European Banking Federation

Chief Executive

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Mr Hans HOOGERVORST
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International Accounting Standards Board
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***Subject*: EBF comments on the IASB Impairment project**

Dear Mr Hoogervorst,

The European Banking Federation (EBF)[1] is supportive of a more forward looking provisioning approach and has been contributing to the work of the IASB with the aim to developing a principle-based model that is consistent with risk management practices and capable of application to open portfolios. The European banks are supportive of an approach which differentiates between performing assets and those that are no longer performing or that have suffered credit deterioration that is both not reflective of the initial credit risk and relevant for the life time expected loss measurement. Such an approach would help to ensure that impairment allowances are meaningful for different portfolios in different jurisdictions, compared to an approach which is only based on the level of expected losses which would be likely to prejudice higher risk products, businesses and regions.

The IASB model is therefore a step in the right direction, but needs to be both clarified, simplified to make it operational without undue cost as well as to increase its understandability and therefore the likelihood of its acceptance.

The definition of the criteria for moving from 12 months' to lifetime expected losses is one of the most sensitive elements of the IASB model. This definition is likely to be the key driver of the level of impairment allowances recognized and, if it is not clear, could drive significant inconsistency in practice. It also forms the conceptual basis for the model and therefore it is essential that the objective of the criteria is clearly explained.

[1] *Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.*
The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

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In particular, the terms ‘more than insignificant’ and ‘at least reasonably possible’ introduce a high degree of complexity.

- The term ‘more than insignificant’ suggests employment of a relative credit quality test with a numerical threshold of probability of default to be set for each asset on initial recognition. Such test would require data to be stored on expected losses/ probability of default on initial recognition of an asset and the establishment of processes to compare that to updated data for each period. The operational challenges of collecting and tracking the necessary data for assets are likely to be very significant, and may not be feasible. It is also unclear how to apply this criterion in situations where credit deterioration is experienced subsequent to initial recognition, but which had been expected when the loan was made and priced accordingly at origination.

- The term 'at least reasonably possible' when applied to the probability of not recovering cash flows implies an absolute test, although it is not clear what level of probability of default would be consistent with this term. Given all financial assets have a probability of default of greater than zero at origination a default will normally in all circumstances be at least reasonably possible on a probability basis, particularly if the unit of account is a portfolio.

  There is also a risk that the criteria as drafted would force a life time expected loss measurement for assets that have deteriorated from an extremely good credit quality (e.g. AAA) to a strong credit quality (A-) while it is noted that the Board has asked the staff to provide clarification of this issue, but the EBF would like to highlight its importance.

In practice it is more likely that the credit quality of assets will be monitored against an absolute level of credit quality as appropriate for the product type, industry sector and economic environment of the asset. A separate relative test appears unnecessary to capture the substance of this credit management process, and introduces a high degree of complexity.

Removing the relative test and amending the absolute test in a way which aligns with the credit risk management of the portfolio would be both simpler and result in a single understandable principle to be applied. It would substantially reduce the operational difficulty of applying the IASB’s current proposals.

The threshold for lifetime measurement should be the point at which the probability of default reaches an absolute level that is relevant from a credit risk management perspective for the particular portfolio. While the principle applied to all portfolios would be the same, the level would be different for different types of loans and portfolios. Consideration must be given to the nature of each portfolio, its maturity, its credit risk characteristics and its geographical location to ensure that the threshold is meaningful for a given portfolio.

The EBF understands that the 12 month measurement basis was introduced as a practical expedient despite the fact that the approach is in conflict with the revenue recognition principle as well as with the measurement of assets at fair value where no D1 loss is recognized. The 12 months could be seen as a proxy for a yield adjustment, although conceptually it is hard to justify 12 months. The provisions for such loans are seen mainly as a buffer because normally the majority of those loans will never default. A 12 month allowance is therefore seen from an economic perspective as more than sufficient to cover the associated risk**.** Clarification to the mechanism should be given to ensure that the provisions accumulated on loans that are subject to 12 month EL measurement on a portfolio basis will be effectively used to cover losses on those loans that will be transferred for the life time expected losses measurement.

Using 1 year PD for transfer determination would lead to further operational simplification. While some adjustments should be made, PD 1 year is already used for Basel purposes. It is therefore believed that such approach would increase understandability and comparability.

Without modification of the IASB's model, there is a risk that the FASB model, which lacks a conceptual basis, could be seen as superior mainly given its apparent operational simplicity. The model ignores the link to interest rate recognition leading to full day one loss and the financial reporting would reflect only the dynamic of volumes in the loan portfolios (i.e. additional provisions for new loan originations), obscuring the information about credit deterioration and risk management. Such a model would not meet the objectives of financial reporting.

The European banks are also concerned that the FASB model, if adopted globally, would distort a level playing field given the shorter average maturity of loan portfolios in the US as well as the securitisation practices resulting in derecognition of loans shortly after origination. The impact on the retail business in some European countries could be significant and it is also expected that in these countries lending would become more expensive or the business lending structure would be forced to change, resulting in shortening the maturities of the loans.

It is important that the final proposal is tested and a cost benefit analysis is undertaken to evaluate the practical impact and to ensure that the objectives of the revision are met, including evaluation of possible alternatives such as the Time Proportionate Approach.

The industry would be happy to further elaborate on any of the ideas expressed above and is committed to work with the IASB to simplify its proposal so the resulting model is conceptually sound, operationally feasible and cost efficient. The EBF would welcome an opportunity to discuss its proposal in a meeting with the IASB.

Yours sincerely,

Guido Ravoet

Copy to:

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