IACPM
INTERNATIONAL ASSOCIATION OF CREDIT PORTFOLIO MANAGERS

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Mr. Hans Hoogervorst
Chairman
International Accounting Standards Board
30 Cannon Street
EC4M 6XM London
United Kingdom
Via Email to: commentletters@ifrs.org

SUBJECT: Response to IASB Exposure Draft ED/2013/3, Financial Instruments: Expected Credit Losses

Dear Mr. Hoogervorst:

The International Association of Credit Portfolio Managers[i] (the "IACPM") appreciates the opportunity to comment on the IASB's Exposure Draft "Financial Instruments: Expected Credit Losses". The IACPM recognizes the importance of revising the accounting standards for credit loss and impairment, given the experience of the financial crises of the last several years.

The members of the IACPM will be strongly impacted by changes to the accounting standards for Expected Credit Losses ("ECL"). Our members have responsibility for managing their firms' credit portfolios. This activity includes measuring and analyzing credit risk, from both an individual credit and a portfolio perspective, and making decisions to control concentration, add diversification, and managing the return of the portfolio relative to risk. In carrying out these responsibilities successfully, credit portfolio managers contribute to maintaining the safety and soundness of their respective financial institutions. Importantly, while the scope of credit portfolio management functions varies firm to firm, the core asset class focus of all our members is corporate credit, and it is from that perspective that we provide this feedback.

We have examined the proposed credit loss standards from both IASB and FASB, and note that they appear to be driven more by regulatory objectives than accounting needs. As such, neither standard fits particularly well into existing accounting frameworks. There are two aspects of the proposed standards (from both FABS and IASB) that are particularly troubling:

- The proposed standards are uniquely focused on a single industry (banking), when other industries (any entity with a sizeable investment portfolio) are clearly exposed to the same accounting realities around credit loss.

- The proposed standards do not align recognition of revenue and expense. It requires banks to recognize an upfront loss on instruments that have been acquired at market rates where no loss exists. This effect is more pronounced in the FASB model as opposed to the IASB model due to the recognition of lifetime losses on recognition of the instrument; however, the IASB model also does not fully reflect economic reality.

If implemented as proposed, we expect these fundamental shortcomings may prove problematic, and will likely lead to some reconsideration of the standard in the future. In the interim, however, we recognize that we have likely moved too far down this path to fully reconsider the expected loss approach. We also note that the current IASB proposal is preferable to the current FASB proposal, in that it deals with ECL in a practical way that more closely reflects economic reality. Bearing this context in mind, we offer the following constructive suggestions to refine the standard:

1. More Clarity is Required in Respect of Forward Looking Forecasts of ECL

The proposed standard is not sufficiently clear on how to incorporate forward-looking forecasts. This could potentially lead to considerable inconsistency in reported ECL. For example, no two market participants would be likely to agree on the quantitative impact of a decline in GDP or of an event like September 11, 2001.

In our conversations with regulators and accounting authorities, it is clear that one driver of both the FASB and IASB impairment standards was the experience around portfolios of US residential mortgages in the 2007 and 2008 period. There is a general consensus that it was apparent that these portfolios were going to experience significant losses but that those losses could not be recognized under existing impairment standards. While we support the need for change to address this problem, we believe it is important to acknowledge that other bank asset classes did not experience the same challenges around losses. Wholesale loans for example experienced a relatively modest increase in defaults – an increase which was almost impossible to estimate or anticipate through the events of 2007 or 2008. In our experience, most economic downturns are only clearly visible and understood in hindsight. The experience around US residential mortgages in 2007 and 2008 was exceptional. The proposed standards need to better recognize this reality.

We recommend that the IASB clarify that ECL should generally reflect historical data except where clear and compelling evidence exists that ECL is likely to differ from historical norms. The IASB should require qualitative disclosure around the confidence that ECL will reflect historical norms. For example, in the case of September 2001, one would expect most banks to reflect increased uncertainty around forecasts based on historical data. However, in the case of September 2008, following the Lehman Brothers default, one would expect increased

ECL in respect of mortgage portfolios based on clear and compelling evidence of much higher impending defaults. This may seem like a subtle change but it is likely to improve consistency of disclosure and provide more meaningful disclosure to end users of financial statements. We also note that banks should be able to pool historical data. Otherwise, it will be much more difficult for individual banks to gather statistically relevant data necessary to support revised forecasting based on forward looking information.

2. The Definition of Lifetime Expected Credit Losses Should be Modified at Stage 2

While there is no doubt that loss estimates change when credit deterioration occurs, the use of lifetime ECL can still be highly problematic from an accounting perspective, particularly for long duration portfolios. Lifetime ECL on a long dated portfolio can be quite significant (applying the formula $PD_{lifetime}$ * Loss Given Default (LGD) * Utilization Given Default * Notional). It seems particularly inappropriate to recognize lifetime ECL where the portfolio subject to lifetime ECL is still expected to earn significant future income over the life and where that income is expected to exceed credit losses. We believe it would be more appropriate to recognize losses over the period that is reliably estimable and predictable at Stage 2. This is much more meaningful from an accounting perspective.

3. A Technical Consideration around the boundary between Lifetime and 12 Month ECL

The proposed standard stipulates a generally sensible barrier between the 12 month and Lifetime ECL bucket of significant credit deterioration where significant credit deterioration represents a downgrade from investment grade to non-investment grade or, for non-investment grade entities, a downgrade below the inception rate. We recommend that IASB further clarify that a single notch downgrade may not represent significant credit deterioration where there is robust asset coverage of the facility and a loss is unlikely. This is important for Basel compliant banks where the rating alone is not necessarily the sole indicator of credit quality. This is particularly true where there is robust security.

4. More time is required for Implementation

The move to an ECL standard is theoretically straightforward but it is operationally complex. Banks will incur significant costs to modify and link numerous complex systems to meet the extensive data requirements. The challenges are particularly severe for universal banks with extensive retail operations. Basel 2 compliant banks currently calculate PD and LGD factors for their capital calculations. However, the PD and LGD factors for accounting will be based on expectations as opposed to the down-turn, through-the-cycle factors used for regulatory capital calculations. It will take considerable time for banks to gather the data and validate the factors for accounting. Banks must also work with a number of different regulators to understand their expectations, particularly around capital. This work will take several years to complete. We recommend a five year preparation period leading to an implementation date no earlier than Jan 1, 2018.

5. Disclosure requirements should be simplified

We observe that the objectives of the proposed disclosures are similar to the current disclosure objectives but the volume of information will be significantly more than Banks have previously disclosed. Specific loss factors, or other granular model inputs, will lead to detailed disclosures of how model inputs form part of the model output, which is not necessarily meaningful information to financial statement readers. We believe that for the disclosures to be effective, emphasis should be placed on a qualitative discussion which will describe the Bank's outlook used in deriving the ECL. This could be disaggregated by portfolio or geography to provide a financial statement reader a baseline in comparing banks.

6. Alignment with FASB

We are certain that IASB is going to receive many requests for a converged impairment standard with FASB. It is undesirable to have two different accounting standards that require different data and disclosures and lack real comparability. Many institutions will need to comply with both standards. The differences between the standards will introduce operational complexity and higher costs. End users of financial statements are likely to be frustrated by the differences. However, in spite of the desirability to achieve alignment, we encourage the IASB not to seek alignment at any cost. As discussed above, the FASB model is flawed. The IASB proposal is a more pragmatic model that more realistically reflects economic reality. It is undesirable to sacrifice a better reflection of economic reality merely to achieve alignment.

We appreciate this opportunity for dialogue with the IASB in order to create more transparent accounting rules. Should you have any questions about our comments, or wish to discuss, please do not hesitate to contact me.

Sincerely,

Som-lok Leung
Executive Director
IACPM

[i] The IACPM is an industry association established in 2001 to further the practice of credit exposure management by providing an active forum for its member institutions to exchange ideas on topics of common interest. Membership in the IACPM is open to all financial institutions that manage portfolios of corporate loans, bonds or similar credit sensitive financial instruments. The IACPM represents its members before legislative and administrative bodies in the US and internationally, holds conferences and regional meetings, conducts research on the credit portfolio management field, and works with other organizations on issues of mutual interest relating to the measurement and management of portfolio risk. Currently, there are 86 financial institutions worldwide that are members of the IACPM. These institutions are based in 17 countries and include many of the world's largest commercial wholesale banks, investment banks and insurance companies, as well as a number of asset managers. More information about the IACPM may be found on our website: www.iacpm.org.