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Ref.: BAN/HvD/SS/LF/SR

Dear Mr. Enevoldsen,

Re: FEE Comments on EFRAG's Draft Comment Letter on IASB Request for Information ("Expected Loss Model") ***Impairment of Financial Assets: Expected Cash Flow Approach***

(1) FEE (the Federation of European Accountants) is pleased to provide you below with its comments on the EFRAG Draft Comment Letter on the IASB Request for Information ("Expected Loss Model") *Impairment of Financial Assets: Expected Cash Flow Approach* (the "IASB paper").

(2) A summary of our position is presented below, whereas some further observations and the responses to the questions are included in the appendix to this letter.

(3) Like EFRAG we welcome the decision of the IASB to review the incurred loss model in the context of the other impairment approaches as we share EFRAG's views that there are concerns about the current incurred loss model approach. We also see merit in the further examination of the expected cash flow approach including an investigation of the costs and benefits of this approach.

(4) We understand that the purpose of the IASB paper is to ask for information on the feasibility of the expected cash flow approach. We note that the IASB paper indicates that it does not seek views on the relative advantages and disadvantages of alternative impairment approaches. We question the logic of such an approach and would have expected that at least the features and underlying principles and concepts of the expected loss model would be open for comment at this stage and not only the feasibility for practical implication. We have concerns about the proper application of due process. In assessing whether to adopt an expected loss model of impairment it will need to be considered whether the operational costs of implementation by preparers is

outweighed by the benefits to users. In this respect we appreciate being part of the joint project with EFRAG on the concepts and technical details underlying the expected cash flow approach.

(5) We agree with EFRAG that the expected loss model will involve significant operational challenges in Europe, notably it is onerous in data collection since data need to be collected for the whole portfolio and not only for the impaired loans.

(6) In addition our profession is facing increased challenges in relation to auditability. The expected loss model is more subjective in nature compared to the incurred loss model. At present the profession has to address subjectivity and judgment in reporting for example in the use of models. However, the expected cash flow loss provisioning model increases the subjectivity since it relies significantly on the cash flow estimates prepared by the reporting entity which are inherently subjective. Therefore some safeguards need to be built into the process such as disclosures of methods applied and periodical backtesting and immediate reflection of the results of the backtesting in the models applied for the future.

(7) FEE is strongly committed to robust, high-quality global principles-based financial reporting. Principles-based standards require that the appropriate balance is struck as to the level of detailed guidance provided. Too much and too detailed guidance risks to turn the intended principles-based standards into rules-based standards. In responding to various detailed aspects of the Request for Information, the EFRAG calls for "further guidance" acknowledging the criticism of, for example, the current version of IAS 39 as "too rule based". The FEE cautions against seeking extensive guidance on many aspects of the eventual adopted impairment proposals as the cumulative impact of "more guidance" is:

i. A rule-based approach to impairment; and
ii. A detailed reporting approach which conflicts with the actual business model of the reporting entity.

(8) Therefore in order to allow development of expected loss systems aligned to the business models of individual entities, the proposed standard should not become too prescriptive on the required methods of loss quantification in relation to movements in and out of portfolios, provided the expected loss model principles are adhered to.

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Association Internationale reconnue par Arrêté Royal en date du 30 décembre 1986

(9) We agree however with EFRAG that expected cash flow loss provisioning model needs to be examined further and appreciate together with EFRAG to make a contribution to the discussion of the underlying concepts and technical details.

For further information on this letter, please contact Ms. Saskia Slomp, Technical Director.

Yours sincerely,

Hans van Damme
President

Appendix - Comments on EFRAG's response to questions asked in paragraph 11 of the IASB's paper

> **EFRAG's request to constituents**
>
> EFRAG recognises that the IASB paper is asking questions about feasibility and those questions can best be answered by preparers. With that thought in mind, EFRAG has been canvassing views from its constituents and, in preparing this draft letter, has focused largely on trying to convey the views heard to date.
>
> EFRAG is still seeking views and more detailed information. It therefore requests that constituents please forward any further relevant information for consideration in developing our final response.
>
> EFRAG would also like to draw its constituents" attention to the fact that the current thinking is that any new model will apply to all entities, not just financial institutions. We would therefore also be interested in hearing the views of non-financial institutions (henceforth „corporates").

(10) It would be helpful developing application guidance for the implementation of the expected loss model on short-term receivables, which can be a key concern in particular for non-financial entities, whereby similar guidance could be provided as at present is the case under IAS 39.

Question 1—Is the approach defined clearly? If not, what additional guidance is needed, and why?

(11) Although we prefer to avoid detailed rules, we agree with EFRAG that additional guidance is needed on (i) what information to use in circumstances when historical data is not available; (ii) unit of account, diversification and correlation; (iii) how to deal with the revolving credits (e.g. credit card portfolios); and (iv) transition provisions. We broadly support EFRAG's comments as set out in the draft comment letter in response to Question 1 but at the same time reiterate our concerns mentioned in Paragraph 7 of our covering letter.

Components of the Expected Loss Model

<u>Historical data</u>

(12) We agree with EFRAG that the expected loss model will involve significant operational challenges in Europe, notably it is onerous in data collection since data need to be collected for the whole portfolio and not only for the impaired loans and since the expected loss model requires having to obtain historical loss data for all financial assets held at amortised cost. Financial institutions do not

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always have historical loss data—particularly for some types of financial assets or some types of markets or the historical loss data do not reflect the losses to maturity. Similarly, corporates do not currently have sufficient data to calculate expected losses on their portfolios of receivables. It would be helpful developing application guidance for the implementation of the expected loss model to short term receivables, as indicated earlier.

Timing of cash flows

(13) While there are significant challenges in having sufficient suitable historical loss data on which to base expectations of losses, it should be recognised that it will be virtually impossible to develop expectations of the timing of the missing cash flows. The timing of the missing cash flows could be material to the calculation of the original effective interest rate. In our view this issue needs to be addressed by the standard setter to enable implementation of the expected loss model.

Future Economic conditions

(14) Management's view on the future economic conditions needs to be taken into account in preparing the cash flow estimates. We are concerned in this respect about short term loans and receivables where the average duration of the life is significantly shorter than the economic cycle. Financial reporting must avoid setting up provisions for loans which have not yet been granted. The model should be based on estimates of losses on loans that are recognised and irrevocable loan commitments that have been entered into and should not provide for losses on future transactions and events.

(15) We believe that it would be helpful to clarify what is meant by an expected loss (for instance whether it is based on weighted probability or single most probable outcome), in particular whether the approach to loss quantification as defined in IAS 36 is expected to be applied on financial instruments.

Unit of account, diversification and correlation

(16) We agree with EFRAG's observation that the unit of account is important in measuring assets and liabilities and support EFRAG's comments in relation to diversification and correlation. The IASB should provide more general guidance on how a reporting entity should take into account correlation and diversification between individual assets or portfolios when calculating an expected loss. Disclosures about the way the portfolios are created, the items are regrouped and how the loans are eventually excluded from the group when they are individually impaired would be necessary. Some guidance should be developed for the benefit of users as to the constitution of loan portfolios for impairment purposes and what should be the adequate unit of account for that purpose. See

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also our comments below in paragraph 17 on movements in and out of portfolios.

Portfolios

Movement in and out portfolios

(17) Although we prefer that the proposed standard defines only the general principles for movements in and out of porfolios, we agree with EFRAG that some application guidance on this subject would be useful in order to ensure homogenity of portfolios, enable backtesting and allow relevant disclosures as explained in paragraph 24 of this letter.

(18) In order to allow development of expected loss systems aligned to the business models of individual entities, the proposed standard should not become too prescriptive on the required methods of loss quantification, provided that all expected changes in cash-flows of individual assets and portfolios from initial recognition to the reporting date are properly reflected.

Revolving credits

(19) We agree with EFRAG that further guidance is needed on revolving credits including credit cards and overdrafts. We also refer to our comments in paragraph 14 of this letter.

Transition provisions

(20) We agree with EFRAG that transition provisions are important since they could significantly impact the financial result of a reporting entity and could become decisive on early implementation decisions.

Question 2—Is the approach operational (ie capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?

Lack of data

(21) We agree with EFRAG's observations concerning historical data and the need to collect such data for the whole population on loans and receivables and not only for the impaired loans and receivables. The transition provisions should allow sufficient time for data gathering.

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Control processes

(22) We agree with EFRAG's observations concerning the control process.

(23) In addition to the necessary extension of the control processes and the specific procedures to be designed to mitigate the potential lack of historical data, our profession is likely to face challenges in relation to auditability. The expected cash-flow loss provisioning model increases the subjectivity since it relies significantly on the cash-flow estimates prepared by the reporting entity which are inherently subjective. Some safeguards need to be built into the process such as disclosures of the methods applied, periodical back testing and immediate reflection of the results of the back testing in the models applied for the future.

(24) Also, in order to introduce discipline and comparability, it would be useful to introduce a default definition (this definition could align with the model provided by the Basel 2 framework which uses both qualitative default characteristics and a quantitative 90 days overdue criterion and would ensure a relatively objective point in the debt history where problems are clear and quantification more objective). Such definition can be used for backtesting, disclosure purposes but also might be used as a threshold when items needs to be removed from a performing loan portfolio and either individually assessed or assessed in a portfolio of defaulted loans with similar characteristics.

Effective interest rate

(25) The model proposal requires including the expected loan losses at inception (based on expected cash-flow fall-outs) in the initial effective interest rate. This is a challenging requirement and some qualitative disclosures should be required on how the reporting entity applies this principle. In addition some high level quantitative disclosures (e.g. the percentage of the total contractual interest rate of the loan portfolio not recognised due to the initial loan loss expectation) should be considered for disclosure provided the cost/benefit analysis is positive.

Unit of account and correlation

(26) We agree with EFRAG that the unit of account may also cause operational difficulties. The reporting entity should have sufficient flexibility to reflect the business model it is using.

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Question 3—What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?

EFRAG's request to constituents EFRAG is still seeking information on the magnitude of costs associated with implementing an Expected Loss Model. We would therefore be grateful if preparers could forward to us information about their cost estimates so that our final letter can take into account a broad spectrum of cases.

(27) We have no specific observations to make concerning the magnitude of the costs. The foreseeable order of magnitude for implementation costs is probably high considering the pervasive impact of this change.

(28) The systems impacted would include legacy systems, pricing tools/procedures, CFO management information systems and related profitability calculation engines, risk management systems and accounting systems. The likely extent of systems and other procedure changes can be illustrated as follows:

- the legacy systems would have to be upgraded to include new information needed to make this approach viable (supplying input data needed to perform calculation envisaged by the model); the pricing tools/procedures should be able to manage the breakdown of the credit risk spread component within the total rate applied and negotiated with customer;

- the CFO management information systems and the related profitability calculation engines should be upgraded to support the on-going measurement of variations of several different components over the whole product life, enabling the separate tracking of different measures correspondent to different available business levels, consistently with the pricing conditions set at origination and with the progressive refresh of original hypotheses about customer credit risk profile;

- the risk management systems would require investments and upgrades as main source of the basic parameters (credit risk parameters) needed as input for the model, granting their constant calibration on a monthly basis.

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(29) Regarding the lead time to implement the approach, we are of the opinion that, given the need for data, the proposed standard should not be mandatory before 2012 (see paragraph 21 of this letter).

Question 4—How would you apply the approach to variable rate instruments, and why? See the Appendix for a discussion of alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments.

(30) Like EFRAG FEE supports using the effective interest rate calculated upon initial recognition of the instrument. We also refer to our observations in paragraph 25 of this letter.

Amortisation of upfront costs

(31) Like EFRAG we support approach A: amortising upfront costs using the original effective interest rate calculated upon initial recognition of the instrument.

Impairment of Variable Rate Instruments

(32) We recognise that there are different approaches to account for the impairment of variable rate instruments. Another approach that could be considered is to amend the effective interest rate for movements in the benchmark but keep the credit spread constant. FEE is working together with EFRAG at present on a joint project on different approaches on the expected losses and loan loss provisioning.

Question 5—How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:

(a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?

(b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?

(33) We agree with EFRAG that the eventual standard should adopt a principles-based approach: a reporting entity should be able to choose whether it removes a financial asset for which an impairment loss has been identified from a portfolio of performing assets. Appropriate disclosures should be required as to the approach taken by the reporting entity.

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Question 6—What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?

EFRAG's request to constituents
EFRAG is still seeking suggestions from preparers on whether there are any simplifications to the expected cash flow approach that would make implementation easier. We would therefore be grateful if preparers could forward to us suggestions to simplify the model and/or simplifications in the implementation approach.

(34) Guidance on short term receivables based on IAS 39 short cuts would constitute a simplification (see also paragraph 10 of this letter).

Other observations

(35) We wish to signal an issue in relation to reinsurance as an example of unintended consequences in other areas beyond IAS 39, which the IASB may need to assess: IFRS 4.20 is referring to the loss model incorporated in IAS 39 for the default risk related to reinsurers´ share in the technical provisions. Due to a limited size of databases it is hardly possible to determine the expected default rate for reinsurance assets. The criteria related to the incurred loss model established in IAS 39 appear to be more operable in a situation with a lack of statistical data.

(36) We also wish to observe that from the perspective of insurers there is far too little attention paid to the impairment accounting for corporate bond portfolios held at amortised cost. The paper does not adequately recognise that the challenges are significantly different where a portfolio approach cannot realistically be used and hence there are a number of additional operational and technical challenges in implementing the proposals.

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