



National Australia Bank Limited
ABN 12 004 044 937

800 Bourke Street
Melbourne Victoria 3008
AUSTRALIA

1 April 2011

Sir David Tweedie
Comment Letters
International Accounting Standards Board
1st Floor 30 Cannon Street
London EC4M 6XH
UNITED KINGDOM

Dear Sir David

Supplement to ED/2009/12 Financial Instruments: Impairment

We are pleased to have the opportunity to comment on the Supplement to the Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the supplement).

National Australia Bank (NAB) is one of the four major banks in Australia. Our operations are predominately based in Australia, New Zealand, the United Kingdom, the United States and Asia. In our most recent annual results we reported net profit after tax of A\$4.2 billion and total assets of A\$686 billion.

Our comments on the specific questions raised by the IASB are addressed in the Appendix and we have set out below our key comments.

Overall, we agree with the proposed impairment approach and continue to support the efforts of the IASB and FASB in developing a converged impairment standard. We agree with an impairment approach where expected credit losses are gradually built up over time, however acknowledge that the time-proportional approach alone may be inadequate to capture credit losses that occur in early loss emergence scenarios. We believe that the floor approach, which is calculated based on expected losses for the foreseeable future, enables the impairment allowance balance to be built-up quicker than on a time-proportional basis in such early loss scenarios and helps address the issue of delayed recognition of expected credit losses. Consequently, we support the proposed approach requiring the recognition of impairment at the higher of the time-proportional amount and the floor for the 'good book'.

For short dated portfolios with an average life of less than twelve months, we believe the impairment allowance determined under the floor approach would be based on the expected credit losses for the remaining life of the portfolio notwithstanding the twelve months minimum requirement for 'foreseeable future'. Whilst in our view it is clear how the floor would be applied to short dated portfolios, we encourage the IASB to include some practical guidance to illustrate the application of the foreseeable future concept in practice.

We believe that the proposed impairment provision approach is operational. We are satisfied with the supplement's description and the level of guidance for the concepts of a 'good book', a 'bad book' and the 'foreseeable future'. We support the proposed principles-based approach as it aligns the accounting requirements to how entities measure and manage credit risk for its portfolios.

We support a single impairment approach for all financial assets irrespective of how the assets are managed (i.e. within open or closed portfolios or as a single instrument). Furthermore, we believe the approach should be applied to loan commitments and financial guarantee contracts as it is consistent with how financial institutions typically manage and measure credit risk from a business and regulatory perspective.

We are concerned about the extent and detail of the proposed disclosures and believe that these should be revised to be aligned with the principle nature of the standard. Specifically, we disagree with the requirements for quantitative disclosures for back testing results, total expected credit losses, differences between the impairment allowance calculated under the time-proportional approach and the floor, and detailed disclosures by credit risk rating grades. We believe the proposals are over prescriptive and extremely onerous for entities to operationalise. Further the additional detail would cause confusion rather than provide useful information to users.

Should you have any queries regarding our comments, please do not hesitate to contact Marc Smit, Head of Group Accounting Policy at marc.smit@nab.com.au.

Yours sincerely



Peter Beharis
General Manager, Group Finance

Appendix

Detailed Answers to Questions

GENERAL

Question 1

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

Yes, the proposed impairment model requiring the recognition of impairment at the higher of the time-proportional amount and the floor for the good book, and full lifetime expected losses for the bad book, would result in earlier recognition of expected credit losses compared to the current incurred loss model of IAS 39. Therefore we believe that the proposed model would address the perceived weakness of delayed recognition of expected credit losses.

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?

The proposed model is operational for all portfolios and single assets. We support a single impairment approach for all financial assets that are subject to impairment irrespective of how the assets are managed as any differences would result to inconsistency in the impairment allowance recognised for the same assets. Further, introducing different methodologies for open and closed portfolios creates unnecessary operational challenges and inefficiencies, as well as additional complexity which may lead to confusion for users.

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?

We agree with the proposed approach for the good book and continue to support the efforts of the IASB and FASB in developing a converged standard that will be applied by entities reporting under either IFRS or USGAAP.

We agree with an impairment approach where expected credit losses are gradually built up over time, however acknowledge that the time-proportional approach alone may be inadequate to capture credit losses that occur in early loss emergence scenarios. We believe that the floor approach enables the impairment allowance balance to be built-up quicker than on a time-proportional basis in such early loss scenarios and helps address the issue of delayed recognition of expected credit losses and the notion of "too little, too late". Consequently, we support the proposed approach requiring the recognition of impairment at the higher of the time-proportional amount and the floor for the good book.

We believe the time-proportional approach would be operational, particularly with the decoupling of the calculation of interest revenue and credit losses. While we consider the annuity method potentially difficult to operationalise for some entities due to the complexity in requiring an entity to convert the entire amount of the credit losses expected for the remaining life of the portfolio, into annuities on the basis of the expected life of the portfolio and accumulating these annuities for the portfolios age. We nevertheless support the various options proposed in the supplement for the calculation of the time-proportional impairment allowance as it caters for different levels of sophistication across entities and facilitates implementation.

We believe that the proposed approach would provide more useful information than the current incurred loss model as it uses more forward-looking information to determine credit losses. Further, an approach that aligns the accounting requirements to how organisations measure and manage credit risk better reflects the performance of the entity's portfolios and provides more appropriate information to users.

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 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 believe the requirement to differentiate between the two books is clearly described. The proposed approach is operational and auditable as it is operationally consistent with how we manage and measure credit risk within our portfolio. We support the proposed approach as it aligns the accounting requirements to how entities measure and manage credit risk for its portfolio.

MINIMUM IMPAIRMENT ALLOWANCE AMOUNT

Question 9

- (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 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.

We agree with the proposal to require a floor that is based on the expected losses for the foreseeable future in the determination of the impairment allowance. We believe that the proposed time-proportional approach on its own may be inadequate to capture credit losses that occur in early loss emergence scenarios. Therefore, the requirement of a floor that is based on expected losses for the foreseeable future would ensure that adequate impairment allowance would be recognised, particularly for portfolios with early loss patterns.

We are satisfied with the supplement's description of the foreseeable future concept and understand the requirement to make use of all reasonable and supportable information to develop forecasts of future events and conditions. We note that the determination of the foreseeable future would reflect the specific characteristics of the portfolio. Although the time horizon for foreseeable future is not specifically defined or any detailed guidance on its determination is provided, which may reduce comparability across entities, we support the principles-based approach being proposed as it aligns the accounting requirements to how entities measure and manage credit risk for its portfolios. We believe that this would better reflect the performance and specific characteristics of an entity's portfolios and provide more appropriate information to users.

Consequently, we do not believe that imposing predefined rules or ceilings will be required. We believe however that some additional guidance should be included to illustrate the application of the foreseeable future in practice, particularly for longer dated portfolios (i.e. 5 or more years). For such portfolios, it is our view that the time horizon for the foreseeable future would not be equal to or close to the average life of the portfolio but a time period

where reasonable and supportable information is used. Consequently, we believe that there is an implicit ceiling due to the availability of reasonable and supportable information and it is unlikely that the foreseeable future would extend out for a long period of time.

Further, we believe that the floor should be applied in all scenarios for consistency and to ensure that the impairment model is operational. Invoking the floor only in specific scenarios requires another process to be developed, adding further complexities and judgement that are unwarranted.

We concur with the view that the foreseeable future is a minimum of twelve months as we believe that entities should generally be able to forecast future events and conditions based on reliable and supportable information for this time period. Although the ability to forecast will be difficult in an economic downturn, we believe that reliable and supportable information would still be available for the purposes of determining an impairment allowance for a twelve month time horizon, albeit there may be greater volatility during an economic downturn. Furthermore, we believe that the foreseeable future period is generally greater than twelve months for most portfolios however acknowledge that consideration needs to be given to specific characteristics of the portfolio and the position we are in across the economic cycle.

Based on our interpretation, for short dated portfolios with an average life of less than twelve months, we believe the impairment allowance determined under the floor approach would be based on the expected credit losses for the remaining life of the portfolio notwithstanding the twelve months minimum requirement for foreseeable future. Whilst in our view it is clear how the floor would be applied to short dated portfolios, as noted above we encourage the IASB to include some practical guidance to illustrate its application in practice.

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 portfolio for which you believe this will be the case.

It is difficult to categorically state whether the floor will typically be equal or greater than the impairment allowance under the time-proportional approach without performing detailed calculations and simulations.

However, from a theoretical perspective, we believe that the floor will typically be equal or greater than the time-proportional amount in the following scenarios:

- in benign periods where the foreseeable future has a time horizon greater than twelve months; and
- for portfolios with early loss patterns.

We believe there may be instances where the floor will be lower than the time-proportional amount depending on the characteristics of the portfolio and where we are in the economic cycle. We believe that there will be instances where the determination of the impairment allowance balance will alternate between the two approaches.

FLEXIBILITY RELATED TO USING DISCOUNTED AMOUNTS

Question 11(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?

Question 11(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?

We agree with the flexibility provided by the IASB enabling an entity the choice of either using a discounted or undiscounted estimate as it is aligned with the principles based nature of the proposed approach and facilitates implementation. Similarly, we agree with the ability to use a discount rate which is within the range of the risk free rate and the effective interest rate.

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?

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 the FASB approach (i.e. to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

As discussed throughout this letter we support the proposals in the supplement for estimating impairment provisions for the two books. The proposals in the supplement we believe overcome the FASB's concern about "too little, too late" given the floor would capture the expected credit losses on portfolios with early loss patterns.

PRESENTATION AND DISCLOSURE

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 support the proposed approach that separates the determination of interest revenue from expected credit losses as it removes the significant operational challenges arising from an integrated effective interest rate approach.

Consistent with our views provided in our comment letter on the Exposure Draft ED/2009/12 Financial Instruments: Amortised Cost and Impairment, we do not support an integrated effective interest rate approach due to the following:

- Mixing interest revenue and initial expected credit losses reduces transparency for financial statement users;
- Inappropriate netting of revenue and expenses;
- Inconsistency between credit losses expected at inception and subsequent changes; and
- Different amortised cost principles for assets and liabilities.

Please refer to our comment letter on the Exposure Draft ED/2009/12 Financial Instruments: Amortised Cost and Impairment for further details.

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?

Yes, we support a single impairment approach for all credit exposures including loan commitments and financial guarantee contracts that are not accounted for at fair value, for consistency and simplicity. We believe it would be operational as it is consistent with how financial institutions typically manage and measure credit risk from a business and regulatory perspective.

Question 17Z

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

Yes, we support the proposed presentation requirements with interest income and impairment losses being separately disclosed within the statement of comprehensive income.

Question 18Z(a)

Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you agree with and why?

Question 18Z(b)

What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

We are concerned with the level and detail of the disclosures being proposed and question the value it provides to users. We believe that the disclosure requirements are extremely onerous for entities and would create unwarranted operational challenges. We note that detailed disclosures in respect to credit quality are already provided by financial institutions in a public document required under the Basel II Accord, which in essence is similar to the proposed disclosure requirements. However, the proposed disclosure requirements will require financial institutions to create a separate process to collate and populate this information on a different basis without necessarily providing additional value and may lead to confusion for users due to differences in numbers and information presented. Further, we believe that the extensive level of disclosures being proposed reduces the comprehensibility and usefulness of financial reports, and may distract users from the key information being provided in financial reports.

Specifically, we have concerns with the following proposed disclosures:

- We do not believe that quantitative disclosures on the analysis of actual outcomes and previous expected credit losses contained in paragraph Z12 should be required. The calculation of expected credit losses is not an exact science and requires the use of assumptions around probability of default, loss rates and the forecasting of future events and economic conditions. Therefore, by its nature, expected credit loss calculations will never be completely accurate and will inevitably differ to actual outcomes. The proposed disclosures will only draw attention to this and confuse unsophisticated users. Further, we do not believe this requirement would be operational for open portfolios given assets are constantly added and removed from the portfolio.
- Similarly, for the reasons noted above, we do not believe that the total amount of expected credit losses should be disclosed.
- We question the relevance of the proposed disclosures detailed in paragraph Z14 based on an entity's credit risk rating grades. An entity's credit risk rating grades

would not be meaningful for users given it is an internal measure and the rating scale varies between entities. Detailed disclosures around the entity's rating scale and how the ratings are determined would be required to provide any relevant information to users.

- We are also uncertain about the value of the disclosure of the difference between the impairment allowance determined under the floor and the time-proportional approach, especially if the impairment allowance has been determined under the floor approach.
- We refer to the IASB's recent tentative decisions regarding the requirement to disclose quantitative information in respect of assets written off but for which the entity is still pursuing collection. We do not believe that such quantitative disclosure should be required given its commercial sensitivity and anticipate that such instances would likely to be immaterial.

We believe that if the IASB is to endorse a principles-based approach to the accounting for impairment then it should also be proposing disclosures that are based on the principles adopted by management in measuring and managing the credit risk for its portfolios. We welcome the inclusion of credit risk and impairment disclosures in financial reports that are consistent with the information that senior management and the analyst community place significant focus on such as coverage ratios, loss ratios, loan to security value ratios and credit risk grades (where applicable) across the various portfolios. We propose that any list of disclosures should be provided only as examples and application guidance.

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?

Yes, we agree with the proposal that the impairment allowance to be transferred between the two books is determined based on the weighted age and life of the financial assets being transferred. The proposed approach appears to be an appropriate and operational method to assign the impairment allowance for disclosure purposes.