EFRAG
European Financial Reporting Advisory Group

Financial Instruments: Amortised Cost and Impairment Summary of feedback received in outreach on the IASB's Supplementary Document

Background

1 On 31 January 2011, the IASB published a supplementary document to its November 2009 Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (hereafter 'the supplementary document'), to address concerns about operational difficulties of some proposals in the original exposure draft. The supplementary document included proposals for accounting for impairment of financial assets managed in an open portfolio. The supplementary document was issued as a joint proposal with the FASB, to ensure common impairment solutions.

2 In preparing its response to the IASB on the supplementary document, EFRAG carried out various outreach activities from February to March 2011. The objective of the outreach was to collect input from European constituents, mainly from preparers, regarding conceptual accounting issues as well as practical and implementation challenges arising from the proposals included in the supplementary document. The outreach programme included the following activities:

(a) Discussion Forum on Financial Instruments held jointly with the IASB in Brussels on 28 February 2011 (please see the detailed feedback included in the report published on EFRAG's website http://www.efrag.org/files/EFRAG%20public%20letters/SD%20Impairment/Financial_Instruments_Discussion_forum_-_28_February_2011_final.pdf); and

(b) A survey that was based on a questionnaire followed up by an interview with selected preparers.

3 The input received during the outreach activities was considered in finalising EFRAG's response to the IASB on the supplementary document.

4 The purpose of this document is to provide a summary of the key messages received in the survey conducted as part of the outreach activities on the supplementary document. This document was prepared by EFRAG staff solely for the convenience of the European constituents.

Scope of the survey

5 EFRAG staff surveyed twenty preparers, including sixteen banks, two insurance companies, one corporate and one European industry organisation. The IASB and/or the FASB staff participated in the majority of the interviews.

6 The geographical split of the participants in the survey is depicted below:

	Responses
Austria	1
Belgium	1
Denmark	2
Europe	2
France	2
Germany	6
Italy	2
Spain	3
Sweden	1
Total	20

7 The survey covered the following topics:

(a) Characteristics of the portfolios and the scope of application;

(b) Distinction between the good book and the bad book;

(c) Proposed impairment model: time-proportional expected credit losses, floor, good/bad book classification;

(d) Scope of application of the proposed model; and

(e) Costs and benefits of the model.

Executive summary

8 The following key messages were received from European constituents that participated in the survey conducted as part of the outreach activities:

- *General support for the proposals in the supplementary document* – the proposals in the supplementary document received a broad support, in particular the proposed operational solutions based on decoupling of interest income and credit losses. The new concepts of 'open portfolios' and the distinction between the 'good book' and the 'bad book' were welcomed, because they are aligned with the way, in which loans are generally managed by commercial banks.

- *Disagreement with the 'higher of' approach and the floor* – the model with a floor does not retain the link between recognition of interest and credit losses. That link is lost when the allowance is based on the floor and a spike in the provisions might be recognised. Concerns were also raised about the concept of 'foreseeable future'.

- *Consistent accounting treatment for similar economic events* – it was noted that the impairment model proposed in the supplementary document, which is based on decoupling of interest income and credit losses, should be applied

consistently to all financial assets measured at amortised cost. However, concerns were expressed about the direct applicability of the model to individual assets, bonds and outside the banking sector.

- *Testing the model* – preparers that participated in the survey could not perform a detailed quantitative assessment of the expected impact of the proposed model on the existing portfolios, because of the time constraints and a number of uncertainties around the implementation of the model. Only preliminary qualitative assessment was available at this stage.

Overall feedback

Characteristics of the portfolios and scope of application

Views expressed by banks

9 The majority of banks expressed support for a single impairment model that would be applied to closed and open portfolios as well as to individual items. They provide the following reasons in support of their view:

(a) to keep the impairment process operational and avoid complexity;

(b) to avoid cherry picking;

(c) to ensure that the total amount of provisions is independent of the segmenting process: 'The size of the cake should not depend on the way you cut it'.

10 Commercial banks largely use open portfolios for managing the loans in their banking business. The commercial banks that participated in the survey confirmed that the use of closed portfolios is limited to discontinued activities, to some portfolios acquired after their origination, or to cases of product-oriented business (e.g. credit cards or consumer credit).

11 One participant representing a bank noted that the expected loss model proposed in the supplementary document is designed for portfolios. Therefore, that participant advocated the use of the proposed model, which is based on the partial catch up allocation, for both open and closed portfolios. The main argument for his view was that open portfolios consist of single exposures with similar information available, and therefore the same methodology could be applied to all types of portfolios.

12 However, when items are managed on an individual basis, some would prefer the option of a strict application of the original expected cash flow model. In addition, an investment bank noted that the proposed impairment model based on decoupling of credit losses and interest income would be appropriate for portfolios, as it addresses the practical issues, however it would not be appropriate for assets managed on an individual basis, as for those assets it is possible to allocate the credit losses to a specific timing in the future. This participant suggested that an annuity approach would be more appropriate for individual assets, and that the final standard should allow it.

13 In general, participants representing banks believed that the proposed impairment model would be operational for originated loans, as well as for bonds and other acquired securities for those entities that follow the internal ratings-based approach under Basel II and therefore have information about risk parameters

available. However, that might not be the same for entities that follow the standardised approach under Basel II.

14 In addition, banks provided the following comments:

(a) The proposed impairment model should also be applied to loan commitments (this is consistent with the feedback provided by the IASB's Expert Advisory Panel);

(b) It is not clear how the proposed approach could be applied to acquired loans, individual non-significant loans and short-term receivables, because it is unlikely that historical data or other relevant parameters would be available for those items. Therefore, simplifications should be considered;

(c) The 'time-proportional' approach is not appropriate for assets that are managed on a closed portfolio basis, unless the losses incurred on the loans belonging to that portfolio are taken into consideration.

Views expressed by other preparers

15 The majority of the participants advocated a *single* expected loss model for all financial instruments, including open and closed portfolios as well as individual instruments.

16 Some participants expressed concerns about application of the model outside the lending industry, particularly to investment portfolios of bonds held by insurance companies.

17 One company noted that the supplementary document scopes out short-term trade receivables and that they would be subject to requirements of the new revenue standard, once it is finalised. That company stressed that the current practice in relation to classification of credit losses on trade receivables in profit or loss should not be changed, and that they should be recognised as an operating expense rather than as a reduction of revenues. That company believes that the current practice best reflects the way in which credit risks and losses on trade receivables are managed by the most companies, and that it results in the more useful information to users about revenues and the level of economic activity.

'Good book' and 'bad book'

18 Overall, the banks that participated in the survey supported the proposed split into the good book and the bad book as an operational solution. However, other preparers were less optimistic.

19 Participants, in general, confirmed that for the purposes of the recognition of the entire amount of expected losses in the bad book, entities will generally continue to rely on the same triggers that are currently used under the incurred loss model and that in practice the time-proportional approach would not change the recognition of impairment losses in relation to the bad book. However, unlike IAS 39 *Financial Instruments: Recognition and Measurement*, the new model will require recognition of an additional allowance for a portion of the losses expected to occur over the life of the instrument.

Views expressed by banks

20 The definition of the 'good book' and the 'bad book' in the supplementary document is broadly consistent with the existing banking practice for managing the credit position and capital requirements and for accounting for impairment. At banks, these internal processes are generally set up to comply with the requirements of Basel II. Although the requirements in Basel II are more detailed and granular, the definition of default in it is broadly consistent with the underlying concept of the supplementary document (i.e., the change of business strategy towards the recovery of the investment). Being broadly consistent with the existing practices, the proposed classification is considered operational.

Accounting consequences of the classification as a 'bad book' loan

21 In general, when a credit assessment indicates that there might be difficulties with a particular loan (for example, starting with the 'watch list' status) and/or the loan is transferred to the bad book, the full amount of the expected loss on that loan is provided for. Usually, in creating this provision only specific risks are considered.

22 One bank described its process for estimating the discounted cash flows for the impairment of bad loans, as follows:

(a) for individually significant defaulted customers, the credit losses are projected on individual basis by the risk managers;

(b) for individually insignificant defaulted customers, the credit loss calculation is done on a statistical basis using Basel II parameters (for example, probability of default, exposure at default, loss given default).

Usage of the provisions

23 In general, when a loan is transferred from the good book to the bad book, the related part of the portfolio provision is released to profit or loss, and the amount of provision is determined on an individual basis. A number of participants expressed concerns about the absence of specific guidance on the usage of provisions and on the assessment of losses for the good book at a portfolio level, after a transfer of loans from the good to the bad book.

24 Two banks noted that it would not be feasible to allocate the initial estimate of the expected loss to a specific loan in the good book, because generally, a provision for the good book is created on a statistical undifferentiated basis for a large number of loans with similar characteristics. Therefore, only a proportional allocation of the provision in the good book would be practicable. One of these two banks also observed that when a portion of the initially expected credit loss in respect of the good book is allocated to a loan that is subsequently moved to the bad book, it would be difficult to demonstrate that it is appropriate to move more than a proportional amount of the provision (i.e., other than the crystallisation of the expected loss for the good book) and thus recognises a decrease in the amount of the provision for the good book.

25 One bank expressed a concern that a provision for the good book would only be reduced if the expected loss is decreasing or if the portfolio is in a run-off situation while in a steady state situation; the provision would hence not be usable.

Migrations from the bad to the good book

26 Two banks observed that some loans can move from the bad to the good book, for example, following a successful restructuring and a given observation period. The following comments were made:

(a) Attention should be given to the restructured loans, which are considered 'bad' loans in accordance with Basel II, but from a credit management perspective are usually transferred back to the good book.

(b) The requirement in paragraph Z7(c) of the supplementary document to disclose the nominal amounts of loans for which there has been a modification of contractual terms needs further clarification. It is not clear whether this requirement relates to the loans that are re-classified back from the bad book to the good book or whether it is limited to the restructured loans. Further examples of this disclosure should be developed in the final standard.

Views expressed by other preparers

27 One company noted that it used a similar to the good-bad book concept for the internal management purposes, and therefore the general distinction between the good and the bad book seemed to be operational.

28 Some companies were concerned that the criteria for the bad book were not sufficiently flexible to reflect different risk management approaches that could exist in practice. While risk management activities of a corporate could be similar to those of a financial institution, they are not necessarily the same. In addition, approaches to the management of financial assets could significantly vary between entities. Some companies believed that this fact was not adequately considered in developing the proposals in the supplementary document.

29 The insurance companies noted that the distinction between the good book and the bad book, as proposed in the supplementary document, would be operational for the lending business, but it would not be operational for the investment business (e.g., bonds held as part of an investment portfolio), due to the differences in the nature of these businesses, in particular, in respect of the recovery strategy and the access to information. One insurance company referred to the academic literature, which provided evidence of the information advantage that banks as private lenders have over public bondholders.

30 The insurance companies suggested that the IASB conducts outreach and consults with preparers and regulators outside the banking sector prior to finalising the IFRS, as the implementation of the 'good' and the 'bad' book concept may be a more costly and more challenge for non-banks.

Decoupling and time-proportional allocation of expected credit losses

Views expressed by banks

31 In general, banks believed that the impairment model based on the integrated effective interest rate, as originally proposed in the exposure draft, was not operational. Conversely, they believed that the impairment model based on decoupling, without a floor, as proposed in the supplementary document:

(a) represents a major simplification of the impairment model proposed in the exposure draft,

(b) helps to reduce operational complexity while trying to align the timing of recognition of interest income and expected credit losses; and

(c) should be applied not only to open portfolios, but also to closed portfolios and individual financial assets.

32 One bank noted that in addition to the time-proportional expected credit losses approach, the IASB's Expert Advisory Panel considered various alternatives, which would result in decoupling of interest income and credit losses.

Appropriateness of the time-proportional expected credit losses approach

33 The majority of banks supported the proposed time-proportional expected credit losses approach, as it allows reflecting the existing link between the timing of recognition of interest income and credit losses to the extent possible. It was observed that it is almost impossible to align perfectly the timing of recognition of interest income and expected credit losses, as by definition, future interest is not being recognised. The time-proportional expected credit losses approach is considered to be a reasonable solution for reaching the initial objective of reflecting that link.

34 The following additional comments about the proposed time-proportional expected credit losses approach were provided:

(a) this approach is operationally feasible;

(b) the calculation can be explained and produces results that are comparable; and

(c) this approach results in an earlier recognition of credit losses compared to the current incurred loss model.

35 Notwithstanding the broad support for the proposed time-proportional expected credit losses approach, a number of banks observed that the time-proportional allocation results in a non-linear (double declining) recognition of expected losses and for this reason it would break to some extent the link between pricing of the asset and losses recognition. In fact, this approach achieves a simplified partial catch-up approach (i.e. deferral to the future of some of the changes in credit loss estimates and immediate recognition of some of the changes in estimate) and it does so because it accelerates the recognition of residual expected credit losses. As a result, the time-proportional approach produces an accelerated recognition of the credit losses, compared to the original expected cash flow model, for which the IASB did not foresee a partial catch-up mechanism.

36 Those banks would prefer a simple forward-looking approach, under which the remaining expected credit losses would be allocated over the remaining life of the instruments on a straight-line basis, without the accelerated recognition or simplified partial catch-up, as proposed in the supplementary document.

The issue of early loss emergence patterns

37 The Boards considered the introduction of a floor in the time-proportionate component of the model, because the time-proportional approach may not create a sufficient allowance in an early loss emergence scenario.

38 Participants of the EFRAG's survey generally did not consider the floor to be an appropriate way of dealing with early loss emergence patterns. In particular, they considered that the economic cycle and the presence of a form of collateral have a far greater impact on the actual losses than loan loss profiles over the lives of the loans. In addition, banks do not currently monitor the expected loan loss profile for open portfolios and data on loss patterns is only available in limited cases or for some product types. It was also observed that for open portfolios in a steady-state environment, the potential insufficient allowance for early loss patterns would not be a major issue, as the time-proportionate allocation would already create a buffer. Finally, some observed that if the entity has specific information about a loss pattern, this is similar to estimating incurred losses and should be treated as provision in the bad book.

39 Some suggested that, instead of introducing a floor, the time-proportionate approach should be adjusted either

(a) including an accelerated recognition of losses for special products, if the information is available, or

(b) providing for the excess of foreseeable losses over expected losses, and not for the full amount upfront.

40 However, others noted that the possibility to develop the time-proportionate approach further in that direction had been abandoned by the IASB, because it would over-complicate the model.

Views expressed by other preparers

41 The time-proportionate approach does not appear to be immediately applicable to corporate activities: the possibility to rely more on external data or to develop a simplified approached might need to be evaluated.

42 A corporate commented that the current model cannot be considered a simplification. The FASB approach might come closer to fulfilling all objectives. An insurance company doubted that the proposed approach could work for bonds.

The higher of: the time-proportional amount and the floor

Views expressed by banks

43 Overall, banks believed that the proposed approach requiring a comparison of the time-proportional amount with the amount of credit losses expected to occur within a foreseeable future (the 'floor') in order to determine the 'higher of' amounts for the allowance, was rather complex. In addition, concerns were expressed that two separate calculations had to be done regularly, and that switches could occur between the time-proportional amount and the floor from period to period. This would make information rather complex to understand for the users. The main concerns in relation to the 'higher of' approach included the following:

(a) The 'floor' approach would not reflect faithfully the economics underlying the lending transactions as it would lead to 'day one' losses. The floor is considered to be conceptually inconsistent with the time-proportional expected credit losses approach. It is also considered to be disconnected from risk management practice and pricing of the loans. The link between recognition of interest income and credit losses would be lost, when the allowance is based on the floor and a spike in the provisions might be recognised.

(b) Some believe that the time-proportional amount for the 'good book' plus the full amount of expected losses for the 'bad book' would be sufficient to ensure the adequate and the timely coverage for future losses. In addition, a credit allowance for the 'good book' represents a buffer. When actual losses occur, they are usually fully provided for within the 'bad book' and the buffer that is built up in the 'good book' would not be used.

(c) Two different concepts for expected loss allowances (the time-proportional amount and the floor) make the impairment model overly complex. The possibility of switching between the time-proportional amount and the floor from period to period could be misleading for users, and could impair consistency overtime, potentially with unpredictable results. For example, for users it will be difficult to interpret what the carrying amount represents in terms of measurement attribute. In addition, preparers might find it difficult to rationalise the switch from the time-proportional approach to the floor approach at different reporting dates.

(d) It would add complexity and costs, by requiring two separate sets of estimates and calculations without a clear benefit. For example, manual journal entries and multiple calculations of the credit losses would have to be done. It would be inappropriate to have three different types of estimates of the expected losses, including the estimate for the entire life of the instrument, the estimate for the next twelve months (performed for Basel II purposes) and the estimate for the foreseeable future, if different from the previous two, and to reconcile the different figures.

(e) The model has two layers of subjectivity: one attached to the estimate of the expected losses for the entire life of the portfolio and the other attached to the foreseeable future amount.

(f) The 'floor' (with a foreseeable future period of more than twelve months) could easily dominate the impairment model in most circumstances of the European lending industry. As a result, the link between recognition of interest income and credit losses would be lost.

<u>'Foreseeable future'</u>

44 In general, significant concerns were expressed about the term 'foreseeable future' that was introduced in the supplementary document, as it was considered to be unclear, too vague, and not operational, and to rely on a subjective assessment. Concerns have been expressed about the judgement required (i.e. how to substantiate its forecasts and make them auditable).

45 In addition, the length of the foreseeable future period could vary between different portfolios, between different entities and between different phases of the business cycle. It was suggested that if the time period for the floor is not predetermined,

then divergent practices could arise, thus reducing comparability and resulting in the less useful information for the users.

46 It was observed that the estimation of losses for the 'foreseeable future' does not reflect current practice; in fact, the existing practice is mainly based on one-year budgeting processes or Basel II estimations through-the-cycle. Some participants in the survey recommended adopting a predefined period of twelve months (in line with budgeting or Basel II processes).

Impacts of the floor and quantitative assessment

47 In general, preparers that participated in the survey confirmed that they were only able to produce a preliminary qualitative assessment of the model proposed in the supplementary document, because of time constraints. A number of participants observed that there were several uncertainties around the implementation of the model, preventing them from performing a proper assessment. In particular, they felt that a number of elements needed to be clarified, before the impact of the proposals could be assessed in detail. Such elements included the definition of the 'foreseeable future', the transfer of allowance from the good book to the bad book, more detailed guidance on the measurement of the expected losses, guidance on weighing external and entity-specific data, historical data against current economic conditions and supportable forecasts.

48 Despite the absence of quantitative evidence for understanding when – and for which portfolios – the allowance would be based on the floor or on the time-proportionate approach, preliminary analyses suggest that if the floor is set at twelve month maximum, its impact would be limited.

49 One bank noted that it was not feasible to develop a final opinion on the impairment model proposed in the supplementary document without a full overview of the new accounting standard on financial instruments as all other outstanding parts of the standard also need to be taken into consideration.

Views expressed by other preparers

50 The views on a minimum period of twelve months varied. One company argued that the requirement for the foreseeable future to be a minimum of twelve months might not be operational in all situations. For example, during the 2009 economic crisis, many companies were not able to prepare forecasts for a period longer than one or two quarters. It was noted that in difficult economic conditions entities would not be able to provide reasonable estimates for a long period; while in stable economic conditions it would be feasible to preparer forecasts for a period of twelve months or for a longer period. In addition, that company also argued that prescribing a minimum period of twelve months is setting a rule, which might not be in line with the principles-based approach of IFRS. Conversely, one insurance company that participated in the survey supported the clear guidance (i.e., the minimum twelve month period) and believed that it would be more operational. In addition, another company suggested that a set period for the foreseeable future would result in comparable figures and therefore would be more useful for the users. That company suggested that the definition of the foreseeable future should be 'the next twelve months unless a longer period can be justified'.

51 Another constituent commented that for evaluation on an individual basis the allowance determined by the floor might be higher than that resulting from the application of the annuity approach.

52 The views on the 'floor' proposals were split as well. One company believed that the floor should always be considered. Conversely, another company believed that the floor should be considered only if there is evidence of an early loss pattern; however that company admitted that such approach would be very difficult to apply.

Cost and benefits: has the balance been achieved?

53 Overall, banks and companies that participated in the survey were concerned about the additional costs resulting from a requirement to perform two separate calculations for impairment purposes on regular basis.

54 In addition, concerns were raised about the subjectivity of inputs required for calculations, especially in relation to the early loss pattern and foreseeable future. To reduce such subjectivity and costs associated, one bank proposed to solve the early loss patterns issue by adjusting the inputs for time-proportional calculation (age or life).

55 Some participants believed that the benefit of the model proposed by the IASB is a reasonable trade off between:

(a) reflecting the economics underlying lending transactions,

(b) achieving an operational solution without undue complexity[1] and

(c) ensuring that an appropriate proportion of expected future losses is provided for.

56 In general, banks that participated in the survey considered that the starting point for the implementation of the model will be the existing process for measuring the capital requirement for credit risk, which is based on an estimate of one-year 'through-the-cycle' expected losses. This mechanism is relatively sophisticated for those banks that apply the internal rating based approach. These banks have received supervisory approval to use the internal rating based approach and rely on internal estimates of risk components in determining the capital requirement for a given exposure. Less sophisticated banks that have not implemented the internal rating based approach measure their capital requirement using the standardised approach (i.e. based on fixed parameters).

57 However, operational challenges will emerge to generate, via robust processes:

(a) the expected losses for the entire life of the assets, starting from the one-year losses estimated for Basel II requirements and to

(b) adjustments from the through-the-cycle estimates into point-in-time estimates; and

(c) weighted average life and average age of the portfolios.

58 Preparers observed that to a certain extent, similar processes may exist as part of the budgeting process (i.e. forecasting the cost of risk in the coming year), for

[1] challenges in implementing and adjusting the parameters while the elimination of the decoupling represents a substantial improvement

performance measurement (i.e. return on risk adjusted capital) and for pricing the loans at origination, but significant system and process changes may well be required. However, the efforts are deemed to be lower than in the case of implementation of a strict expected cash flow model.