Federation of European Accountants
Fédération des Experts comptables Européens

Sir David Tweedie
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1 April 2011

Ref.: BAN/PRJ/SKU/IDS

Dear Sir David,

Re: FEE Comments on the IASB Supplementary Document *Financial Instruments: Impairment*

(1) FEE (the Federation of European Accountants) is pleased to comment on the IASB Supplementary Document *Financial Instruments: Impairment* (the "Document").

(2) As a founding organisation of EFRAG, we have also contributed to the EFRAG consultation process by submitting on 1 April 2011 the FEE comments on EFRAG's Draft Comment Letter issued on 28 February 2011. EFRAG has not yet issued its final comment letter. We have considered their Draft Comment Letter in our response.

(3) In general, we support the expected loss approach for the impairment model for all financial assets measured at amortised cost. Such model is more relevant as it takes into account expected future developments that will impact credit losses. However, the expected loss approach is inherently more judgemental, which places more challenges on the standard setter to ensure consistent application by using clearly defined principles and terms.

(4) We agree that at initial recognition and for the performing assets in the "good book" also subsequently expected credit losses should be allocated over the life of the financial asset. This way net interest revenue matches the credit losses at initial recognition.

(5) We also agree that should such assets become impaired, the resulting loss needs to be recognised immediately.

Consistent approach

(6) We would like to stress the importance of applying a consistent general impairment model for all financial assets at amortised cost.

New concepts and terms

(7) The Document introduces new concepts of “floor” as well as “good vs. bad book”. While we think the “good and bad book” is a step in the right direction, we believe the IASB needs to consider further clarification and guidance on this concept. For both terms (if the “floor” is also retained in the final standard whilst not supported by our position) clear definitions should be provided.

(8) Additionally, there is a need to identify clearly principles and guidance for a financial asset to be moved from “good book” to “bad book”, with due consideration to the sound risk management practices of the reporting entity. In particular the preparers would need some indication by possibly making a reference to good business practice. Such indicators are provided in the current IAS 39. Otherwise, there is a risk that the process will be too judgemental and will lack consistency.

(9) We support the use of a single time-proportionate model for expected loss recognition in the “good book” due to its principal soundness, neutrality and simplicity compared to the proposed dual-impairment model.

(10) We are concerned that in certain circumstances, particularly in the case of economic downturns or a crisis, application of the two concepts of “floor” and “foreseeable future” might lead to improper provision balances as explained in detail in the Appendix to this letter.

(11) Moreover, if the floor concept is to be applied to closed portfolios and individual loans, it will inevitably create day–one losses, which are hardly reconcilable with the initial measurement of all financial assets at fair value.

Comment period

(12) We support the efforts of the IASB to develop a consistent model with a clear principle. However, we need to bear in mind that the proposals need to be operational and the current proposals for open portfolios need to be reconciled with the full amortised cost impairment model. Therefore in our opinion a 60-day comment period should be extended to give the preparers additional time to analyse the proposals and their practical consequences in detail. Also, if the proposals coming from the Board deliberations of this consultation result in other important amendments, the Board should consider re-exposure of the complete amortised cost and impairment model.

Convergence

(13) We welcome the convergence efforts by both the IASB and the FASB to develop a common impairment model for financial assets. However, in our opinion the robustness in application, a clear conceptual basis and quality of the solution have higher priority.

(14) Overall, we are convinced that the proposals in the Document are moving in the right direction. However, as mentioned above we are concerned about certain concepts and believe more specific guidance (not rules) needs to be provided.

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Our responses to the questions in the Invitation to comment on the Document are contained in the Appendix to this letter.

For further information on this letter, please contact Sylwia Kujawa, Project Manager from the FEE Secretariat on +32 (0) 2 285 40 86 or via email at sylwia.kujawa@fee.be.

Yours sincerely,

Philip Johnson
President

General

Question 1

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

(15) We agree that the approach proposed by this supplementary document deals with the perceived weakness of delayed recognition of expected credit losses. We have some doubts whether this approach offers an unbiased neutral solution to this perceived weakness as well as whether it meets some other concerns discussed below. Already in our letter submitted to the Board on 30 June 2010 in relation to the IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment* we were suggesting limited changes to the then proposed provisioning model for incurred losses (bad book) and replacement of the current portfolio impairment model by an expected loss model for performing assets in the good book. Therefore we appreciate the general model presented by the IASB and propose further amendments.

Scope – open portfolios

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.

(16) We believe that in principle there should be one consistent impairment model for all financial assets carried at amortised cost. Otherwise, application of different approaches may result in financial information that proves difficult to understand for users. We would support some practical simplifications wherever relevant, but certainly the idea of "decoupling" the interest and credit risk in the profit and loss should be consistently applied to all credit risk exposures measured at amortised cost.

(17) Having said this, we are very concerned that, in the case of closed portfolios and individual credit exposures, the proposed dual-test model with the floor would result in the recognition of day-one losses. Such recognition is inconsistent with the initial measurement of all financial assets at fair value. Furthermore, the application of the model on individual items needs to be re-considered as it might expose the preparers to further challenges and inconsistent application.

(18) There is a need to re-consider and clarify further the scope of the exclusion proposed by the Document. We understand that currently the Document scopes out loan commitments, financial guarantees, as well as short–term receivables. There are no apparent operational reasons that would prevent the application of the proposals for categories other than loan portfolios, provided these are measured at amortised cost (e.g. bond portfolios).

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Differentiation of credit loss recognition

Question 3

Do you agree that for financial assets in the 'good book' it is appropriate to recognise the impairment allowance using the approach described above? Why, or why not?

Question 4

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

Question 5

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

(19) We fully support the proposal that on the "bad book" the entire amount of expected credit losses is recognised in the impairment allowance.

(20) We propose amending the dual-test concept of the "good book" by removing the "floor" approach for the following reasons:

- The time-proportioned provisions based on the Expert Advisory Panel's proposals provide for expected losses that match the interest revenue stream from the performing asset and the "bad book" concept ensures that all identified losses are immediately recognised. We are convinced that such approach fully respects the overarching principles of neutrality and going concern, since in a going concern situation the matching principle is fully justified and consistent with other IFRS solutions;

- The "floor" concept can be applied solely to open portfolios since to do otherwise is in contradiction to the initial measurement of financial assets at fair value;

- The concept of foreseeable future is difficult to apply since (i) the probability of reliable estimates of the future decreases gradually rather then bi-nominally, (ii) the foreseeable future is inherently getting shorter in difficult and volatile periods leading to contra-intuitive and perverse results, and (iii) the ability to foresee and hence estimate based on the foreseeable future differs significantly between individual preparers and would lead to inconsistent application penalising those with more reliable forecasting models;

- The 12-month floor is a rule-based criterion and for stable open portfolios with an average maturity of 4 years or less prevents the use of time-apportioned provisioning. Furthermore, should the foreseeable future be extended to 24 months, the time-apportioned method would not be applicable to stable portfolios with an average duration not exceeding 8 years which timeframe currently, covers the vast majority of all loan portfolios;

- Switching between the time proportionate approach and the immediate recognition of expected losses over the foreseeable future would be difficult to interpret, particularly for period-based performance analysis.

(21) We support the IASB model that uses the proposed straight-line time-proportioned provisioning for the "good book", which ensures reasonable matching of the expected losses with the interest revenue stream from the performing assets. The "bad book" concept ensures that all incurred losses are immediately recognised. The difference between the straight-line recognition of the losses and the effective interest method used for revenue recognition represents a useful simplification of the model where the cost-benefit approach works.

(22) Although we consider the consistent application of the matching principle on the expected losses in the good book to the interest income as the preferred principle based and easy to understand approach for the "good book", should the IASB decide to deviate from this approach and consider some exception in the case of portfolios with clearly front-loaded loss patterns, we would prefer to replace the proposed "floor" approach by introduction of following principle: Should the proposed straight-line time-apportioned provisioning for the "good book" prevent timely recognition of expected losses in portfolios where empirical historical evidence, or other relevant analyses, provide relevant proof of a pattern with significant front-loaded losses, the straight-line approach should be rebutted and expected loss recognition should be front-loaded accordingly. In such a case we propose that the IASB analyses the pros and cons of such deviation from the matching principle, which we suggest, would address the "too little too late" concern without the day-one losses problem and other deficiencies related to the "floor" concept.

Question 6

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

Question 7

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

Question 8

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

(23) We believe that the approach based on two types of books is an appropriate one and we also support the principle-based definition provided by IASB. Such approach ensures principal comparability between entities with similar portfolios of financial assets, which use different judgement or apply different credit risk management practices.

(24) We believe that the definitions of the two books are consistent with the existing practice for good credit risk management. Impairment losses for "good book" are usually regularly assessed on a portfolio basis (and reasonably matched against the interest income recognition pattern), whereas losses for items within the "bad book" are estimated on an individual basis (or on a group basis consisting of non-performing assets with very similar credit rating and risk characteristics, particularly in the case of large retail portfolios).

(25) Regarding the description of the differentiation between "good book" and "bad book" in the context of determining the impairment allowance (Questions 6), we are concerned that the guidance in paragraphs B3 and B4 of the Document would result in a later transfer to the "bad book" in comparison to the existing individual impairment criteria of IAS 39 and the Basel Accord default definitions. In general, the later the assets are moved to the bad book, the less relevant the time-proportionate approach of good book provisioning. In order to strike an appropriate balance between the risk management practices and comparability, we suggest consideration of additional criteria – e.g. expectation to collect all contractual cash flows from each individual asset of the "good book" on an asset-per-asset rather than a portfolio basis.

(26) In terms of "good book" and "bad book" differentiation for the purpose of determining the impairment allowance (Question 7), we think the proposal is operational and auditable. We believe that the majority, if not all, of existing accounting systems could deal with the distinction and the related impairment calculation.

(27) Having said that, in order to support consistent application we would encourage the IASB to provide illustrative guidance regarding the transfer of a financial asset from one book to another. Particularly, we note the absence of any guidance considering the treatment of the related provision in the relatively rare case of assets moving from the "bad book" to the "good book".

Minimum impairment allowance amount

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 amount related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?

(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

(d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?

(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.

(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

Question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2.1(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.

(28) We do not agree with the proposal to require a floor for the impairment allowance related to the 'good book' for the reasons stated in our response to Question 3.

(29) We disagree with the 'floor' approach and we also disagree with the rule-based 12 months minimum foreseeable future definition for the reasons stated in our answers to Question 3. We are also convinced, as mentioned above, that the foreseeable future (however defined) would become a moving term in line with the basis of changes in economic conditions, since the more exposed and volatile part of the economic cycle the preparer is in, the shorter the foreseeable future becomes. Although we are not in possession of any "hard data", we are not convinced that the assumption that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months is justified. Even if it would be justified, we question why setting a minimum period is needed in a principles-based standard-setting environment.

(30) We agree with the statement contained in paragraph BC86 of the Document that "the lack of any clear articulation of what the foreseeable future period means is likely to result in significant divergence on practice". However, if the Board decides to retain the immediate recognition of expected losses in the "good book" under certain circumstances – contrary to our views presented above, we would prefer a clear definition of the reflection period as 12 months to the extremely subjective and moveable foreseeable future concept.

<u>Flexibility related to using discounted amounts</u>

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?

(31) We believe that the flexibility permitted in the use of the discounted or undiscounted estimate when calculating the time-proportional allowance amount will make discounting more feasible operationally. It would contribute to the general simplifications in the IFRS standards, particularly if applied to portfolios with shorter duration.

(32) We are of the view that the discounted approach will be most likely applied by large financial institutions with comprehensive systems and observable loss patterns whereas the undiscounted one will be preferred by smaller preparers. We note that in some cases it is significantly more difficult to predict the timing of losses than the magnitude, particularly in the "good book". While discounting can provide relevant

and theoretically correct information, its application can be challenging, very judgemental and therefore result in less reliable information. In order to ensure consistency, introduce discipline, avoid earnings management and judgemental approaches, we would support a consistent approach to discounting with clear and meaningful disclosures of the policy choice.

Approaches developed by the IASB and FASB separately

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (i.e. to recognise expected credit losses over the life of the assets)? Why or why not?

(33) For the reasons discussed above, we support in principle the IASB approach, possibly combined with options to deal with portfolios with front-loaded loss emergence patterns and other improvements raised in this letter.

Question 13

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (i.e. to recognise currently credit losses expected to occur in the foreseeable future at or after the first reporting date after initial recognition of the financial assets)? Why or why not?

(34) We do not prefer the FASB model for assets. It does not distinguish the good and bad books, which we strongly support. Moreover, it does not maintain the link between the pricing of financial assets and expected credit losses and, except for the special circumstances of open portfolios, it creates day-one losses leading to initial measurement of loans on an arbitrary and difficult to interpret measurement basis defined as 'fair value less the expected losses over the foreseeable future'. The subsequent measurement basis would be 'initial fair value plus effective interest rate (inherently including straight-lined life-time expected losses) less excess of expected losses in the foreseeable future over the straight-lined life-time expected losses', which we consider difficult for understanding and interpretation.

(35) Additionally, as already mentioned in the cover letter, we have serious concerns about the application of the concept of "foreseeable future". In particular, we are concerned that in certain circumstances, particularly in the case of downturns or an economic crisis, application of the two concepts of "floor" and "foreseeable future" might lead to inappropriate provision balances. This is mainly because during downturns the foreseeable future inherently shrinks, possibly even under the 12 month overriding limit.

(36) We understand the efforts of the IASB to ensure convergence in the context of the political call for action. However, we remain convinced, in line with the principles outlined by Hans Hoogervorst in the February 2011 Financial Reporting Conference presentation in Brussels, that the basic demand for transparency and the principle of neutrality should be prioritised in the best interest of financial markets, investors and general financial stability. As already stated in numerous FEE documents, we prefer

to align the financial reporting and regulatory reporting approaches wherever the difference cannot be justified by different objectives of the two frameworks. In line with this position and principles of transparency, we are supporting principles, which are on one hand not exaggerating any pro-cyclical effects, on the other hand not hiding volatility and real impairments in the downturn.

QUESTIONS IASB-ONLY RE-DELIBERATIONS

Impairment of financial assets

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?

(37) In our letter submitted to the Board on 30 June 2010 in relation to the IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment* we expressed our concern that - as entities usually store contractual and accounting data in a separate system from the system of expected losses data information - implementation of the integrated effective interest rate approach would represent an operational challenge.

(38) Therefore we support the IASB decision to "decouple" the computation of the effective interest rate from the consideration of credit losses. This will ensure that the method is operational. We strongly support expansion of this approach from open portfolios to all credit exposures measured at amortised cost.

Scope – Loan commitments and financial guarantee contracts

Question 15Z

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

Question 16Z

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

(39) In our opinion 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) should be subject to the impairment requirements proposed in the Document (Question 15Z) since both loans and loan commitments are usually managed within the same business strategy.

(40) Regarding financial guarantees (Question 16Z), our final response depends on whether those types of contracts remain in IAS 39, will be regulated by IFRS 9, or are included in the new Insurance Contracts standard. If the IASB is unable to provide a principle-based definition distinguishing between financial guarantees and credit insurance (which has proved to be a very challenging task up to now), we would prefer to distinguish these products by reference to the business model used by the individual reporting entity.

(41) The IASB could consider proposing application of the common proposals to financial guarantees for loans scoped into IFRS 9 in line with the proposals in this Document, since the credit risk behaves very similarly and the uniform model will save cost to preparers and simplify interpretation for users.

Presentation

Question 17Z

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

(42) In our letter submitted to the Board on 30 June 2010 in relation to the IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment* we stated that the split of information as proposed into gross, initial and expected losses, net and subsequent loss adjustments would provide some insight, at least to understand the quality of the initial expectations. The time-proportioned model usefully splits the interest and credit risk information presentation and places less importance on the initial versus subsequent provisions, so it gains our support.

Disclosure

Question 18Z

(a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement 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?

(43) We are of the opinion that in terms of disclosure the priority should be placed on simplification and comparability – the latter not only between entities but also between entities operating in different jurisdictions.

(44) Having said that, we believe, however, that disclosures at a meaningful level of aggregation are inevitable as the expected loss model incorporates a great degree of judgement. Therefore, it is necessary to provide the users of the financial statements with the relevant information and data in order to enable them to make informed decisions Critical disclosures include (i) the qualitative information on the application of the principles of the standard, (ii) the movement analysis of the provisions in the bad book and to final write offs, (iii) information on the back-testing and robustness of the implemented expected loss model.

(45) It would be desirable for the IASB to consider the proposals in the Document in the light of the existing disclosure requirements under IFRS 7.

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?

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(46) We support the general principle that provisions built should be ultimately used for loan write offs. Whereas the proposed transfer of the time-proportionate provision accompanying the loan from the "good book" to the "bad book" has certain information value, we are not sure about the result of a cost benefit analysis of the proposed good book provision movement disclosure. Users will certainly benefit from a full analysis of movements in the "bad book". Anyway, it is critical for the model that the "good book" provision balance is reinstated after any significant transfer to reflect the real remaining expected loss in the "good book" after such transfer.