



Basel Committee on Banking Supervision

BANK FOR INTERNATIONAL SETTLEMENTS

**Chairman**

**Via email**

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21 December 2012

### **Financial Instruments: Impairment**

Dear Hans and Leslie

Impairment of financial instruments is a topic of significant importance for the global financial markets at large and for banks and banking regulators in particular. The Basel Committee's interest in this topic is consistent with the April 2009 call by the G20 Leaders for "*Accounting standard setters to work urgently with supervisors to [...] achieve a single set of high-quality global accounting standards*" as an action to strengthen financial supervision and regulation. Moreover, in this respect the G20 Leaders requested that accounting standard setters "*strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information*" and "*improve accounting standards for provisioning...*".

We acknowledge the considerable efforts of the IASB and the FASB (collectively, the Boards) to replace the existing incurred loss credit impairment model. We are concerned, however, that the Boards may not reach convergence given the FASB's recent decision to pursue an impairment model that differs from the IASB's model. While the Boards have made significant progress in developing expected loss models, we also remain concerned as to whether the eventual standards will result in the early and timely build-up of sufficient levels of credit allowances.

I would like to reaffirm the Committee's strong support for achieving a converged solution for impairment recognition and measurement. I would also like to reiterate the imperative that the impairment model resulting from the Boards' internal and bilateral deliberations should ensure sufficient levels of provisions at banks. This can best be achieved by a robust expected credit loss impairment model.

To assist you in understanding the Committee's high level of interest in the critically important topic of impairment, attached to this letter are the following:

- Minimum principles setting out the Committee's position on the key elements of a new impairment model, which the Committee plans to

make public and are consistent with its *High level guiding principles for the replacement of IAS 39*<sup>1</sup> (August 2009) and views expressed in our various comment letters since then (Appendix A); and,

- Scenarios representative of various economic situations and bank business models, which have been developed to solicit feedback from the Boards that will assist the Committee in understanding the application of their respective impairment models. Questions that accompany the scenarios are designed to ascertain the process by which the impairment models would be applied. In this sense, indications of the broad direction of the allowance balances would be welcome, together with references to the outcomes that would result from applying the current incurred loss model to the same scenarios (Appendix B). The scenarios also may be beneficial to the Boards for purposes of field testing their impairment models

If you have any questions regarding this letter, please feel free to contact Sylvie Mathérat (+33 1 4292 2602), Chair of the Committee's Accounting Task Force, or the Secretariat's Xavier-Yves Zanota (+41 61 280 8613).

Yours sincerely



Stefan Ingves

Cc: Mark Carney, Chairman of the Financial Stability Board

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<sup>1</sup> <http://www.bis.org/publ/bcbs161.pdf>



## Appendix A

### Minimum principles for the recognition of credit-risk related impairment

The following minimum principles set out the Committee's positions consistent with those expressed in its *High level guiding principles for the replacement of IAS 39*<sup>1</sup> (August 2009) and various comment letters since then. The most critical elements relevant to the Committee's evaluation of the Boards' impairment models are summarised below.

#### Overarching principles

##### Scope

- The new standard should apply the same impairment approach to all financial assets measured at amortised cost or fair value through other comprehensive income.

##### Objectives

1. To build an expected credit loss model.
  - Impairment recognition and measurement should be based on sound methodologies that reflect expected credit losses over the remaining life of a bank's existing portfolios<sup>2</sup> at the reporting date.
2. To ensure early identification and recognition of expected credit losses.
  - The new impairment approach should incorporate a broader range of available information than under the incurred loss approach;
  - Loss experience should be considered over the complete economic cycle;
  - Quantitative and qualitative assessment methods should be used to estimate expected credit losses; and,
  - The new standard should require earlier provisioning than under the incurred loss approach and avoid or minimize cliff effects to the extent possible.

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<sup>1</sup> Available at [www.bis.org/publ/bcbs161.pdf](http://www.bis.org/publ/bcbs161.pdf)

<sup>2</sup> The Committee's *High level guiding principles for the replacement of IAS 39* state that: "Loan loss provisioning should be robust and based on sound methodologies that reflect expected credit losses in the banks' existing loan portfolio over the life of the portfolio.[...] For the purpose of these principles, expected credit losses are estimated losses on a loan portfolio over the life of the loans and considering the loss experience over the complete economic cycle".

3. To ensure sufficient levels of allowances.

- The overall balance of provisions should be sufficient to absorb expected credit losses of all financial assets reported at amortised cost and fair value through other comprehensive income; and,
- The expected loss model should reflect the effects of any credit deterioration on collectability expectations.

*Principles for the recognition and measurement of impairment*

- The new impairment approach should allow impairment recognition for groups of financial assets with similar risk characteristics (open and closed portfolios) and for individual financial assets. The inclusion of guidance relating to impairment measurement for individually reviewed financial assets, when needed, would enhance the final standard.
- The new standard should utilise approaches that draw from relevant information in banks' internal risk management and capital adequacy systems when possible (e.g. approaches that build upon or are otherwise consistent with loss estimation processes related to bank internal credit grades may be useful). Such approaches require the recognition and measurement of expected credit losses across the entire range of a bank's internal credit grades for financial assets measured at amortised cost or fair value through other comprehensive income;
- The impairment approach should allow for the exercise of professional judgement when estimating impairment allowances. It should require the consideration of:
  - Leading economic and market indicators;
  - Portfolio and borrower-specific characteristics;
  - Lending policies and procedures, including underwriting standards that guide the process for loan approval by specifying contractual terms such as pricing, maturity, amortisation requirements, collateral coverage and collateral valuation;
  - The impact of increased risks from loan originations during expansionary economic periods;
  - Collection practices; and,
  - All other relevant information.
- Cash flows expected to be collected should be discounted at the original effective interest rate; and,
- Profit or loss should not be overstated due to an inappropriate treatment of the interest income. Depending on the credit risk deterioration since origination, interest income may be either no longer recognised or fully provisioned.

*Presentation and disclosure*

- Impairment allowances should be presented separately from the related financial assets (as contra assets); and,
- The new standard should be supported by robust and transparent disclosures as this will improve comparability among institutions and consistency of application over time.

*Implementation and level playing field*

- The new standard should contain clear definitions and principles, as well as adequate guidance (including illustrative examples, where appropriate), to foster an effective implementation and consistent application;
- The new standard should be practical in terms of its use and application by financial institutions across all jurisdictions and facilitate the ability of auditors to verify provisioning practices, regardless of an institution's size or complexity; and,
- The new standard should be introduced with appropriate transitional arrangements.



## Appendix B

### Recognition and measurement of credit risk-related impairment Scenarios

The following scenarios, which are representative of various economic situations and bank business models, have been developed to solicit feedback from the Boards that will assist the Basel Committee in understanding the application of their respective impairment models. Questions that accompany the scenarios are designed to ascertain the process by which the impairment models would be applied. In this sense, indications of the broad direction of the allowance balances would be welcome, together with references to the outcomes that would result from applying the current incurred loss model to the same scenarios. The scenarios also may be beneficial to the Boards for purposes of field testing their impairment models.

If there are any questions regarding the scenarios, including the underlying assumptions, please feel free to contact the Basel Committee Secretariat's Xavier-Yves Zanota (+41 61 280 8613).

#### Scenario 1: Portfolio of residential mortgage loans – effects of lending policies and underwriting standards

- Stable business line: residential mortgage financing, 30 year maturity.
- Credit risk management: portfolio basis / delinquency status / loss rates tracked by delinquency bucket.
- Moderately favorable economic environment [modest GDP and asset price growth (including real estate), no substantial liquidity concerns, low and stable unemployment rates].
- Delinquency trends stable over last 18 months.
- Forecast (next 2 years) is for continued moderate economic growth: default rates expected to be relatively consistent with historical default rates (as of previous 2 years).
- Current portfolio segmentation:

Past due status	% of total portfolio volume	Annual loss rates (years -2 / -1)
Current	98.10%	0.55% / 0.50%
1-30 days	1.69%	8% / 6%
31-60 days	0.09%	16% / 12%
61-90 days	0.03%	28% / 25%
More than 90 days	0.09%	52% / 48%

- Lifetime expected loss rates (for this portfolio based on bank's long term experience for similar economic environments): 7.3%.

Q1(a) Up to this point, would an allowance be required for this portfolio? How would it be calculated?

Q1(b) What factors would be considered in determining whether an allowance is required?

- The bank engages in an aggressive lending policy (loans underwritten grow at a 20% annual average).

Q1(c) Would the change in lending policy justify an increase in expected losses to be recognised (despite recent experience reflecting very low annual loss rates) based on evidence of strong correlation between credit growth and portfolio adverse selection? Would the corresponding allowance respond to 12 month or lifetime expected losses?

- The bank relaxes underwriting standards [reflected in: a) borrowers are granted loans for nearly the entire price of the purchased property; b) compared to previously underwritten loans, borrowers deemed as equally risky are granted loans at a lower price / subject to more favorable amortisation schedules].

Q1(d) Would the change in underwriting standards justify an increase in expected losses to be recognised (despite recent experience reflecting very low loss rates)? Would the corresponding allowance respond to 12 month or lifetime expected losses?

- Sudden downturn: increasing unemployment, declining residential property market (as well as commodities and stock markets) resulting in decreasing collateral values / liquidity concerns.
- Defaults increase significantly above bank's average historical experience: % of loans 30 days + past due increases from 1.9% to 4.1%.
- Recovery becomes difficult despite tightened practices (due mainly to many loans granted in the preceding years entering negative equity).
- Lifetime expected loss rates (based on updated portfolio segmentation and bank's long term experience for similar economic downturns): 18.3%.

Q1(e) Assuming that the probability of not fully collecting principal and interest (evaluated on a portfolio basis) has increased significantly, how would the allowance level now be calculated? What factors would be considered to contribute to its increase [e.g. general economic indicators (increasing unemployment rates); collateral value (declining home prices); borrower payment capacity (declining commodities and stock markets affecting wealth)]? How would those factors be incorporated into the allowance estimate?

Q1(f) When estimating future cash flows, how long should the current adverse conditions be assumed to remain in place?

Q1(g) Would a more segmented assessment of loans within the portfolio be required?

Q1(h) If switching to individual assessment of loans within the portfolio (e.g. upon their default), what would happen with allowances for expected losses not yet identified

with individual loans? Would they be allocated to individual assets? If so, would the whole amount needed to cover expected losses on individually impaired loans be transferred, or would amounts be transferred on a proportionate basis to each impaired loan?

Q1(i) Would additional segmented information be required to enable impairment to be measured separately for loans with different statuses (e.g. performing, unchanged credit risk since inception, collectively impaired, individually impaired, defaulted)?

## Scenario 2: Portfolio of residential mortgage loans – early loss pattern

- New business line (< 3 years underwriting experience on this type of loans): residential mortgage financing, 20 year maturity, high income-segment, different country (geographical dispersion across the country).
- Borrower low risk profile, mature market segment: underwriting standards relaxed to gain market share (average loan-to-collateral value (LTCV) > 90%).
- Credit risk management: portfolio basis / LTCV and vintage / loss rate estimation based on updated LTCV (available public real estate data for each geographic area) and individual aging of amounts due (principal and interest).
- Moderately favorable economic environment [modest GDP and asset price growth (including real estate), no substantial liquidity concerns, low and stable unemployment rates].
- LTCV trends (peer data) stable over last 2 years.
- Forecast (next 2 years) is for continued moderate economic growth: default rates expected to be relatively consistent with historical default rates (as of previous 2 years).
- Lifetime expected loss rates (based on peer group data for similar portfolios and economic environment): 6.4%.

Q2(a) Based on existing information, would an allowance be required for those loans?

- Despite low overall levels, market dynamics show high concentration of defaults occurring during the first 3 years of loans' lives.
- New peer group information shows annual loss rate for year -1 confirming market dynamics:

Age (years)	LTCV	Annual loss rates (year -1)
≤ 3	< 80%	0.005%
	80%-90%	0.200%
	> 90%	1.100%
4-6	< 80%	0.003%
	80%-90%	0.150%
	> 90%	0.890%
> 6	< 80%	0.004%
	80%-90%	0.150%
	> 90%	0.620%



Q2(b) Could loans within the portfolio (or alternatively, the portfolio as a whole) be considered “impaired on initial recognition”?

Q2(c) If not, how would the allowance estimate be affected by the loss curve? Considering the early loss pattern, would the allowance recognise the effect of defaults substantially expected to take place in the upcoming 3 years (which can be deemed to substantially capture lifetime expected losses), or would loss recognition be restricted to 12 month expected losses (i.e. broadly a third of lifetime expected losses) owing to perceived quality of loans within the portfolio and favorable economic prospects?

Q2(d) What factors would be considered when estimating the allowance?

### **Scenario 3: Portfolio of loans impaired on initial recognition**

- New business line: automotive financing, 5 year maturity.
- Partial amortisation: balloon payment calculated with respect to the expected value of the vehicle at the end of the financing term.
- Credit risk management: portfolio basis.
- Objective evidence of impairment (not identified with individual loans), based on thorough understanding of the market’s dynamics.
- High level of expected defaults (e.g. 20% of all loans in the portfolio) on a linear basis (4% each year).
- No expected recoveries.
- Pricing reflects high perceived risk (e.g. 15% interest rate).

Q3(a) Could loans within the portfolio (or alternatively, the portfolio as a whole) be considered “impaired on initial recognition”? Would this depend on a specific level of expected losses at the outset (i.e. the portfolio being considered impaired on initial recognition only if expected losses exceed a predetermined threshold)?

Q3(b) Would an impairment loss be initially recognised? How would the effective interest rate be computed?

### **Scenario 4: Collateralised retail financing – initial interest-only period before amortisation begins**

- New business line: retail financing, real estate collateral, 10 year original maturity, loans geographically dispersed within a country.
- High credit quality at origination, average LTCV 90%.
- Partial amortisation: interest-only payments up to year 5 / bullet payments from years 6 to 10.

- Credit risk management: portfolio basis (based on homogeneity of loans at origination) until: a) 90 days + past due; or b) borrower-specific information suggesting forthcoming cash shortfall.
- Lifetime expected loss rates (based on historical peer data for similar portfolios and economic environment): 21.3%.

Q4(a) Based on existing information, what would be the required level for the portfolio allowance?

- Behavioral patterns show high concentration of defaults on years 6-10 (nearly no defaults on interest-only payments).
- Updated peer group information shows annual loss rates for years -5 to -1 confirming behavioral patterns:

<b>Amortisation period</b>	<b>Annual loss rates (basis points, years -5 to -1)</b>
Interest-only	15 / 15 / 15 / 30 / 30
Amortising	50 / 75 / 110 / 350 / 330

- Tracking of past due status yields the following information:

<b>Past due status</b>	<b>% of total portfolio volume</b>	<b>Annual loss rates (years -2 / -1)</b>
> 90 days	6%	18% / 23%

Q4(b) Considering the updated information, how would the allowance estimate be affected by the loss curve? Bearing in mind the portfolio's loss pattern and the peculiarities of the amortisation schedule, would the allowance recognise the effect of defaults substantially expected to take place from year 6 onwards?

Q4(c) In light of the above, what would be the required allowance in years 1 to 4? Would it be restricted to 12 month expected losses, or would it be possible to somehow recognise losses above that time horizon?

Q4(d) What would be the required allowance in year 5 (i.e. just before amortisation starts)?

Q4(e) What factors would be considered when estimating the allowance?

## **Scenario 5: Retail financing - minor deterioration in credit quality**

- Stable business line: unsecured retail financing (e.g. portfolio of revolving consumer loans), stable customer base, loans originated in a single country.
- Medium-High credit quality at origination.
- Credit risk management: portfolio basis / initial segmentation based on credit score and year of origination / subsequent re-segmentation based on past due status, as follows:

Past due status	Management basis
1-30 Days	Initial segmentation
31-120 days	Re-segmentation, with loans subject to more active credit risk management
More than 120 days	Charge-off

Q5(a) Up to this point, would an allowance be required for the portfolio?

- Changing economic environment [growing unemployment rates, declining GDP and residential real estate prices, liquidity concerns, substantial productivity contraction impacting portfolio assets (due to affected industries and geographic areas)].
- Average annual loss rates:

Past due status	Annual loss rates (basis points, years -5 to -1)
1-30 days	25 / 20 / 28 / 50 / 65
31-120 days	75 / 70 / 80 / 125 / 130

Q5(b) To what extent would the allowance increase?

Q5(c) Would any information be disclosed to compare current lifetime loss expectations (i.e. after credit deterioration) with the original lifetime expected loss?

## Scenario 6: Impaired loans - improvement in credit quality

- Stable business line: unsecured retail financing, installment loans, stable customer base, loans originated in a single country.
- Medium-High credit quality at origination.
- Credit risk management: portfolio basis.
- Objective evidence of portfolio impairment: significant credit quality deterioration since inception.
- Lifetime expected loss rates (based on bank's long term experience): ranging from 10.6% (year -5) to 9% (year -3).

Q6(a) At this stage (i.e. year -3), what would be the required level for the allowance on this portfolio?

- Moderate signs of recovery in economic environment (years -2 / -1).
- Updated lifetime expected loss rates (based on historical experience adjusted to reflect recent experience, as well as economic forecasts and qualitative information): from 8.7% (year -2) to 5.1% (year -1).

Q6(b) With respect to the previous assessment, how do the updated loss rates impact allowance levels?

- Effective collection practices.
- Favorable economic indicators: decreasing defaults / improving credit quality.

Q6(c) With respect to the previous assessment, how would evidence of improvement in existing conditions impact the allowance level?

- Forecasts (supported by independent, reputable sources): GDP growth, increase in residential property prices, and improvement in unemployment rates.
- Lifetime expected loss rates (based on bank's long term experience adjusted by economic forecasts and qualitative information): 4.1%.

Q6(d) How would the credit quality improvement be recognised? If lifetime expected losses had previously been recognised, would it imply: a) a complete reversal of the corresponding allowance; b) a partial reversal that set the allowance to a balance representing the new estimate of lifetime expected losses; or c) a partial reversal that set the allowance to a residual balance representing the 12 month expected loss estimate?

## Scenario 7: Debt securities

- Business line: purchased debt securities (traded in active market), AA issuer, 10 year original maturity, 8 year remaining maturity.
- Business model: held to collect contractual cash flows.
- Credit risk management: individual basis / implied spreads and loss rates for securities of similar industry sector and rating.
- Average historical loss rate (over the last 10 years): 0.02%.

Q7(a) Would the securities qualify for the "amortised cost" category?

Q7(b) Would an allowance be required for those securities? How would it be calculated?

Q7(c) Would the impairment measurement approach change if the securities were categorised as "fair value through OCI" instead?

- After 2 years, issuer experiencing financial difficulties: 10% decline in market price, reduced trading volume.
- Rating downgrade to BBB: average historical loss rate up to 0.2%.

Q7(d) How would the change in credit quality be recognised?

Q7(e) Would the requirements for recognition of lifetime expected losses be met?

### **Scenario 8: Corporate loan – established business**

- Business line: originated loan to corporate (e.g. medium-sized road carrier).
- No previous relationship with borrower.
- According to peer statistics, medium historical loss rates in the particular segment.
- Favorable economic indicators, no signs of borrower financial difficulty.
- Borrower earnings highly dependent on oil prices.

Q8(a) Would an allowance be required for the loan? How would it be calculated?

- Political uncertainty affects some oil-producing countries.

Q8(b) Would the situation justify an increase in the recognised expected losses? Would the corresponding allowance respond to 12 month or lifetime expected losses?

- Oil price increases affecting borrower earnings.

Q8(c) Would the loan be considered impaired? How would the situation affect the allowance balance?

### **Scenario 9: Corporate loan – start-up**

- Business line: originated loan to a start-up business (e.g. bio-medical engineering firm).
- No internal or external credit history.
- Favorable economic indicators, no signs of borrower financial difficulty.

Q9(a) What factors would be considered when determining whether an allowance is required for the loan?

Q9(b) Would additional information be disclosed on the limited estimation capabilities?