



Accounting Standards Board

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24 March 2011

Dear Françoise

EFRAG DCL on IASB's Supplementary Document "Financial Instruments: Impairment"

This letter sets out the views of the UK Accounting Standards Board (ASB) on the EFRAG Draft Comment Letter (DCL) on the IASB's Supplementary Document "Financial Instruments: Impairment".

We attach a copy of our response to the IASB which sets out our views on the proposals in the IASB Supplementary Document. In overview, the ASB is greatly encouraged by the IASB and FASB's efforts to answer the calls of the G20 and others across the globe to develop consistent accounting standards for loan impairments that took expected losses into account. We are also encouraged by the efforts put in by the IASB to address concerns raised by constituents about the operational difficulties of implementing its original proposals to open portfolios. In particular, we note that the proposals in the Supplementary Document:

1. by decoupling the recognition of credit losses from the EIR calculations the IASB have made the model operationally feasible; and
2. the separate treatment of impairment depending on whether it is part of the good book or the bad book is an improvement that recognises the credit risk management approach adopted businesses. This split recognises that in the good book entities are mainly concerned with income recognition whereas in the bad book the main concern is the recovery of cash

On the concerns raised in the covering letter of the DCL:

- In principle, we agree with your concern that the 60-day comment period is insufficient to assess the additional requirements in the supplementary document. However, in our view a more worrying concern is the lack of any field testing of the proposals either by the two boards or by constituents (due

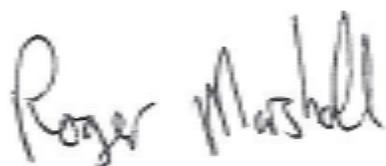
to the timing of the comment period coinciding with the year end reporting pressures for most constituents). As mentioned in our response to the IASB we believe that this lack of field testing could lead to significant changes to the final standard being identified after it has been issued.

- Although we note your concern with the common approach proposed in the supplementary document we do not agree that the proposals are not of a sufficiently high quality. As you will note from our covering letter we also have concerns with some of the detailed elements of the proposal. However, we believe that in overview the IASB and FASB have taken a significant step in the right direction by arriving at common approach that deals with the operation concerns raised by constituents on the IASB's original proposals. We also note that significant amount of time and effort has already been spent by the IASB and FASB project teams, the two Boards as well as constituents in considering the a number of different and original approaches to impairment of financial assets held at amortised cost. There have been problems with all of these stand-alone models which have proved difficult to solve. We believe this is the reason the two boards have adopted a pragmatic approach that maintains the quality of the IASB approach in the main but addresses its short-comings by the use of the floor. As a result, we do not agree that further time should be spent on arriving at yet another original model; instead, we would prefer that focus shifts on field testing and removing any unintended consequences in this common proposal. We recommend that, on this issue EFRAG specify exactly the nature of its concerns so that efforts can be made to resolve these issues.
- We would also refer you to our letter where we raise a number of other concerns with the IASB proposals.

We have responded to the questions for constituents in the DCL in the appendix to this letter, although we would also refer you to the appendix to our response to the IASB for more detail on our views on the detailed aspect of IASB's proposals.

If you would like to discuss these comments, please contact Seema Jamil-O'Neill on 020 7492 2422 or myself on 020 7492 2434.

Yours sincerely



Roger Marshall
Interim Chairman, Accounting Standards Board

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Appendix: Comments on Requests for information in the DCL

Question on Page 8 of EFRAG DCL after paragraph 33 of Appendix B

- E1 Do constituents believe that a consistent impairment approach for the determination of impairment allowances for financial assets carried at amortised cost is preferable to multiple approaches? Why or why not?
- E2 Do constituents believe that the proposals are at least as operational for financial assets carried at amortised cost other than those managed within open portfolios (e.g. assets managed in closed portfolios and individual assets)? Why or why not?
- E3 Do constituents believe that the proposals are operational for portfolios other than loan portfolios (e.g. bond portfolios?)

1. The ASB believes that a consistent impairment approach for the determination of impairment allowances for all financial assets carried at amortised cost is preferable to multiple approaches. The fact that multiple approaches to impairment are included in IAS 39 is a major source of criticism and confusion for users. We believe a single approach is preferable to users as it reduces the ambiguity around the impairment allowance included in an entity's financial report.
2. we believe that these proposals are at least as operational for financial assets carried at amortised cost other than those managed within open portfolios (e.g. assets managed in closed portfolios and individual assets). After all, the original proposals, which have been adapted in this supplementary document, were considered to be just as easily applicable for closed portfolios and individual assets.
3. We believe that some thought needs to go into how these proposals will be applied to bond portfolios and gilts. In particular, we are not certain how expected losses will be assessed for such portfolios.

Questions on Page 11 of EFRAG DCL after paragraph 52 of Appendix B

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|----|---|
| E4 | Do constituents believe that requiring a time-proportionate approach that allows loan loss profiling can deal with the issue of an early loss emergence scenario? |
| E5 | Do constituents believe the proposed approach is operational? If not, would you recommend a different approach? |
| E6 | Would the proposed approach for determining the impairment allowance be operational outside the financial services industry? |
| E7 | Would the proposed approach provide decision useful information? If not, how would you modify the proposals? |

1. We do not agree that requiring a time-proportionate approach that allows loan loss profiling can deal with the issue of an early loss emergence scenario. This is partly because it incorporates another layer of subjectivity into a calculation that already requires a significant level of judgement to be applied.
2. We believe that the proposed approach is more operational than that proposed by the IASB in its original ED. We do believe that a significant amount of field testing is required to iron out any unintended consequences and to make some of the language used in the guidance more appropriate to entities other than those in the financial industry. Having stated that, we do believe that the proposed approach for determining the impairment allowance is operational outside the financial services industry and can easily be adapted for short term receivables.

Question on Page 13 of EFRAG DCL after paragraph 62 of Appendix B

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|----|---|
| E8 | Are the definitions of 'good book' and 'bad book' consistent with the existing practice for credit risk management? Why or why not? |
| E9 | Are these definitions an appropriate driver for the application of the two different approaches to the recognition of expected credit losses? Why or why not? How would you suggest to amend these definitions? |

3. We believe the definitions of 'good book' and 'bad book' to be consistent with the existing practice for credit risk management for not only financial institutions but also non-financial institutions. We have no significant concerns with the these definitions, although we do believe that some changes are required to make them applicable to non-financial institutions as well.

Question on Page 16 of EFRAG DCL after paragraph 73 of Appendix B

E10 Do you believe that impracticable to determine the effective interest rate or an approximation thereof for particular portfolios of financial assets carried at amortised cost? For which particular types of portfolios do you expect it to be lower?

4. We have been unable to find any field testing by constituents to enable us to evaluate whether impracticable to determine the effective interest rate or an approximation thereof for particular portfolios of financial assets carried at amortised cost. We also do not believe that there is sufficient information in the supplementary document to perform meaningful modelling without making some significant assumptions which may or may not have been considered by the two Boards.

Question on Page 18 of EFRAG DCL paragraph 82 of Appendix B

E11 Are constituents aware of specific instances where it would be impracticable to discount expected credit losses even if it were calculated on a simplified basis? If so please provide examples of such situations in addition to the explanation of why it would be impracticable.

E12 Are constituents aware of instances where it would be impracticable to determine the effective interest rate or an approximation thereof for particular portfolios of financial assets carried at amortised cost? If so please provide examples of such situations in addition to the explanation of why it would be impracticable.

5. We are not aware of specific instances where it would be impracticable to discount expected credit losses even if it were calculated on a simplified basis.
6. We understand from our constituents that it is impracticable to determine the effective interest rate for open portfolios of financial assets carried at amortised cost. This is a concern due to the requirement to re-evaluate the expected losses and the impairment charge at each reporting date which would entail the recalculation of the effective interest rate on the basis of the assets held in the portfolio on that date.

Question on Page 20 of EFRAG DCL paragraph 92 of Appendix B

- E13 The G-20 Finance Ministers and Central Bank Governors called for convergence towards a single set of high-quality, global, independent accounting standards on loan-loss provisioning and the impairment and valuation of financial assets. They encouraged the IASB to take account of the Basel Committee guiding principles on IAS 39 and the report of the Financial Crisis Advisory Group.
- E14 To understand the possible broader impacts of the proposals in the Supplementary Document, EFRAG would like constituents to comment on whether or not they believe the proposals:
- (a) result in useful information to users in general;
 - (b) promote a level playing field;
 - (c) are pro-cyclical;
 - (d) give rise to regulatory issues or concerns; or
 - (e) have other macroeconomic effects.

7. The ASB believes that the common approach in the supplementary document in general results in useful information to users and if adopted by both boards would result in a level playing field.
8. We do agree that the proposals are likely to result in some pro-cyclicality in the impairments recognised in an entity's income statement i.e. in the event of a crisis the increase in provisions is likely to be sharper than is the case for incurred losses. This is because the crisis is likely to have an impact on both the expected losses and the expected lives of the financial assets. Furthermore, it will be difficult to provide reasonable and supportable information to support a reduction in the loss allowance once the crisis has peaked. We believe this pro-cyclicality is a function of a forward looking impairment allowance based on expected losses and would prevail regardless of the approach chosen.
9. Depending on how the "foreseeable future" is defined we understand that it is possible for banks complying with Basel II to have a higher accounting loan loss allowance (if the foreseeable future is longer than 12 months) than that for regulatory purposes (which would be based on 12 months). This extra allowance will be a deduction for the banks' Tier 1 regulatory capital but the excess amount would only be permitted to be added back to the Tier 2 regulatory capital. Given that Basel II is only applicable for European banks we believe that it is more preferable that a regulatory rule change would be the easiest way to deal with this in the event that this requirement is retained by the IASB in the final standard.

Question on Page 22 of EFRAG DCL paragraph 102 of Appendix C

E15 Do constituents believe that it would be operational to apply the proposed impairment requirements to all loan commitments that are not accounted for at fair value through profit as well as financial guarantee contracts? Why or why not?

10. Yes the ASB believes that it would be operational to apply the proposed impairment requirements to all loan commitments that are not accounted for at fair value through profit as well as financial guarantee contracts. Please refer to the answer to question 15Z and 16Z in the appendix to our response to the IASB.

Question on Page 25 of EFRAG DCL paragraph 114 of Appendix C

E16 Do constituents believe that the proposed disclosure requirements are appropriate?

11. The ASB has raised a number of concerns with the disclosure requirements included in the supplementary document. Please refer to the answer to question 18Z in the appendix to our response to the IASB.



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Sue Lloyd
International Accounting Standards Board
30 Cannon Street
London
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24 March 2011

Dear Sue

Re: Supplementary Document “Financial Instruments: Impairment”

I am writing to you on behalf of the UK’s Accounting Standards Board (ASB) to comment on the International Accounting Standards Board’s (IASB’s) supplementary document “Financial Instruments: Impairment”.

The ASB welcomes the IASB’s and the FASB’s efforts in trying to develop a common approach in this key area of financial reporting. We are greatly encouraged by the two Boards’ efforts to answer the calls of the G20 and others across the globe to develop consistent accounting standards for loan impairments that take expected losses into account. We are also encouraged by the efforts put in by the IASB to address concerns raised by constituents about the operational difficulties of implementing its original proposals to open portfolios. In particular, we note that:

1. in decoupling the recognition of credit losses from the EIR calculations the IASB has made the model operationally feasible;
2. the separate treatment of impairment depending on whether it is part of the good book or the bad book is an improvement that recognises the credit risk management approach adopted by businesses. This split recognises that in the good book entities are mainly concerned with income recognition whereas in the bad book the main concern is the recovery of cash; and
3. some commentators are concerned that the proposals are likely to result in some pro-cyclicality in the impairments recognised in an entity’s income statement i.e. in the event of a crisis the increase in provisions is likely to be sharper than is the case for incurred losses. This is because the crisis is likely to have an impact on both the expected losses and the expected lives of the financial assets. Furthermore, it will be difficult to provide “reasonable and supportable” information as evidence for a reduction in the loss allowance once the crisis has peaked. We believe this pro-cyclicality is a function of a forward looking impairment allowance based on expected losses and would prevail regardless of the approach chosen.

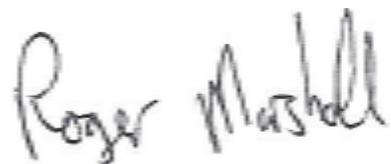
However, we believe that the concerns listed below need to be addressed before a final standard can be issued in this area.

1. We understand that the IASB is still working to its original June 2011 deadline for completion of their financial instruments project as a whole. The current outstanding issues that would need to be completed before the standard can be finalised is long and includes: the final solution to netting of financial instruments and the associated disclosures; the general and portfolio hedge accounting model; the final solution on impairment that is applicable to all different types of financial instruments; an overview of all the new disclosures introduced by the different phases of the project and how they interact with each other and the current requirements in IFRS 7; and a review of consequential changes to other standards. Given that the final standard on financial instruments will be applicable for financial institutions as well as corporate entities we believe some of the language would also need to be amended to ensure it is meaningful for all types of entities. As a result, we do not believe that the IASB deadline is achievable without compromising the quality of the final product. We also note that in certain areas the IASB's decision making is further ahead than the FASB. Therefore, the ASB would recommend that the IASB revise its timetable to ensure that a quality converged solution can be developed for financial instruments as a whole.
2. In the context of the amortised cost and impairment phase of the project, the ASB is concerned about the lack of a single impairment solution for all financial instruments. One of the main criticisms levelled at the impairment requirements in IAS 39 is that they differ depending on the nature of financial instrument. The ASB would recommend that the two Boards attempt to develop not only a common solution in this area but that it should be applicable to all different types of financial instruments. We believe that with some modifications, which we note in the Appendix to this letter, the common approach is applicable to the majority of financial assets held at amortised cost. Therefore, we would recommend that time is spent to ensure that a single solution is achieved as far as is feasible.
3. We note that the financial assets carried at amortised cost form a large part of the balance sheets of financial institutions as well as being a significant balance for non-financial entities too. This means that the level of impairment allowance and the changes booked to the income statement can have a significant impact on an entity's profitability. We note however, that due to the deadline set by the IASB and the sixty day comment period on this supplementary document there has been little field testing of the proposals, by the two boards or the constituents. We also note that a number of aspects of even this limited scope document have yet to be defined (see Appendix to this letter for details). We believe that this is likely to have a significant impact on the eventual quality of the standard issued. We are concerned that rushing the current draft through to final standard may lead to amendments subsequent to issuance for problems identified during the implementation phase.

4. The ASB believes that the concept of the floor is a pragmatic solution which not only provides an answer to the question of how to ensure sufficient impairment allowance is built up for financial instruments with early loss patterns but also helps provide the two Boards a window of opportunity to arrive at a converged solution on this issue. But we go on to note that, the notion of “foreseeable future” needs clear definition in the context of IFRS. In our response to question 9, in the appendix to this letter, we recommend that this be defined as a set period after the date of the statement of financial position or reporting date. We believe that this would make the result from entities more comparable and reduce the potential for earnings management in this key area of financial reporting which requires a significant use of judgement. We would recommend that both boards revisit these concepts.
5. The ASB would also like to raise concerns about the amount of unnecessary choice and application of judgement permitted in the proposals for an area that already requires significant levels of management judgement. The proposals as they currently stand permit that: loan allowances can be based on expected losses or the floor; expected losses can be calculated using a straight line or annuity approach; the expected losses can be discounted or undiscounted; etc. As a general rule, the ASB believes in principles-based standards. However, given that there is insufficient clarity in how some aspects of the proposals fit in with the principle of amortised cost accounting, we are concerned that the amount of choice could be counterproductive. We believe it may lead to an increase in complexity for users and provide earnings management potential to preparers.
6. We are concerned that some of the disclosure requirements in the supplementary document are excessive and are likely to lead to information in the financial statements that is not decision useful to users. We would recommend that clear disclosures of the methodology and inputs used to calculate the allowance for the good book would enhance its reliability from the point of view of the users.
7. We would also recommend on a general note that, close to the end of the project on financial instruments, there should be review of all the new disclosures introduced by the different phases of this project as well as those in IFRS 7 to ensure that there is no overlap of disclosures which could be presented once and in a simpler way.
8. Finally, although there is no specific mention of transition arrangements in the supplementary document the ASB would caution against quick implementation for this phase of the financial instruments project. Given the significant increase in the loan loss allowance expected as a result of the implementation of these proposals the two Boards should ensure that sufficient time is available to constituents for implementation purposes after the issue of the final standard.

Should you have any queries on the above please do not hesitate to contact me on 020 7492 2434 or Seema Jamil-O'Neill on 020 7492 2422.

Yours sincerely

A handwritten signature in black ink that reads "Roger Marshall". The signature is written in a cursive style with a large initial 'R'.

Roger Marshall
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APPENDIX - RESPONSES TO THE DETAILED QUESTIONS IN THE INVITATION TO COMMENT

Question 1

Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (i.e. delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

1. The ASB believes that the revised impairment model proposed in the supplementary document goes some way to addressing the concerns raised with the IASB's model proposed in its ED "Financial Instruments: Amortised Cost and Impairment". The ASB also agrees that the proposed model will go a long way to dealing with one of the main criticisms levelled at the impairment approach in IAS 39 i.e. delayed recognition of expected credit losses during the crisis.
2. We also believe that in decoupling the recognition of credit losses from the EIR calculations the IASB has made the model operationally feasible. The separate treatment of impairment depending on whether it is part of the good book is also an improvement that recognises the credit risk management approach adopted by a vast majority of businesses.
3. However, we have some concerns with certain elements of the proposals which are discussed in more detail in answers to the questions that follow.

Question 2

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

4. Another criticism levelled at the impairment model in IAS 39 is that it proposes different impairment requirements depending on the type of instrument held by an entity. This has led to complexity in accounting and reporting for preparers as well as making the resulting accounting difficult to understand for users.
5. The ASB therefore advocates the use of a single impairment model for all financial instruments carried at amortised cost. We believe that this can be achieved through the use of the same accounting objective which can then be simplified for the less complex financial instruments.

6. We believe that the proposed model, which decouples the credit loss from the EIR calculation and requires separation between the good and bad book loans, is operational for a number of different financial instruments including: those managed in closed portfolios; groups of loans managed collectively; groups of loans managed individually; and short term receivables.
7. We would, however, recommend that the IASB look to simplify some of the language used in the guidance to the ED to ensure that the requirements are just as applicable for non-financial entities as they are for financial ones.
8. Additionally, we believe a significant amount of field testing is required to identify the applicability of detailed aspects of the model to non-corporate entities which may not have sophisticated credit management systems with the years of historical credit information as some banking entities are likely to have. Such field testing would further enable the two Boards to fine tune the model for non-financial entities.

Question 3
Do you agree that for financial assets in the 'good book' it is appropriate to recognise the impairment allowance using the approach described above? Why or why not?
Question 4
Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?
Question 5
Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

9. The approach described in the Supplement requires that expected credit losses on financial assets in the "good book" would be recognised on a portfolio basis over a time period at the higher of the time-proportional expected credit losses and the credit losses expected to occur within the foreseeable future (the "Floor"). The ASB notes that this "higher of" approach is a pragmatic solution that attempts to ensure that the expected credit losses for the financial assets held in an open portfolio are recognised at the earliest possible opportunity. As such, the ASB believes that the common approach will ensure that expected losses are recognised on all financial assets held in an open portfolio, regardless of the pattern of expected losses.
10. Another concern is in relation to the lack of information on some of the detailed aspects of the proposed model. We understand that no decision has been made yet on how the expected cash flows are to be used as the basis for calculating the time-proportional expected credit losses. Furthermore, the time-proportional expected credit losses are to be calculated using a choice of two very different methodologies: a straight line basis or an annuity method. In paragraph IE4 it is stated that the supplementary document does not describe how to measure expected losses nor does it explain how to calculate weighted average age or weighted average life "as these are commonly understood concepts". The ASB would suggest that these may be commonly

used concepts within some financial institutions but that they are not commonly used by non-financial entities.

11. We discuss the concept of the 'floor' in more detail in the answer to questions 9 and 10 where we have some more detailed suggestions. However, in the context of this common approach our suggestion would be to consider the objective for amortised cost accounting and the role played by the impairment allowance for expected losses in achieving that objective. The original IASB ED "Financial Instruments: Amortised Cost and Impairment" defined the objective of amortised cost measurement as providing "information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the *financial instrument*." Given this objective it is difficult to understand how the concept of the floor based on the losses over the 'foreseeable future' complies with this objective. In particular, the explanation of what foreseeable future might constitute in paragraph B11 of the supplementary document seems to imply that it has more to do with "best estimate of credit losses expected to occur in the future time period for which specific projections of events and conditions are possible". Paragraph B12 of that document goes on to note that an entity will use all "reasonable and supportable information" to develop its forecast of future events. Therefore, we have difficulty in understanding the link between the original objective based on the expected life and the concept of the floor based on the best estimate concept and requiring reasonable and supportable information to develop the forecast. If the two Boards are to continue to use the concept of the floor, and there may be many valid reasons for doing so, we would suggest that further consideration needs to be given to this issue before the standard can be finalised. (we consider this issue in more detail in the answer to questions 9 and 10, including the reasons for having the 'floor' and how the 'foreseeable future' may be defined.)
12. The above considerations also lead us to wonder how reporting entities would explain the impairment allowance thus calculated to users of financial statements in an understandable way, in particular, if the floor is applicable one year and the time-proportional expected credit losses the following year.
13. We further note that, due to the timing of this supplementary document and the short comment period neither financial institutions nor the non-financial institutions have had sufficient time to perform any meaningful field testing. Aside from the recommendations from the Expert Advisory Panel the two Boards themselves do not appear to have performed much field testing of the common model during their deliberations either. We do not consider this to be satisfactory given the enormity of the numbers involved and the likely impact on some financial institutions' profitability (financial assets at amortised cost currently form approx 30-45% of total assets for the largest banks in the UK and the impairments charged to the P&L in 2008 ranged from almost 400-38% of profit after tax). This lack of field testing could lead to changes to the standard after publication and initial application.

Question 6

Is the requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

Question 7

Is the requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If not, how could it be made more operational and/or auditable?

Question 8

Do you agree with the proposed requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

14. The ASB agrees with the proposed requirement to differentiate financial assets carried at amortised cost between the two group for the purposes of the determining impairment allowances. We believe that this approach is consistent with the way vast majority of entities manage their portfolios of financial assets. We also believe that recognition and measurement based on the way an entity manages its business can help the users understand the management's approach to running the business, in this case the credit management policies adopted.
15. Furthermore, the ASB also believes that the concept of the good and bad books and operation of it described in the supplementary document is equally applicable for financial and non-financial entities as well as financial assets that are not managed as part of an open portfolio including short term receivables.
16. However, as noted in the answer to the preceding questions, we would suggest that the IASB consider the language used in the supplementary document to ensure that it doesn't read like guidance only for a financial institution. We believe that field testing of the final proposals with some non-financial institutions would greatly help modify the language to make it more widely understood by entities of all types and levels applying IFRS.

Question 9

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

- (a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?
- (b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?
- (c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?
- (d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?
- (e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.
- (f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

Question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

'Floor' for the good book

- 17. The ASB believes that the concept of the floor is a pragmatic solution which not only provides an answer to the question of how to ensure sufficient impairment allowance is built up for financial instruments with early loss patterns but also helps provide the two Boards a window of opportunity to arrive at a converged solution on this issue. On this basis, we would support the notion of the floor.
- 18. However, as already mentioned in our answer to questions 3,4 and 5 above, we believe that further thinking is required by the two Boards in relation to this concept and the resulting reporting of an entity's performance measurement.
- 19. We also understand that the review of the impairment allowance on each reporting date will ensure that it is only built up to the extent that a loss is expected to arise or as indicated by the floor and that any excess amounts will

be released on that date. We do not believe this has been clearly outlined in the current Supplementary document and would need to be addressed before the final standard is issued.

Defining the 'Foreseeable future'

20. We believe there are considerable problems in trying to implement the notion of "foreseeable future" in the context of IFRS. The only time there is evidence of the use of such a notion in the context of financial reporting relates to references when considering accounting for tax and in the consideration of the going concern basis for a reporting entity.
21. The way 'foreseeable future' is described in the supplementary document we believe that it is closer to the consideration of an entity's going concern basis. This is because it requires the development of projections by considering "past events, historical trends, existing conditions, and current and future economic events and trends to evaluate and project these of circumstances that will prevail in the future." A similar exercise is undertaken when an assessment is made of an entity's going concern basis. However, the later is required to be considered for a period of twelve months from the date of the issuance of a company's results.
22. Given the time-proportional basis would ensure that an expected loss allowance is built up over the expected life of the financial instrument, we believe that the role of the floor in the common approach should be limited to ensuring that only the losses arising over and above the time-proportioned expected amounts up to the end of the following reporting period should be taken into account. As a result, we think that the concept of the floor naturally aligns itself to the notion of going concern and so the foreseeable period should not be any longer than that considered for the notion of going concern.
23. We also believe that there is considerable earnings management potential in the proposal given potential for additional subjectivity in deciding what might constitute foreseeable future for different economic conditions, markets, financial instruments and entities. For economic conditions that are fairly volatile e.g. in emerging markets it may be difficult to make an accurate assessment of future trends beyond twelve months. The UK economy pre-credit crisis could be described as stable and so five year predictions could easily be made. However, during the credit crisis it was difficult to make predictions from one month to the next. As a result we believe that if the concept of foreseeable future is left unspecified then lots of different interpretations will be made by entities depending on the markets they operate in and the financial assets they carry at amortised cost.

Other considerations

24. Additionally, the requirement in paragraph B12 of the supplementary document to use "reasonable and supportable" information in developing forecasts of future events and conditions is difficult to understand and does

not appear to be in line with the IASB's conceptual framework qualitative characteristics of relevance, faithful representation and verifiability.

25. Due to the timing of the consultation we have been unable to accumulate sufficient information to determine whether the floor would typically be equal to or higher than the amount calculated under the time-proportional expected loss calculations. However, we believe that this will depend on:

- the expected cash flows included when calculating the expected losses,
- how these are calculated i.e. best estimate or the present value of cash flows,
- whether or not discounting is permitted,
- the timing of the expected losses i.e. losses beyond the expected life may or may not be ignored in the calculation of the floor, etc.

26. We believe that significant field testing is required to understand this issue in practice. But before undertaking such field testing the two Boards will need to be clear in their rationale for the inclusion of the floor in the calculation of an impairment allowance.

Question 11

The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

- (a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?
- (b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

27. In principle, we support the discounting of credit losses as it takes into account the time value of money for longer dated financial assets, which are typically held at amortised cost. The need for discounting is dependent on the expected lives of the financial assets i.e. expected lives of longer than a couple of years will clearly be impacted by discounting. As stated in our answers to the previous questions, whether the credit losses are discounted or not will make a difference to the reported number; discounting would take the time value of money into account but incorporating it would mean that the amount reported is less than the undiscounted amount.

28. However, we believe that whether or not discounting is permitted is tied in with the issue of whether or not expected lives of financial assets change as a result of economic conditions. Recent experience shows that the expected lives of financial products such as mortgages, which are often managed in open portfolios, lengthened considerably during and after the credit crisis as banks began looking more closely at their credit exposures and the range of available products declined considerably. Such changes in expected lives would lead to a significant change in the impairment allowance as the same

amounts of expected losses are time-proportioned over a longer period. Discounting would further complicate this situation as the discounting would also be adjusted for the change in expected lives.

29. We have also been informed by some constituents that discounting at any rate other than the risk free rate is operationally problematic; it requires entities to reassess the effective interest rate for financial instruments held in the open portfolio at the reporting date, something that has always been difficult to calculate.
30. We would recommend that a risk free rate is mandated if discounting is required by the final standard. However, we are aware that this is a cross cutting issue for a number of IFRSs currently under development. We would therefore recommend that, IASB ensure cross cutting agreement on whether or not expected cash flows are discounted and the applicable rate for IFRS across the board and, in particular, in relation to the financial instruments, insurance and fair value measurement projects.

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (i.e. to recognise expected credit losses over the life of the assets)? Why or why not?
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31. The ASB believes that the changes described in this supplementary document to the original IASB model are a considerable improvement and would make the requirements more operational. We are concerned that, the IASB-only approach does not appear to address the early loss pattern demonstrated by a number of financial instruments carried in open portfolios.
32. However, we support the general concept of recognising expected credit losses over the life of a financial asset. We believe that this approach would help overcome the criticisms levelled at the impairment model in IAS 39 i.e. it did not permit early recognition of losses that entities were fully expecting to arise and that, as a result, the performance of the entities was overstated at the outset of the financial crisis.

Question 13

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (i.e. to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?
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33. We have already raised our concerns with the concept of the floor and the notion of the foreseeable future in the answers to questions 9 and 10. We see the floor as having a minimal role in the common approach to the extent that

it addresses the concern with the IASB-only model of not recognising sufficient impairment allowance for financial assets with early loss patterns.

34. We believe that the FASB model moves away from the way entities price and manage their credit risk by requiring all foreseeable losses to be incorporated immediately. Financial entities base their lending decisions on an assessment of the credit worthiness of their counterparty. Any expectations of losses at the outset are reflected in the pricing decision over the life of the product resulting in a clear symmetry between the interest earned on those assets and the expected credit losses. Similarly, most corporate entities are likely to assess pricing and payment days on the basis of the counterparty's credit worthiness. As a result, we believe that severing the link between the credit risk and the interest earned is not an adequate reflection of the economics of the transactions undertaken by the entities.
35. The FASB approach also does not differentiate between the good and bad books. Some commentators consider this to be a simplification, however, we believe that this approach combines the good loans, that are less likely to suffer losses, and bad ones, where losses are almost certain and the only question is how much. Such differentiation and how the management manages the risk on the two very different types of loans is important information for users in assessing the management's competence. By adopting this approach the FASB is depriving the users of valuable information.

Question 14Z

Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

36. The ASB agrees that for open portfolios the determination of effective interest rate should be separate from the consideration of expected losses on the basis that it is not cost effective to operationalise combining the two in a single calculation.

Question 15Z

Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

Question 16Z

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?
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37. We understand that most constituents that are financial entities tend to manage loan commitments together with other items in open portfolios i.e. certain types of undrawn credit card commitments are managed together with credit cards with existing balances. This is because these commitments

can be drawn at any time and once drawn tend towards an early loss pattern. Therefore, we believe that it is appropriate to subject loan commitments whether within IFRS 9/ IAS 39 or IAS 37 to be subject to the same impairment requirements.

38. We are not aware of any operational difficulties with the application of the proposed requirements to loan commitments and financial guarantee contracts.

Question 17Z

Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?

39. The ASB believes that the proposed presentation requirements are appropriate for the model proposed in the supplementary document. The separation presentation of interest income from credit losses would ensure that users are provided clear information on these two very important elements that impact the profitability of financial assets carried at amortised cost.

Question 18Z

(a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?

(b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?
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40. The ASB welcomes the inclusion of credit risk and impairment disclosures that go beyond the basic listing of maximum credit exposures and collateral held that are currently required by IFRS 7. In particular, we are pleased to see that the disclosures will provide more information on the links between the nominal amounts of the financial assets and the allowance carried by an entity as required by paragraph Z7 of the supplementary document.

41. We have some concerns about the level of disclosure required, set out below, which we would recommend that the IASB address prior to issuing the final standard. In particular:

- a. We are not convinced that the requirements for paragraph Z8 to provide five year table of impairment allowance history is necessary. Instead, we would recommend that summary quantitative information based on an entity's risk management of its exposure to credit risk is required (as currently required by paragraph 34 in IFRS 7).
- b. We are not sure why the information required per paragraphs Z12 on the comparisons between previous expected credit losses and the actual outcomes is relevant. Given that the reconciliations of changes

during the year in the allowance as required by paragraph Z7(a) would already provide this information in a more useful manner.

- c. We are also not certain of the relevance of the tabular disclosure required by paragraph Z14 based on an entity's credit risk grades. Such internal grades are likely to have little significance for users and would require extensive disclosures of how the ratings are arrived at and managed to make them meaningful for users.

Question 19Z

Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

- 42. We agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups. A prerequisite for managing financial assets as part of a portfolio is that individual assessments of creditworthiness are not made until specific information is available about the changes in credit worthiness. As a result, separating out the exact amount of the expected credit loss for a particular financial asset is not in line with how these portfolios are managed.