



AUSTRALIAN BANKERS' ASSOCIATION INC.

Tony Burke
Policy Director

Level 3, 56 Pitt Street
Sydney NSW 2000
Telephone: (02) 8298 0409
Facsimile: (02) 8298 0402

1 April 2011

Technical Director
File Reference No. 2011-150
FASB
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116
USA

Email: director@fasb.org

Dear Sir,

Financial Instruments: Amortised Cost and Impairment

Thank you for the opportunity to comment on this supplement. Our comments on the specific questions raised by the boards are addressed in the Appendix; however we have set out below our general thoughts on the supplement to the Exposure Draft.

We are supportive of these changes the boards have made to the methodology proposed in the original Exposure Draft, ED/2009/12, together with the cooperation between the IASB and FASB to produce a joint standard.

The new methodology is operational and substantially less complex than that proposed in the original Exposure Draft. However, we believe the supplement requires some changes to ensure it can be applied consistently across entities.

Measurement

We recommend that the boards consider adjusting their approach to be more consistent with loan credit risk pricing. This would consider losses over the full life of the portfolio and annualise these amounts before removing credit losses to date. Estimates would then be reassessed at each reporting date taking into consideration actual compared to expected runoff and actual compared to expected losses. This recommendation is elaborated on further in questions 3, 4 and 5.

ABA-#107978-v1-ABA_Impairment_Supplement_-_Ltr_FASB_-_1Apr11

Presentation

Whilst the supplement proposes that interest income and impairment expense should be presented separately, it is silent on whether impairment expense is still to be presented within the amounts that aggregate to become Net Interest Income (NII). As noted in our comment letter on the original exposure draft, we are opposed to including impairment within NII - NII is a key metric for retail banks and is well understood by users of the financial reports. Inclusion of a credit loss adjustment within NII (even though it is separate from interest income) will lead to confusion amongst users and further non-GAAP measures.

Disclosure

We are concerned about the extent and detail of the proposed disclosures. We consider that the detail and content of disclosure should be based on the application of principles only.

We would be happy to discuss the above with you should you require further detail. Please contact the undersigned with any questions or comments.

Yours sincerely



Tony Burke

APPENDIX – RESPONSE TO SPECIFIC QUESTIONS

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?

The approach described in the supplement will deal with the perceived weakness of the current impairment models but only if it is interpreted and applied appropriately. The current drafting of the standard leaves room for interpretation and judgement. These areas include:

- Good book/bad book classification;
- Foreseeable future; and
- Discounting.

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.

The proposed model is operational for all portfolios.

We consider it important that the methodology for closed portfolio and off-balance sheet (eg loan commitments and financial guarantees) exposures is the same as that for open portfolios.

It is operationally inefficient to have different methodologies for open and closed portfolios. It would cause an undue level of complexity, confusion for users and additional costs of implementation.

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?

We agree that it is appropriate to recognise expected losses on a portfolio basis over the life of portfolios, with a floor ensuring that allowances cannot be negative.

However, the time proportional calculation does not represent how loans are priced.

- The proposed balance sheet driven methodology determines time-apportioned provisioning at any reporting date by taking expected losses over the remaining life of the portfolios divided by the full life of the portfolio.
- Pricing models consider expected losses over the full life of the portfolio and annualise these over the full life.

These two calculations will produce different outcomes. While the proposed approach is operational, it is inconsistent with a key desired outcome, to approximate the credit-adjusted effective interest rate.

Question 5

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

Whilst a better understanding of losses over the life of a portfolio and the timing of these losses is useful information, the calculation of the time proportional provision will not be useful. As discussed above, the proposed calculation does not reflect the pricing or timing of the loan.

We recommend that the boards consider adjusting their approach to be more consistent with loan credit risk pricing. This would consider losses over the full life of the portfolio and annualise these amounts before removing credit losses to date. Estimates would then be reassessed at each reporting date taking into consideration actual compared to expected runoff and actual compared to expected losses. Such an approach would work in conjunction with a floor, which would remove the risk of "negative" provisions.

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?

Whilst the requirement to distinguish between the two groups is clearly described, the method for distinguishing between these groups is not. We consider that it would be appropriate to apply credit risk management practices to determine the distinction between the good book and bad book.

The distinction between the two groups is currently operational. Without further guidance, we would consider the differentiation to be similar to that of current impaired and non-impaired asset distinction and hence, no extra work would be required.

Given the current assessment of the two groups, we consider it is critical to continue to distinguish between them for the purpose of calculating the impairment allowance due to their different risk profiles and management objectives.

Minimum Allowance – Floor

Question 9

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

- a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?
- b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?
- c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?
- d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?
- e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve

months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.

- f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of 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 requirement for a floor and consider that the approach be adjusted to be more consistent with loan credit risk pricing, as noted in our response to questions 3, 4 and 5, this would need to work in conjunction with a floor, which would remove the risk of "negative" provisions.

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 level of the floor in comparison with that of the time apportioned expected loss will vary depending on the portfolio. It will depend upon the expected behaviour of the portfolio and the point in the portfolio's life.

Measurement

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?

We are concerned with the flexibility in respect of the use or not of a discount. Impairment calculations are judgemental and hence comparability can be difficult. Flexibility on this adds an extra level of judgement and further reduces comparability.

As discounting is common practice when measuring present values of future cash flows for accounting purposes ideally discounting would be required.

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

Our preference is for credit losses to be recognised over the expected life of an asset. As noted in question 9, the requirement for a floor depends on the details of the methodology in respect of time apportionment.

We do not prefer the FASB approach. The recognition of all credit losses upfront does not accurately reflect the economics of banking or the principles of accounting for provisions that require expenses to be reasonable, probable and linked to a past event in order to be recognised. Interest revenue is earned over a period of time and hence it is appropriate to recognise impairment losses over a period.

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 agree that the determination of the effective interest rate should be separate from the consideration of expected losses.

The previously proposed methodology was overly complex and was not operational. Financial institutions manage credit risk and losses separately from interest rate risk and related return measures and hence not on an effective interest rate (EIR) basis. Measurement on an EIR basis would not mirror how we manage our business and therefore we do not consider it appropriate.

Scope: Off Balance Sheet Exposures

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?

We consider it important that the methodology for closed portfolio and off-balance sheet exposures (e.g. loan commitments and financial guarantees) is the same as that for open portfolios.

These exposures to a customer are managed for credit risk purposes on the same basis and therefore it is appropriate to use the same impairment methodology.

Presentation

Question 17Z

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

We are supportive of the presentation of impairment expense separately from interest revenue.

Additionally, we do not believe that expected credit loss expense should be presented within the aggregation of items making up Net Interest Income.

Net Interest Income (NII) is a key metric for retail banks and is well understood by users of the accounts. Inclusion of a credit loss adjustment within NII will lead to confusion amongst users and further non-GAAP measures.

Credit losses should be presented as a single number (encompassing expected credit loss and gain/loss due to changes in expectations) on the face of the income statement in order that they and other key line items can continue to be clearly identified and understood by users.

Disclosures

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?

Quantity of Disclosures

We are concerned about the extent and detail of the proposed disclosures. We consider that the detail and content of disclosure should be based on the application of principles only.

As articulated in paragraph 11 of the original exposure draft, disclosures should enable users of the accounts to fully understand the credit quality of financial instruments and the effect of these on the results of an entity. The disclosures

detailed in this supplement are extensive and we question their usefulness. We consider the quantity of disclosures currently proposed will reduce the useability and comparability of financial statements. In addition, the considerable number of disclosures may confuse users and draw attention away from the validity of the information provided.

Considerable disclosures in respect of credit quality are given in Banks' Basel II Pillar 3 document. This is a public document that is released on the Australian Stock Exchange and can be viewed on Banks' websites. The inclusion of additional detailed disclosures in financial statements will provide similar information on a different basis and confusion will result from differences in the numbers.

Class of financial asset

The supplement requires all disclosures to be by class of financial asset. We consider the boards should clarify their requirement is in respect of assets accounted for at amortised cost.

Back Testing

We believe that quantitative disclosures should not be required in respect of back testing.

Impairment models, by their nature, are never 100% accurate – the proposed disclosures will merely highlight this and confuse less knowledgeable users, such as retail investors. Qualitative disclosures could, however, assist users in understanding the accuracy of models.

Disclosure of assets by risk grade

We question the use of disclosures of assets by risk grade, in particular with respect to retail and SME portfolios. The disclosure of such information, whilst on first review may seem useful, would not give a true picture of the risk as this is not how such assets are managed for credit risk purposes and therefore could mislead users of the financial statements.

Additionally, given this information is not already available, operationally, the preparation of these disclosures would be time consuming and costly.

Watch List Disclosures

The definitions and use of "watch lists" differ widely across different financial institutions.

For example, within Australia, the use of watch lists amongst the big four banks can range from reasonably well rated entities that are under close review to entities rated a lower grade, but not yet considered "troublesome". The meaning of watch list per the exposure draft may actually be what is sometimes considered "troublesome" in Australia. Therefore we consider the requirement to disclose details in respect of these will be rendered irrelevant due to the lack of comparability, and this disclosure requirement should be removed.

Comparatives

Given the quantity and complexity of the disclosures, we request that the boards consider, as part of transition requirements, to allow the build up of comparatives over a number of years, instead of requiring full comparatives in the year of adoption.

Written-off assets still subject to collection

We note included in the boards' recent tentative decisions, the requirement to disclose quantitative information is in respect of items written off that are still subject to enforcement activity.

Whilst we understand the requirement to disclose qualitative information in respect of these assets, we question the value in quantitative disclosures, given that the information is commercially sensitive.

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?

We do not agree with the proposal.

Whilst the proposal could be seen to assist in ease of understanding and the comparability of disclosures, it would be difficult to calculate and track operationally. Therefore, as it does not impact measurement or presentation, we consider that no amount should be transferred upon transfer of the asset and a new provision should be raised.