

Financial Instruments: Impairment

The ABI's Response to the Supplement to IASB ED/2009/12

Introduction

1. The ABI is the voice of insurance, representing the general insurance, investment and long-term savings industry. It was formed in 1985 to represent the whole of the industry and today has over 300 members, accounting for some 90% of premiums in the UK.
2. The ABI is grateful for the opportunity to respond to the IASB's April 2011 exposure draft of its supplement on *Financial instruments: Impairment*. This supplement follows up on the original November 2009 IASB exposure draft *Financial Instruments: Amortised Cost and Impairment*. It is appropriate that the IASB has given due consideration to the responses to its earlier exposure draft and invited comments on revised proposals.

General comments

3. Making appropriate provision for expected credit losses on financial instruments is a difficult but important subject. Investors need financial reporting that is prudent and transparent while preparers need accounting that is operational and practical in its approach and reflects the economics of their business.
4. IASB's original approach may have been overly theoretical and operationally difficult to apply. However the starting point of recognising that the contractual rate of interest included an amount to compensate for credit impairment that would arise over the life of loans, and that appropriate provision over the life of the loan for such future impairment was necessary, is sound.
5. We are pleased that IASB and FASB have worked together to attempt to find a compromise solution but it is evident that the conceptual bases of their respective approaches are quite different. The proposed common approach is essentially pragmatic and indeed may produce a more appropriate answer than would either the IASB or FASB alternatives also being canvassed. We are not, however, convinced that the current compromise proposal will always reflect the reality of the economics of the lending transaction and emerging loss experience. In any case, we do not agree with the FASB approach that seeks, on the one hand to provide immediately for credit losses at inception but on the other only to provide for those losses that are expected to arise in the foreseeable future rather than over the life of the loan.
6. We agree on balance with the decision to apply a good book/ bad book distinction for banks on operational grounds but it is vital that this does not provide a basis for

accounting arbitrage and introduce unnecessary inconsistency between preparers based on their policy of when to manage loans in the bad book. A principle-based approach is needed that is capable of wider application and that would ensure that, for example, the expected losses on the good book are calculated on a sufficiently prudent basis to guard against this.

7. It is unclear to us why the problems of expected early loss patterns need impinge on the expected loss model since an incurred loss model will tend to be more prudent than the underlying economics in such circumstances and correspondingly less prudent than the economics when losses are expected to fall predominantly in the later parts of the loan life. It is for the latter, which will be more usual, that an expected loss approach particularly needs to be devised.
8. The agreed conceptual starting point under the IASB approach is that loan arrangements are entered into based on an implicit allowance for future credit losses. This ought to be subject, however, to the proviso that the original lending decision based on the actual contractual rate remains defensible. If not, then it is appropriate that an impairment (or, where appropriate, a writing up) of the asset should be recognised straight away. No doubt some proponents of the foreseeable future approach to impairment are seeking to find a way to provide for what were bad lending decisions *ab initio*.
9. The annuity approach to calculating appropriate provisions is more sophisticated in its incorporation of the present value of expected future losses. Against that, it needs to be recognised that higher provisions would need to be made in the early years when a higher proportion of loans will be performing and still permitting collection of contractual interest payments. Actual expectations at the outset of accumulated impairment based on an incurred loss approach may have a very different profile. The real measure in such circumstances of the impairment to the loan will be how far behind or ahead of this expected profile of incurred losses the actual incurred losses are.
10. On this basis the fair amount to recognise for impairments at any point in time would be the original time-apportioned expected credit losses minus the expected actual incurred loss plus the actual incurred loss. Thus at any point in time an appropriate provision for expected losses should be calculable and the actual incurred loss in the reporting period will be the key variable element of the charge to profit or loss for the period. Put another way, the impairment will be the original time apportioned expected loss provision determined at the outset plus or minus an experience adjustment. That approach should provide better and more transparent information to users of accounts and a conceptually appealing and coherent solution to what is a genuine accounting problem of great practical significance.
11. We think that this view is consistent with the bad book approach proposed by the IASB, but we suggest that the IASB's requirements need to be articulated in a way that can be applied sensibly outside the banking arena as well. We emphasise that the objective must be to build up an adequate level of balance sheet provision to

absorb expected credit losses in the good book and to ensure that income to date is fairly recognised and not overstated.

12. Use of a foreseeable future forward looking estimate will be subjective and runs the risk that a souring of economic conditions will lead to a foreshortening of management's horizon and, in turn, an insufficient increase in the rate of provisioning. If a foreseeable future formulation is to be applied under the standard it will be particularly important that the time period employed in this regard, and any increase or decrease is disclosed.

ABI

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