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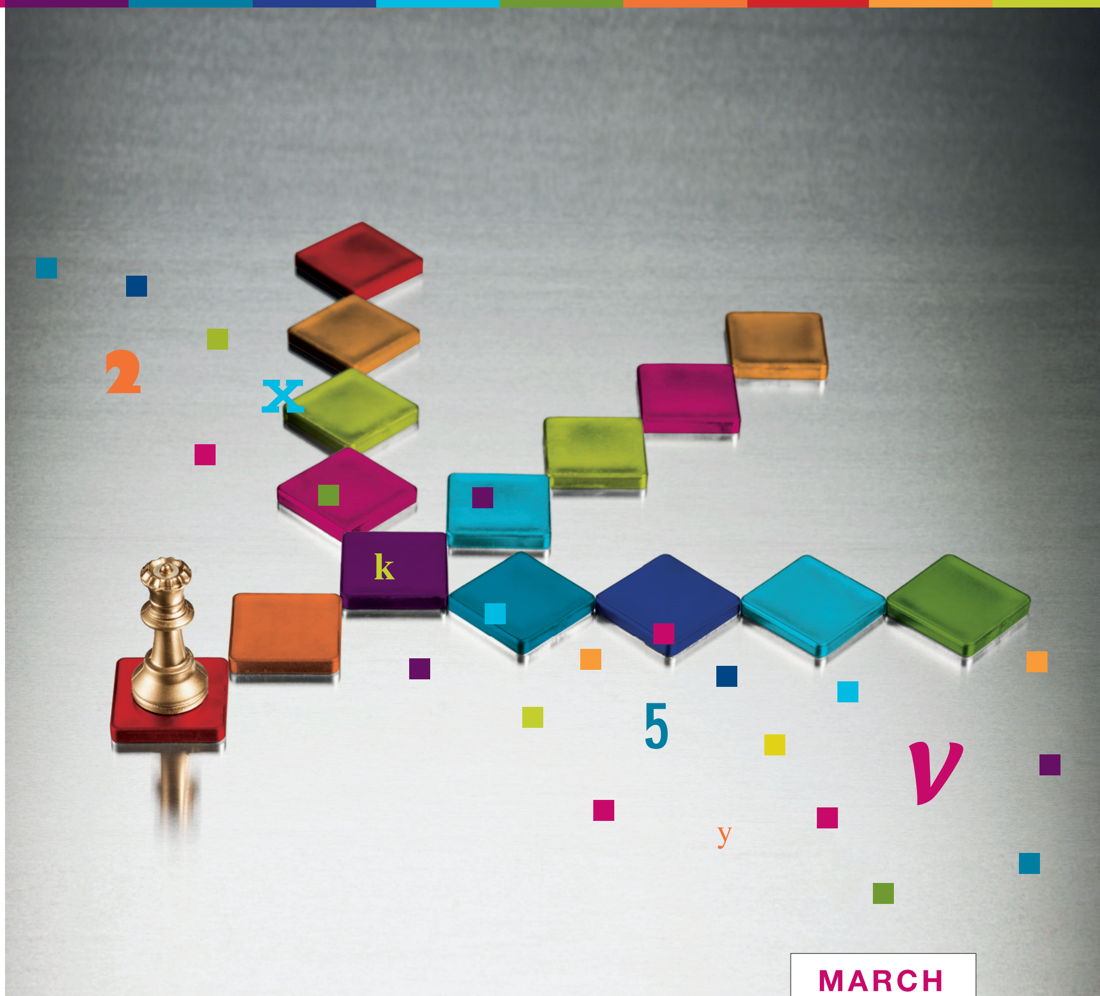
European Financial Reporting Advisory Group

EFRAG-IASB Discussion Forum on Financial Instruments

Feedback report



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EFRAG

European Financial Reporting Advisory Group

EFRAG - IASB DISCUSSION FORUM

FINANCIAL INSTRUMENTS

FEEDBACK REPORT ON THE MEETING WITH CONSTITUENTS

28 FEBRUARY 2011

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European Financial Reporting Advisory Group

TABLE OF CONTENTS

Foreword 3

Hedge Accounting 4

Offsetting Financial Assets and Financial Liabilities 13

Impairment 15

Foreword

On 28 February 2011, EFRAG and the IASB held a discussion forum on financial instruments. This event provided an opportunity for European constituents to obtain information about, and share their views on, the hedge accounting, impairment and offsetting proposals that are part of the IASB's IAS 39 replacement project[1].

The participants were keen to understand the IASB's proposals and engaged in an active debate with the IASB team about the impact of these proposals. While supportive of many of the proposals, participants provided suggestions for further improvements to the IASB.

This report provides an overview of the feedback received during the discussion forum and outlines questions raised by constituents and answers provided by the IASB team[2]. This feedback report was prepared by EFRAG staff for the convenience of the European constituents.

We hope that this input will help to shape the IASB's proposals to reflect European views.

We would like to thank the IASB team and all constituents who attended the event for their participation. We would also like to thank Dexia Corporate University for hosting the event.

Françoise Flores
EFRAG Chairman

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[1] IASB Exposure Drafts *Hedge Accounting* (comments due on 9 March 2011), *Offsetting Financial Assets and Financial Liabilities* (comments due on 28 April 2011) and Supplementary Document *Financial Instruments: Impairment* (comments due on 1 April 2011).

[2] The views expressed during the Discussion Forum were those of the IASB member and the IASB staff present at the event. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.

Hedge Accounting

Overall feedback

The direction of the IASB proposals on hedge accounting received broad support. The European constituents particularly appreciated the move towards a principle-based standard and the alignment of the hedge accounting objective with an entity's risk management activities.

In the discussion, participants focused mainly on the following areas of concern:

- ***Reflecting risk management in accounting: remaining limitations*** – the proposals in the IASB Exposure Draft *Hedge Accounting* (the ED) align hedge accounting much closer to an entity's risk management and remove a number of existing limitations. However, some limitations remain. In particular, concerns were raised about inflation in financial instruments and credit risks not being eligible risk components. Alternative approaches were suggested to reflect hedging of credit risks in accounts. In addition, some constituents raised concerns about limiting items eligible for hedging only to those that affect profit or loss and excluding those that affect other comprehensive income.

- ***Operationality of proposals: effectiveness testing, rebalancing and voluntary de-designation*** – a number of questions were raised about operationality of proposals on effectiveness testing and rebalancing, in particular, how to interpret 'an unbiased result', and whether the new guidance could result in a more stringent approach to effectiveness testing than the existing '80-125' threshold. A number of participants expressed their regrets that voluntary de-designation had been removed, as it is a good tool for dealing with the limitations of the current hedge accounting model.

- ***Macro hedging and EU carve out*** – macro hedging (hedging of open portfolios) attracts a great deal of interest in Europe. This area, which triggered the IAS 39 EU carve-out in 2004, has not yet been addressed by the IASB. European constituents, particularly representing the banking industry, were eager to understand the direction of the debate on macro hedging, especially in the context of IFRSs as adopted in the EU.

Questions and answers

Objective of hedge accounting

Q: Hedge accounting under IAS 39 is not aligned with risk management, because this is not a requirement and because many valid economic hedges fail the hedge designation criteria. In fact, hedge accounting is used by many entities as part of their financial reporting 'toolbox' – which also includes the fair value option and classification under IAS 39 – to achieve a desired accounting outcome. For example, when an entity hedges a fixed-rate liability that does not qualify as a hedged item, it can look at the asset side of its balance sheet to

identify an asset that it can designate as a hedged item. Economically, the entity hedges a liability, but for hedge accounting purposes, it applies hedge accounting to an asset. In addition, entities can voluntarily de-designate or restart hedge accounting at their convenience. Do you have any views on designation, de-designation and re-designation in this respect? Is the above approach appropriate? Should it be permitted?

A: *Under IAS 39, at present, an entity could indeed achieve hedge accounting for hedges that are completely disconnected from the entity's risk management strategy. As a result, the accounting outcome does not always reflect the risk management perspective, which may lead to results that may be difficult to understand for investors.*

The proposed objective of hedge accounting is to reflect the risk management activities of an entity. However, the level of detail in which risk management needs to be documented was deliberately left undefined. The IASB is particularly interested in the feedback on this issue to understand whether and to what extent it is feasible to address it. One could consider strengthening the objective of hedge accounting by explicitly requiring the accounting to be consistent with the underlying economics.

Q: At present, the risk management strategies are written at a higher than transaction level, which may not be sufficiently granular to make the link between the risk management and accounting. What type of feedback does the IASB need on this topic?

A: *The IASB is especially interested in examples. The purpose is to present risk management in a way that is useful for users of financial statements. If entities believe that some requirements will not result in accounting that provides useful information for users, they should provide examples and explain why they do not agree that such information is useful.*

Hedged items

Q: Why do you believe that only items affecting profit or loss are eligible for hedging? One could argue that equity investments measured at fair value through other comprehensive income (OCI) or emission rights measured through OCI should also qualify as eligible hedged items. For example, in some situations, an entity could consider hedging changes in the fair value of a strategic investment. In this case, the derivative used for hedging would cause additional volatility in profit or loss and the accounting would not be aligned with the economics of the transaction.

A: *The IASB has not yet finalised its deliberations on emission rights and this issue has not been discussed in the context of hedge accounting. This is similar to the issue of hedging of pensions that affect OCI.*

The question about equity investments is different and has been raised many times. Originally, the category of equity investments through OCI (in IFRS 9) was intended for strategic equity investments only. It was not meant to include equity investments that are held for their investment value; such investments were intended to be accounted for at fair value through profit or loss. Strategic equity investments through OCI would

have been the exception and, as such, much less of an issue with regard to the non-eligibility for hedge accounting. A second reason for excluding equity investments through OCI from hedge accounting is the prohibition to reclassify (recycle) gains and losses on equity investments from OCI to profit or loss.

Q: The issue of recycling may not be that important, as it is just an artificial question of ''above or below the line'', i.e. OCI versus profit or loss in a continuous statement.

A: *This is a good argument, but many constituents, especially in Europe, do not share this view. Some argue that the ''net income'' line is of particular importance in communicating the performance of an entity, and therefore object to a single statement of comprehensive income prior to a proper debate on the content of performance statements, the principle underlying recognition of items in OCI and recycling.*

Q: The interest element of a forward contract can be significant in the case of exotic foreign currencies hedges. Would the board consider permitting entities to apply the accounting treatment proposed for the time value of options to the interest element of a forward contract?

A: *The board has not discussed this. The discussion was limited to the time value of options, given their volatility.*

Risk components and hedges of credit risk

Q: The exclusion of inflation risk on financial items from the list of eligible hedged items to be treated as risk components is a rules-based limitation, which is not a good approach.

A: *The inflation risk can be hedged; however, only if it is contractually specified. The board has decided to reflect the existing guidance on this issue, including the existing interpretations.*

Q: Hedge accounting for credit risks is an important issue for banks. To be eligible for designation as a hedged item, a risk component must be separately identifiable and reliably measurable. This is often not the case for less liquid assets that are hedged with credit default swaps. The issue of hedge accounting for credit risks has been left open in the ED, although the ED outlined three possible alternatives. Which route will the board follow during the re-deliberations on this issue?

A: *The three alternatives in the ED are, in fact, variations of the fair value option applied to the hedged asset. The IASB realises that these three solutions could add volatility to profit or loss, which is not reflective of the risk management strategy. The IASB is seeking input from constituents on other alternative approaches.*

Participants in the meeting suggested the following alternative approaches to hedges of credit risk:

Alternative 1 – in finalising the classification and measurement guidance for financial liabilities, the board accepted that the own credit risk component in the fair value of liabilities could include both the liquidity and the credit risks. Similar to that, the board could consider allowing the credit and the liquidity risks to be designated together as a hedged item. Of course, there would be ineffectiveness, because the risk management objective would be to hedge the credit risk only, whilst the designated hedged component would include the liquidity risk as well. It remains to be considered how this ineffectiveness could be addressed to achieve the optimal hedge.

Alternative 2 – under this approach, the credit risk is hedged using a credit default swap as a hedging instrument. Assuming that the relevant testing demonstrated high effectiveness, this approach may be acceptable when the hedging credit default swap is referenced to the hedged asset and there is an active market for such credit default swaps (in which case there is likely to be high effectiveness). To measure ineffectiveness under this approach, the data from the credit default swaps market, with appropriate valuation adjustments, can be used to determine a proxy for the change in the fair value of the asset attributable to the credit risk.

Alternative 3 – the 'separately identifiable' and 'reliably measureable' criteria seem to work, in general, for financial assets, but not for the credit risk. The 'reliably measurable' criterion provides a practical barrier to hedging credit risk, as it may not be possible to measure changes in the fair value of a hedged item due to changes in credit risk separately from those arising from changes in liquidity risk. The Board could consider allowing a narrow exception to the general requirements for hedging credit risk. However this would leave an open question as to how to measure and recognise ineffectiveness. The Board should make an effort to find a solution for addressing ineffectiveness in practice, because much credit hedging takes place in the context of illiquid instruments.

Q: Should the credit risk debate fall within the scope of the financial instruments project or within the scope of the insurance project? If it were in scope of the insurance project, then the existing issues with IFRS 9 could be solved.

A: *The IASB will discuss the topic of financial guarantees during its meeting on 1 March 2011.*

Q: The discussion about financial guarantees will not resolve the issue, because a credit default swap will still be in the scope of IAS 39 / IFRS 9. The issue will remain. Could a treatment similar to the proposed treatment for the time value of options (i.e., considering the premium as a kind of insurance premium, deferring it in OCI and then reversing it on a rational basis) solve this issue?

A: *Only some financial guarantees meet the definition of insurance. Additionally, this approach would not solve the issue, because the economic nature of a credit default swap is different: for a credit default swap, the credit risk is only one of the variables affecting the fair value of*

the hedged item, rather than being a discrete component like the time value of an option.

Hedge effectiveness

Comments: Some participants raised comments on the interpretation of 'unbiased' and 'minimise ineffectiveness' and expressed concerns that the new guidance could result in a more stringent approach to effectiveness testing than the existing '80-125' threshold.

Q: Can you provide some examples to illustrate the difference between 'biased' and 'unbiased' results of a hedging relationship?

A: *A hedging relationship would create a biased result if there is an expectation that the change in the fair value of the hedging instrument would systematically exceed the change in the fair value of the hedged item (or vice versa). This requirement intends to prevent entities from intentionally designating a speculative position as a hedging relationship. For example, when at the start of a hedging relationship the peg between USD and a foreign currency is 1.2, designating a hedging relationship using a hedge ratio of 1.3 would point to a bias.*

Q: If the objective of hedge accounting is to reflect the risk management activities in financial reporting, then why is there a need for effectiveness testing as a qualifying criterion for hedge accounting? Is this a carry-over from IAS 39 and the anti-abuse measure?

A: *Risk management practices vary considerably. Therefore, the board believed that it was necessary to introduce an extra qualifying criterion for hedge accounting. This requirement is not intended to restrict any activities undertaken by entities as part of their risk management policies, but rather to bring clarity.*

The possibility to designate a risk component as a hedged item will allow the sources of ineffectiveness to be reduced in several instances.

The goal is to have a clearer measure of effectiveness and ineffectiveness to assist the users of financial statements.

Q: At present, a hedge qualifies for hedge accounting when the result is within the range of 80 to 125 percent. Under the new requirements, the hedge relationship should minimise the expected hedge ineffectiveness. What would happen to a hedge that is effective at 90 percent, but does not minimise the expected hedge ineffectiveness?

A: *Effectiveness should be assessed in accordance with an entity's risk management policy. The hedge relationship that could minimise ineffectiveness does not need to be a perfect hedge, but it should result in the hedge ratio being consistent with the risk management policy.*

Based on the feedback received on the ED, it seems that the wording 'an unbiased result' requires further clarification. Originally, the Board intended to prevent entities from designating a speculative market position as part of the hedge relationship.

Designation – de-designation

Q: Many constituents appreciate that the objective of hedge accounting is linked to the risk management of an entity. Under the proposed approach, a change in the risk management objective would trigger a discontinuation of hedge accounting. In contrast, if the risk management objective is unchanged and the qualification criteria continue to be met, an entity could not choose to discontinue hedge accounting. At present, many risk management strategies are written at a level higher than individual transactions, therefore they might not be sufficiently granular. What input from constituents does the IASB seek on this topic?

A: *The objective is to present risk management in a way that is useful for the users of financial statements. If constituents believe that some requirements would not result in information that is useful for users, then examples and arguments should be provided to reflect this.*

Q: In one of the board discussions, there was a reference to the relationship between the use of hedge accounting, the use of OCI and insurance liabilities. Was this only an 'aside' by a Board member or was the IASB working on this as a direct or conceptual connection?

A: *The IASB did not discuss this in the context of hedge accounting.*

Q: The prohibition to voluntarily de-designate a hedge could cause problems for non-financial entities that hedge the foreign exchange risk of accounts payable and receivable. These entities usually designate a cash flow hedge for the foreign exchange risk from the date when they enter into a forecasted transaction, and de-designate this hedge when the transaction results in a recognised receivable or payable. Once the receivable or payable is recognised, there is no need for hedge accounting, as IAS 21 allows offsetting of their revaluation with the change in the fair value of the derivative.

A: *Switching hedge accounting 'on' and 'off' is very confusing to the users. Therefore, the Board has decided to prohibit voluntary de-designation. However, in this specific case, the fact that the forecast transaction has been recognised as an existing asset might imply that the hedged item has expired, therefore triggering discontinuation.*

Rebalancing

Q: In the energy industry, the maturity of a traded hedging instrument is generally relatively short compared to the maturity of the hedged item. Therefore, entities often use a dynamic strategy for hedging a risk by entering into different derivatives during the life of the hedged item to economically re-establish their hedge. This could mean that an entity ends up entering into offsetting derivatives and new derivatives to re-establish the correct hedge ratio, potentially ending up with layers of derivatives. Would all of these derivatives need to be included as part of the ongoing hedge accounting relationship?

A: *It should be possible for the entity to de-designate the offsetting derivatives and to use the new derivatives as the basis for the ongoing hedging relationship.*

Q: Rebalancing is a new concept and constituents are unsure how it would work in practice. Is the IASB planning any additional educational efforts for constituents?

A: *As this ED proposes some new concepts and techniques, it might require a change in mindset for everyone involved. The board may consider providing more examples, but it is too early to say at this stage.*

Presentation

Q: The proposals for the presentation of fair value hedges may result in numerous separate line items on the face of the balance sheet, including insignificant amounts. Will the IASB consider a simpler model for presentation on the face of the balance sheet combined with disclosure in the notes?

A: *Feedback from constituents would be very helpful to understand whether the requirement in the ED would result in two additional line items on the face of the balance sheet, or rather in ten or more.*

Q: The proposed presentation of fair value hedges introduces additional line items. Also for fair value hedges on a group basis the hedging effects of groups are shown gross. One could argue that in such situations the balance sheet could include an additional ten lines. Would this make the balance sheet more useful to the users? Why did the IASB propose this?

A: *The IASB is concerned about transparency and these proposals were designed with that in mind. While information could be provided in note disclosures, the Board has held a long standing view that disclosures are not a substitute for recognition on the face of the balance sheet. Users are particularly interested in the primary financial statements. However, as noted earlier, we are very interested to understand the number of additional line items that entities foresee being added to the financial statements.*

Q: Why did the IASB decide to present the results of fair value hedging in OCI, especially considering that the amount will always be zero?

A: *The ED requires showing ineffectiveness in profit or loss, as is already the case today. The proposed presentation in OCI is meant to show all information on hedges in the same place to increase transparency and also to give information about how effective fair value hedges are. These changes were designed to make hedging information more useful to the users of financial statements.*

IASB due process and coordination with FASB

Q: Why did the IASB publish its proposals on hedge accounting before finalising the debate on macro hedging?

A: *The proposals in the ED are of great interest and significance for non-financial entities, who do not necessarily want to wait until macro hedging issues have been solved.*

The objective was to develop an operational model for general hedging as soon as practicable. IFRS 9 has already been adopted in other parts

of the world and there is an urgent need there to address hedge accounting.

Q: What is the expected timeline for the proposals on macro hedging?

A: *As quickly as practicable, ideally during the summer this year.*

Q: The FASB recently released a consultation document on selected issues about hedge accounting, including the IASB proposals on general hedging. Their comment period ends on 25 April 2011. The proposals included in that consultation document are quite different from those that the FASB published at an earlier stage. How does this fit into the IASB due process on the project, particularly given that the FASB has asked a significant number of additional questions?

A: *Earlier in the hedge accounting discussions, the project was a joint one. However, some time ago the IASB and FASB decided to proceed separately due to differences in the scope of the projects (the IASB wanted to do a more comprehensive review of hedge accounting). The FASB subsequently issued some hedging proposals as part of its financial instruments ED issued in May 2010. We are sure that any remarks on the FASB ED will be mentioned in the comment letters that the IASB will receive. No matter which questions we ask, people always find a way to express their concerns so the fact that they asked more questions is not anticipated to change the relative feedback that we receive.*

The FASB will listen to the feedback we receive from our comment letters and outreach activities. They will consider the feedback they get in response to the consultation document on the IASB's hedging ED, along with the feedback that they received on their own proposals and then decide how to proceed with their hedging project. It may be that the FASB wants to stick to hedge accounting as an exception, as opposed to the risk management approach of the IASB.

Macro hedging and the European carve-out

EU endorsement

A question was raised in the audience about the process of adoption of the new financial instruments standard in the EU. A representative of the European Commission noted that IFRS 9 will be assessed for endorsement as a whole, when all phases (including general and macro hedging) are finalised.

Q: Will the issues, which originally lead to the European carve-out (i.e., macro hedging, prepayment options and sub-Libor), be resolved?

A: *These issues will be discussed in the context of hedge accounting for open portfolios. It would be good to resolve them, but it is too early to say if this will be the case. The Board will reconsider the proposals in the ED in respect of the sub-Libor and pre-payment option issues in the next phase of its re-deliberations, with a view to finding a solution that could work for both general and macro hedging.*

Q: Macro hedging is very important for banks. When commenting on this ED, should banks *guess* what the proposals for macro hedging will be like?

A: *Unfortunately, these are consequences of a phased approach; constituents have to comment on the consultation documents that are available. At the moment (until the IASB issues any further macro hedge accounting proposals) the general hedge accounting proposals should be considered in conjunction with the macro hedging provisions in IAS 39.*

Feedback received during the outreach event

Q: The IASB has held numerous outreach events during the past months. What did you learn from the outreach so far? What about field-testing?

A: *It is too early to draw conclusions, especially because the IASB has not yet received a significant number of comment letters. During the outreach events, we meet not only with accounting policy people, but also with people who are involved in risk management activities, to ensure that the IASB understands their concerns and to identify areas for further work. The feedback provided during the discussion forum today confirms the messages that the IASB received on other occasions. There may be some operational issues, but no one seems too opposed to the risk management approach and in fact most are highly supportive of it.*

Offsetting Financial Assets and Financial Liabilities

Overall feedback

The proposals in the Exposure Draft *Offsetting Financial Assets and Financial Liabilities* (the ED) are largely based on the existing offsetting requirements in IAS 32 *Financial Instruments: Recognition and Measurement*. Therefore, the direction taken by the IASB in this area received broad support. However, participants raised questions about the reasoning behind some decisions and provided comments about some operational issues. The discussion focused on the following issues:

- ***Which numbers are more useful: gross or net?*** – Considering recent extensive discussions in Europe as to whether presentation in the primary statements should aim to portray credit risk, it was noted that some believe that the IASB was not very persuasive in providing arguments against the net presentation in certain cases, especially in the case of derivatives.

- ***Is convergence on offsetting feasible?*** – As the joint IASB and FASB proposals on offsetting represent a significant change for US GAAP, participants were concerned about a potential push-back in the US, which could preclude convergence in this area.

- ***Operationality concerns*** – Some concerns were expressed that in certain cases of settlements on exchanges, it could be difficult to demonstrate that the 'simultaneous' criterion for offsetting is met, because of the procedures adopted at some exchanges.

- ***Disclosures*** – Some participants believe that the disclosure proposals were too prescriptive and moving away from the principle-based nature of IFRS 7.

Questions and answers

Which numbers are more useful: gross or net?

Q: Before the ED was issued, there were extensive discussions in Europe about credit risk and the most useful presentation on the face of the balance sheet. Why did the IASB decide that master netting agreements do not satisfy the criteria for offsetting? The arguments provided in the ED are not very persuasive.

A: *The net presentation may be the best way to portray the credit risk exposure. Having said that, why do you believe that the credit risk is so special that it warrants a specific presentation on the face of the balance sheet? The balance sheet is intended to present the 'multidimensional' exposure to risks and the information about cash inflows and cash outflows.*

Q: Why do you think that the gross presentation of derivatives on the face of the balance sheet will result in more useful information to users? Usually, the amounts of derivatives are much larger than the rest of the items on the balance sheet; therefore, there is a danger that they could obscure the real risks. One could argue that derivatives justify a different treatment, particularly, because their fair value represents a 'close out value' and it is more useful to look at the net rather than at the gross number. The gross amount on the balance sheet does not really provide much information about the real cash flows and about the risks.

A: *There are certain limitations of a balance sheet amount for derivatives, but these limitations are not necessarily related to the master netting agreements. In such situations, there is a need for enhanced disclosures to explain how the risk is mitigated – for example, in using a master netting agreement, collateral or another instrument – but this information is better placed in the notes.*

Is convergence on offsetting feasible?

Q: The offsetting proposals are joint proposals with the FASB, and are intended to achieve convergence in this area. Do you expect any push back, considering that the ED represents a big change from the US GAAP perspective?

In addition, the proposals in the ED were supported by all the IASB members, whilst the FASB was divided (i.e., they voted 3:2). In the worst case scenario, the FASB will keep the current US GAAP offsetting requirements and there will be no convergence in this area. This is quite a big issue for financial institutions, as comparability is distorted at present. Could you speculate about the dynamics of the re-deliberations, given that the number of the FASB members has increased to seven, and that the new members are also eligible to vote?

A: *Convergence is important, but both boards take decisions based on their views about good financial reporting. The desirable outcome would be to have comparable numbers in the balance sheet.*

Operationality concerns

Q: Although settlements on exchanges may be intended to be 'simultaneous' from an economic point of view, sometimes they are designed in such a way that it could be difficult to demonstrate that the 'simultaneous' criterion for offsetting in the ED is met. Are you going to consider how to address such cases?

A: *The IASB would appreciate input from constituents on this issue. Examples of situations, in which the proposals would cause such concerns, would be helpful.*

More extensive disclosures on offsetting rights?

Q: The disclosure proposals in the ED seem to be very prescriptive and quite granular. What was the reason for moving away from the IFRS 7 principle-based approach?

A: *One of the reasons for being prescriptive in this area was the intention to ensure that a net number, which is presented in the financial statements, is arrived at using the same basis and is therefore comparable.*

Impairment

Overall feedback

The IASB and the FASB efforts to develop a common approach to accounting for the impairment of financial assets, and the attempt to address concerns about operationality of the expected loss model for open portfolios, were broadly supported.

However, some areas continue to cause concerns and attract questions about operationality, in particular:

- ***Foreseeable future and comparability concerns*** – concerns were raised about the term 'foreseeable future' not being defined and referring to the entity's own practice.
- ***Effect of the floor*** – concerns were raised that, for short-term portfolios, the floor could result in 'day one losses' and in providing for more impairment losses than intended or needed.
- ***Operationality of proposals and field-testing*** – overall, the effort to address concerns about operationality of the expected loss model were broadly supported. However, some questions were raised about the new concepts, namely, the 'bad book' and the 'foreseeable future', and the need for proper field-testing was highlighted.

Questions and answers

Interaction with the original impairment proposals

Q: Does the proposed impairment model intend to approximate the outcomes of the credit-adjusted effective interest rate method, as proposed in the original impairment exposure draft (i.e., on initial recognition, expected credit losses on a financial asset would be allocated to each period in its life)?

A: *The time-proportional part of the model partially results in such an approximation. However, the floor requirement moves the outcome further away from the original proposals while addressing concerns about the adequacy of the provision. This was a priority for the FASB, and we needed to reach a common solution.*

Effect of the floor

Q: Would the floor result in the recognition of a 'day one loss' equal to all expected losses in the case of short-term portfolios? Would this not penalise new businesses?

A: *The floor would result in recognition of all losses expected to occur in the foreseeable future period. Day one losses are less of an issue in the case of a steady portfolio. Taking into account the early recognition effect in the case of growing portfolios versus a steady state situation, it needs to be assessed how much of a concern this would be, compared to adopting a simpler model based on the foreseeable future time horizon.*

Q: To the extent that the purpose of the floor is to address the issue of early loss emergence patterns, would it not be possible to use some form of loan loss profiling as was considered by the IASB in its December 2010 meeting under Alternative 5: *Time-proportionate approach with notional sub-portfolios to accelerate recognition of expected losses*?

A: *In open portfolios, the effect of early loss emergence is difficult to identify because its impact evens out in such a portfolio. It would be hard to tell how such an approach differs from an incurred loss model. The issue with Model 5 was that it was giving strange results and was difficult to apply to open portfolios.*

The Board has indicated in the Basis for Conclusions to the Supplementary Document that the floor may not be the only way to address the early loss pattern concern. The question of whether the floor is catching more than intended will probably be a subject for further re-deliberations. If it appears that the floor is very dominant, one could consider whether a simpler, FASB type, model could be adopted or another approach could address the issue of front-loaded losses.

Foreseeable future

Comments: concerns were raised about the term ‘foreseeable future’ not being defined and referring to the entity’s own practice. Firstly, this could cause comparability issues between entities and secondly, the longer the “foreseeable future” period is, the larger the amount of impairment provision would be. Therefore, entities with the longer forward-looking perspective would be in a disadvantaged position.

Q: What does the term ‘foreseeable future’ mean?

A: *The foreseeable future is defined as ‘the period over which specific projections of events and conditions are possible’ and should be no less than 12 months. In the near term, more granular projections can be made, while for the long run, estimates will be based on (historical) trends adjusted for forward looking expectations.*

Q: Is the ‘foreseeable future’ a fixed period or could its length vary depending on the circumstances?

A: *The underlying assumption in the Supplementary Document is that in the normal course, the length of the foreseeable future does not vary significantly from period to period. However, there could be situations in which the foreseeable future does change based on economic conditions or other factors.*

Q: How long should the foreseeable future be?

A: *The proposals presume that, under normal conditions, the foreseeable future period would be rather stable. No specific time frame is required for the foreseeable future period (as long as it is greater than 12 months).*

Provisions cannot be used – 'too much until too late'

Q: Does the proposed model allow the built up provisions to be 'used' when losses are incurred?

A: *Expected losses need to be reassessed at each reporting date. When loans have been transferred from the good to the bad book, the expected loss provision for the good book will change accordingly. It is important to use forward-looking information in updating the expected loss as opposed to the sole use of historical loss experiences. However, this is not a through-the-cycle model and it is not possible to utilise or draw down the provision with a view to replenishing it later.*

Q: How useful would the information resulting from the proposed model be? Some argue that the model is pro-cyclical.

A: *Using provisions in bad times may give the wrong information to investors. The provisioning should not be based on averages. Furthermore, the financial statements should reflect the economics of what is going on in the entity and its environment.*

Q: What does a 'loss' mean under the proposed model?

A: *A 'loss' corresponds to a shortfall in contractual cash flows.*

One model fits all?

Q: Does the proposed common approach apply to all types of assets? Would it, for example, apply to an open portfolio of sovereign debt?

A: *We have asked a question in the Supplementary Document as to whether the proposed common approach works well for all types of assets, including individual assets and bonds.*

There is nothing specific about sovereign debt that would justify a different impairment model. Therefore, sovereign debt that is managed in an open portfolio and measured at amortised cost would be within the scope of this document.

Q: Individual financial assets and bond portfolios are generally managed on a different basis. In this context, do you believe that the proposed 'good-bad book' approach would work? In addition, current internal systems do not allow looking at a portfolio in two different ways. Therefore, the entire portfolio would most likely be considered bad.

A: *We have asked a question in the Supplementary Document as to whether the approach can be applied to individual assets. The IASB does not think that the model would work without the bad book concept.*

Q: Have the IAS 39 impairment triggers been removed?

A: *The proposed model is built around internal credit risk management policies that distinguish between good and bad books and for which the provisioning requirements differ.*

Q: Might the IASB consider dropping the floor or the time-proportional approach?

A: *Both scenarios are possible.*

Discounting or not?

Q: What is your view on discounting of the expected losses? Discounting could be a problem when an entity cannot forecast the timing of the losses.

A: *A practical solution might be that impairment calculations consider only the principal amount. In this case, companies would not worry about the time value of money and the applicable discount rate. The impact of future interest income that gets discounted would be limited. The discounting question will be further discussed.*

Q: What is the proposed discounting approach for bad books?

A: *This matter has not yet been discussed.*