The voice of banking
& financial services

Sir David Tweedie
Chairman
International Accounting Standards Board
30 Cannon Street
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1 April 2011

Dear Sir David,

ED/2009/12 - Financial Instruments: Impairment

This is the British Bankers' Association's response to the above document; we welcome the opportunity to comment.

In our view, the Supplementary Draft (SD) represents a significant step towards the development of a new impairment model which is more forward-looking than the IAS 39 incurred loss regime and goes some way towards overcoming the considerable operational challenges of the proposals outlined in the Exposure Draft on amortised cost and impairment issued last year. However, whilst we believe the model is a significant step forward and has the potential to result in an improvement in financial reporting, there are important areas which require further thought. The changes proposed are likely to entail significant levels of expenditure, both for implementation and ongoing maintenance, and given their high impact and systemic importance, there is a pressing need for field-testing of the final completed proposals to ensure they will deliver the intended benefits for justifiable levels of cost.

We welcome the Board's intention to simplify the expected cash flow model and understanding of the need to develop a principles-based standard, which permits entities the opportunity to align the proposed model with their internal risk management practices based on expected loss. We support also the requirement to distinguish between the good book and bad book and determine the impairment allowance for each separately. In principle, this reflects the way in which entities mange their businesses. The criteria for this differentiation, however, needs to be better specified than in the SD not least to ensure consistent interpretation and prevent the point at which a loan is classified as part of the bad book occurring late in the credit risk management process.

We have considerable concerns over the concept of the foreseeable future as a basis for loss recognition, not least because it does not reflect the link between the pricing of assets and expected credit losses. We also believe that in many cases a floor linked to the foreseeable future will result in impairment allowances on performing portfolios being recognised immediately, particularly if it is extended beyond 12 months. Furthermore, we question the decision-usefulness of the information which will be produced by the model. In our view, it is highly unlikely that the concept will be applied in a consistent manner across jurisdictions. We are aware that for many loan books of relatively short duration, the floor will become the determining factor in the impairment calculation.

There are a number of fundamental issues that the SD does not address – including assets that are not held in open portfolios, purchased assets, the methods for measuring credit losses, and how to recognise interest income after impairment. While we understand the reasons for the IASB choosing

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to address these at a later stage, it should be noted that these are important to an understanding of the overall model and how it will be applied in practice. For example, the recent tentative decision by the IASB that expected loss estimates should be expected values, based on probability–weighted averages, appears to presume a degree of accuracy and level of information on the effects of future conditions which may not exist in practice, and may increase the costs of the proposals significantly. Our comments below should be seen against this backdrop and we look forward to being given the opportunity to comment on these proposals in due course. Overall, however, we support a single impairment model for all assets held at amortised cost.

Before commenting further on the specifics of the proposals, we would wish to underline our on-going support for the IFRS 9 project and the need for a high-quality, converged, approach to the financial reporting of financial instruments. If need be, we believe that the Boards should extend the 30 June 2011 deadline for the delivery of the final standard to allow time for a high quality standard which is suitable for adoption by both the IASB and the FASB. We note here that the disclosures proposed in the SD are targeted at IASB constituents only. In the interests of a level-playing field and transparency we would wish to see the two boards agree a common set of disclosures.

The importance of a high-quality standard is the reason why some believed that a 60 day comment period for these proposals was unreasonably short, particularly as it coincided with the main reporting period for a large number of financial institutions. As noted above, it will be important to ensure that adequate time is allowed for thorough field-testing of the final proposals. As a final point, we would urge the Boards to recall that the proposals will be applicable to a wide number of institutions, not all of which are as complex or as sophisticated as those which have been directly engaged in the review of the proposals. It will be important for the Boards to reach out to smaller institutions and consider their needs in finalising the proposals. Given the importance of this matter, we strongly recommend that a complete standard is re-exposed for comment and field testing, with roundtable discussions to consider the outcome of the evaluation, before the standard is finalised.

We comment on the specific questions in the SD below.

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 proposals in the Supplementary Document go some way towards responding to concerns over the delayed recognition of credit losses inherent in the existing incurred loss model as they would result in earlier recognition of expected credit losses and larger impairment allowances. However, especially given the limited time available to review the model, we believe it is too early to make a definitive assessment of how the model could work over a full economic cycle and whether it would in reality result in an improvement in financial reporting. As important areas remain to be decided, we would strongly urge the IASB to conduct a thoroughly field-test the completed proposals before concluding its deliberations on this issue.

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.

As a matter of principle, we would wish to see a single model which applies equally to all financial instruments measured at amortised cost.

We believe the proposed model could be applied to closed as well as to open portfolios. While an expected loss impairment allowance is less meaningful in the context of single assets, the approach has more validity when applied at portfolio level. We recall that one of the overarching objectives for the project to review IAS 39 was to reduce the level of complexity in that standard and to us; a single model in this area would be an important contributor to that objective.

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 take these questions together.

We welcome the Board's intention to simplify the expected cash flow model and respond to concerns over operability, although we note that the proposed approach remains complex and will require entities to maintain two impairment models for accounting purposes which will be costly and will lead to a dilution of effort, especially given that most entities also run a third model for regulatory purposes. We consider the proposed model to be operational, albeit costly, although we hold concerns over the concept of the floor and the extent to which it will drive the recognition of losses in the model. The combined approach represents a compromise between two very different models and we encourage the IASB to focus on the model which it believes will provide the most useful and relevant information.

We consider that for financial assets in the 'good book' the time proportionate approach provides decision useful information; it presents the evolution over time of profits and losses arising from credit decisions, represented by the difference between interest income and the cost of providing credit (in the form of changes in expectations of credit losses). In this regard, it is probably the best available depiction of a 'principal and interest' amortised cost banking model under IFRS 9.

However, we do not agree with the inclusion of a 'floor' (see our comments on Question 9) for reasons including:

- It does not reflect the economics of lending or any risk management practice;
- It breaks the link between asset pricing and impairment;
- The resulting asset net of impairment does not represent even an approximation of amortised cost. It is therefore contrary to the objective of amortised cost and impairment as set out by the IASB;
- It does not provide useful information to investors about the performance of lending decisions and activities; and
- It is incompatible with the expected loss approach (the measurement approach of a loss arising in the "foreseeable future", as defined in the SD, is a different measurement approach than that used in an estimation of a lifetime expected loss).

For these reasons, we reiterate our view that the most relevant information is likely to be provided through the time proportionate model without a foreseeable future floor.

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 answer these questions together.

We support the proposed requirement to differentiate between the good book and bad book for the purpose of determining the impairment allowance as in principle this aligns with the way in which financial institutions manage their businesses and relates closely to the way credit risk is managed and monitored. However, we are concerned that, as drafted, the point at which a loan may be classified as part of the bad book may occur relatively late in the credit risk management process. Accordingly, the differentiation in B2 may benefit from a clearer criterion relating to the probability that a loss will be incurred on a given loan or group of loans. In our view, B2 and B3 would permit a bank to make this differentiation and can therefore be considered operational and auditable; however we note that as drafted it is open to potentially differential interpretation and may therefore benefit from a clearer principle as previously described. One such approach might be to include a requirement that the ‘bad book’ includes all those assets for which there is objective evidence that the cash flows that were expected on initial recognition may not be recovered in full. This would also enable entities to leverage off their existing systems, but not replicate the problematic recognition triggers that are set out in IAS 39.

The approach should be operational and auditable as it will become embedded, like the current IAS 39 triggers, into an entity’s internal operating policies, which are subject to audit and disclosure in the financial statements.

It should be noted, however, that credit risk management techniques vary across the industry, and between jurisdictions as a result of legal and regulatory requirements, and as such entities will adopt different approaches. It will therefore be important to require disclosure as set out in Z15(a) to enable users to understand the criteria used by the entity to make the differentiation.

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?**

We hold considerable concerns about the concept of the foreseeable future floor, not least because it does not reflect the link between the pricing of assets and expected credit losses. We believe that in many cases a floor linked to the foreseeable future will result in impairment allowances on performing portfolios being recognised immediately. We question the decision-usefulness of expected loss information which ignores the economic linkage between pricing and credit risk. In addition, we question whether the foreseeable future will be applied consistently without further guidance and definition.

As noted elsewhere in our response, however, we recognise that the IASB may be required to adopt some form of floor in the interests of achieving convergence. If this is to be the case, then we would wish to see the floor set at a maximum of 12 months. This would limit the extent to which the floor would dominate the recognition of losses for open or longer dated portfolios, where we believe investors are most interested in the link between credit risk and pricing, and would align the calculation of impairment for accounting purposes with estimates generated for risk management and prudential supervision purposes.

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?

The time-proportionate approach does not distinguish between near-term and longer term losses, as it is does not rely upon forecasting the timing of uncertain losses as a key factor in loss recognition. In the context of open portfolios, however, the approach does provide coverage for early loss patterns. While the approach necessarily involves the deferral of an element of near-term expected losses, it also requires immediate recognition of a time proportionate amount of longer term losses. In a mature open portfolio of loans at different stages in the expected loss cycle, the cumulative amount of expected losses in the mid to long term may well be sufficient to cover near-term losses, as the absolute amounts of loans outside their early loss stage period are likely to be larger than those in their early stage loss period. We recognise that this may not be the case in all circumstances, for example in new portfolios exhibiting strong growth patterns, and a case may be made for an additional floor to cover such scenarios, although we do not advocate a general requirement for a floor.

c) If you agree with a proposed minimum allowance, 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 to be determined and why?

The SD is insufficiently clear on what it means for a loss to occur within the foreseeable future and therefore this concept is open to a very wide range of interpretations. However if it is considered necessary as a practicable expedient then we would wish to see the floor set at no more than twelve months. This will go some way towards preventing the floor from dominating the model and permit entities to utilise their model data.

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

As noted above, we have considerable concerns with the concept of the foreseeable future as a basis for loss recognition including its use as a floor. While an entity may have a set forecasting horizon the degree of reliability around the quality of estimates is highly varied and subject to constant change, depending on economic conditions. We therefore believe that the economic cycle would have a bearing on the length of the foreseeable future, with this being longer in good times than in bad. For this reason we doubt the foreseeable future is an operational concept.

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.

If it is decided to require a foreseeable future floor, we believe that further guidance and disclosure will be needed to bring rigour to the way in which the foreseeable period is applied by entities and to help users understand the decisions taken in making this determination. We would expect the determination to be made on the basis of entities risk management practices and the level of data they hold about individual product types and portfolios.

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 thee years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.**

We see no conceptual basis for a ceiling and consider that this represents a further departure from the economics of pricing and credit losses. As noted above, we would like to see the foreseeable future limited to a period of twelve months to prevent the floor from dominating loss recognition.

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.

In the limited time available it has not been possible for our members to conduct any testing of this matter. The answer will depend on the type of financial instrument and the nature of the market. However, in general, we estimate a foreseeable future floor of more than 18 to 24 months will tend to dominate loss recognition under the combined model.

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?**

It is difficult to understand why such flexibility should be permitted given that discounting of longer term amounts is a common feature of IFRSs. That being said, discounting may be more practicable in the context of the bad book, as the timing of losses in the good book is much more difficult to establish with any degree of reliability.

We would agree that flexibility should be granted over the selection of the discount rate, but would consider that the effective interest rate would represent the most effective discount rate as it is the most consistent with the objective of amortised cost and impairment.

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 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?

We read the approach referred to in the question as the IASB model excluding the foreseeable future floor. If this is the case then we strongly favour the IASB approach for open portfolios over alternatives in the SD as it reflects the link between pricing and the cost of credit without the day one loss effect.

As noted above, if it is considered necessary as a practicable expedient to add an additional level of prudence to achieve convergence, then we could accept a foreseeable future floor on the basis that it was set at no more than twelve months to prevent it from dominating the loss recognition pattern within the model.

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)? Why or why not?

As noted above, we favour the IASB approach. The general concept of the FASB is fundamentally different to the concept of the IASB and in particular does not reflect the economic substance of pricing and credit risk.

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?

We strongly support the decision to retain the IAS 39 definition of the effective interest rate and not to require it to be adjusted to reflect the spreading of initial expected credit losses, seeing this as a major improvement over the original proposal which would have been costly and difficult to implement and maintain.

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?

We believe that all loan commitments not accounted for at FVTPL should be subject to the impairment requirements.

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

We believe that the requirements would be operational for loan commitments and financial guarantee contracts and note that existing practice is to apply the IAS 39 impairment model to loan commitments and guarantees within the scope of IAS 37.

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

We support the proposed presentation approach, in particular the separate presentation of impairment and interest income.

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?**

In general our members have not had sufficient time to evaluate the disclosure proposals which is a matter for concern given that the disclosure may involve significant implementation costs. We would strongly prefer an approach in which the key elements of the impairment model were first decided following which disclosure proposals could be brought forward and field tested.

In addition, we would recommend that the interaction of the disclosures and the requirements of IFRS 7 are carefully considered to ensure that there is no duplication and the overall effect of the disclosures will be focused and balanced.

Finally, we note that the proposed disclosure requirements are intended to apply to IFRS users only. We would urge the two boards to work together towards the development of a common set of disclosures which will enhance transparency and provide a level-playing field.

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?

The calculation of the transfer amount will not result in a different impairment losses being recognised in profit of loss. This is because the required provisioning levels are driven by the balance sheet amounts and in particular the good book provision is always replenished so that it equals the amount required under paragraph 2(a). We question the value of disclosures which are focused on the calculation of transfers for this reason as we do not believe they will provide useful information.

Yours sincerely

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