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**Le Président**

JFL/PhB

N°54

**IASB**  
**30 Cannon Street**  
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**UNITED KINGDOM**

Dear Madam, Dear Sir,

I am writing on behalf of the CNC to comment on the IASB DP "*Request for Information (Expected Loss Model) Impairment of Financial Assets : Expected Cash Flow Approach*" (the "IASB DP") published on 25 June 2009.

The CNC supports the decision of the IASB to review the Incurred Loss Model currently included in IAS 39 and to analyse possible alternatives or complementary impairment approaches, such as the Expected Loss Approach, that enable earlier and more timely recognition of credit risk and related losses. The CNC shares the views of those who have criticized the Incurred Loss Model as stated in paragraph 5 of the IASB DP. The CNC considers that the principles underlying the Expected Cash Flow Approach can improve the representation of the economic effect of credit risk on revenues generated over the life of a financial asset measured at amortised cost.

The CNC notes that the G20 leaders' Declaration on 2 April 2009 included a "call on the accounting standard setters to work urgently with supervisors and regulators to improve standards on valuation and provisioning" and welcomed "the FSF recommendations on pro-cyclicality that address accounting issues", in particular the recommendation that "the FASB and IASB should reconsider the incurred loss model by analysing alternative approaches for recognising and measuring loan losses that incorporate a broader range of available credit information". The CNC also note that the ECOFIN Conclusions on pro-cyclicality on 7 July 2009 considered that "...the lack of flexibility of accounting rules in allowing for through-the-cycle provisioning have been important factors in the amplification of the financial crisis" and that "standard setters should give priority to amending current accounting rules and allowing for more flexibility for provisioning expected losses". The Basel Committee on Banking Supervision issued on 27 August 2009 "Guiding principles for the replacement of IAS 39" in response to the G20 leaders' above-mentioned call and in order to help the IASB when reviewing IAS 39. The Basel Committee highlights that one of the accounting lessons from

the financial crisis is that “the new standard should reflect the need for earlier recognition of loan losses to ensure robust provisions”. These loan loss provisions should “reflect expected credit losses in the banks’ existing loan portfolio over the life of the portfolio...allow(ing) early identification and recognition of losses...and considering the loss experience over the complete economic cycle”. The CNC considers that the IASB’s work on alternatives to the Incurred Loss Model should aim at appropriately responding to these convergent requirements and recommendations.

However, the CNC is aware that the implementation of the Expected Cash Flow Approach represents a difficult operational challenge for preparers and implies significant costs. This is not only the case for the banking industry, but also for other economic sectors which may not have internal systems at their disposal to evaluate expected losses on debt securities and receivables that they hold. Moreover, this approach raises specific application difficulties where short-term credit transactions are concerned. Therefore, we encourage the IASB to continue discussing with preparers and other stakeholders in order to carefully analyse possible simplifications or alternative approaches that could address the above-mentioned difficulties while achieving similar results and minimizing operational implementation difficulties as well as application costs. Such approaches may be inspired by techniques and methods developed when the current provisions on impairment on a collective basis were implemented.

Developed general comments have been included in part 1 of the Appendix attached to this letter to explain our views further in this respect. Our detailed answers to the Discussion Paper’s questions are set out in part 2 of the Appendix.

We hope you will find these comments useful and would be pleased to provide any further information you might require.

Yours sincerely,



Jean-François LEPETIT

## Appendix

### **1 – General comments**

#### ***1.1 - Why is a new approach on credit loss needed?***

The main objective of IFRSs is to provide information to investors on the financial situation of an entity. This includes providing in a timely manner an appropriate information on risk exposures as well as an appropriate assessment of the resulting losses.

Numerous analyses on the causes of the crisis point out that wrong assessment of risk exposure and underestimation of their expected negative consequences in terms of losses are part of the main causes of the financial crisis. It led investors, including financial institutions, to accumulate excessive risk exposures on the basis of a too optimistic view of these risks. This was particularly the case where credit risk was concerned.

IFRS cannot be considered as responsible for the mess. However, they have been blamed for not being able to appropriately reflect the necessary protection (through recognition of impairment) against growing accumulation of risks, as well as for not having sent on time explicit warning signals to investors on the related expected losses they would entail.

In the current amortized cost measurement approach in place under IAS 39, impairment tests on credit risk are based on an incurred loss approach that requires the identification of objective evidence of impairment before recognising a loss. This may have resulted in a late recognition of credit losses due to a late identification of objective evidence of impairment.

This raises the question of the ability of accounting for impairment based on an incurred loss approach to reflect and provide useful information to investors on credit risk in a timely manner. In this respect, there is a perceived need to replace or complement the current incurred loss approach used to determine impairment related to credit risk. A new approach should be able to reflect the inherent credit risk of loans, receivables and other debt instruments in a timely manner. The Expected Cash Flow Approach proposed in the IASB DP may allow significant improvements to be made in that direction, if appropriately designed and applied.

#### ***1.2 – Expected loss approach and counter-cyclical measures***

The financial crisis – as well as the preceding financial and real estate bubbles – also evidenced pro-cyclical attitudes of actors of the financial industry, who seem to be over-optimistic in good times and over-pessimistic in bad times. This resulted in these actors accumulating risks in good times by granting loans and subscribing to debt instruments on the basis of their apparent high profitability and low risk. On the contrary, these actors may currently overestimate credit risk on such financial instruments in bad times, which may result in excessive restriction of lending activities on the basis of their apparent low (or negative) profitability. Accounting rules have been accused of favouring pro-cyclical attitudes by providing an underestimated representation of credit risk in good times, as well as an overestimated representation of this risk in bad times.

Some stakeholders, especially among public authorities which are obliged to monitor the consequences of the financial crisis (FSF statements, FSA's Turner report), are willing to eliminate or reduce pro-cyclical attitudes in the financial system in order to prevent the next financial crisis.

In such a context, several proposals have been made to implement counter-cyclical measures (which need to be applied "through the cycle" to be efficient). These measures aim at providing incentives to slow down lending activity in good times, and to boost it in bad times. Some of them consist in putting aside part of profits recognised in good times and putting them back in bad times.

The Expected Cash Flow Approach developed in the IASB DP is based on a methodology that aims at assessing the inherent credit risks and related credit losses in order to improve the representation of the real economic situation of the creditors. It seems that in the IASB staff proposal, related expected losses are estimated "point in time" (i.e. based on estimate considering in which phase of an economic cycle the related loans are granted). If expected losses on a loan whose duration is equal or longer than an economic cycle are estimated using this approach, it may have counter-cyclical effects, as the calculation of these expected losses will automatically encompass an economic cycle. However, if the loan's duration is shorter than an economic cycle, counter-cyclical effects may be reduced. The "point in time" approach could even result in pro-cyclical effects if the initial estimate of the expected losses subsequently appears wrong and has therefore to be revised. This may especially be the case when short-term loans are concerned, if the assessment on the current phase of an economic cycle in which the loans are granted finally proves to be wrong. A regular reassessment of the expected losses' estimate would contribute to minimize this potential pro-cyclical effects. An estimate of the expected losses using a "through the cycle" approach (i.e. based on statistical historical data which encompass an economic cycle) may also have more counter-cyclical effects.

### ***1.3 – Rationale of the Expected Cash Flow Approach***

The current requirement to identify objective evidence of impairment before recognising a loss may result in explicit recognition of the credit risk at a late stage compared to the whole duration of the lending transaction. However, the credit risk exposure begins as soon as the loan is granted and the lender is completely exposed to this risk at inception of the loan and until maturity. This credit risk cannot be completely eliminated through the selection of borrowers. Therefore, the lender generally monitors credit risk through mutualization techniques on a large number of borrowers.

Credit risk is generally charged to the borrower from the beginning through the contractual interest rate. For a given borrower's credit risk profile, the importance of the risk is influenced by the duration of the loan (generally the longer the duration, the higher the risk) and the pricing of the credit risk is based on such an analysis. Risk premiums are generally recognised as income, as part of interest, on an accrual basis, whereas the incurred credit losses they are supposed to offset will be recognised when they occur over the life of the loans. This creates a timing mismatch between the recognition of the revenue and the expense that this revenue aims to offset.

Exposure to credit risk is generally concentrated in specific kinds of entities (mainly financial institutions), whose core business is to grant loans and manage the related credit risk. In particular, they have developed experience in mitigating this risk over a large number of borrowers. Therefore, their loan portfolios expose them to a global credit risk that is almost certain, while the probability of credit risk on each loan granted remains low<sup>1</sup>.

In order to improve information provided to investors on credit risk, it seems justified to have an accounting mechanism that will provide timely recognition of expected credit losses, taking into account the premises described above. As such a mechanism meets the objective of general purpose financial statements, it is appropriate to recognise it in the profit and loss account. This recognition procedure will also prevent a timing mismatch between the recognition (as revenue on an accrual basis) of the credit risk premium included in the interest rate charged to the borrower and the recognition of the related credit loss.

This mechanism should use information from the internal credit risk assessment systems that are available, if any. These kind of systems have already been developed by banks and other credit institutions for regulatory purposes (prudential expected losses approach<sup>2</sup>) but also – and in priority – for their own needs to consistently assess and price credit risk, which is a crucial objective for them. Moreover, these entities are generally obliged to develop internal control and audit procedures to check the robustness of their internal credit risk assessment systems (regulations on internal control), which are also normally reviewed by prudential supervisors and to some extent by external auditors. Therefore, these internal credit risk assessment and measurement systems can be considered as the most robust and reliable information available on credit risks for lending activities. The objective of providing the most reliable and complete information on credit risk to users of financial statements may be fulfilled by recognising credit losses on this basis than by using estimates made by other parties which have not the same information systems at their disposal.

#### ***1.4 – Application difficulties for the Expected Cash Flow Approach***

As mentioned in the cover letter, entities outside the banking sector may not have at their disposal internal systems that would allow them to reliably estimate expected losses on debt instruments that they hold. They have generally not developed sophisticated internal credit risk assessment systems similar to those developed by banks, which have a strong incentive to invest in such kind of systems through Basel II prudential requirements. Therefore, entities other than banks may have more difficulties in assessing expected losses on their held debt instruments.

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<sup>1</sup> this reasoning is similar to the one used in paragraph 24 of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* when obligations are concerned “Where there are a number of similar obligations...the probability that an outflow will be required in settlement is determined by considering the class of obligations as a whole. Although the likelihood of outflow for any one item may be small, it may well be probable that some outflow of resources will be needed to settle the class of obligations as a whole. If that is the case, a provision is recognised”.

<sup>2</sup> We may nevertheless note that the prudential requirements in terms of prospective assessment of credit risk have been limited to a one year horizon when Basel II was under discussion. Current assessment techniques must go beyond this time horizon.

Moreover, the Expected Cash Flow Approach, as described in the IASB staff papers, is designed primarily to be applied to lending activities, where the creditor can generally directly assess the credit risk profile of the debtor. Specificities related to the assessment of expected losses on debt securities or receivables, which are generally the kind of debt instruments held by insurance companies or corporate entities, may have not be addressed appropriately. Some specificities can be illustrated as follows.

Debt securities are generally issued and acquired in a way that results in the holder having no direct regular contact with the debtor. Therefore, the holder generally has no direct access to detailed information on the debtor. Reliable external sources of information are therefore needed to enable the holder to precisely assess the credit risk profile of the debtor and the related expected losses. The availability and quality of these sources of information may vary to a large extent depending on the type of debt securities concerned, as well as on the visibility of their issuer.

Receivables are generally short-term credits, for which the distinction between incurred and expected losses could be difficult to assess on a loan-by-loan basis. A forward-looking assessment of the risk profile of the debtor (in fact the customer/client) would be necessary, but may be difficult to undertake, especially if the clients concerned are not regular ones. The issue of considering the potential effect of roll-over credit facilities with regular clients on the estimation of expected losses should also be clarified. Finally, receivables generally do not include interest charges, which make an effective interest rate approach neither justified nor practicable.

There are also specific difficulties in applying the Expected Cash Flow Approach to short-term credits, even in the banking industry. There may be historical statistics available, that will enable an assessment of the level of expected losses “through the cycle”. However, when the duration of a credit is shorter than the duration of an economic cycle, there is a debate on whether the expected losses should be calculated using a “point in time”<sup>3</sup> method rather than “through the cycle”<sup>3</sup>. When expected losses are estimated using a “point in time” method, the main issue is to assess in which phase of the economic cycle the entity granting the loans is. This kind of exercise has proven to be extremely difficult to undertake, even by skilled and experienced economists. Therefore, calculating expected losses on short-term credits using a “point-in-time” method seems very uncertain in practice. It may not result in a reliable assessment of the inherent credit risk of the loans concerned and may not provide other expected benefits, for example in terms of forward-looking information. On the contrary, when expected losses are estimated using a “through the cycle” method, the estimate may be more reliable, as there would be no need to make difficult assumptions on the current phase of the economic cycle where loans are granted. However, the average expected loss amount calculated “through the cycle” may not correspond exactly to the amount of losses expected in the phase of the economic cycle in which a short-term loan is granted and fully reimbursed. This may generate difficulties in following up the use and reversal of the related expected loss provisions. This concern may be alleviated if the roll-over of short-term loans that generally occurs and mutualisation of credit risk premiums charged over time are taken into consideration.

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<sup>3</sup> As defined in the last paragraph of part 1.2

But more fundamentally, it would be extremely costly to apply the Expected Cash Flow Approach on individual loans when a very large number (millions) of loans are concerned, especially when using an effective interest rate method. This implies that portfolios of extremely homogeneous loans (in terms of credit risk profile) should be defined narrowly. Then, maintaining the homogeneity of these portfolios as well as ensuring the appropriate use or reversal of the expected loss provisions would be major issues. One possible approach to address these two above-mentioned issues could be to design portfolios by generation and/or by maturity. However, designing such kind of “closed” portfolios would oblige financial institutions to distinguish and follow up a very large number of portfolios (several hundred thousands in big commercial banks). Another way to design portfolios would be to focus on types of credit and risk profile to ensure their homogeneity without considering initiation date or maturity. These “open” portfolios will be continuously renewed with loans falling due removed and newly granted loans included. These kinds of portfolios raise significant practical issues, such as the necessity to reassess the measurement of expected losses on a regular basis in order to check if their homogeneity is not altered over time. It will also be more difficult to follow up the effective use or reversal of the related expected loss provisions, as the portfolio will roll over permanently.

It may be noted that a “point in time” expected loss approach seems easier to apply to “closed” portfolios whereas a “through the cycle” expected loss approach seems more consistent with “open” portfolios.

### ***1.5 – Conclusion on the Expected Cash Flow Approach***

As a conclusion, the CNC considers that the principles underlying the Expected Cash Flow Approach are conceptually sound and could contribute to a significant enhancement of information provided to users on a timely manner on credit risk and related credit losses compared to the current Incurred Loss Approach. It may also create incentive to better assess and price credit risk in lending activities by reflecting in a timely manner the negative impact of an underestimate and miss-pricing of this risk on net revenues. However the method developed by the IASB staff in order to apply this approach, i.e. based on an effective interest rate including the effect of expected losses applied to individual loans, results in most cases in very significant implementation problems and excessive application costs.

The complex implementation issues and application costs of this method may be reduced if applied by banks that already have sophisticated internal credit risk assessment systems in place and benefits related to this method may appear greater when applied to long-term loans (mortgage loans or loans granted to companies for capital investment) the duration of which is equal or longer than the duration of an economic cycle.

However, in most cases and especially where short-term loans, receivables or debt securities are concerned, as well as in non-banking sectors, the application difficulties and operational costs would clearly not be balanced by the expected lower benefits. The IASB should therefore analyse with constituents simplified or alternative approaches that will minimize these difficulties and costs while ensuring that the principles and merits of the Expected Cash Flow Approach are preserved.

One way to address these issues could be to apply - at least on short-term loans, debt securities and receivables - a simplified expected loss approach that may re-use techniques and methods already developed when implementing the current IAS 39 provisions on impairment made on a collective basis. Adaptation of these techniques and methods in order to achieve results similar to those that would be reached through the approach developed by the IASB staff may represent a balanced solution in terms of application costs versus information benefits. Some proposals are developed in response to Question 6 in this respect.

## **2 – Answer to the specific questions**

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

Our main comment would be to keep the approach principles based. As situations may be significantly different from one entity to another, especially between banking and non-banking activities but also within a given sector and depending on the type of credit concerned, it is not desirable to define detailed technical prescriptions that would be mandatory for all preparers. The accounting provisions should only ensure that techniques used by preparers are compatible with the general principles of the Expected Cash Flow Approach and provide consistent results. As an example, preparers should be free to decide how to design portfolios on the basis of which expected losses will be estimated, provided that estimation techniques, recognition process and timing, as well as follow up of the related expected losses are consistent with the general approach.

However, some guidance would be useful on how to refer to existing and available external data that could be used to estimate expected losses when the entity does not have an internal credit risk assessment system (which would be the case of many non-banking entities which hold debt securities) or when there is a lack of historical statistics on certain kinds of credit transactions (new products or markets, lack of data on certain countries). It could also be useful to have details on how historical data may be updated/amended by new information. In such a respect, indications included in the current AG 89 of IAS 39 may be re-used.

### **Question 2 : Is the approach operational (i.e. capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?**

As explained in part 1.5 of this Appendix, the Expected Cash Flow Approach as described by the IASB staff may be operational in certain circumstances by some banks which have developed sophisticated internal credit risk assessment systems (in particular in order to meet Basel II prudential requirements) and only if applied to long-term loans, such as mortgage loans and loans granted to companies for capital investments, whose duration is longer than the duration of an economic cycle. Even in such cases, application difficulties and operational costs would be very significant.

However, in most cases, the Approach is not operational, especially when short-term credits granted by banks, receivables held by corporate, or debt securities held by insurance companies are concerned. Difficulties in implementing the method, undue application costs and uncertainty about the reliability of the expected loss calculation, as explained in part 1.4 of this appendix, would reduce the added value of the information provided and will not ensure an appropriate balance between costs and benefits. In particular, the application of this approach on an individual basis is not operational. The application on portfolios designed through their origination date and/or maturity will also be extremely costly, especially for big banks (several hundred thousands portfolios to be designed and followed).

Proposals to make the Approach operational are described in our answer to question 6 (simplifications).

**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?**

Some preparers (big banks) have indicated that implementation costs may reach tens of millions euros per bank, not to mention operational recurrent costs. And the implementation period may require up to 3 years.

**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.**

Our preliminary comment would be to have a principles based approach. Preparers should be allowed to apply the method they would prefer, assuming that the different methods applied are consistent with the general principles and will achieve results that would not be significantly different.

#### **Amortisation of upfront costs**

We support Approach A, as it would be easier to implement and the resulting differences with Approach B, which is conceptually more “pure”, would generally not be significant.

#### **Impairment of variable rate instruments**

We would prefer Approach B, which consists in fixing the initial expected credit spread while resetting the variable interest rate, as it is less complex to apply than Approach A.

**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?**

Our preliminary comment would be to have a principles based approach. Preparers should be allowed to apply the method appropriate to their business model and information system, assuming that these different methods are consistent with the general principles and will achieve similar global results.

Methods described in (b) could be applied as an incurred loss on an individual loan would normally materialize the expected losses initially assessed at the level of the portfolio, assuming that this assessment is reliable. Such a process would avoid changing the design of the portfolio and the resulting necessity to reassess the measurement of related expected losses, assuming that the incurred loss was “expected”.

However, an impaired loan should be removed from the portfolio if it materializes a wrong initial assessment of the homogeneity of the portfolio or a subsequent deterioration of its homogeneity due to changing conditions.

One may also find merits in removing impaired loans from a portfolio in order to more easily distinguish and monitor these loans. It may correspond to management practices that monitor impaired loans separately from non-impaired loans.

In any case, specific information on incurred loss on individual loans is considered by our constituents, preparers as well as users of financial statements, as useful information that should continue to be provided.

**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?**

One operational simplification would consist in recognising expected losses collectively on a specific line rather than changing the outstanding amount of each loan.

Another simplification would consist in not imposing the Expected Cash Flow Approach to short term debt instruments such as receivables. In such cases, the distinction between expected and incurred losses could be very thin and would not result in significant differences in related outstanding amounts. Moreover, as interest is generally not charged on receivables, there is no recognition of credit risk premium that could result in an accounting mismatch between revenues recognised on an accrual basis and incurred credit losses recognised later. Finally, it may be difficult and costly to predetermine the credit risk profile of the generally numerous clients concerned, especially if they are not regular ones, in comparison to the amounts of debt concerned. Therefore, one simplification could consist in allowing the Incurred Loss Model to be maintained on short term debt instruments, where differences between incurred and expected losses are not significant.

More generally, as explained at the end of part 1.5 of this Appendix, a practical solution would be to allow entities to apply a simplified or alternative method that may re-use techniques and methods already developed when implementing current application of IAS 39 provisions on impairment made on a collective basis. Adaptation of these techniques and methods in order to achieve results similar to those that would be reached through the approach developed by the IASB staff may represent a balanced solution in terms of application costs versus information benefits. One significant adaptation would consist in removing the requirement of identifying a loss event (objective evidence of impairment) that should occur between the initial recognition and the closing date or the reporting period, when analysing impairment on a collective basis. Such a simplification would be particularly beneficial when applied to loans or other debt instruments whose duration is shorter than an economic cycle.

The main characteristics of a simplified or alternative method, which would aim at ensuring the same global objectives as the proposed Expected Cash Flow Approach (enhanced and earlier information provided on credit risk exposure and related losses, timing matching between recognition of expected losses as expenses and related charged credit risk premiums as revenues) would be:

- **application based on debt instruments portfolios** (loans, securities, ...), that share similar credit risk profiles at initiation resulting in an appropriate degree of initial homogeneity of the designed portfolios where credit risk is concerned; this would avoid huge operational costs that an application based on individual loans would generate; entities should be free to determine how to best define these homogeneous portfolios by applying their professional judgment in a principles based approach; for example, banks may use the portfolios' segmentation they have defined under Basel 2; there is a debate on how portfolios should be designed, as described in the sixth paragraph of part 1.4 of this Appendix:
  - designing “open” portfolios (continuously renewed with loans falling due removed and newly granted loans included) would avoid a very large number of portfolios to be distinguished and followed up; it also seem easier to assess and apply expected losses estimated “through the cycle” to “open” portfolios;
  - designing “closed” portfolios (defined by generation or maturity and followed up until their extinction) would ease the following up of these portfolios and related expected loss provisions including the use and reversal of these provisions; it also seem easier to assess and apply expected losses estimated “point in time” to “closed” portfolios;

If the objective is to respond in the best possible manner to the concerns of the G20 leaders and ECOFIN on pro-cyclicality, as well as to follow the recommendations of the Basel Committee<sup>4</sup>, a “through the cycle” approach should be favoured and consequently, designing “open” portfolios may be more appropriate in such a respect;

- **expected losses estimated on the outstanding amount of the portfolios (but recognised on an accrual basis)** on the basis of the best (statistical, historical, rating or other credit profile analysis...) information available, in particular on the basis of internal credit risk assessment systems developed to fulfil Basel 2 prudential requirements, if any; there is also a debate on the basis for estimating expected losses, as described in the last paragraph of part 1.2 and fifth paragraph of part 1.4 of this Appendix:
  - **if the expected losses are estimated “through the cycle”**, historical data would be those related to the type and period of debt instruments concerned, but on statistical series that should encompass at least one economic cycle and therefore may be longer than the related period of these debts; this should avoid the difficulty of assessing in which phase of the economic cycle the entity granting the loan or holding the debt instrument is;
  - **if expected losses are estimated “point in time”**, historical data would be those related to the type and period of debt instruments concerned considering the phase of the economic cycle where the loans are granted; this would facilitate the following up of the use and removal of these provisions over the life time of the related loans;

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<sup>4</sup> G20 leaders' and ECOFIN's requirements and Basel Committee's recommendations are mentioned in the cover letter

If the objective is to respond in the best possible manner to the concerns of the G20 leaders and ECOFIN on pro-cyclicality, as well as to follow the recommendations of the Basel Committee<sup>5</sup>, a “through the cycle” approach should be favoured;

- **recognising expected losses on an accrual basis**, which would ensure a time match between recognition of credit risk premium in revenues and related expected losses; this will avoid recognising day one losses, which are not justified from an economic point of view on lending contracts whose economic terms are at market;
- **re-estimation of expected loss parameters recognised through a catch-up adjustment**, as the offsetting credit risk premium initially charged in the contractual interest rate cannot generally be adjusted consistently;
- **subsequently, where “open” portfolios are concerned, expected loss provisions increase proportionally to the increase of the outstanding amount of the related debt instruments; this increase is accrued on the basis of the average maturity of the debt instrument portfolios**; this would provide a simplified approximation of the global effects of changes in the portfolios (including inclusion of new granted loans, removal of repaid loans or impaired loans that would be followed up separately and the older maturity of remaining loans) as well as of the time match between recognition of credit risk premium on new loans as revenues and the related expected losses;
- **subsequently, where “open” portfolios are concerned, expected loss provisions decrease proportionally to the decrease of the outstanding amount of the related debt instruments; this decrease is recognized immediately**; this would represent a simplified approximation reflecting the reduced risk exposure resulting from the decrease of the outstanding amount of held debt instruments and ensure a consistency between the reduction of subsequent credit risk premium received and related expected losses.
- **Subsequently, where “closed” portfolios are concerned, monitoring of the use and reversal of expected loss provisions should be made portfolio by portfolio until the extinction of the related portfolios**; if appropriately estimated, these provisions will finally correspond to the cumulated incurred losses occurring over the life of the related portfolios materialized by no collection of part of the contractual cash flows.

We may add that, on first time application, expected losses on outstanding amounts of debt instruments portfolios should be recognised through equity in the opening financial situation. This is the usual way to retrospectively apply new accounting standards. The potential impact of this first time application may be reduced depending on the level of incurred losses already recognised in the closing balance, assuming that the Expected Loss Approach is complementary to the Incurred Loss Approach.

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<sup>5</sup> G20 leaders’ and ECOFIN’s requirements and Basel Committee’s recommendations are mentioned in the cover letter