



8 April 2011
International Accounting Standards Board
30 Cannon Street
London
EC4M 6XH
United Kingdom

Dear Sir / Madam

Re: Supplementary Document *Financial Instruments: Impairment*

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Supplementary Document *Financial Instruments: Impairment* ('the Supplementary Document') issued by the IASB on 31 January 2011.

This letter is submitted in EFRAG's capacity of contributing to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG, in its capacity as advisor to the European Commission, on endorsement of the definitive IFRS in the European Union and European Economic Area.

We welcome the IASB's efforts to find operational solutions for the difficulties identified in respect of the model exposed in the November 2009 proposals. We also welcome the IASB's and the FASB's efforts to develop a common approach to accounting for the impairment of financial assets. EFRAG agrees with the IASB that the most challenging operational issue relates to the implementation of the expected cash flow approach to open portfolios of financial assets, and supports the development of an operable impairment approach based on the separate allocation (decoupling) of interest income and expected credit losses.

However, we believe that in developing an operational impairment approach for open portfolios, the Board has made significant changes to the original model. Therefore, we believe that the Board should clarify the objectives of the model and, in particular, be more explicit as to the extent it represents a revenue recognition and/or impairment model.

In the context of the impairment aspect of the model, EFRAG believes that it is appropriate to provide in full for 'incurred' losses. Equally, we agree that it is appropriate to apply a time-proportionate approach (as explained in paragraph 18 in the Appendix) to 'expected' losses in the revenue recognition aspect of the model. However, we are concerned that the proposed good book/bad book distinction does not adequately cater for losses that are 'incurred but not yet reported/recognised' (IBNR). In our view, those losses should be captured by the impairment aspect of the model; it may therefore be more appropriate to retain the concept of triggering events for incurred losses currently contained in IAS 39.

Therefore, we also disagree with the proposals to set a floor at a level to reflect credit losses expected to occur within the foreseeable future. We do not believe that a floor is the only way to deal with the issue of early loss patterns (which, in any event, seem to us to be more relevant in the context of closed portfolios). In our view, entities need to

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consider all available information in the determination of the time-proportionate allowance. Therefore, if an entity expects losses to materialise in the near future, it should be required to accelerate the build-up of the allowance balance to reflect this information. However, if the IASB were to retain a floor in the model, we suggest that it should not be based on the notion of some indeterminate ‘foreseeable future’; rather, we recommend that it be a fixed 12-month period. In addition, the evaluation of any such floor should take into account the time-proportionate amount that is expected to arise over that same time period and only require immediate provision for any excess.

EFRAG strongly believes that a consistent accounting treatment should be applied to similar economic events. Therefore, we believe that the decoupling of interest income and credit losses should be applied consistently to all financial assets measured at amortised cost. However, it is clear that the model has been designed primarily to cater for the loan portfolios of lending businesses. We believe the Board should further develop the guidance and the model to make it more suitable to non-lending businesses, closed portfolios and individual items (e.g. listed bonds). Finally, we believe it would be inappropriate to permit entities a free choice between the proposed model and the original expected cash flow model.

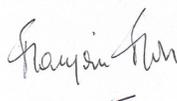
We noted above and further explained in paragraph 22 of the Appendix a number of application issues which, together with the short comment period, has made it impossible for preparers to conduct a proper quantitative assessment (including simulations of the impact on actual portfolios). Therefore, we believe that prior to issuing the final standard, the IASB should conduct field-testing to confirm that the guidance is robust and that the model is operational and overcomes the weaknesses of IAS 39.

EFRAG believes that disclosures play a fundamental role in complementing financial information derived from applying the decoupled effective interest rate, as well as the proposed impairment model. Any model of loan loss allowances inevitably involves a high degree of judgement and adding in expected losses potentially increases that. To increase transparency and comparability, we believe that the disclosures should help users to understand the effects of the credit risk of financial instruments on an entity’s financial position and performance (see paragraphs 60,61 and 63 of the Appendix). Furthermore, we urge the IASB to consider the proposals in the Supplementary Document in the context of the existing disclosure requirements in IFRS 7 and to ensure that the level of guidance included in the disclosure standard remains consistent and balanced across topics.

The IASB has split the revision of IAS 39 into a number of phases. However, considerable interdependencies exist among the phases of this project (particularly the amortised cost and impairment phase) and other projects that the IASB is currently working on. Therefore, we believe that the IASB will need to consider the entire package of proposals before finalising the resulting standard.

If you wish to discuss our comments further, please do not hesitate to contact Chiara Del Prete, Patrick Mommens or me.

Yours sincerely,



Françoise Flores
EFRAG, Chairman

Appendix

EFRAG's responses to the questions in the Supplementary Document *Financial Instruments: Impairment*

The responses to the questions in the Supplementary Document are based on the assumption that short-term trade receivables are not within, and will not be brought into, the scope of the proposals. Additionally, the reference to 'day-one losses' relates to origination or acquisition of financial assets carried at amortised cost, rather than short-term trade receivables that result from sales to customers.

Question 1

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

EFRAG's response

Assuming that incurred losses under IAS 39 were provided for in full under these proposals, we would expect earlier recognition of credit losses, because of the allowance that is required for the good book.

- 1 In its letter, dated 28 June 2010, EFRAG supported the direction of the proposals in the 2009 Exposure Draft *Amortised Cost and Impairment* (the 'November 2009 proposals').
- 2 In particular, EFRAG supported the IASB's objective of developing an alternative to the incurred loss impairment model for financial assets that uses more forward-looking information about credit losses and aims to eliminate the delay in recognition of credit losses on financial assets.
- 3 We believe that the amortised cost and impairment model for financial assets should be based on an expected loss approach and that an entity's estimate of impairment losses should reflect all existing information, including expected future developments and forecasts of future events and economic conditions.
- 4 We understand that the approach proposed in the Supplementary Document relies on forward-looking information about credit losses and that an entity would not need to delay recognition of credit losses until objective evidence of impairment existed. Assuming that incurred losses under IAS 39 were provided for in full under these proposals (see also our comment in paragraph 26(b)), we would expect earlier recognition of credit losses because of the allowance that is required for the good book. However, we note that existing practices under IAS 39 for loan loss provisioning vary considerably, which may affect the degree to which these proposals impact the accounting of individual entities.
- 5 Before being able to provide a conclusive response to the question, we would ask the IASB to engage in field-testing with constituents to determine the degree to which the proposals address the perceived weaknesses of IAS 39.
- 6 We believe that field-testing of the proposals is necessary, because their suitability depends greatly on the loan loss patterns and the availability of forward-looking information. Please refer to our response to Questions 3, 4 and 5 for our observations on the field-testing of the proposals.

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.

EFRAG's response

EFRAG supports a consistent impairment model for all financial assets carried at amortised cost.

We believe that the IASB should clarify the objectives of the model and, in particular, explain to what extent the objectives are the same as those of the impairment model in the original Exposure Draft.

If the IASB were to adopt the model in the Supplementary Document, we believe it would be inappropriate to permit entities a free choice between that model and the original expected cash flow model.

- 7 EFRAG strongly believes that a consistent accounting treatment should be applied to similar economic events. Therefore, we believe that all financial assets carried at amortised cost should be measured and presented using a consistent impairment approach.
- 8 We note that the expected cash flow model originally proposed by the IASB was not considered to be operational, particularly in the context of open portfolios. We welcome the IASB's efforts, in the Supplementary Document, to address the significant operational challenges identified with impairment for open portfolios.
- 9 We believe that, in developing an operational impairment approach for open portfolios, the Board has made significant changes to the original model, to the point that this can be considered a new model — it introduces the notions of a good book, a bad book and of a floor; it decouples interest and credit losses; and it introduces the time-proportionate allocation of expected credit losses.
- 10 Therefore, we believe that the Board should clarify the objectives of the model and, in particular, explain to what extent the objectives are the same as those of the impairment model in the original Exposure Draft. To the extent that there is more than one objective, i.e. revenue recognition and impairment, we believe that would be helpful to make this explicit.
- 11 We believe that, in principle, requiring the use of different approaches in different situations would not result in a simplification of the guidance and might be difficult to implement and maintain. We observe that users may also find it difficult to understand the information resulting from the different approaches applied to a single class of financial assets. Furthermore, if such approaches differ considerably (or even represent different models), issues of comparability or accounting arbitrage may arise. If the board were to adopt the model in the Supplementary Document, we believe it would be inappropriate to permit entities a free choice between that model and the original expected cash flow model.

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- 12 EFRAG supports a consistent approach to measure the impairment for all financial assets carried at amortised cost and believes that the decoupling of interest income and credit losses should be applied consistently to all financial assets carried at amortised cost. However, the board should further develop the guidance and the model to make it more suitable to closed portfolios and individual items.
- 13 We refer to our comment letter of 28 June 2010, where we support a scope exemption for those short-term financial assets that arise in the normal course of business, that do not carry contractually stated interest, and that arise from the revenue generating transactions that an entity engages in. Paragraph 1 of the Supplementary Document scopes out 'short-term receivables without a stated interest rate that are so short-term that the effect of discounting for the time value of money is immaterial'. EFRAG is concerned that the scope exclusion is not sufficiently clear.
- 14 For instance, we agree that short-term credit card receivables that do not bear interest, because they are paid when due, still have a stated interest rate and are within the scope of the proposals. However, this is not sufficiently clear from the wording of the Supplementary Document. We therefore recommend to the IASB to clarify the scope exclusion.
- 15 Finally, EFRAG has the following concerns about the application of the proposals in cases other than open portfolios:
 - (a) the guidance should clarify whether there are possible day-one losses that would arise if the proposals were to be applied to closed portfolios or individual items;
 - (b) it is not clear to us how the model should be applied to single assets, such as bonds; and
 - (c) the proposals should clarify that the assessment of credit losses is entity-specific and that the entity should consider all available information, which may include market data that the entity considers pertinent. For example, the implied credit spread observed in the market may, at times, not be aligned with loan loss expectations based on other sources of data.

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?

EFRAG's response

EFRAG supports the efforts of the IASB to develop a more operable impairment approach.

We agree that the IASB approach should be modified to mitigate the risk of inadequate provision balances for portfolios with front-loaded loss emergence patterns. However, we believe that a floor is not the only way to deal with this issue. Instead, the IASB should consider an approach requiring a time-proportional approach, based on expected loss profiling that ensures that an allowance is built up faster.

EFRAG believes that before issuing the final standard, the IASB should conduct field-testing to confirm that the model overcomes the weaknesses in IAS 39 and that the guidance is robust.

16 We support the efforts of the IASB to develop a more operable impairment approach, based on the decoupling of interest income and expected credit losses.

17 EFRAG agrees with an approach whereby expected losses are not necessarily attributed to specific periods. It is consistent with the approach suggested by EFRAG in its response to the November 2009 proposals, whereby expected credit losses are recognised to the extent that they relate to periods up to and including the reporting date. We note that the Expert Advisory Panel suggested a similar approach.

18 We are therefore supportive of a time-proportional approach to the Expected Losses in the “good book”. Our understanding of how this would work on an undiscounted basis is illustrated in the following example:

Consider a portfolio of good loans of 100, with expected lifetime losses of 5 (as these are good loans this also equates to the losses anticipated over the remaining life), a weighted average age of 2 years and a weighted average life of 5 years. The allowance amount provided under the time-proportionate approach would then be simply 2, with an expectation that, if nothing else in the portfolio changed, a further expected loss of 1 will be recognised in the subsequent 12 months.

If, for whatever reason, at the end of the following year the portfolio is the same size and has the same weighted average age and life, but the expected lifetime losses are now 10, then the impairment charge recognised in the profit or loss for that period in relation to the good book will be 2, to bring the total allowance to 4. This represents in effect a partial catch up approach which EFRAG supported in its comment letter on the ED. Furthermore the expectation of next year's expected loss charge will now be 2 and not 1.

19 To the extent that there is a loss emergence pattern which is front loaded, then , this formula for the time-proportionate approach will have two effects:

(a) To the extent that the “early period” has happened by the year end date, such losses will have been recognised as incurred;

(b) To the extent it has not then, in a relatively stable portfolio, the future “early losses” on part of the portfolio will be counterbalanced by reduced expectations of losses on the remaining portfolio. If this is not counterbalanced, then further consideration should be given as to how the allowance is accrued, but there seems to be no particular rationale to recognise it upfront.

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- 20 We therefore disagree with the proposals to set a floor at a level reflecting credit losses expected to occur within the foreseeable future. In fact, we believe that an impairment model should reflect the link between the pricing of the asset and the expected credit losses.
- 21 We understand that, as explained by the Board (paragraph BC74 of the Supplementary Document), the time-proportional approach may not create a sufficient allowance in an early loss emergence scenario. As the IASB approach (i.e. without a floor) does not take account of front-loaded loss emergence patterns, we agree that the approach should be modified to mitigate the risk of inadequate provision balances for such portfolios.
- 22 We do not believe that a floor is the only way to deal with this issue. For example, as the IASB discussed in its December 2010 meeting, this issue could be addressed by requiring a time-proportional approach based on expected loss profiling that ensures that an allowance is built up faster. In our view, entities need to consider all available information in the determination of the time-proportionate allowance. Therefore, if an entity expects losses to materialise in the near future, it should be required to accelerate the build-up of the allowance balance to reflect this information. However, if an entity expects to have built up sufficient provisions by the time those losses are expected to materialise, we see no reason for requiring that entity to recognise an immediate loss. We stress, however, that such a method should not result in a negative allowance that defers incurred losses to future periods (i.e. incurred losses should be recognised immediately).

Field-testing

- 23 EFRAG's outreach activities confirm that those preparers that have performed an initial assessment of the proposals were only able to produce a preliminary qualitative assessment, due to uncertainties regarding the interpretation of the proposals that would affect their implementation. We believe that the following elements of the model need to be clarified before the impact of the proposals can be assessed in detail:
- (a) the definition of the 'bad book' and the transfer from the good book to the bad book (see our response to Questions 6, 7 and 8 below);
 - (b) the definition of the 'foreseeable future' (see our response to Questions 9 and 10 below);
 - (c) without more detailed guidance on the measurement of the expected losses, it is not possible to assess the impact of the proposals on existing portfolios;
 - (d) how entities would weigh external and entity-specific historical data against current economic conditions and supportable forecasts;
 - (e) how the allowance for the good book should be reassessed at the reporting date and after a transfer of part of the allowance into the bad book; and
 - (f) how lifetime expected losses should be calculated (e.g. loan prepayments and extensions);
 - (g) how the model would apply to portfolios of bonds or individual assets.
- 24 Due to the uncertainties mentioned above and to the short comment period, it was neither feasible for preparers to do a detailed quantitative assessment of the proposals (including simulations of the effect on their current portfolios), nor was it

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possible for EFRAG to find any quantitative evidence on the possible impacts of the model. As such, we believe that prior to issuing the final standard, the IASB should conduct field-testing that addresses:

- (a) when – and for which portfolios – the allowance would be based on the floor or the TPA approach, if the floor were to be retained. This is pivotal in assessing the usefulness of the resulting information and whether it reflects the link between the recognition of interest and the recognition of credit losses. It is also necessary to assess the role of the three approaches proposed in the Supplementary Document;
- (b) to what extent the model overcomes the weaknesses in IAS 39 that can result in late recognition of credit losses;
- (c) to what extent the proposals are operational and suitable for direct use outside the lending industry. No compelling evidence has been produced to date;
- (d) the robustness of the guidance to implement the model without excessive room for interpretation;
- (e) the need for a cost/benefit analysis – a preliminary assessment done by preparers shows that the model is more operational than the expected cash flow model proposed in November 2009. However, implementing the model will require investments (e.g. for producing point-in-time estimates of expected losses for the entire life of the portfolio or for computing the weighted average) whose impact will vary depending on the type of preparer (e.g. whether or not the preparer already has an internal rating-based system for measuring credit risk); and
- (f) the level of disclosures required in order to mitigate possible divergence in practice (under IAS 39), given the judgemental nature of the model and its link with the entity's credit risk management

25 We have a number of further concerns regarding the proposals that are discussed in our response to Question 9.

Question 6

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

Question 8

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

EFRAG's response

EFRAG agrees that an approach based on the two groups is appropriate. Given the diversity in credit risk management practices, the proposed disclosures are essential to ensure a measure of comparability between entities.

We believe the IASB should clarify that incurred losses under IAS 39 should be provided for in full.

The IASB should ensure that the guidance is also appropriate for entities other than lending businesses.

26 EFRAG agrees that an approach based on the two groups is appropriate, as it is aligned with the way entities manage their loan portfolios. However, we note the following:

- (a) There is diversity in credit risk management practices and in the definitions of good book and bad book portfolios. Therefore, we agree that the disclosures proposed in paragraph Z15(a) of the Supplementary Document are essential to ensure a measure of comparability between entities.
- (b) The application guidance in paragraph B3 of the Supplementary Document suggests that a transfer to the bad book might take place at a later stage in the credit process, than the recognition of an incurred loss under IAS 39 – that is, the credit risk management process is a continuum and assets pass through various stages of uncertainty about collection, with recovery proceedings occurring relatively late in the process. As currently drafted, we are concerned that the proposed good book/bad book distinction does not adequately cater for losses that are 'incurred but not yet reported/recognised' (IBNR). Therefore, we believe the IASB should clarify that incurred losses under IAS 39 are provided for in full under the proposals in the Supplementary Document, in order to avoid delayed classification of incurred losses into the bad book.

27 EFRAG's outreach activities and due process confirmed that the definition of bad book is broadly consistent with the existing credit management practices of banks and is considered operable and auditable. However, we question whether the definition of 'bad book' portfolio can be applied by non-lending businesses. The proposed guidance is drafted from the perspective of a lending business and assumes that entities in other industries use similar credit risk management practices and does not consider the vast majority of IFRS issuers that do not have such systems or that are not lending businesses.

28 Therefore, we suggest an approach that first sets out the general principle that all entities can apply and relate to. The application guidance should then assist entities of differing complexity in applying the principle. To achieve this, we suggest redrafting paragraph 3 as follows:

Whether it is appropriate to recognise expected credit losses over a time period depends on the degree of uncertainty about the collectability of a financial asset. It is no longer appropriate to recognise expected credit losses over a time period if the collectability of a financial asset, or group of financial assets, becomes so uncertain that the entity's ~~credit risk management~~ objective changes for that asset, ~~or group thereof~~ from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset.

In order for this change to be effective, we also suggest redrafting paragraphs B3 and B4 as follows:

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- B3 An entity shall differentiate the two groups ~~on the basis of its internal credit risk management as follows:~~
- (a) ... [unchanged]
 - (b) ~~Entities that~~ Other entities do not manage credit risk using an approach that differentiates the management of financial assets depending on the uncertainty about their collectibility in a way similar to the principle in ~~paragraph 3~~ must still differentiate their financial assets into two groups for the purpose of determining the impairment allowance in accordance with paragraph 2. For example, an entity might comply with that principle. These entities might comply with the principle in paragraph 3 using criteria such as days past due, whether the expected return is below the risk-free interest rate, or when management identifies loans as doubtful (sometimes also considered by an entity as 'problem loans').
- 29 EFRAG supports, as stated in our response to Question 2, the use of a consistent approach to impairment for all assets carried at amortised cost. If it is decided to apply this approach to items other than open portfolios of assets we encourage the IASB to amend the text accordingly.
- 30 Finally, we understand that the IASB has recently started discussions regarding the application of the proposals to purchased assets. We believe that the IASB should specifically address in the final standard how the model would be applied to:
- (a) purchased distressed assets and impaired loans acquired in a business combination; and
 - (b) restructured debt or other loans that are reclassified back into the good book.

Question 9

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

- (a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?
- (b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance amount related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?
- (c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?
- (d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?
- (e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.
- (f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

Question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2.1(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

EFRAG's response

A floor is not the only way to deal with the risk of inadequate provision balances for portfolios with front-loaded loss emergence patterns. EFRAG believes that the IASB should consider an approach requiring a time-proportional approach based on expected loss profiling that ensures that an allowance is built up faster.

We believe that the board should clearly state the objective of the proposed model.

We are also concerned that the floor might result in the immediate recognition of all the expected losses for good books of short-term loans.

31 As explained in our response to Questions 3, 4 and 5 above, we welcome the IASB's efforts to develop an operational approach to the impairment of financial assets carried at amortised cost.

32 As noted in paragraph IN5 of the Supplementary Document, the primary objective of IASB's original proposals was 'to reflect initial expected credit losses as part of determining the effective interest rate, as the IASB believed that this was more

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reflective of the economic substance of lending transactions'. In our opinion, the Basis for Conclusions is insufficiently clear about the benefits of the common approach to users and preparers. Also, it does not adequately explain the rationale behind the mechanics and the impacts of the following aspects of the common model, such as:

- (a) why the time-proportional calculation of expected credit losses recognises the particular fraction of expected future losses that it does (paragraph B8 of the Supplementary Document);
- (b) why an entity is given a choice between a time-proportional calculation based on a discounted or undiscounted straight-line approach and an annuity approach (paragraph B8 of the Supplementary Document);
- (c) the difference between (1) the information that needs to exist to predict expected future losses and (2) the 'reasonable and supportable information' that needs to exist to support specific projections of events and conditions for the purpose of calculating the floor;
- (d) how the time-proportional calculation is expected to interact with the floor; and
- (e) why a floor is still needed for the good book portfolio, given that all expected credit losses need to be recognised in respect of any bad loans identified with a portfolio.

We believe that these clarifications are needed to help constituents understand the objectives of the proposed model.

33 We have the following concerns about the inclusion of a 'floor' in the proposed model:

- (a) We do not believe that a floor appropriately reflects the economics of lending transactions, because it ignores the link between the pricing of financial assets and expected credit losses (e.g. it gives rise to day-one credit losses for newly originated financial assets and underestimates (overestimates) the net return on new (older) assets in an open portfolio). In addition, we understand from our consultations that in the case of short-term portfolios the allowance would be set at the level of the floor.
- (b) In all other instances in IFRSs, where the standards require assets or liabilities to be accounted for 'at the higher of' one measurement basis or another basis, both bases are defined in their own right and can each be interpreted in a meaningful way. However, in these proposals it has not been made clear how a user might interpret the value of assets that are accounted for at amortised cost minus a 'floor-based' impairment allowance.
- (c) As this would be an entirely new concept in IFRSs, we believe that if the board were to retain this approach, it should explain what the 'floor' represents in terms of performance measurement.

34 In addition, we have concerns about the use of the term 'foreseeable future' and what it means. In particular:

- (a) We question whether the notion of a floor can be applied consistently in a way that provides comparable information. As noted in paragraph BC86 of the Supplementary Document, 'the lack of any clear articulation of what the foreseeable future period means is likely to result in significant divergence in practice.'

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- (b) We are concerned that a floor based on the foreseeable future would result in the immediate recognition of an impairment allowance on performing portfolios that have an average life of between 12 months and 3 years, effectively providing for impairment losses on these portfolios as if they were comprised entirely of bad book loans.
 - (c) The flexibility in selecting and changing the period seen as the foreseeable future may result in earnings management and a loss of comparability in information from one year to another and across different entities.
 - (d) The length of the foreseeable future can change with the phases of a business cycle or reacting to changes in the conditions of the financial markets. An increase in the market volatility might result in higher uncertainty attached to the forecast for the foreseeable future and the length of this period needs to be shortened.
 - (e) Fair value estimates often require events and conditions to be projected up to the end of the life of an asset and are not limited to an assessment of merely the foreseeable future.
- 35 EFRAG's outreach activities confirmed that the definition of 'foreseeable future' is not considered to be sufficiently detailed to be operable and its interpretation varies across entities, across reporting periods and across types of assets. The preparers participating in our outreach activities also believe that the length of the foreseeable future (i.e. the period for which they can formulate explicit forecasts) depends on the phase of an economic cycle.
- 36 In relation to Question 10, we point out that it was not possible to find quantitative evidence about the expected impact of the proposed model on existing portfolios. As explained in the response to Questions 4, 5 and 6 above, field-testing needs to take place before the standard can be finalised. However, our outreach suggests that in a typical steady-state open portfolio, a foreseeable future of 12 months would be the only factor that determines the level of provisioning if the average expected life of the assets is less than four years.
- 37 If the IASB were to retain a floor in the model, we suggest that it should not be based on the notion of 'foreseeable future'. Instead, we recommend that the floor be a fixed 12-month period, because this would be an effective way of addressing many of the concerns raised above. In any event, the guidance and disclosures should be such that the floor concept is consistently applied in a transparent manner that users of financial statements are able to understand and compare.
- 38 As noted in our response to Questions 3, 4 and 5, we do not believe that a floor is the only way to deal with the risk of inadequate provision balances as a result of early loss emergence scenarios. Instead, we believe that the IASB should consider an approach requiring a time-proportional approach, based on expected loss profiling that ensures that an allowance is built up faster.

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?

EFRAG's response

EFRAG believes that requiring or permitting discounting and use of the annuity approach would over-complicate the model and that the benefits of doing so would be outweighed by the costs of application and the loss in comparability.

From a conceptual perspective, EFRAG does not agree with the proposed flexibility in the proposals (i.e. discount/undiscounted, annuity/straight-line and the choice of discount rate).

- 39 EFRAG does not agree with the proposed flexibility from a conceptual perspective.
- 40 IFRSs generally require cash flows, that will occur in the future, to be discounted. This requirement is based on the presumption that the time value of money should be considered in a measurement based on future cash flows. In theory there are circumstances in which we could support the use of discounted amounts in determining the allowance.
- 41 However, we note that one of the main challenges in implementing the expected cash flow model for open portfolios was the impossibility to predict reliably when losses will occur. This was one of the main reasons for developing the time-proportionate allocation approach proposed in the Supplementary Document. Therefore, we believe that requiring or permitting discounting and use of the annuity approach would over-complicate the model and that the benefits of doing so would be outweighed by the costs of application and the loss in comparability.

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?

EFRAG's response

EFRAG is supportive of the general concept underlying the November 2009 proposals and we support the development of an operable approach, based on the separate allocation ('decoupling') of interest income and expected credit losses. In order to mitigate the risk of inadequate provision balances for portfolios with front-loaded loss emergence patterns, we believe that the IASB should consider requiring a time-proportional approach based on expected loss profiling that ensures that an allowance is built up faster.

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- 42 We are supportive of the general concept underlying the original IASB approach (i.e. to recognise expected credit losses over the life of the assets) and welcome the introduction of a partial catch-up approach, as proposed in our 28 June 2010 comment letter. We prefer an approach that:
- (a) maintains a link between the pricing of financial assets and the expected losses. As actual losses occur over the life of a portfolio of financial assets, recognising expected credit losses over the expected life better reflects the economics of the lending transactions; and
 - (b) results in immediate recognition of expected losses for the remaining life of a financial asset when it is transferred to the bad book.
- 43 Since we understand that operational simplification is crucial to making the impairment model workable, we support the development of an operable approach, based on the separate allocation ('decoupling') of interest income (which are allocated using the effective interest rate as currently defined in IAS 39) and expected credit losses (both initial and revised).
- 44 As explained in our response to Questions 3, 4 and 5 above, we agree that the IASB approach should be modified to mitigate the risk of inadequate provision balances for portfolios with front-loaded loss emergence patterns. However, we believe that a floor is not the only way to deal with this issue and the IASB should consider an approach requiring a time-proportional approach based on expected loss profiling that ensures that an allowance is built up faster.

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 at or after the first reporting date after initial recognition of the financial assets)? Why or why not?

EFRAG's response

EFRAG does not support the FASB model because it does not reflect the economics of lending transactions. In addition, we have concerns about the application of the concept of 'foreseeable future'.

- 45 As explained in our response to Question 9, EFRAG does not support the recognition of all credit losses expected to occur in the foreseeable future at, or after, the first reporting date after initial recognition of the financial assets. This approach does not reflect the economics of lending transactions (i.e. it does not maintain the link between the pricing of financial assets and expected credit losses). In addition, we also note our concerns about the application of the concept of 'foreseeable future'.
- 46 We recognise, however, that the FASB model is operationally less complex to apply, because it does not rely on a good book/bad book split or a time-proportional calculation in combination with a floor.

Questions IASB-only re-deliberations

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?

EFRAG's response

EFRAG believes that decoupling of interest income and credit losses should be consistently applied to all financial assets carried at amortised cost.

- 47 In our response to the November 2009 proposals, we commented that an integrated effective interest rate approach could be operationally burdensome and that we would be supportive of a decoupled effective interest rate calculation that approximates the allocation profile achieved by the November 2009 proposals.
- 48 As explained in our response to Question 2 above, EFRAG believes that decoupling of interest income and credit losses should be consistently applied to all financial assets carried at amortised cost.
- 49 If the Board were to adopt the model in the Supplementary Document, we believe it would be inappropriate to permit entities a free choice between that model and the original expected cash flow model.

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?

EFRAG's response

EFRAG supports the view that the same impairment approach should apply for both loans and loan commitments, since they are often managed within the same business strategy.

Regarding financial guarantee contracts, we believe it is better to retain the current option in paragraph 2(e) of IAS 39.

- 50 EFRAG supports the view that the same impairment model should apply for both loans and loan commitments, since they are often managed within the same business strategy.
- 51 We recommend that the IASB takes a more comprehensive approach that also deals with revolving loans.

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- 52 Regarding financial guarantee contracts, we believe that the common proposals could be applied to the extent that they do not result in the recognition of negative assets.
- 53 In its comment letter on the Exposure Draft *Insurance Contracts*, EFRAG noted that ‘financial guarantee contracts’, as issued by banks, and ‘credit insurance contracts’, as issued by insurers, could both meet the definition of an insurance contract. We acknowledge that it is generally desirable to have similar accounting for similar contracts. However, the existing guidance that only requires insurers to apply insurance accounting has worked well in practice. Therefore, given the practicability concerns regarding the application of the insurance contract proposals by non-insurers, we believe it is better to retain the current option in paragraph 2(e) of IAS 39.

Question 17Z

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

EFRAG’s response

EFRAG agrees with the proposed presentation, as it is consistent with the decoupling of interest recognition and credit loss recognition proposed in the Supplementary Document.

- 54 EFRAG supported the presentation requirements of the November 2009 proposals for all assets carried at amortised cost other than short-term trade receivables. In our view, the proposals provided valuable information about the extent to which interest income represented compensation for credit losses. Short-term trade receivables do not include an interest component and therefore we did not support the presentation for those financial assets.
- 55 We agree with the proposed presentation, as it is consistent with the impairment approach proposed in the Supplementary Document (i.e. decoupling of interest income and credit losses).

Question 18Z

- (a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?
- (b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

EFRAG’s response

EFRAG supports the proposed disclosures, but urges the IASB to consider the proposals in the Supplementary Document in the context of the existing disclosure requirements in IFRS 7 and to ensure that the level of guidance remains consistent and balanced across topics.

The IASB should develop disclosures on experience adjustments that allow users to understand the quality of earlier accounting estimates.

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- 56 EFRAG believes that disclosures play a fundamental role in complementing financial information derived from applying the decoupled effective interest rate as well as the proposed impairment model. The proposed model implies application of more judgement than IAS 39. To increase transparency and comparability, we believe that the disclosures should help users to understand the effects of credit risk of financial instruments on an entity's financial position and performance.
- 57 We believe that the proposed disclosures with regard to the allowance account, expected credit loss estimates and credit risk management aim to achieve this. We agree that these categories are relevant to provide an insight into an entity's credit risk management activities and the effect of those activities on the entity's financial position and performance.
- 58 Having said that, we are concerned about the requirement to disclose for five annual periods the information listed in paragraph Z8 of the Supplementary Document. In general, we believe that the requirement to disclose a time series does not automatically increase the informational value of disclosures and therefore we suggest that the IASB re-assesses the need for this requirement.
- 59 Furthermore, we believe that the proposals should put more emphasis on ensuring that information is disclosed at an appropriately disaggregated level. For example, fair value disclosures regarding portfolios of financial instruments for which an impairment allowance exists should be sufficiently detailed. Additionally, we wonder whether the disclosures should include information on when an entity considers financial assets irrecoverable (write-off trigger), as there are current significant differences in practice between jurisdictions.
- 60 We observe that in its recent deliberations, the IASB has tentatively decided to remove the concept of 'non-performing loan' and instead require disclosure of the movement during the period in the nominal amount of financial assets that are 90 days past due, but not included in the bad book. We also find it difficult to understand how the proposals would interact with the disclosure requirements of IFRS 7 *Financial Instruments: Disclosures* (e.g. disclosures about incurred losses), as well as proposed disclosure requirements as part of other phases of the IAS 39 replacement project. Therefore, we urge the IASB:
- (a) to reconsider the proposed disclosure requirements once the uncertainties regarding the interpretation of the proposals (see paragraph 23 above) have been resolved. In particular, we believe that where the model calls for the use of judgement, the disclosures should be such that users can understand the basis on which these are made; and
 - (b) to consider the proposals in the Supplementary Document in the context of the existing disclosure requirements in IFRS 7 and to ensure that the level of guidance included in the disclosure standard remains consistent and balanced across topics.
- 61 Finally, we understand the reasons why the board believes that vintage information and credit loss triangles might be inconsistent with the notion of an open portfolio. However, we believe that an alternative form of disclosure about experience adjustments, which allows users to understand the quality of earlier accounting estimates, should be developed in consultation with users.

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?

EFRAG's response

EFRAG believes that there should be no transfer between the respective allowances, but rather that they both be adjusted to reflect the loans contained in each of the two groups.

- 62 EFRAG believes that, in the case of an open portfolio, the attribution of the good book allowance to the loans that are transferred to the bad book would generally have little informational value. Under the proposals, the calculation of the amount transferred ignores all of the attributes specific to the loans involved, other than their weighted average age and life. Hence, the amount transferred does not reflect (1) the actual losses incurred; (2) the expected losses; or (3) the time-proportionate amount that would have been calculated on a 'sub-portfolio' basis. In any event, depending on the basis on which the amount transferred is calculated, the transferred amount would be incompatible with the measurement basis of the good book allowance, the bad book allowance or both. For those reasons, we believe that there should be no transfer between the respective allowances and rather that they both be adjusted to reflect the loans contained in each of the two groups.
- 63 In developing disclosure requirements on the allowance account, the IASB should consider the need of users to understand experience adjustments. To that end, users would need to understand how much of the change in the allowance account for the bad book relates to loans that were already in that book and how much relates to loans that were transferred during the period. They would need similar information regarding the good book allowance account.

Other issues

- 64 EFRAG has noted in the past that it is important for the IASB to consider the development of IFRS 9 as a whole. In our view, this is important not only because of the interaction between the different phases, but also because the availability of new information may lead to a reconsideration of earlier decisions. This phase proposes that an open portfolio of financial assets carried at amortised cost could have frequent additions and disposals. In our view, this may sit uneasily with the guidance provided in B4.1.3 of IFRS 9 (phase 1). There, an entity can only classify a portfolio of assets if sales or disposals are infrequent. We suggest that the IASB ensures that requirements throughout the comprehensive IFRS 9 are consistent before its finalisation.