29 March 2011

Our ref: ICAEW Rep 37/11

Your ref: Supplement to ED/2009/12

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
London
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Dear Sir David

Supplement to ED/2009/12 *Financial Instruments: Impairment*

ICAEW is pleased to respond to your request for comments on the supplement to *ED/2009/12 Financial Instruments: Impairment.*

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours sincerely

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ICAEW REP 37/11

SUPPLEMENT TO ED/2009/12 *FINANCIAL INSTRUMENTS: IMPAIRMENT*

Memorandum of comment submitted in March 2011 by ICAEW, in response to the IASB's supplement to ED/2009/12 *Financial Instruments: Impairment* published in January 2011.

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INTRODUCTION

1. ICAEW welcomes the opportunity to comment on the supplement to *ED/2009/12 Financial Instruments: Impairment* published by the International Accounting Standards Board (IASB).

WHO WE ARE

2. ICAEW operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, we provide leadership and practical support to over 136,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. We are a founding member of the Global Accounting Alliance, which has over 775,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. We ensure that these skills are constantly developed, recognised and valued.

MAJOR POINTS

Overall assessment

4. While we welcome the publication of the supplementary proposals, we feel that it is important that the IASB continues to receive feedback and that it remains open to changes to its approach. The ultimate aim must be to develop impairment requirements that are conceptually sound, which are operational and which produce results that are understandable. While it may be that some progress has been achieved for open portfolios, many important areas are outstanding, not least the measurement of credit losses. In addition, it is not clear how the supplementary proposals supersede or are otherwise linked to the original exposure draft.

5. As noted in paragraph IN20, there are many aspects of the original exposure draft which are yet to be re-deliberated. Given the interim nature of this consultation, we will be unable to comment fully until we have seen the complete picture. We also note that the timing and length of the consultation period have made it challenging for many constituents to review the proposals in as much depth as would have been desirable. Therefore, we believe that further consultation, outreach and field testing will be necessary before the proposals can be finalised. In our view, it is more important that the final impairment requirements work appropriately than that a particular deadline is achieved. Field testing is likely to be necessary to ensure that the proposals are operational and work as intended for different portfolios.

Convergence with US GAAP

6. As well as trying to make the IASB's original proposals operational, the stated objective of the supplement is to try to 'enhance comparability internationally', particularly with the Financial Accounting Standards Board (FASB). As a result, the proposal represents a compromise between two different approaches. Essentially stitching two models together is likely to cause confusion as there is no clear conceptual basis underlying the combined approach. It is also likely to be more expensive to apply than a single, clear approach. These are heavy disadvantages to bear for the sake of a compromise.

7. Convergence is clearly desirable but not if the price is a poor standard arising from too much compromise. In order to achieve convergence we may in this instance be willing to support an outcome that both Boards feel able to support, even if this would not necessarily be our preferred solution, as long as the outcome was a high quality, operational standard with clear underlying principles.

Our preferred approach

8. Before commenting in more detail on these proposals, the following will help put our views into context. While we understand the need for more forward looking provisioning, we continue to believe that provision must be made for losses that have occurred at the balance sheet date.

9. In our view problems arose in the application of the IAS 39 *Financial Instruments: Recognition and Measurement* incurred loss model primarily because:

   - The standard does not permit losses which have not been incurred at the balance sheet date to be recognised regardless of how certain the entity is that the future event giving rise to the loss will occur; and
   - Impairment triggers were interpreted inconsistently.

10. Concerns have also been raised that the application of IAS 39 allowed interest income to be overstated in periods before losses occurred.

11. The aim of a revision to the IAS 39 requirements should be to address these shortcomings without introducing unnecessary complexity or new weaknesses. In our view, in conceptual terms our preferred approach, which represents a variation of the approach in the supplementary document, would ensure adequate provision is made for:

    - All losses which have occurred at the balance sheet date. This may be referred to for simplicity as the 'bad book', although we are not certain that the proposals in the supplement agree with this definition of the 'bad book'; plus
    - Any other losses not already recognised which are expected to occur over the life of the portfolio. These losses should be provided for on a time-proportional basis, as the supplement suggests for the 'good book' hence avoiding overstating profit or loss; plus
    - Any other losses not already recognised which the entity believes are probable as a result of conditions at the balance sheet date. This is not the same concept as the 'floor' in the supplementary proposals. In our view a mechanism of this nature (which for simplicity we refer to as a 'floor') is not a necessary component of the calculation of the allowance for the 'good book'. Instead we see it as an additional tool that would come into use only when the entity has evidence that there are losses which would not otherwise be recognised.

12. In our model, this 'floor' mechanism would only be used in limited circumstances for loans or portfolios that are not in the 'bad book' but where management has probable cause to believe that recognising lifetime expected losses on a time-proportional basis is insufficient. This may be a result of the timing of losses, although we are not convinced that this is relevant in open portfolios.

13. Examples of situations where we believe the use of this 'floor' mechanism might be relevant include where the largest employer in a city is closing down and has announced significant redundancies but has not yet closed and all the loans to their employees are still performing at the balance sheet date. Entities should not be precluded from recognising the expected losses on loans to the employees in these circumstances, if the losses are likely to be greater than those already provided on a time-proportional basis. Similarly, consider a portfolio of loans that are making interest payments but where there is an expectation that, as a result of falls in property values, it will not be possible for the loans to be repaid at maturity in say five years. If the portfolio was on a 'watch list' but not in the 'bad book', it may be that the time-proportional allowance is insufficient to cover the loss expected in five years.

14. As noted above, our concept of a 'floor' is therefore different from that in the proposals. The proposals concentrate on the 'foreseeable future' and how long a period this should be. We do not think that the future is foreseeable, regardless of whether it is defined as one month, one year or three years. Rather, we would concentrate on making sure that, unlike IAS 39, the

entity is not precluded from recognising losses relating to events which the entity has probable cause to expect to occur in the future.

15. We can accept the introduction of a ‘floor’ as an additional component to the calculation of the impairment allowance because we believe it will allow sufficient flexibility to cope with wide ranging economic conditions and events. It was the absence of such flexibility, which discouraged the use of appropriate management judgement, which called many to question the incurred loss approach during the financial crisis. Such flexibility will also help ensure that a single approach can be applied to a wide variety of different types of assets whether they are held in open or closed portfolios or as individual items.

16. We also believe that the relevance of the ‘floor’ is partially linked to where the line is drawn between the ‘good book’ and the ‘bad book’. As part of their credit risk management process, entities recognise varying degrees of uncertainty of collection ranging from having no concerns to having significant concerns before an asset is placed into recovery and is transferred to the ‘bad book’ as defined in these proposals. For example, loans may be moved onto the ‘watch list’ if payments have been missed, if a customer’s credit rating has been downgraded or if the value of the collateral has declined significantly. The items on the ‘watch list’ are then monitored more closely so that appropriate action can be taken if needed. It is not entirely clear when loans are put in the ‘bad book’ in terms of these supplementary proposals and it may be that they end up in the ‘bad book’ at a later stage than we would consider appropriate. It seems to us that the further along the process assets are transferred to the ‘bad book’, the greater chance there is that recognising losses on a time-proportional basis will fail to result in an adequate provision, resulting in more reliance on the ‘floor’.

17. An alternative that would reduce the need for the ‘floor’ would be to create the ‘bad book’ based on indicators of impairment along the lines of IAS 39. This would help ensure that sufficient allowance is made for assets which are ‘less than good’. However, depending on how the allowance is measured, it is possible that the allowance may be overstated. For example, recognising lifetime expected losses on loans which have missed one payment may be considered excessive. Maintaining the notion of triggers would not be an improvement on IAS 39. Hence instead we support making the distinction based on credit management procedures which will vary from entity to entity.

18. Another idea which could eliminate even the need for a ‘floor’ mechanism along the lines set out in paragraph 11 above, would be to define the ‘bad book’ by the degree of uncertainty about the collectability of the assets. If the ‘bad book’ contained all assets or groups of assets that are not expected to be recoverable in full as a result of known or probable events, then we would have more confidence that the overall level of the allowance was adequate.

19. If there is flexibility in where the distinction between the ‘good book’ and the ‘bad book’ is drawn, there will always be a concern that, for loans that are not yet in the ‘bad book’ but for which there is a lot of evidence of impairment, recognising losses on a time-proportional basis may not be adequate. We therefore believe that a ‘floor’ can help bridge the gap between the ‘good book’ and the ‘bad book’ in these circumstances by ensuring that the allowance is sufficient.

20. Our responses to the questions below, particularly those regarding our views on the ‘floor’ and the ‘foreseeable future’ should be considered in the context of our preferred approach as described above. If it is not possible for the Boards to develop such an approach, we can accept an appropriately limited ‘floor’ along the lines set out in the supplementary proposals being included in the final standard if this is necessary in order to achieve comparability with US GAAP. However, in our view this would be an entirely arbitrary rule and as such we suggest that the ‘foreseeable future’ should be limited to one year.

Our response to the original exposure draft

21. We raised a number of fundamental concerns when responding to the IASB's original exposure draft and proposed a number of possible ways forward. We are pleased that the IASB has included a number of our suggestions in their supplementary proposals.

22. There are a number of important areas where our concerns have to some extent been addressed by the supplementary proposals. These include:

    - The original exposure draft spread initial expected credit losses by including them in the determination of expected cash flows for calculating effective interest rate. While we accepted that this approach had some conceptual merits, we felt that its application was so complex that the resulting output would be difficult to understand and explain. We also raised concerns about the cost of implementation. We suggested that impairment should be separate from effective interest and are pleased to note that the IASB is now proposing to 'decouple' the computation of the effective interest rate from the consideration of credit losses.
    - The original exposure draft was based on the idea that it is possible to estimate reliably the amount and timing of future expected cash flows over the life of all financial assets. We felt that while it may be possible to estimate total losses, particularly for large portfolios with past history, the timing of the cash flows cannot always be predicted. We are pleased to note that under the new proposals the timing of cash flows do not have to be predicted, apart from when considering the amount of losses expected to occur in the 'foreseeable future'.
    - The original exposure draft proposed a single approach to impairment for all assets. It did not recognise that for credit management purposes, many entities divide their financial assets into a 'good book' and a 'bad book'. We highlighted this distinction and are pleased to note that it is recognised in the new proposals.
    - For the 'good book' we suggested that the initial expectation of losses should be spread. We are pleased to note that the new proposals spread both initial loss expectations and changes in expectations for the 'good book' albeit subject to a 'floor' of credit losses which are expected to occur within the 'foreseeable future'.
    - For the 'bad book' we suggested that expected losses should be recognised in full when the asset becomes non-performing. We are pleased to note that the new proposals suggest immediate recognition of such losses.

23. There are, however, some areas where our concerns have yet to be addressed satisfactorily by the supplementary proposals. These include:

    - We were concerned that the original exposure draft did not provide sufficient clear and practical guidance to assist management in applying their judgement when determining expected losses and therefore were concerned that the results could be artificially volatile or open to manipulation. The supplementary proposals do not address how to determine expected losses.
    - We were concerned that the original exposure draft required estimates of future losses to be based on probability-weighted outcomes; an approach which we believe is neither used in practice for developing loss expectations nor is capable of being successfully implemented. Instead of using a probability-weighed approach we suggested the use of best estimates. We note that the IASB has yet to re-deliberate the issue of measuring credit losses.
    - We suggested that guidance be provided on identifying the point at which an asset is considered to be non-performing and recommended that this should be aligned to how the assets are managed. The new proposals address this point by explaining that assets should be transferred to the 'bad book' when the entity's risk management objective becomes one of recovery rather than one of receiving regular payments.

However, we have concerns whether this point will accord with the general understanding of a non-performing asset and whether any difference in measurement or timing of loss recognition between the ‘good book’ and ‘bad book’ as defined will result in anomalies.

24. Overall, we feel that the new proposals could be a significant improvement on those contained in the original exposure draft. We feel that the supplementary proposals are potentially more operational than those in the original exposure draft, although the compromise approach is likely to be complex and expensive to implement for both large and sophisticated banks and for other entities. We have a number of recommendations that we believe would improve the proposals further and make them more operational in practice.

Minimum impairment allowance amount

25. In our view, given the relatively short period of the consultation, there is insufficient data available to consider adequately the circumstances and for what type of portfolios (eg, low credit grade, short lived, revolving etc) in which the ‘floor’ will always be greater than the time-proportional expected losses. In the absence of sufficient testing of the proposals against a wide variety of portfolios and economic conditions, it is impossible to provide a definitive response to these proposals. While we support introducing flexibility into the standard to ensure appropriate loss recognition for assets or portfolios that are not in the ‘bad book’ but where management has probable cause to believe that recognising lifetime expected losses on a time-proportional basis is insufficient, there is no sound conceptual basis for the proposed minimum impairment allowance amount described in the supplementary proposals. Therefore we do not support the minimum impairment allowance amount as drafted in the supplement.

26. If the Boards are minded to maintain the ‘floor’ as drafted and if research and field testing indicates, as we understand some believe, that the ‘floor’ is typically equal to or higher than the time-proportional expected losses at least for portfolios with expected lives of say four years or less, then it may simplify the final standard if only that element is retained, at least for those types of portfolios, although this would not be consistent with developing a single approach to impairment. Similarly, if there is unlikely to be a material difference between the two calculations in the majority of circumstances, then it would again simplify the requirements to retain only one element. Some may prefer to retain only the ‘floor’ and avoid the complications of the time-proportional calculation while others may prefer to retain only the time-proportional calculation since this may work better for a wider variety of assets. It may also be necessary to maintain the ‘floor’, perhaps with a bright line definition of the ‘foreseeable future’ at say one year, to make the methodology work as intended and to achieve a consistent approach with the FASB. We can accept such a compromise approach since we believe that overall the importance of achieving a consistent approach with FASB is such a high priority in this area. However, our preferred approach is set out in paragraphs 8 to 20 above.

27. In our view, in order to determine the losses expected in the ‘foreseeable future’, entities will need to determine lifetime expected losses. Therefore, an approach that includes two elements need not be seen as requiring two calculations but instead should require the entity consider two aspects of the same calculation. In addition, if analysis of data obtained during outreach and field testing is not done by the standard setters and the results incorporated into the final requirements, we believe that each entity will need to determine and review on a regular basis their own parameters for when the ‘floor’ will come into play in order to simplify the application of the requirements in their circumstances. While some of the larger banks may have the capacity to cope, we do have concerns about whether smaller banks and other entities will be able to do this.

When does an asset become part of the ‘bad book’?

28. The proposals state that assets should be transferred to the ‘bad book’ when the entity’s risk management objective becomes one of recovery rather than one of receiving regular payments. For entities such as banks this should be clear enough. However, we are concerned that the guidance in paragraphs B3 and B4 could be seen as contradictory and

unless this is clarified it may create an element of uncertainty for some preparers and users of financial statements.

29. The proposed distinction between what is in the ‘good book’ and what is in the ‘bad book’ is unlikely to be consistent between entities. Moreover, the definition of what is in the ‘bad book’ is unlikely to be consistent with users’ general view of a non-performing asset. Hence, if the IASB were to proceed with the current definition of when an asset becomes part of the ‘bad book’ there may need to be a large education effort to explain why assets with significant indications of impairment remain in the ‘good book’.

30. Under the current proposals there will be different gradations of assets within the ‘good book’ and analysis of this book and the impairment allowances related to each credit grade may be necessary to explain the overall impairment allowance. The disclosure proposed for credit risk management in the IASB-only appendix addresses this point, although we have concerns about whether the level of detail proposed is operational.

31. More importantly, we are concerned that differences in the measurement or timing of loss recognition between the ‘good book’ and the ‘bad book’ as defined will result in anomalies. Impairment for a portfolio with strong indications of impairment which is not yet in recovery will be determined by the higher of the time-proportional impairment allowance and the expectation of losses in the ‘foreseeable future’. If the portfolio were in recovery, the impairment would be equal to the lifetime expected losses. In some circumstances for portfolios with strong indications of impairment, the expected losses in the ‘foreseeable future’ (or even time-proportional expected losses if the remaining life is sufficiently short) should be equal to the lifetime expected losses. However, we do not have sufficient information about the measurement requirements, for example, whether discounting will be required or only permitted, and whether the measurement will rely on best estimates or probability-weighted averages, to be certain that this will always be the case. For example, consider a portfolio of loans that are making interest payments but where there is an expectation that, as a result of falls in property values, it will not be possible for the loan to be repaid in say five years. If the portfolio was on a ‘watch list’ but not in recovery, it may be that the ‘good book’ impairment allowance would be less than the allowance if the portfolio was in recovery. We are not comfortable with this result. We suggest that further research and field testing should be undertaken, once the measurement proposals are finalised, to ensure that any differences in impairment allowance at the border between the ‘good book’ and the ‘bad book’ can be justified in conceptual terms and are understandable.

What is the ‘foreseeable future’?

32. We are not comfortable with the notion of the ‘foreseeable future’ as set out in paragraph 14 above. However, if the Boards are minded to continue with the approach, we agree that, in theory, the ‘foreseeable future’ cannot be a specific period and will differ depending on the nature of the portfolio and the economic conditions. Unless set at a fixed period of time by the Boards as a compromise which will be applied consistently in IFRS and US GAAP, we would not support other parties, such as regulators, requiring a fixed period of time to be considered since this is unlikely to result in the same time period being applied consistently across different jurisdictions, reducing international comparability. In our view, if the ‘foreseeable future’ has relevance it should relate to the future time for which specific projections of events and conditions are supportable based on past experience and current and future projections. That is, the period should cover losses which the entity has probable cause to believe will occur in the future, as a result of conditions at the balance sheet date. Entities are likely to consider different periods for different portfolios, making transparent disclosures important.

33. We note that the ‘foreseeable future’ is a dynamic rather than static concept and will change depending on circumstances. Entities may have a shorter view of the ‘foreseeable future’ in times of high volatility and therefore potentially lower credit losses than in more stable times. For example, contrast an entity’s likely view of the ‘foreseeable future’ in 2006, during relatively benign economic conditions against 2008 in the midst of the financial crisis. It may be that this

would not necessarily result in lower losses being recognised in times of volatility because there may well be higher expected losses even over a shorter time horizon. Nonetheless, we would caution that counterintuitive results should be avoided and entities should explain such a link between expected losses and changes in their view of the ‘foreseeable future’. We also note that introducing a different notion that concentrated on losses for which the entity has probable cause to believe have occurred or will occur in the future, as a result of conditions at the balance sheet date, may reduce the emphasis on the time period over which the future is foreseeable and increase the emphasis on the losses themselves and the overall adequacy of the allowance, which may help in understanding the requirements.

34. We are uncertain of the interaction of IAS 10 *Events After the Reporting Date* and the supplementary proposals. Rather than assessing whether subsequent events provide better evidence of conditions existing at the balance sheet date, would the aim be to assess whether such events were ‘foreseeable’?

Disclosures

35. The proposed model requires the application of significantly more judgement than is required by IAS 39. We therefore regard appropriate disclosures as being essential if users are to understand the effects of credit risk on an entity’s financial position and performance. In particular we believe that such disclosures should provide sufficient information to enable users of the financial statements to assess the judgements made by management and to enable them to draw meaningful comparisons across entities.

36. On the whole we are supportive in principle of the proposed disclosure requirements which we believe would increase transparency and comparability. However, we do have some reservations as explained in our reply to question 18Z.

Unexpected losses

37. There will always be events that come along from time to time that cannot be predicted. Therefore, regardless of what expected loss model is used there will never be an impairment allowance in the financial statements sufficient to cover unexpected losses. We do not believe it could ever be an aim of accounting standards to meet this concern and it may be helpful if this point is addressed in the final basis of conclusions in order to manage user expectations.

Clarity of the requirements

38. While we are not suggesting that the final standard will need additional guidance, we are concerned that terms such as ’expected weighted average life of the portfolio‘ are not well understood and are not capable of being determined on a consistent basis by different entities without further description of what is intended.

Are portfolios truly open?

39. We are concerned about how much tracking would be needed to make the output understandable and to meet the disclosure requirements. This could be potentially very onerous.

Applicability to assets that are not part of an open portfolio

40. We are supportive of a single impairment methodology that can be applied to all financial assets carried at amortised cost. However, we are yet to be convinced that the proposals could be applied to assets that are not part of an open portfolio

41. The wider applicability of the proposals may depend on the measurement requirements, particularly whether it is possible to determine initial expected losses for individual assets. If the intention is that there is no initial expected loss so that impairment is only recognised when there is an expectation of loss, then it may be that the proposals are operational to individual assets.

42. We also have concerns about how the proposals would apply to purchased distressed debt securities which may show yields different from originated loans if there are no further expectations of loss and immediate gains if loss expectations improve.

Entities that are not financial institutions

43. Much of the most sophisticated and detailed issues around open portfolios are mainly, if not entirely, relevant to financial institutions. Impairment of financial assets held at amortised cost is nevertheless a key issue for other corporate entities. The IASB needs to ensure that the needs of those corporates and the users of their financial statements are not overlooked.

Costs and benefits

44. The proposals could impose a significant burden on banks and other financial sector institutions, particularly where current systems and processes do not generate the information required to comply with the proposals. Before finalising their proposals we would encourage the Boards to consider whether the benefits fully justify the potential costs involved.

Effective date

45. We refer you to our submission in response to your *Request for Views on Effective Dates and Transition Methods*. We note that, since the supplement does not require an entity to separately identify changes in loss expectations from initial recognition, these proposals appear more capable of retrospective application than the original exposure draft. Entities should be able to make the assessments of expected losses and expected lives of portfolios and perform the time-proportional calculation at the date of implementation. However, there may be some hindsight which will be difficult to avoid in considering ‘foreseeable future’ losses in the prior year restated comparatives. Therefore, the Board may like to consider whether it would be more appropriate for the date of transition to be the earliest opening balance sheet presented or the opening balance sheet at the date of transition. This should be considered as part of the overall assessment of the cost and benefits of requiring comparatives to be restated for the implementation of IFRS 9 *Financial Instruments*.

46. We would not wish the effort that will be involved in first time application to be underestimated. Even if these proposals are more operational than the original exposure draft, entities will need sufficient lead time before adopting them.

RESPONSES TO SPECIFIC QUESTIONS/POINTS

Question 1

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

47. We believe that the impairment method should seek to avoid losses being recognised too late or, to put it another way, the impairment method should ensure that the entity is able to recognise all losses that have occurred and that are expected to occur based on reasonable and supportable assumptions at the balance sheet. We share concerns about the overstatement of assets but equally we believe that assets should initially be recognised at fair value and therefore do not support immediate recognition of lifetime expected losses as originally proposed by the FASB. Therefore, the proposed approach goes some way toward preventing undue delay in the recognition of losses.

48. However, as set out in paragraphs 16 to 20 above, the need for the 'floor' is to some extent the result of where the line is drawn between the 'good book' and the 'bad book'.

49. We agree that there should be a mechanism to avoid the delayed recognition of expected losses, but, other than as a compromise to achieve convergence, we do not support the 'floor' as set out in the supplementary proposals.

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.

50. We are supportive of a single impairment methodology that can be applied to all financial assets carried at amortised cost. There are operational challenges to the supplementary proposals but we judge them to be more operational than the original exposure draft.

51. Whether the proposals are at least as operational for individual assets may depend on the measurement requirements, particularly whether it is possible to determine initial expected losses for individual assets. If the intention is that there is no initial expected loss so that impairment is only recognised when there is an expectation of loss, then it may be that the proposals are operational to individual assets. Since individual assets have credit spreads, it is more likely that entities would be required to determine loss expectations on individual assets, which may be problematic for some entities and some types of asset. Whether the proposals are operational depends on whether the expected losses are determined based on best estimate or on probability-weighted outcomes. We have concerns that, outside areas like insurance companies, probability-weighting is not well understood or applied, even by large banks. Applying probability-weighting to individual instruments will be even more problematic than applying it to large portfolios with historic loss experience.

52. We do not see why the proposals should be less operational for closed portfolios, provided that the time-proportional expected losses are reappraised each period so that any unused allowance is removed from the balance sheet by the end of the life of the portfolio. This aspect may need to be better explained if the proposals were to be applied to individual assets and closed portfolios.

53. We have concerns about how the proposals would apply to purchased distressed debt securities which may show high yields if there are no further expectations of loss and immediate gains if loss expectations improve.

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?

54. The approach described above is that expected credit losses would be recognised on a portfolio basis over time at the higher of the time-proportional expected credit losses and the credit losses expected to occur within the 'foreseeable future' (being a minimum of twelve months). When commenting on the IASB's original proposals, we said that we were content for the initial expectation of losses on the 'good book' to be spread if practical mechanisms can be developed to do this, there is sufficient guidance to ensure loss estimates can be verified and losses that have occurred in the 'bad book' are recognised immediately and separately presented. Therefore, we support the time-proportional aspect of the calculation.

55. We have concerns about the 'floor' as defined in the supplementary proposals which are set out in detail in paragraphs 25 to 27 above. We also have concerns about the 'foreseeable future' as defined which are set out in detail in paragraphs 32 to 34 above. The 'higher of' approach is not our preferred approach as it is a compromise that may not result in the highest quality standard. Nevertheless, we can accept this approach, with a bright line definition of the 'foreseeable future' at say one year, to make the methodology work as intended and to achieve a consistent approach with the FASB. Our preferred approach is set out in paragraphs 8 to 15 above.

Question 4

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

56. We had concerns that the IASB's original proposals were not operational in practice. However, while we believe that the current proposed approach to determining the impairment allowance on a time-proportional basis will be challenging, we believe that it is capable of being applied in practice.

57. We have particular concerns about whether the current proposals are operational for smaller banks which apply the Basel standardised approach and for other entities, although we recognise that such entities may have many fewer portfolios and a less complex business model. We urge the IASB to ensure sufficient outreach with such entities in addition to the further field testing which we feel is necessary to ensure that the proposals can be applied as intended to a wide variety of different types of financial assets.

Question 5

Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

58. We believe that the proposed approach could potentially provide information that is useful for decision-making. However, due to the level of judgement inherent within the proposals there will inevitably be a degree of inconsistency on application. Therefore, in order to maximise the usefulness of the information provided and to increase comparability, we believe that adequate disclosures are necessary.

59. In our view, such disclosures should not only explain the overall movement in the impairment allowance account during the period but should also include details of, for example, the estimation technique applied, the inputs and assumptions used and so on. We are pleased to note that the proposed disclosures in the IASB-only appendix to the supplement refer to many of these issues. Nevertheless, the volume of the disclosures, particularly where there are many different types of assets and many different credit grades, could be daunting for both preparers

and users. While this is not a reason not to continue with the proposed approach, it may be a reason to consider whether further simplifications can be made. Simplifications should be considered where the level of tracking of items necessary to meet the disclosure requirements would not be compatible with the notion of open portfolios.

60. We have some concerns that the time-proportional loss charged in a particular period and the allowance recorded in the balance sheet (which we think will generally represent say 50% of lifetime expected losses) will have limited information content and may not be easily understood by users of the financial statements. Explaining the assumptions underlying the expected loss figures is probably of more use than the proposed detailed movement over time analysis of allowance accounts.

Question 6

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

61. The current proposals state that assets should be transferred to the ‘bad book’ when the entity’s risk management objective becomes one of recovery rather than one of receiving regular payments. Our reading of this is that the intention was that for the assets to be transferred to the ‘bad book’ they would need to be with, say, the recovery department where specific actions are being taken rather than simply on a ‘watch list’ or just having missed a payment. This view is supported by the examples in paragraph B3 (foreclosure of real estate, restructuring debt, exercising call options on breach of covenant). However, the text and examples in paragraph B4 are not consistent with this understanding since the examples provided include days past due or the loans being classified as doubtful. Therefore, we have to conclude that the requirement is not clearly described. Our concerns about and our suggestions regarding the differentiation between the ‘good book’ and the ‘bad book’ are set out in paragraphs 16 to 20 and 28 to 31 above.

Question 7

Is the requirement to differentiate between the two groups (ie ‘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?

62. We are satisfied that the requirement to differentiate between the two groups will be both operational and auditable so long as it is clear at which point an asset should be transferred from the ‘good book’ to the ‘bad book’.

Question 8

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

63. When commenting on the IASB’s original proposals, we suggested using the idea of a ‘good book’ and a ‘bad book’. We believe that the requirement to differentiate between the two groups is an appropriate starting point when determining the impairment allowance. It seems reasonable that entities will have more specific information about expected cash flows and losses for assets which are being monitored because there are concerns about their collectability and that they should use this better information to provide for all the losses which they expect on such items.

64. Our concerns about and our suggestions regarding the differentiation between the ‘good book’ and the ‘bad book’ are set out in paragraphs 16 to 20 and 28 to 31 above.

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 credi 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.

65. Our views on the 'floor' as set out in the supplementary proposals and our preferred view on a mechanism to ensure that the allowance is sufficient are set out in paragraphs 8 to 20 and 25 to 27 above. In addition, our views on the 'foreseeable future' are set out in paragraphs 32 to 34 above.

66. We can see some reduction in operational complexity by only invoking the 'floor' in circumstances where there is evidence of an early loss pattern. In the absence of general data to determine in which circumstances this is likely to be the case, we would prefer to allow entities to make their own simplifying assumptions which they can justify and keep under review in their own circumstances.

67. We do not agree that a 'ceiling' should be introduced. We see this as an unnecessary bright line.

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.

68. We have heard a number of commentators suggest that the 'floor' will typically be equal to or higher than the amount calculated using the time-proportional method for some or all types of portfolio. This will be more likely to be the case for short duration portfolios, such as those with an average life of less than four years. Since we expect that, on average, the time-proportional loss allowance will be about 50% of the lifetime expected losses for an open portfolio, this does not seem an unreasonable assumption. However, we have seen no empirical evidence that supports or refutes this view. We encourage the IASB to undertake additional field testing to provide a better basis for deciding how best to proceed in this area. If the 'floor' is to be included to achieve a converged approach, we suggest that the 'foreseeable future' is limited to one year to ensure that, overall, the proposals operate as intended.

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?

69. In our view the vast majority of entities would choose to apply the straight-line approach to time-proportioning credit losses allowed by paragraph B8 (a) rather than the annuity method allowed by paragraph B8 (b). We acknowledge that discounting will create additional complexity and may not be material in some circumstances. However, not discounting is theoretically unsound and may have knock on implications for how interest is recognised on impaired loans which should be considered when the IAS 39 requirements in this area are moved to IFRS 9. We also note the final requirements in this area should be consistent with other requirements in IFRS concerning discounting, for example, in the insurance proposals.

70. Allowing a choice between discounted and undiscounted estimates reduces comparability. Permitting flexibility in the selection of discount rate only reduces comparability further. We would prefer the IASB to require a consistent approach to recognising losses on a straight-line basis and a consistent discount rate.

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 (ie to recognise expected credit losses over the life of the assets)? Why or why not?

71. If field testing and analysis reduced our concerns about the adequacy of impairment in circumstances where it would appear that the recognition of losses on a time-proportional basis could be insufficient, then we would prefer the common proposal to be the IASB approach. We would also prefer an approach based on the IASB approach that included flexibility to allow earlier recognition of expected losses where the entity had probable cause to believe that such losses would be incurred in the future.

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 (ie to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

72. While the FASB approach has some attractions in terms of operational simplicity, we do not support it. It may address concerns about adequacy, but it does not properly match losses to income and may result in inappropriate ‘day one’ recognition of losses, particularly for individual items. These conceptual difficulties mean that it is unlikely to work well as a single model. We support the development of a single model for impairment and this is another reason why we do not support trying to build such a model on the FASB approach.

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?

73. We agree with the proposals to ‘decouple’ the computation of the effective interest rate from the consideration of expected losses. Although the IASB’s intentions are not clear from the scope of the supplementary document, we support the ‘decoupled’ approach being applied to all financial assets carried at amortised cost.

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?

74. We support the development of a single impairment methodology that can be applied to all financial assets carried at amortised cost and believe that this should be extended to loan commitments and financial guarantee contracts recognised at amortised cost.

Question 16Z

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

75. We believe that the proposed requirements could be operational if applied to loan commitments and financial guarantee contracts. However, the current proposals give no guidance on how the impairment model should be applied in such instances.

76. Creating an impairment allowance prior to a loan being drawn down creates some additional presentational issues since the allowance represents a liability (for an onerous contract) rather than a reduction to the value of an asset. It should be presented separately to avoid distorting coverage ratios. In some cases when facilities are set up the lender will receive fees in advance that are deferred and recognised as part of the effective interest rate calculation as and when the loan is drawn down. In these situations, the impairment charge will not match the recognition of interest income which appears to be the consequence of the allowance representing a liability.

Question 17Z

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

77. We agree with the proposed presentation requirements. Interest revenue and impairment losses should be presented as separate line items. This should apply to all assets carried at amortised cost so we assume the presentation proposals in the original exposure draft are superseded by the supplement.

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?

78. The proposed model requires the application of significantly more judgement than is required by IAS 39. We therefore regard appropriate disclosures as being essential if users are to understand the effects of credit risk on an entity’s financial position and performance. In particular we believe that such disclosures should provide sufficient information to enable users of the financial statements to assess the judgements made by management and to enable them to draw meaningful comparisons across entities. In practice, we have concerns about

whether this can be achieved, given the volume of assets of different types in different jurisdictions. Resolving the issue of how this volume of data can be aggregated into meaningful and understandable information is critical.

79. On the whole we are supportive in principle of the proposed disclosure requirements which we believe would increase transparency and comparability. However, we do have some reservations as explained below.

80. Paragraph Z6 suggests that where disclosures are made by class of financial asset this will involve grouping financial assets into classes that are appropriate to the nature of the information disclosed and take into account the characteristics of those financial instruments including their grouping into portfolios. Paragraphs BZ17-BZ21 provide further guidance on how this should be done. It may be helpful for entities to have regard to the information they provide to management, along the lines of IFRS 7 *Financial Instruments: Disclosures*, and also consider aligning the asset classes along segmental lines as set out in IFRS 8 *Operating Segments.* Doing so may be helpful in making sure the disclosures reflect how the business is managed. For example, this may be of particular relevance if, as a result of the legal frameworks in different jurisdictions, the line between the 'good book' and the 'bad book' is drawn in different places in different jurisdictions.

81. Paragraphs Z7(a)-(c) require reconciliations of an entity's allowance account to be disclosed. These requirements are illustrated in paragraphs BZ22-BZ25 and IEZ15-IEZ18. We are concerned that obtaining this information may be difficult in practice and that the costs of preparing it may outweigh the benefits. Field testing would provide an indication of the complexities of gathering this data in practice and the outcome could be used to provide a more practical example within the final standard. Nevertheless, such disclosure, perhaps less detailed, may be necessary in order to make the movements over time on the allowance account explainable and understandable.

82. Paragraph Z12 refers to making disclosures comparing actual outcomes to previous estimates of expected credit losses. Since there is no experience of applying these requirements in practice, there will be no experience of such 'back testing'. We do not support including a disclosure requirement that only applies when an entity performs 'back testing.' We suggest that the requirement is removed at this stage and possibly reconsidered when the IASB conducts a review of the application of IFRS 9, if there appear to be demand for such disclosure at that stage.

83. We are unclear whether the disclosures in the supplementary document are intended to be in addition to or instead of the disclosures in the original exposure draft. We also unclear how the proposed disclosures would interact with those in IFRS 7. We urge the Board to reconsider the disclosure requirements on a holistic basis to ensure that they coherent, consistent and balanced across topics.

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?

84. In our view, provided the allowance for both the 'good book' and the 'bad book' are sufficient at the period end and the movements on the allowances are taken to profit or loss, the 'transfer' would happen automatically. Since the transfer envisaged by the proposals would have to be calculated on an average basis as a portfolio amount is allocated to individual assets, we are not convinced that the information value of the transfer is worth the cost and effort involved in making the calculations. Therefore, we would transfer none of the expected credit loss.

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