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Dear Sir David

**ED/2009/12 Financial Instruments: Amortised Cost and Impairment**

Lloyds Banking Group plc ('LBG') is pleased to comment on the proposals contained in the Supplement to the above exposure draft ('Supplement').

The Supplement addresses the key concerns we expressed in our response to the ED. In particular, we are pleased that the Board now proposes to de-couple the expected loss calculation from income recognition (EIR) in order to make the proposals operational. We are also supportive of the requirement to differentiate between 'good' and 'bad' books and to account for these using different approaches which reflect the primary objective of managing the portfolio of financial assets. We believe these changes ensure that the approach is operational for financial institutions.

However, we have the following concerns with the proposals contained in the Supplement:

***'Floor'***

We do not believe that the introduction of the 'floor' is consistent with the original objectives of the Board's expected loss model. The inclusion of a floor introduces rules undermining the core principle of the approach and involves significant judgement. The floor could give rise to 'day 1' losses on new and growing lending portfolios and creates potential volatility in the income statement.

The floor will also present a significant operational burden given the need to calculate the time apportioned allowance in addition to the amount of the floor. There is also likely to be significant diversity in practice as to how the floor is applied across the banking industry, given that an entity's interpretation of "expected loss" will determine the level of the floor.

The foreseeable future period is dependent on an entity's ability to forecast expected losses. In theory, the more sophisticated an entity is, the longer the period for which the entity should have the ability to make specific projections of events and conditions, and therefore, the higher the level of the floor. This is likely to give rise to different floors for similar items across entities and significantly reduces comparability. An alternative approach might be to set a consistent 12 month floor as a rebuttable presumption which we believe would lead to

greater comparability between entities, simplify financial statements for users and lessen the operational burden for preparers.

***Pro-cyclicality***
Whilst we acknowledge that the IASB has partially addressed pro-cyclicality, the model proposed in the Supplement could be more pro-cyclical than the incurred loss model when the credit cycle deteriorates due to higher migrations of assets from the good book into the bad book and also due to higher expected losses in the foreseeable future. Those entities that have longer foreseeable future periods would experience even more income statement volatility.

***Good book and bad book definitions***
We are supportive of the principles differentiating between the good book and the bad book for impairment purposes. However, we are concerned that there could be significant diversity of interpretation and practice, particularly around renegotiated loans and forbearance arrangements. For example, it is not clear how an entity should classify a loan for which expected cash flows are revised downwards but where the loan is still performing or where a loan is restructured. We would urge the Board to undertake further outreach activity in this area to develop appropriate guidance

***Credit cards and overdrafts***
The Board has yet to consider and provide guidance on the treatment of credit cards and overdrafts. These are material to the Group's operations and we would encourage the Board to engage with preparers of financial statements, perhaps through the EAP, to fully understand the implementation issues and to provide high quality guidance.

We appreciate that the Board has yet to address these areas and also the treatment of loan commitments and financial guarantee contracts. We would strongly encourage the Board to re-expose any new proposals relating to such instruments for comments before finalising a standard.

We believe that the Board should be mindful of the complexities of implementing an expected loss model and encourage the Board to consider the effective date and transition requirements (please also refer to our comment letter on the Request for Views on Effective Dates and Transition Methods).

We have set out our responses to the specific questions in the Supplement in the Appendix to this letter. These comments should be read in the context of our overall comments above.

Yours sincerely

David Joyce

## APPENDIX – RESPONSES TO THE QUESTIONS IN THE SUPPLEMENT

### 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?***

We believe that the proposed model addresses delayed recognition of credit losses to a greater extent than the incurred loss model.

### 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.***

We believe that the proposed approach could also be applied to closed portfolios and single assets, although we encourage the Board to undertake field testing and outreach-activities to consider the practical application of the proposals to these assets. For example, applying the floor to a single asset would give rise to a floor that is different to the floor calculated for an open portfolio containing the same assets. The time-proportional allowance calculated on an aggregate basis would also differ from an allowance calculated on closed portfolios that are structured by vintage. These are some of the practical issues that the Board needs to address.

### 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?***

We support a time-proportional approach to the recognition of credit losses for loans that are being managed for the collection of interest and principal as we believe that there are conceptual merits to recognising expected losses over the period in which losses arise and interest revenue is earned. However we have two concerns:

***Floor*** - We question how the concept of the floor fits into this model. Please see our response to Question 9 regarding our concerns with the floor.

***Annuity allocation method*** - The Supplement provides entities with an option to recognise the time-proportionate amount either on a straight line basis or using an annuity approach. The annuity method is complex and from the current explanation provided, it is not clear how the approach would work for more realistic cases where losses can occur throughout the life of the loan. We are concerned around how transparent an entity could be in explaining how the annuity method works and the results it achieves. If the Board retains the annuity method, more application guidance should be provided on more realistic scenarios involving multiple expected loss timing assumptions to ensure consistency between entities.

**Question 4**
***Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?***

The time-proportional basis relies on an entity's ability to forecast expected lifetime losses and by not prescribing a method by which to do this, we believe the approach would be operational. Estimating over an asset's entire lifetime will be significantly more operationally challenging than estimating over a shorter period due to subjectivity around the forecasting. The ability to use long run average data beyond the foreseeable future makes the method more feasible.

As acknowledged in the Supplement, there will be a period over which an entity has specific data to use as inputs to the impairment model. The Supplement refers to 'shorter' and 'medium' terms (paragraph B7) for which an entity would use 'specific inputs'. Beyond those periods, an entity could revert to a long term average loss rate. The foreseeable future is defined in paragraph B11 as the period for which specific projections are possible. This would seem to imply the foreseeable future comprises both the short and medium terms. There appears to be no real significance of the use of the terms short and medium terms other than their relation to the foreseeable future. To avoid confusion, we recommend that the Board refers to only the 'foreseeable future' and 'periods beyond the foreseeable future'.

**Credit cards and overdrafts** - The Board has yet to provide guidance on credit cards and overdrafts. Such products do not have an obvious expected life and currently, entities are responsible for devising appropriate approaches to EIR methods and loan loss provisioning, which leads to significant diversity in practice. We would appreciate the Board providing guidance on how to apply the proposed approach to these instruments for which the definition of expected life is particularly challenging, as is average age. Notwithstanding our concerns regarding the floor (see covering letter and response to question 9), one possible solution to this would be not to require the 'higher of' test for these instruments and to only require the floor.

**Question 5**
***Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?***

We believe that users of financial statements are better placed to respond to this question.

**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?***

The broad principle for the distinction between the good book and bad book as proposed in the Supplement is clear. However, we are concerned that there will be significant diversity of interpretation and practice leading to reduced comparability. For example, it is not clear under the proposals how an entity should classify a loan for which expected cash flows are revised downwards but where the loan is still performing or where a loan is restructured. We would urge the Board to undertake further outreach activity in this area to develop appropriate guidance that reduces divergence of practice.

**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?***

As the distinction is based on an entity's internal risk management practices, the ability to differentiate between the good book and the bad book is operational.

**Question 8**
***Do you agree with the proposed requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?***

We are supportive of an approach that differentiates between the good book and the bad book. There is a difference between how financial assets in the good book and the bad book are managed and we agree with the Board's approach that the distinction should be reflected in the financial statements.

**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 related to the 'good book' on 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.***

(a) We do not support the requirement for a floor. We do not believe the inclusion of a floor is consistent with the overall objectives of the ED which were to 'reflect initial expected credit losses as part of determining the effective interest rate'. Further, we believe the floor adds an unnecessary level of complexity to the impairment approach.

The time-proportional approach without the floor has conceptual merit on the grounds that expected losses are recognised over the period in which those losses are incurred and interest revenue is earned. Please refer to question 4 for our comments regarding the operational feasibility of the approach.

(b) The floor would be more relevant for portfolios with an early loss pattern and also in an economic downturn. However, the application of the floor requires a significant level of judgement when determining the foreseeable future. Applying the floor only when there is evidence of an early loss pattern will add more subjectivity and raise issues for entities entering into a new line of business.

(c) We do not agree with the floor. We are concerned about the potential consequences of the foreseeable future being used to determine an impairment allowance. The more sophisticated an entity is (i.e. the better its credit forecasting capability), the longer its foreseeable future is likely to be and therefore the higher its allowance. This will create inconsistencies and reduce comparability in practice. Besides which, in an open portfolio, early loss patterns would likely be cross-subsidised by older "seasoned" loans, removing this issue.

While we are not supportive of the floor, should the Board proceed with the joint approach, an alternative could be to introduce a rebuttable presumption that the foreseeable future is 12 months.

(d) Yes. During benign parts of the economic cycle, forecasting is relatively simple and forecasts going out for a number of years may prove to be accurate if the economy remains steady. However, in an economic downturn, the future is less predictable and the foreseeable future period is likely to decrease for some portfolios. Conceptually, therefore, the foreseeable period could, and should, change in light of circumstances, leading to increased volatility, increased management judgement and a lack of comparability across entities.

(e) Recent years have demonstrated that reliable and supportable forecasts can rarely be made for a period of longer than 12 months. While we view the foreseeable future as generally short, we believe a 12 month period is appropriate as many banks already have internal ratings-based models built around this definition for regulatory capital purposes.

(f) We believe that due to the potential consequences of entities using different foreseeable futures, a period of 12 months should be made a rebuttable presumption for the period.

**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.***

The impact of the floor will depend on the level of granularity at which portfolios are defined (and hence the floor is applied). The higher the level of granularity, the more frequently the floor will apply, and hence the higher the overall allowance required. This seems contradictory to the objective of the floor, which is to make sure short term expected losses are fully provided for. In our view if the floor is to be included in the final model, the floor should also always be applied at the highest possible level, whereas all other calculations should be applied at the most granular level possible.

In a steady state portfolio the time-proportionate approach will result in a 50% allocation (as the steady state portfolio will be half its average age). In these circumstances the floor is likely to be effective for shorter effective maturity portfolios, where the allocated age will be short compared to the foreseeable future. In longer dated mature portfolios, the floor is unlikely to be effective. However we are concerned that in respect of new and growing portfolios a day 1 loss would arise which we do not support.

In addition, in an economic downturn, the losses expected in the foreseeable future would most likely exceed the fraction that is arrived at using the proportionate method.

**Flexibility related to using discounted amounts**

**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?***

(a) We support the proposed flexibility in allowing an entity to choose whether to discount estimates or not.

The Supplement proposes that where an entity chooses to discount estimates, the entity discounts expected losses. However, it is not clear in the proposals as to how losses are defined. For example, a loss could be defined as the difference between the carrying value of a loan and the present value of expected future cash flows or it could be defined as a shortfall from contractual cash flows. We recommend that the Board clearly sets out its definition of a loss for the purpose of the standard.

The Board should also clarify the point at which expected losses arise (i.e. at the time the cash flows are revised or at the time when the loss materialises), as the timing affects the level of allowance recorded. In addition, where an entity chooses to discount losses, that estimate should include both lost principal and interest. In contrast, for an undiscounted approach, it may make sense for an entity to discount only expected losses of principal, in order to avoid an inconsistent treatment of the time value of money.

The Board has yet to address whether and how cash flows for the bad book should be discounted and we would expect this to be consistent with the approach under IAS 39 for incurred losses.

Furthermore, the Board should clarify the mechanics of how the unwind of discounted losses would interact with the revision of expected loss calculations and the income statement line within which the unwind should be presented.

(b) Conceptually the EIR seems to be a logical discount rate to apply, however, we are supportive of the Board introducing flexibility in the rate that is used in order to ensure that discounting is operational. If the Board does permit a choice, we believe that entities must apply a consistent approach from period to period.

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

We support the general principles set out in the original ED and therefore prefer the IASB approach for open portfolios as compared to the joint proposal. We believe the IASB approach is more aligned with the IASB's original proposals, but introduces changes necessary to ensure the approach is operational.

We are particularly concerned about the subjectivity around the introduction of a floor in the common approach and the operational burden it would introduce by requiring entities to undertake two calculations adding cost and complexity.

**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?***

No - please refer to our comments in question 12.

## Presentation and Disclosure (Response to Questions in Appendix Z)

### 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?***

Yes, we are supportive of the decoupling of the EIR calculation from the recognition of expected losses.

### 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?***

As commented in our response to the ED, we believe that as loan commitments are managed in a similar manner to the financial assets that result from these facilities, there should be consistency in the way in which they are measured, and therefore should be subject to the requirements proposed in the Supplement. Similarly, as financial guarantee contracts have similar risk characteristics, these should also be subject to the same impairment model, to the extent possible.

In addition, we believe there is merit in excluding short term receivables from the scope of the impairment requirements.

**Question 16Z**
***Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?***

In order to calculate regulatory capital in accordance with the Basel II definitions, banks are required to reflect the probability of additional drawings on committed facilities, up to and after a default event is triggered. It could be possible to adapt this calculation for accounting purposes.

However, there are other issues related to loan commitments, such as the recognition of facility fees that the Board has yet to address in its replacement of IAS 18. We would encourage the Board to expose any proposals relating to issues it has not yet addressed, for comments before finalising a standard.

### Presentation

**Question 17Z**
***Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?***

Yes. We do not believe it is appropriate to include expected credit losses within revenue as net interest margin is a key metric for banks. Inclusion of expected credit losses within the revenue line would impair decision usefulness.

## Disclosure

**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?***

(a) We largely agree with the proposed disclosure requirements and believe they are necessary due to the highly subjective nature of firstly, an expected loss model, and secondly, the specific features of the proposed model. In particular, we welcome the disclosures relating to the inputs and assumptions and also those on the good book and bad book definition.

The proposals include disclosures about actual outcomes compared with previous estimates and we are concerned about the operational feasibility of producing these disclosures and also how useful the disclosures would ultimately be. The comparison of expected and actual credit losses requires an entity to track particular assets or groups of assets, as otherwise the comparison would be impossible. The expected loss calculation would be applied at a portfolio level suggesting that the comparison should be undertaken at a portfolio level. In effect, this involves creating closed portfolios for disclosure purposes whilst retaining open portfolios for impairment purposes. We do not believe that the disclosures will be operationally feasible to apply to an open portfolio and urge the Board to remove this disclosure from the final standard.

We are concerned about the requirement to disclose five years of impairment allowance information. Depending on the point in the economic cycle and how the economy has changed, prior information could become outdated and misleading. Accordingly, we suggest the Board reconsiders this disclosure as whether it would be more appropriate to restrict information to include the comparative period presented in the financial statements only.

(b) We appreciate that the Board is yet to consider whether these disclosures will form part of IFRS 7 or not. We believe that it is appropriate for all financial instrument disclosures to be set out in a single standard, i.e. in 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?***

Each time that an asset is transferred out of the good book into the bad book, an entity would over-provide for the good book unless a part of the allowance is transferred to the bad book at the same time or unless the entity revises its good book calculation. This is likely to be difficult operationally and entities are likely to perform the good book calculation at specified reporting dates (e.g. each quarter end) suggesting that a transfer from the good book to the bad book is a reasonable compromise.