Financial Accounting Standards Board
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10 March 2011

- File Reference No. 2011-150
- Financial Instruments: Impairment

Dear Sir.

Thank you for giving us the opportunity to comment on your Supplementary Document, Financial Instruments: Impairment.

I will make some general comments. The enclosed appendix contains the comment letter, which I submitted to the IASB on the supplement to exposure draft ED/2009/12 (Financial Instruments: Amortised Cost and Impairment): Impairment. This covers most of the remaining issues in more detail.

Objective of impairment accounting

Surely the objective of impairment accounting should be to ensure that the impairment allowance balance is sufficient to cover all estimated credit losses for the remaining life of an instrument? This is similar to reserving in insurance: the allowance balance should be sufficient to ensure that all future impairment “losses” would be “funded” without recourse to additional (future) “finance”.

Achieving a common solution

I appreciate the desire for both boards to work together to achieve a common solution. However, I am not convinced that the mixed approach proposed here is an improvement over the approach proposed by the FASB in May 2010, or even just requiring the impairment
Please note that the comments expressed herein are solely my personal views

allowance to be the amount of credit losses expected to occur in the foreseeable future. I remain to be convinced of the importance of reflecting the relationship between the pricing of financial assets and expected credit losses as supported by the IASB. It is also not clear to me that the interaction of the currently proposed time-proportional and floor impairment allowances for the good book has any conceptual basis, or could be easily explained.

Preferred approach

I would recommend that both boards agree to adopt an approach closer to the FASB’s proposals from May 2010. As a minimum it would be useful if the boards (particularly the IASB) would provide a more complete rationale for wanting to reflect the relationship between the pricing of financial assets and expected credit losses in the approach to impairment accounting proposed here.

Yours faithfully

Chris Barnard
Please note that the comments expressed herein are solely my personal views.

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08 March 2011

- Your Ref: Comment letter on Supplement to Exposure Draft ED/2009/12: Amortised Cost and Impairment
- Financial Instruments: Impairment

Dear Sir.

Thank you for giving us the opportunity to comment on your supplement to exposure draft ED/2009/12 (Financial Instruments: Amortised Cost and Impairment): Impairment.

Current impairment accounting under IAS 39 is totally inadequate, as its incurred loss model fails to account for expected credit losses at the time the expectation is created. Its required “loss event” results in delayed and late recognition of credit losses, even when there is an expectation of such losses; it leads to volatility in the recognition of interest revenue when losses occur; it does not reflect the underlying economics of impairment events; and inconsistent interpretation and application of triggers among preparers has led to reduced comparability for users of financial statements. This is so fundamentally flawed that any of: the IASB’s proposals in the original November 2009 exposure draft ED/2009/12, the FASB’s proposals from May 2010, and the current supplementary proposals for open portfolios, would be a vast improvement over impairment accounting under IAS 39.

The current supplementary proposals take parts of the IASB’s and FASB’s original proposals, in order to create a unified accounting approach to impairment for open portfolios, whilst maintaining the desirable features of both of the original proposals. For example, the current supplementary proposals require open portfolios to be split into a good book and a bad book. The impairment allowance for the good book would be the time-proportional amount of the expected lifetime credit losses for the good book (maintaining the link between pricing and impairment allowances as supported by the IASB), with a floor of the amount of credit losses...
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expected to occur in the foreseeable future (ensuring that the allowance balance would be sufficient to cover all estimated credit losses at the reporting date, as supported by the FASB). The impairment allowance for the bad book would be the total expected credit losses, which is a simplified approach to pricing for impairment allowances, as supported by the IASB, whilst maintaining the prudence required by the FASB.

This sounds reasonable at first. However, although each of the components is reasonable in its own right, the combination of proposals may not be. For example, the impairment allowance for the good book can shift between a time-proportional amount and a floor amount. It is not clear that this should satisfy the objectives of either the IASB or the FASB. It is also not clear that the impairment allowance for the bad book represents a simplified approach to pricing, but rather it reflects an entity’s credit risk management approach to bad book assets.

It is not clear to me why we should stress the importance of reflecting the relationship between the pricing of financial assets and expected credit losses in the first place. I fully agree with the FASB in paragraph BC81 on this issue, that “actual impairment losses do not occur ratably over time and often arise as discrete amounts”. Furthermore, we don’t reflect this relationship in the latest proposals for accounting for insurance contracts. Proposed accounting for insurance contracts suggests that expected profit would emerge from the release from risk (from the risk margin), and the passage of time (for the residual margin), which is not in line with the pricing of the insurance contracts. To be honest, and in all simplicity, it might be preferable to simply require the impairment allowance for all assets within open portfolios, and by extension all relevant assets, to be the amount of credit losses expected to occur in the foreseeable future.

Scope of current supplementary proposals

The current supplementary proposals only cover very limited assets, namely financial assets managed on an open portfolio basis. It is difficult to comment with completeness on such limited proposals, which ignore single assets, closed portfolios, purchased loans, short-term trade receivables etc, without an overarching narrative as to, for example, the objective of amortised cost measurement and how an impairment model relates to that measurement. I look forward to providing more complete comments as and when you publish further proposals in this arena.

Unintended consequences

Given the limited scope, and the need to satisfy two accounting boards with different views and objectives, the current supplementary proposals may lead to unintended consequences and perverse results. One example is that the foreseeable future period would be expected to reduce during unusually volatile periods and periods of increasing uncertainty, for example during financial crises. In other words, entities’ abilities to make projections, judgements and

1 See exposure draft ED/2010/8: Insurance Contracts, and my comment letter thereon. The proposed accounting model here contains a mixture of deferral-and-matching and fair value features, and does not reflect how insurers typically price insurance contracts.
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estimates would reduce, possibly leading to lower impairment allowances for the good book, exactly when one would expect, and require higher allowances. I will return to this theme later on, but I would recommend that the boards should consider this issue further, as the proposals for accounting for impairment progress.

Subjectivity and need for controls and disclosure thereon

There are many instances in the current supplementary proposals where considerable judgement would be required to make decisions and determinations. For example:

- the decision to use a discounted or undiscounted estimate when calculating the time-proportional allowance for expected credit losses
- the length of the foreseeable future period
- the allocation of assets and differentiation between the good book and the bad book
- the derivation of weighted average expected life for assets without defined maturities
- whether to adopt a straight-line or annuity approach to allocating expected losses over the life of the good book portfolio
- the determination of when losses are expected to occur
- determining the discount rate to use when discounting expected losses.

I prefer principles-based accounting to rules-based accounting. Disclosure arguably plays a more important role when complementing a principles-based standard compared with a rules-based one. I support the flexibility proposed in the current supplementary proposals, as long as determinations thereof follow a well-documented procedure, and that sufficient and complete disclosure is made of the basis for inputs and assumptions, and the estimation techniques used.
Please note that the comments expressed herein are solely my personal views.

Answers to specific questions raised by the IASB

General

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?

Yes, the approach for recognition of impairment described in this supplementary document deals with the problem of delayed recognition of expected credit losses. As a minimum this is a vast improvement over current impairment accounting under IAS 39. The expected loss model proposed by the IASB in 2009 partly achieved this, by building up and maintaining a provision for expected future credit losses. The proposed introduction of the floor in this supplementary document addresses the FASB’s concerns about the adequacy of impairment allowances under the IASB’s proposals. However, it is not clear that the interaction of the IASB’s model with an additional floor would provide more meaningful information to users of financial statements (users). I would like to hear the views of other preparers and users, and would suggest further field testing to gauge views on the relevance and operability of the current supplementary proposals.

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.

Yes, I would expect that the impairment model proposed in the supplementary document is at least as operational for closed portfolios and other instruments as it is for open portfolios. In any event, I would strongly recommend one consistent impairment model for all assets accounted for at amortised cost.

Differentiation of credit loss recognition (paragraphs 2, 3 and B2–B4)

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?
Yes, this would be an appropriate method. It is certainly simpler and operationally easier to implement than the approach proposed in the IASB’s 2009 proposals, and the introduction of the floor should ensure adequate impairment allowances for portfolios with front-loaded expected credit losses. I am not convinced that this method is superior to simply requiring that the impairment allowance for all assets within open portfolios, and by extension all relevant assets, should be the amount of credit losses expected to occur in the foreseeable future.

**Question 4**

Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

Yes, the proposed approach to determining the impairment allowance on a time-proportional basis is operational. It simplifies the approach proposed in the IASB’s 2009 proposals, and could be easily systematised.

**Question 5**

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

I am not convinced that the proposed approach would provide information that is useful for decision-making. I agree with and support the proposals for the bad book, but the “dual calculation” for the good book has conceptual problems. How should an arbitrary change between time-proportional and floor impairment allowances be interpreted? How does this maintain the relationship between the pricing of financial assets and expected credit losses? How can this be compared with an entity’s credit risk management objectives? In fact, how does this align to an entity’s risk management activities?\(^2\) Wouldn’t it be simpler to adopt the FASB’s 2010 proposals, or even just require that the impairment allowance should be the amount of credit losses expected to occur in the foreseeable future?

**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?

Yes, the requirement to differentiate between the two groups (ie ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance is clearly described.

**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?

The requirement to differentiate between the two groups for the purpose of determining the impairment allowance is operational. However, there is diversity in credit risk management practices between industries, and entities within an industry, and any determination is not

\(^2\) Compare this with the explicit objective under exposure draft ED/2010/13: Hedge Accounting, of aligning hedge accounting with an entity’s risk management activities.
necessarily objective. The determination can require considerable judgement, which introduces some subjectivity here. I have no problem with this, as long as the judgement is applied consistently, and follows a well-documented policy and procedure. In this case the requirement would be auditable.

Question 8
Do you agree with the 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?

Yes. Purely within the current supplementary proposals, this is a good idea. I agree with and support the proposals for the bad book, which are common sense, realistic and prudent, but I am not entirely convinced with the proposals for the good book (see my responses to questions 3 and 5).

Minimum impairment allowance amount (paragraph 2(a)(ii))

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?

Yes, in conjunction with the proposed time-proportional method. This is one method of ensuring that there would be adequate impairment allowances for portfolios with front-loaded expected credit losses, although it is not the only method. The main problem with the floor is the subjective definition of foreseeable future period, and I agree with the FASB’s concerns in paragraph BC86 concerning the reduced comparability of results. However, this type of problem is always more likely to occur with principles-based accounting, and I believe that the appropriate response is sufficient and complete disclosure of the basis for inputs and assumptions made, and the estimation techniques used to determine the foreseeable future period.

  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?

I am not sure what you mean by “evidence of an early loss pattern”. Please would you provide more explanation here? Furthermore, I am not sure exactly how you could get such “evidence” without (as a minimum) making a determination for all assets as to the amount of credit losses expected in the foreseeable future anyway, so it is a moot point. I am not convinced that including another area of potentially arbitrary judgement would provide more meaningful information.
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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?

Yes, I agree that it should be determined on the basis of losses expected to occur within the foreseeable future. I also agree that the foreseeable future period should be no less than twelve months. I agree with your presumption in paragraph B16, and your argument in paragraph BC65 on this issue. Although I like the FASB’s 2010 proposals, I disagree with their arguments in paragraph BC80: the requirement that the foreseeable future should be no less than twelve months will not inconvenience entities where, “typically, entities are able to make reliable estimates of macroeconomic events and expected conditions over a period greater than twelve months”.

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

This is entirely possible. One would expect that the foreseeable future period would shorten during highly volatile and increasingly uncertain times, for example during a financial crisis such as occurred at the end of 2008. Therefore I disagree with paragraph B14. This could also lead to the unintended consequence that the foreseeable future period could shorten, and impairment allowances reduce, at exactly the wrong time, i.e. when they should probably increase.

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.

Yes, I believe that, in normal market conditions, the foreseeable future period is typically a period greater than twelve months. Reams of “reasonable and supportable information” exist including historical data, current economic conditions and economic forecasts, which add credibility to any judgements, estimates and predictions made for the foreseeable future period. One (probably) unintended consequence could be that more sophisticated entities with more advanced systems would be able to make credible projections over a longer period, and therefore hold higher impairment allowances. Although understandable, this would be counterproductive in my opinion.

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.

No, I do not agree that a ceiling should be established here. I agree that there is a problem with comparability, but there would still be a problem in this case. If comparability is desired here, then you could just set the foreseeable future period at a fixed twelve months. However,
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I would not support this, as I believe that this would neglect useful information, and would therefore not provide more meaningful information.

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.

This depends on the duration and maturity of the portfolio and the economic conditions at the time. The floor would be expected to bite more for short-term portfolios and during volatile and uncertain economic conditions, and particularly during economic crises.

Flexibility related to using discounted amounts (paragraphs B8(a) and B10)

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?

In principle I am in favour of this flexibility, as long as the decision as to which method to use is justified. However, in practice I would favour the use of discounted estimates, as we generally allow for the time value of money when considering comparable future cash flow items.

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?

Yes, I agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount, as this reduces operational complexity compared with the IASB’s 2009 proposals, and this was a concern of participants at that time. I agree that this introduces more subjectivity into the assessment of impairment allowances, and that this could be mitigated through effective disclosure of the methodology behind any discount rate used.

In total, I agree with paragraph BC43 that “in the context of amortised cost as a present value measurement, the use of discounted amounts, even if the discount rate provided some flexibility, was preferable to the use of undiscounted amounts”.

Approaches developed by the IASB and FASB separately

Question 12
Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?
I prefer the current supplementary proposals over the IASB approach for open portfolios of financial assets measured at amortised cost. Although not ideal, the introduction of the floor amount ensures adequate impairment allowances for portfolios with front-loaded expected credit losses. However, given that I do not strongly support the objective of reflecting the relationship between the pricing of financial assets and expected credit losses, and thus to recognise expected credit losses over the life of the assets, it might be simpler just to require that the impairment allowance should be the amount of credit losses expected to occur in the foreseeable future.

**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)? Why or why not?

*The FASB approach is conceptually quite sound, and would be simpler to operate compared with the good book (dual calculation) / bad book approach proposed here. I would recommend that you give this approach more serious consideration. As a minimum, I would suggest that you should provide a more robust conceptual basis for the current supplementary proposals, in particular, the rationale for wanting to reflect the relationship between the pricing of financial assets and expected credit losses, and whether the current supplementary proposals actually achieve this.*

**Impairment of financial assets**

**Question 14Z**

Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporated expected credit losses in the calculation of the effective interest rate? Why or why not?

*Yes, I agree that the determination of the effective interest rate should be separate from the consideration of expected losses. This is more operational and would provide welcome relief to preparers.*

**Scope – Loan commitments and financial guarantee contracts**

**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?

*Yes, loan and loan commitments are usually managed within the same business strategy, risk methodology, processes and operations, and there is no rationale for requiring different impairment requirements here.*
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**Question 16Z**
Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

*I principle yes, particularly for loan commitments. However, I support that financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts³, or as a minimum, to retain the existing approach in IFRSs here.*

**Presentation (paragraph Z5)**

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

*Yes, I agree with the proposed presentation requirements within the context of the current supplementary proposals. This would be operationally simple to apply, and would potentially provide meaningful information for users.*

**Disclosure (paragraphs Z6–Z15)**

**Question 18Z**

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

*The proposed disclosure requirements are fairly complete. I would support a sufficient level of disclosure that would inform users of the methodology behind the major judgements and determinations made. This would increase transparency and aid comparability between entities. I also agree that it is important that more information should be disclosed concerning credit risk management, as this would allow users to judge the effectiveness of an entity’s credit risk management activities, their relationship to how financial assets are originated and managed, and their impact on financial performance.*

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

*Concerning paragraphs Z12 and BCZ101, I would recommend that more emphasis should be put on the importance of back testing, and also on other emerging techniques such as reverse stress testing.*

**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?

³ Please see my comment letter on ED/2010/8: Insurance Contracts.
Please note that the comments expressed herein are solely my personal views.

Yes, I 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. This is consistent with the methodology underlying the current supplementary proposals.
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**Summary of my main recommendations to the board:**

- Provide a more robust conceptual basis for the current supplementary proposals, in particular, the rationale for wanting to reflect the relationship between the pricing of financial assets and expected credit losses
- Consider adopting a simpler methodology for impairment accounting here, such as requiring the impairment allowance for all assets within open portfolios, and by extension all relevant assets, to be the amount of credit losses expected to occur in the foreseeable future
- Scope in loan commitments that are not accounted for at fair value through profit or loss

Yours faithfully

Chris Barnard