternative application of the concept of expected loss for impairment has been developed (*see in annex*) that we strongly believe is conceptually valuable, in line with the general objective of financial statements and consistent with the lending activity and credit risk management of financial institutions. Moreover, we think that this “banking industry proposal” would be easier for users of financial information to understand and for preparers to implement at a reasonable cost.

The industry model captures the economic reality of the lending activities of financial institutions and is in line with the philosophy of the six point plan of the Basel Committee to achieve a sound “expected loss provisioning approach” established in their “Guiding Principles for the replacement of IAS 39” issued in August 2009. While the model developed by the banking industry is consistent with the objective of the IASB Exposure Draft, there are some key differences:

- The definition of amortized cost remains as in current IAS 39 and impairment is an independent estimate separate from the EIR calculation;
- The industry model follows the business model of an entity. The approach allows application on the basis of a loan by loan, closed portfolios or open portfolios depending on the business and risk management practices;
- Changes in expectations are spread over the life of the portfolio consistently with the treatment of initial expectations, subject to a condition that total impairment allowances are always equal to or higher than the incurred loss impairment allowances under the current IAS 39;
- Impaired loans are treated as in the current IAS 39



EACB responses to the ED questionnaire

Objective of amortised cost measurement

Question 1: Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?

Yes, the description in the ED of the objectives of the amortised cost measurement is clearly formulated.

Question 2: Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

EACB members believe that the economic approach of amortised cost measurement as described in paragraph 3 of the ED to provide "information about effective return of financial instrument" is appropriate for amortised cost category as a whole and not an individual basis.

In order to meet issues raised by the G20, the ECOFIN and the Basel Committee, we support the development of an impairment model that is based on expected losses for the amortised cost category rather than the current incurred loss model in IAS 39.

However, our members have strong concerns regarding the IASB intention to change the definition of "amortised cost" and the Effective Interest rate calculation (EIR calculation).

The IASB model mixes interest rate risk and credit risk in the calculation of the EIR. Including expected credit losses into an EIR calculation means that it is possible to accurately estimate the timing of future losses over several years. The model treats initial expectations of future credit losses as if they resulted from contractual terms, whereas they actually result from a failure to comply with contractual terms.

Therefore, we strongly support that the amortised cost definition should remain as it is in IAS 39. The current calculation of EIR is based on identified and known components while the Expected Loss is a calculation of estimated future credit losses. On one hand banks manage their interest rate risk and credit risk on a different basis. For this reason these risks should not be co-mingled in the calculation of the EIR. On the other hand, incorporating the loss rate in the EIR calculus would introduce operational issues of complex implementation due to the need of completely revising the methodology of EIR, but also difficult to understand by the users of financial information. Especially, the sequential cash flow consideration at single contract level including back-testing is in practice hardly feasible and a conversion would be too cost-intensive. Furthermore it could lead to an accounting treatment that is not in line with the management of credit risks.

In this respect, the banking industry proposal (see *annex*) is to keep the current definition of the effective interest method under IAS 39 and to exclude the expected loss from the EIR calculation. We propose to present the expected loss in a separate line item



in the income statement, which would allow users of financial statements to distinguish the interest from the credit risk / expected loss of the portfolio. We believe that the current effective interest method under IAS 39 is well understood by users. A change to the proposed model raises operational risks and increases the complexity of implementation, while reducing the transparency of financial information.

Measurement principles

Question 3: Do you agree with the way that the exposure draft is drafted, which emphasises measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why? How would you prefer the standard to be drafted instead, and why?

In the EACB comment letter related to the IASB's Request for Information on "Expected Loss Model", we assessed the approach proposed by the IASB as very high-level. Equally, we think that the ED provides an extensive guidance based on principles, and since some of the mentioned principles are defined quite clearly, the Expected Cash flow model favoured by the IASB seems sometimes not consistent and lacks a principles orientation.

The ED allows only de facto the application of closed Portfolio (here Portfolios may contain only assets which show, e.g., certain terms and characteristics). However, an "Open Portfolio" (possibly in the sense that within a Portfolios credits run out and sequentially new credits come), better corresponds to risk management and credit price increase practices of financial institutions.

Expected losses are determined at a portfolio level, not on an individual asset level. The definition of portfolios for determining expected losses under IFRS should be aligned with the credit risk management practices of the reporting entity. Therefore, the definition of portfolios for determining expected loss should consider at what level credit risk is managed and how the entity's business model is organised. Such an approach is consistent with IFRS 7 ("disclosure through the eyes of management") and IFRS 9 (classification partly based on the business model). In this sense and for calculating expected losses within the portfolios, bank should use robust methods that are adequate from a risk modelling perspective. It should be note, that whatever level of granularity for modelling expected losses is being used, the definition of portfolios does not influence the total amount of expected loss for a bank's overall loan book.

The Banking industry (see *annex*) proposes an "expected loss over the life of the portfolio approach (ELLP)". ELLP is a unique parameter that aggregates the future expected losses of each specified portfolio, i.e. the sum of the absolute default rate over the life of the portfolio. The expected losses would reflect the characteristics of the financial assets, which exist in the portfolio at the reporting date, and the expected lives of the financial assets in the portfolio at that date.

For the purposes of this methodology, the life of the portfolio is defined as the average maturity of the loans in the portfolio weighted by the outstanding balance.

The expected loss for every portfolio should be reviewed and recalculated periodically, at least each reporting period, in order to reflect adjustments due to the changes in the current or expected credit risk conditions and changes in the composition of portfolios.



The ELLP should be spread linearly in the Income Statement over the average life of the portfolio. Changes in expectations about the ELLP should also be spread over the remaining life of the portfolio, consistently with the treatment of original estimate. There is no conceptual difference between the calculation of initial or subsequent loss expectation, both being the entity's best estimate of incurred loss. The IASB model introduces an artificial distinction in the accounting treatment of initial expectations and changes in those expectations increasing the degree of subjectivity and volatility into the recognition of interest income. Full recognition in P&L of the effect of changes in loss expectations in the period of the change creates a higher level of P&L volatility. This higher level is not justified by the economic impact of changes in expectations, because relatively small changes in expectations will have a much greater impact in the period of change than the initial loss estimation. It represents a recognition model that is highly volatile and sensitive to changes in economic conditions, a criticism, which has been made of the incurred loss model.

Therefore, all expected losses, initial as well as subsequent estimates, should be recognised in the income statement through the average life of the portfolio. This is consistent with the principle that revenue from financial assets at amortised cost should be recognised over the life of the instruments. Such model would result in better comparable information, because changes in expectations would be recognised prospectively.

Question 4:

a) Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?

b) Are there any other measurement principles that should be added? If so, what are they and why should they be added?

We support the general objective of the IASB to develop a stronger forward-looking method as requested by public authorities. However, the proposal developed by the IASB has several drawbacks:

- Conceptual and operational issues raised by the use of expected flows in the EIR calculation :

The IASB model is based on the fundamental assumption that it is possible to estimate accurately the timing and amounts of the expected cash flows resulting from loan portfolios, including expected credit losses. However, due to the dependency on the macro economy, our members disagree with the assumption, as it is in practice impossible to predict the timing of losses. Thus, it does not make sense to incorporate the loss rate in the assets EIR calculus. Therefore, we consider that a methodology based on probability-weighted possible outcomes as suggested by the ED would not lead to any better financial information on the performance of the loan and does not justify any additional complexity.



- The recognition of changes in loss estimates;

Regarding the way to account for changes in estimates, we are of view that changes are not conceptually different from initial estimations. We agree that provisioning must not lead to record for a day one loss, as the bank would collect the premium included in the pricing of the loan to cover the credit risk related to its exposure over the maturity of the concourse. In pricing a loan, banks take into account the expected losses, but also the unexpected losses, i.e. the variation of average losses over time. Therefore, one prices a margin over the risk free rate and the credit premium, to cover changes in estimates of expected losses. This margin would be also collected over the loan's life and therefore, the changes in estimates must be recorded symmetrically.

- The determination of portfolios:

The ED proposals are based on individual loans or narrowly defined portfolios. Designation of portfolios through their origination date and or maturity would oblige financial institutions to distinguish and follow up a very large number of portfolios. Therefore, this approach would be very costly to implement. Moreover, maintaining the homogeneity and ensuring the appropriate use of the expected loss provisions would also raise practical issues and would be costly.

A meaningful impairment model based on expected losses should be built up on portfolios basis. As the size and the nature of the portfolios may vary within and between different entities, the definition of portfolios should be based on the way entities manage their credit risk exposure. Therefore, portfolios could be defined as "open" or "closed" depending on business and risks management.

Moreover, in order to assess the exposure to credit risk accurately, sample of loans included in portfolios should be based on significant characteristics and not be limited by a narrow definition of portfolios. The implied segmentation of the EIR approach can lead to too many small portfolios that must be sum up for defaults evaluation.

- Trade receivables

Concerning trade receivables, very short-term loans, the distinction between incurred and expected losses could be difficult and costly to assess. Therefore, we believe that they should be exempt from the expected loss impairment model (similarly to the exception stated in IAS 39 AG79 for trade receivables). However, this exemption does not preclude from using statistical methods for portfolio made of small individual amounts of trade receivables, as currently allowed by IAS 39.

- Debt securities portfolio

The ED does not specifically address the issues of debt securities portfolios. Even if they are listed on securities markets, we believe it is not appropriate to refer to credit spread included in a market price in order to assess expected losses. As these instruments are managed on an amortised cost basis, assessment of impairment should be based on own management judgement and should refer to the losses expected by the holder of the



bonds, whatever prices are on the market. Furthermore, very rare defaults have been observed on listed bonds. For these reasons, we believe that specific features of debt securities portfolios should be taken into consideration and that operational approaches adapted to bonds portfolios should be allowed.

Therefore, as laid down in details in the Banking industry joint paper (see in annex), we consider that the alternative model should be based on the following principles:

1. The new impairment model should not change the current definition of amortised cost or the EIR calculation
2. Expected losses should be determined on a portfolio basis aligned with the credit risk management practices. Open portfolio with similar risk characteristics should be allowed.
3. Expected Losses should be recognised over the life of the portfolio, i.e. the average maturity of the loans in the portfolio weighted by the outstanding balance
4. Impairment loans should be treated as it is in the current IAS 39
5. Impairment allowances are built up to be used. Therefore, when a loan defaults, its incurred loss is booked against existing impairment allowances. If the expected loss is not sufficient, an additional incurred provision should be recognised in the income statement. Any subsequent increases or decrease in incurred losses follow the same mechanism.
6. Expected loss provision at initial recognition and subsequent revisions of estimates are spread over the life of the portfolio. However, significant changes in estimation cannot be presumed being covered by the future margin and should be recognised immediately in P&L.

Objective of presentation and disclosure

Question 5

a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?

b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?

The description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost as described in paragraph 11 is clear and relevant.

However, the list of disclosures as proposed in the ED is too extensive. We believe that the benefits for users of such detailed information outweigh the costs to provide it. Entities should be able to provide disclosures on credit risk which are consistent with the way they manage their credit risk exposures.



We would recommend to the IASB to set out the purpose of such disclosure and to set out the principle so that the entity would be able to decide the usefulness of the information to be provided to meet the objectives for a better disclosure as stated in paragraph 11.

Presentation

Question 6: Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

Under the expected loss approach, interest incomes include a credit risk premium charged to borrowers. Therefore, we consider it would be consistent to present expected credit losses as a reduction of gross revenues.

However, we believe that flexibility should be applying regarding the way entities present their margin and the effect of credit risk. We propose to present expected losses and interests in separate lines in the income statement in order to allow users of financial statements to distinguish the interest from the credit component.

Therefore, we believe the following separate lines should be presented in the income statement:

- Gross interest revenue
- Gross interest expense
- Gross interest margin (subtotal of the items above)
- Expected losses impairment
- Incurred losses in excess of allowance.

Disclosures

Question 7:

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

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

As already mentioned in our previous answers to questions above, we are concerned by the extensive disclosure requirements, their complexity and their volume. We believe that could be confusing for users of financial statements and would not help to provide decision useful information. The costs to provide such information would exceed benefits for users.

Information provided should allow comparability between entities. Therefore, stress testing is not appropriate as not standardised information and as required for entities preparing stress testing for internal risk purposes.



Vintage information as described in paragraphs 19 and 22 could be relevant on a closed portfolio basis, as closed portfolios include loans sharing the same value of parameters used in the EIR calculus (i.e. same contractual rate, same pattern of amortization, prepayment, and residual maturity above the same credit risk exposure). Therefore, vintage information is not relevant when the impairment methodology is based on an open portfolio approach over the expected life of the portfolios as these portfolios with similar credit risks characteristics are continuously renewed with matured or cancelled loans and newly granted loans.

EACB members assess that the requirement of a loss triangle would not be appropriate concerning the volume and maturity of the loans within financial institutions. In fact, only a very few loans have a running period of 50 years and more. Taking into account the effort and costs that would imply the preparation of the loss triangle with the content of the information for the user, we do not believe that such complexity would be justified.

We ask that the IASB to stay at a principle level when defining a non-performing loan instead of giving a 90-day past due limit while different periods could be considered depending on the type of assets.

We strongly think that qualitative and quantitative disclosures should be consistent with the impairment methodology applied by the entity. Above all, in our view, all disclosure requirements should be incorporated into the IFRS 7.

Effective date and transition

Question 8: Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

Taking into account the level of heavy work, implementing any impairment approach would required significant time. An implementing time of three years for the new Impairment model as suggested by the ED does not take into account all the complexities that may implied. The conversion to IAS 39's impairment rules was still time-consuming and costly. The demands of the Expected Cash Flow Approach are still far more complex. However, a conversion to the banking industry model within a 3-annual period is from our point of view possible.

Moreover, we stressed that a single effective date should be defined and required for the whole of IFRS 9 *Financial Instruments*, because the interdependence between the separate steps of the replacement IAS 39-Project are to significant, especially the new regulations for classification and measurement and the new regulations for hedge accounting.

Question 9:

a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?



b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?

c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 8) please describe why and to what extent.

We consider that the application of the new method (such as we proposed) should be considered as a change in accounting method, with a retrospective application and consequently with the recognition of the first time application effects in equity.

However, due to the model complexity and operational concerns, we are not in favour of the restatement of the comparative information.

Nevertheless, it should be kept in mind, that the adjustments resulting from transition to the new model can reach a significant amount and will therefore affect banks prudential capital. Therefore it should be ensured, that the effects on the P&L and equity are well balanced.

Question 10: Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

Entities should be required to provide a qualitative analysis of the effect of the initial application of a new impairment method.

Practical expedients

Question 11: Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

We doubt whether “practical expedients” are necessary for a qualitatively high-quality standard based on appropriately principles. From our perspective, it might be more meaningfully to review the lacks of the IASB “Expected Cash flow model” to define durable and consistent principles, which make possible an operational conversion to a new Impairment model (Cf. Principles proposed by the banking industry).

Within the framework of the ED, rules would be highly welcome in order to allow the user to apply alternative methods based on the already available data and to achieve comparable results.

However, the ED states that a practical expedient may be allowed only if the difference in outcomes with the standard method is immaterial. This would result in applying both methods to evidence the immaterial difference und would be inconsistent with the purpose of the provision. Therefore, this requirement should be eliminated.



Question 12: Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

Instead of providing additional guidance on practical expedients, we suggest the Board to propose an impairment approach based on the principles developed by the Banking Industry (see annex).

Small banks or banks having insufficient loss experience should be allowed using peer group experience for comparable portfolios.

Contact:

The EACB trusts that its comments will be taken into account.

For further information or questions on this paper, please contact:

- Mr. Volker Heegemann, Head of Department (v.heegemann@eurocoopbanks.coop)
- Ms. Johanna Cariou, Adviser, Accounting & Audit (j.cariou@eurocoopbanks.coop)



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EUROPEAN ASSOCIATION OF PUBLIC BANKS -
EUROPEAN ASSOCIATION OF PUBLIC BANKS
AND FUNDING AGENCIES

Impairment: Expected Loss over the Life of the Portfolio

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Impairment: Expected Loss over the Life of the Portfolio

Basic features of an alternative model to IASB expected cash flow model

The European banking industry is evaluating the IASB's Exposure Draft ("ED") "*Financial Instruments: Amortised Cost and Impairment*". The members of the Associations believe that the ED is an important step in the right direction as the industry conceptually supports the development of an impairment model that is based on "expected loss", rather than the current "incurred loss" model in IAS 39. However, they believe that the "expected cash flow" model in the ED has a number of significant and important drawbacks, including:

- Conceptual issues: for example, as proposed in the ED, the initial expected cash flow estimate is recognised over the life of the related assets, whereas the present value of (positive and negative) changes in the expected cash flow estimate must be recognised immediately. This results in significant additional subjectivity, volatility and procyclicality.
- Practical issues, as the proposals in the ED are extremely complex, making the proposals difficult to be:
 - understood by users, e.g. due to the proposed combination of credit losses with interest margins;
 - implemented by preparers, e.g. due to the need to completely revise the methodology for effective interest rates and the need to define expected cash flows by time period whereas entities manage expected losses and
 - made reliable and relevant enough in practice given insufficient modelling capabilities.

For these reasons, the industry has been working to identify a number of sources of complexity as well as the conceptual issues. To address these shortcomings, the members of the Associations have developed an alternative application of the concept of expected loss for impairment that it believes is conceptually superior, in line with the general objective of financial statements and consistent with the lending activity and credit risk management of financial institutions.

The model proposed by the industry is "*Expected Loss over the Life of the Portfolio*" ("**ELLP**") model and is built around the following key principles:

- 1) The new impairment model should not change the current definition of amortised cost or the EIR calculation
- 2) Expected losses in the context of the new impairment model should be determined on a portfolio level
- 3) The methodology is based on the "expected loss over the life of each portfolio"
- 4) Impairment allowances are built up to be used, and therefore they are not just buffers.
- 5) Impaired loans are treated as in the current IAS 39.
- 6) Impairment allowances must be properly considered in the capital framework

1) The new impairment model should not change the current definition of amortised cost or the EIR calculation

Banks manage interest rate risk and credit risk on a different basis. For this reason these risks should not be co-mingled in the calculation of the EIR. This would not only be complex to implement, but also difficult to understand by the users of financial information.

The banking industry proposal is to keep the current definition of the effective interest method under IAS 39 and exclude the expected loss from the EIR calculation. It is proposed to present the expected loss in a separate line in the income statement which would allow users of financial statements to distinguish the interest from the credit component. The members of the Associations believe that the current effective interest method under IAS 39 is well understood by users. A change to this model raises operational risks and increases the complexity of implementation, while reducing the transparency of financial information.

2) Expected losses in the context of the new impairment model should be determined on a portfolio level

An impairment methodology based on estimated expected losses is only meaningful if it is applied on a portfolio basis. Therefore, an expected loss impairment model should be built around the following features:

- Expected losses are determined at a portfolio level. The definition of portfolios for determining expected losses under IFRS should be aligned with the credit risk management practices of the reporting entity. Therefore, the definition of portfolios for the purpose of determining expected loss should consider at what level credit risk is managed and how the entity's business model is organised. Such an approach is consistent with IFRS 7 ("disclosure through the eyes of management") and IFRS 9 (classification partly based on the business model).
- Inherent in this approach is that the size and nature of portfolios may vary within and between different entities. One entity may manage on the basis of a limited number of portfolios where another entity may manage on the basis of many small portfolios. Furthermore, consumer retail business is commonly managed on the basis of large homogeneous portfolios whilst certain large/unique wholesale exposures may be managed on an individual basis. It is important that the portfolio definition for expected loss reflects these different levels of (credit risk) management.
- Financial institutions manage their business and credit risk on an "open portfolio" basis. This means that portfolios may be open to new loans¹ with similar credit risk characteristics as existing loans, i.e. portfolios are dynamic in the sense that existing loans mature and new loans may be added. An open portfolio approach must be allowed as the basis for the determination of expected loss in an IFRS impairment model to align internal risk management practices with the proposed impairment model. It would not be appropriate for an IFRS impairment model to require closed portfolios (i.e. portfolios only containing assets of a specific 'inception date' and/or 'maturity date' that subsequently "run-off" over time), because this would result in a very large number of "run-off" portfolios and, in most cases, a disconnection with internal credit risk management.

¹ In this paper we always refer to "loans", but the model is intended to be applied to all assets that are classified at amortized cost under the future IFRS 9.

- Estimating expected losses is based on statistical parameters (including for example “probability of default” and “loss given default”) that are calibrated by means of various models (e.g. rating methods in accordance with Basel II). A variety of risk models may be used within a reporting entity as long as the selection of risk models is consistent with the objective of providing the best estimate of the expected loss over the life of each portfolio. In this regard, banks with highly sophisticated risk modelling approaches will often apply different models within each portfolio under IFRS.

3) The methodology is based on the “expected loss over the life of each portfolio”

Defining Expected Losses

ELLP is a unique parameter that aggregates the future expected losses of each specified portfolio. The expected losses would reflect the characteristics of the financial assets which exist in the portfolio at the reporting date and the expected lives of the financial assets in the portfolio at that date.

To estimate expected losses and provide discipline to the process, historical loss experience should provide the basis for estimating expected losses. Historical loss experience should be adjusted to reflect the effects of conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist at the reporting date.

Entities that have no entity-specific credit loss experience or insufficient experience may use peer group experience for comparable portfolios.

Measurement and reporting of ELLP

For the purposes of this methodology, the life of the portfolio is defined as the average maturity of the loans in the portfolio weighted by the outstanding balance.

The expected loss for each portfolio should be reviewed and recalculated periodically, at each reporting period.

The ELLP should be spread in the Income Statement over the average life of the portfolio (linearly or any better allocation).

Adjustments to expectations

Changes in expectations about the ELLP must also be spread over the remaining life of the portfolio, consistently with the treatment of original estimate. There is no conceptual difference between the calculation of initial or subsequent loss expectation, both being the entity’s best estimate of incurred loss. Changes in ELLP may result from changes in current or expected credit risk conditions and changes in the composition of the loan portfolios since the last reporting period end. Therefore any adjustments to the initial estimation of the ELLP should be accounted prospectively. In addition, taking into account that the calculation of the ELLP requires a high degree of judgement, the members of the Associations consider that applying a different treatment for subsequent changes could lead to Income Statement manipulation by entities through different reporting periods.

4) Impairment allowances are built up to be used, and therefore they are not just buffers

The principle is that incurred losses (i.e. loan losses recognised on defaulted loans) are booked against the existing impairment allowances (“allowance account”). It is consistent with the principle of this approach that impairment allowances are built up to cover future expected losses. Under this approach, impairment allowances are not prudential ‘buffers’ or reserves.

This is done by using the following criteria:

- Incurred losses are booked against existing impairment allowances
- To the extent that impairment allowances are not sufficient to absorb losses, incurred losses are booked directly to the income statement. It is not possible to have a negative expected loss impairment allowance account.
- Any subsequent increases or decreases in incurred losses are booked against the expected loss impairment allowance account accordingly.
- As a result, the overall impairment allowance (for incurred losses and expected loss together) is:
 - as a minimum at least equal to or higher than the incurred loss impairment allowances under the current IAS 39 model (as all incurred losses are provided for and the portfolio expected loss cannot be negative)
 - never greater than the total expected loss in the portfolio (in case the level of total expected loss is reached, the building up of expected loss would cease) plus the incurred loss impairment allowances under the current IAS 39 model.

Under the proposed model, loans on which incurred losses are identified (herein described as ‘non-performing’ loans) are separated from the performing loans. Consequently no further expected loss is calculated and the expected loss previously created will be allocated to the non-performing loan. For non-performing loans an incurred loss impairment allowance will be calculated and adjusted against the expected loss impairment allowance account. This reflects the fact that non-performing loans are the crystallization of the expected loss.

Although the default of a loan can be analogised to the crystallization of the expected loss from a statistical point of view, expectations about losses for the remaining portfolio do not change (entities do not reduce the default probability of the remaining instruments). As a consequence, after the removal of an instrument from its previous portfolio, the remaining contracts of the portfolio will continue to build up an impairment allowance based on the ELLP over the residual life of the portfolio.

5) Impaired loans are treated as in the current IAS 39.

Instruments on which incurred losses have been identified should be measured as in the current IAS 39 with an exception related to the time value of non-performing assets which should not be recorded in the income statement but, in line with the accounting treatment as follows, directly against the existing impairment allowance (increasing the allowance account). The reason for this is that when a loss has been incurred on a loan and the entity considers it as non-performing the only meaningful information is the amount of that incurred loss.

Therefore the banking industry proposes to keep the actual definition of impairment and the methodology to calculate the incurred loss impairment allowance for those non-performing loans.

If a non-performing loan returns to performing status, the loan and its corresponding impairment allowance should be incorporated into the performing portfolio. Conversely, if the impairment allowances on the non-performing loan need to be increased, additional impairment allowances should be taken from the outstanding portfolio expected loss impairment allowance. This is necessary to ensure that the model is applied consistently.

6) Impairment allowances must be properly considered in the capital framework

Globally, many interested parties are addressing the problem of procyclicality. Close coordination between regulators and standard setters is very important to ensure that the combined effects of proposed changes do not impose excessive capital requirements on banks. Certain prudential aspects, for example the implementation of worst-case stress scenarios, should be considered outside the accounting framework, by banking regulators within an appropriate regulatory framework.

For these reasons, the following issues must be considered in any definitive solution to address procyclicality:

- Coordination between accounting standard setters (IASB) and regulators is essential. The coordination among regulators and Standard Setters is also desirable to simplify implementation of the impairment model as risk parameters from regulatory requirements can, where appropriate, be used as inputs to the provision model.
- Duplication of requirements must be avoided, as could result in overlapping provisions and capital buffers.

7) Comparisons to IASB Model

In summary, the alternative proposal is consistent with the objective of the IASB's Exposure Draft as it is based on expected losses. However, it has some key differences to the IASB proposal which the members of the Associations believe makes it easier to apply, easier to understand by users of financial statements and consistent with the methods financial entities use manage their credit risk. The main differences to the IASB proposal are the following:

- The IASB proposes to include impairment in the definition and calculation of amortised cost and Effective Interest Rate. In the alternative proposal, the definition of amortised cost remains as in current IAS 39 and impairment is an independent estimate separate from the EIR calculation.
- The approach included in the ED implies a loan-by-loan or closed portfolio basis for measuring impairment. The alternative proposal follows the business model of each entity as the primary driver. The approach allows application on a loan-by-loan, closed portfolios or open portfolios, depending on how the business and risks are effectively managed.
- The proposed IASB's expected cash flow approach requires an entity to reassess the expected cash flows each period and to recognise the effects of any changes in credit loss expectations immediately in the Income Statement. In the alternative proposal, subsequent changes in expectations would be spread over the life of the portfolio, consistently with the treatment of initial expectations, subject to the condition that total impairment

allowances (for incurred losses and expected losses together) are always at least equal to or higher than the incurred loss impairment allowances under the current IAS 39 model.

8) *Summary*

The Associations believe that the ELLP model set out in this paper is easier for users of financial information to understand and for preparers to implement at a reasonable cost. The proposed model captures the economic reality of the lending activities of financial institutions and is in line with the philosophy of the six point plan of the BIS to achieve a sound “expected loss provisioning approach” established in their paper “Guiding Principles for Replacement of IAS 39”:

- 1) address the deficiencies of the incurred loss approach without introducing an expansion of fair value accounting;
- 2) promote adequate and more forward looking provisioning through early identification and recognition of credit losses in a consistent and robust manner;
- 3) address concerns about procyclicality under the current incurred loss provisioning model;
- 4) incorporate a broader range of credit information, both quantitative and qualitative;
- 5) draw from banks' risk management and capital adequacy systems; and
- 6) be transparent and subject to appropriate internal and external validation by auditors, supervisors and other constituents.

Additionally, the important issues of disclosure and transition have not been addressed in this paper. The members of the Associations believe that these are key issues for the implementation of the model and must be addressed once the primary principles of the model are agreed.

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