EXECUTIVE BOARD

P. Flynn
Chief Financial Officer

Sir David Tweedie, Chairman
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Subject
Supplementary Exposure Draft:
“Financial Instruments: Impairment”

Dear Sir David,

We have read the proposals contained in the Supplementary Document (“SD”) “Financial Instruments: Impairment”, which is a supplement to the earlier Exposure Draft “Financial Instruments: Amortised Cost and Impairment” (the “2009 ED”) on which we commented as well. We would like to thank you for the opportunity to comment on these proposals. In this letter, we provide specific comments on behalf of ING Group, a world-wide financial services organisation focusing on Banking, Investments, Life Insurance and Retirement Services. We have also contributed to, and support, the comments submitted by various other organisations, notably the European Banking Federation (“EBF”).

Key messages

We appreciate the effort and the time which the IASB has invested in developing this SD. The SD addresses a number of concerns which arose from the 2009 ED, most importantly the suitability for ‘open portfolios’ and the ‘decoupling’ of interest income and credit losses.

We have always supported an expected loss (“EL”) approach to provisioning because it builds higher provisions during the earlier stages of a loan portfolio (in ‘good times’), which can be used as and when necessary (in ‘bad times’). An EL model would provide a better match between the credit spread included in interest income and the EL; it would also reduce the volatility in risk costs in the P&L (procyclicality).

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Although the proposed impairment model addresses some of the fundamental concerns with the model proposed in the 2009 ED, it is less complex and more practical, we continue to have significant concerns with the proposed model. The most critical issues are the following:

- the proposed model lacks an operational mechanism to ensure that EL provisions that have been built can actually be used if and when needed (the "usability" issue);
- the proposed model requires that losses that are expected in the ‘foreseeable future’ must always be fully provided; this requirement is very unclear and may well fully override the EL model in practice (the “floor” issue);
- and, as a result thereof, the proposed model will not reduce (and most likely increase) volatility in the profit and loss account, which is contrary to the objective of changing the current impairment model (the “procyclicality” issue).

The proposed model must be amended to address these critical issues, which are explained further below and are also addressed in our responses to the specific questions raised in the SD (as included in the appendix). We refer to the comments on the 2009 ED in our letter of 30 June 2010. In that letter, we indicated that we had actively participated in the development of an alternative expected loss model by the EBF, which we fully supported. We believe that the “EBF model” provides the right solutions to the above mentioned key concerns.

The “usability” issue

We believe that one of the core components of any EL model must be that expected loss provisions that are built up over the life of a portfolio can be used if and when needed. This is because incurred losses on specific loans are in fact the crystallisation of the expected losses that were estimated for the portfolio to which the loan belongs. As such, expected loss provisions must be built to be used, and should not merely represent a permanent buffer.

The proposed model requires segregation of a “good book” and a “bad book”. When collectability of a loan becomes doubtful, it must be transferred from the good book to the bad book, at which point in time it can only take its proportionate share of the EL provision from the good book to the bad book. In practice, this implies that an immediate incurred loss provision must be recognised in the bad book (total loss minus proportionate EL provision transferred). Even if the entire provision needed for the specific loan were to be transferred to the bad book, the model would require immediate replenishment of the good book provision. This results in a model where the P&L is similar to the current incurred loss model, whereas the balance sheet will include an EL provision that is merely a buffer. We believe that the proposed model should be amended such that is has a clear operational mechanism to ensure that EL provisions can actually be fully used when individual loans are transferred to the bad book.

We believe that the proposed model is based on the view that a natural offset exists between the good book and the bad book: when the economic outlook touches the bottom of the economic cycle the provision in the bad book will have increased because of high incurred losses, whereas the provision in the good book would show an offsetting decrease as a result of the better future economic outlook.
The reverse would then happen when the economic outlook reaches the peak of the economic cycle. We strongly believe that this is a totally theoretical concept. In practice, there is no reliable mechanism which enables entities to conclude precisely where the economy is in the cycle.

The “floor” issue

The proposed model in the SD introduces a floor that requires that the EL provision is always equal to the losses that are expected in the foreseeable future. We have several concerns with this “floor”:

- We do not understand the justification for embedding the concept of a floor in a model which is conceptually developed to recognise the EL over the life of the portfolio.
- The “foreseeable future” is a new concept that is not well defined in the SD. This may result in different interpretations of what is meant by “foreseeable” by different entities and/or different regulators. Furthermore, it is unclear whether the foreseeable future is intended to be a fixed period or whether this may be a shorter period in economic downturns and a longer period in an economic upturn.
- Depending on the interpretation of “foreseeable future”, the amount determined by the floor may in many cases always supersede the amount determined under the EL model. As a result, the provision in the good book will in many cases be driven by the minimum floor rather than by the core EL model.
- The EL model in the SD already requires a catch up to the time-proportionate share of the current lifetime EL for the portfolio. Therefore, compared to the earlier proposals of the industry, the SD model already implicitly includes a floor. The introduction of a foreseeable future floor would therefore mean an additional second floor.
- The concept of a ‘floor’ should be used only as an exception in specific situations rather than as generic mechanism for all types of portfolios in all circumstances.

The “procyclicality” issue

The strong demand for a revised impairment model was largely driven by the procyclicality of the current incurred loss model, as demonstrated in the recent financial crisis. As a result, we believe that a revised model is only acceptable to key stakeholders if it reduces procyclicality. As explained above, we expect that the model proposed in the SD will maintain the incurred loss charges in the profit and loss account similar to the current incurred loss model. Furthermore, it will add volatility by the time-proportionate recognition of changes in expected loss as, in practice, banks will be under pressure to increase their EL estimates in economic downturns, whilst these may be decreased in economic upturn. Instead of building provisions that can be used, this will increase procyclicality. We believe that this increased procyclicality contradicts one of the main objectives of a revised impairment model and, therefore, must be addressed.
Scope of the SD

The scope of the SD is “open portfolios” only. It is unclear whether there will be separate impairment models for ‘open’ portfolios, ‘closed’ portfolios and individual instruments. Furthermore, it is unclear whether the same model will be required for different types of instruments (loans, bonds at amortised cost, financial guarantees, loan commitments, etc). In general, we support one consistent provisioning/impairment model, but we stress the need for appropriate consideration of specific characteristics of different portfolio dynamics and different types of exposures and the need for proper field testing as explained below.

Convergence

We fully support the efforts to achieve a converged impairment model for IFRS and US GAAP. However, the joint proposal in the SD is not a real converged model, but a proposal where the IFRS model from the 2009 ED is “mixed” with the foreseeable future concept from the earlier FASB proposal. We do not believe that simply “mixing” elements of two conceptually different models is the right way to achieve high-quality converged standards.

Finalisation of the proposals and field testing

The proposals in the SD are far-reaching for the financial industry. The time available between the issue of the SD and the deadline for comments is extremely short and it coincided with the annual reporting period; therefore, it gave us very little time for performing any meaningful field testing to understand the financial and operational impact of the proposed model. We strongly believe than any proposed model that results from the 2009 ED, the SD and related comments must be re-exposed and extensively field tested before it is finalised.

In this respect we believe, as also expressed in our comments on other Phases of IFRS 9, that the entire IFRS 9 (including all phases) should not be effective before 2015 and should provide an exemption for restating comparatives at this later implementation date.

As mentioned above, we refer to the comments on the 2009 ED in our letter of 30 June 2010, in which we have proposed an impairment model that addresses the above key issues.

Our responses to the specific questions raised in the SD are included in the Appendix. As we believe that the above issues are critical and must be addressed before the proposal can be finalised, we have not commented in extensive detail on certain less important questions raised in the SD. We are available to discuss these comments further with you and/or your staff.

Yours Truly,

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Appendix: Responses to the questions raised in the supplementary exposure draft
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Question 1
Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (i.e. delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

We support the concept of an impairment model based on expected loss, which by nature should result in earlier recognition of expected credit losses. Although the model proposed in the SD addresses several of the weaknesses of the earlier model in the 2009 ED, we still have significant concerns with the proposals in the SD. These are explained in detail in our cover letter. We strongly believe that these aspects of the model must be addressed to make the model conceptually more robust and result in an impairment model that truly addresses the criticism on the current incurred loss model. Without doing so, the model proposed in the SD would result in a higher level of provisions compared to the current incurred loss approach, but would only add to (instead of reducing) procyclicality.

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.

In principle, we favour a single impairment model for open portfolios, closed portfolios and individual instruments. We believe that the concerns, as referred to above, will equally apply to closed portfolios. Furthermore, we believe that a revised model, which addresses these concerns, must be extensively field tested on open and closed portfolios as well as for individual instruments before it is finalised. The limited comment period of the SD, during the annual reporting season, did not allow such field testing.

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?

We agree with the concept of the ‘good book’ and establishing provisions on financial assets in the good book using an allocation of expected loss. However, we refer to the concerns expressed in the cover letter (mainly the ‘floor’ mechanism and the ‘usability’ of the provision) that must be addressed before the proposed approach is appropriate.
Question 4
Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

The proposed approach is definitely less complex than the earlier model in the 2009 ED. However, the new requirements for the ‘time proportionate approach’ and the ‘foreseeable future floor’ are still unnecessarily complex and would require multiple sets of computation on any reporting date.

Question 5
Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

The proposed approach would provide useful and comparable information for decision making only when the concerns raised above are appropriately addressed.

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?

We generally support the concept of a good book and a bad book and support the proposed requirements on differentiating between the two. We would expect that the differentiation would be in line with risk management practices and would result in a bad book that is similar to loans with incurred losses under the current IAS 39.

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?

The requirements appear to be operational and auditable. However, the proposals need to be extensively field tested in order to understand the full impact.

Question 8
Do you agree with the proposed requirement to differentiate between the two groups (i.e. ‘good book’ and ‘bad book’) for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

We agree with the proposed requirement.
Question 9
The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

(a) Do you agree with the proposal to require a floor for the impairment allowance related to the ‘good book’? Why or why not?

We disagree. We refer to the comments in our cover letter.

(b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the ‘good book’ only in circumstances in which there is evidence of an early loss pattern?

The concept of a ‘floor’ should be used only in cases where it is justified rather than a generic approach for all types of portfolio in all circumstances. However, we disagree that the loss pattern is a justification for a floor. A key characteristic of an open portfolio is that it includes loans in all stages of their lives and, therefore, it is unlikely in practice that an open portfolio would show a different loss pattern over time.

(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?

We do not agree with a proposed minimum allowance amount. Should such minimum be required as a political compromise to achieve convergence, it should be clearly defined and not exceed 12 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?

The length of future period for which the expected loss estimates are reasonably and accurately possible is not equal in all economic conditions. It is longer in “good parts” and shorter in “bad parts” of the economic cycle.

(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.
We refer to (c) above. The foreseeable future period should not exceed 12 months. If the foreseeable future period exceeds 12 months, then the resulting provision is likely to be more often based on the basis of the floor rather than the “core” EL model. As a result, the provision in the good book will be driven by the minimum floor rather than by the “core” EL model.

(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.

As explained above, we disagree with the concept of a ‘floor’ and in no case should it be greater than 12 months.

**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.

We refer to 9(e) above.

**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?

Yes, we agree with the flexibility since in ‘open portfolios’ it will anyway be difficult to apply discounting.

(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, we agree with permitting flexibility.
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?

We prefer the IASB approach over the alternatives in the SD. However, also under the IASB approach, it is critical that the issues in our cover letter are addressed.

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?

No, we support a model based on allocation of expected losses over the life of the portfolio. The reasons as to ‘why’ were included in our comments to the 2009 ED.

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. This is applicable to both ‘open’ and ‘closed’ portfolios and also for individual assets. The reasons as to ‘why’ were included in our comments to the 2009 ED.

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, all loan commitments should be subject to the same impairment requirements, because these are subject to the same risk management procedures and practices.

Question 16Z
Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?
Yes, credit risk on commitments and guarantees is managed in the same manner as credit risk on loans. Hence, the model is as operational for commitments and guarantees as it is for loans.

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

We believe that presentation requirements can only be fully considered when an alternative model, which addresses the key issues identified above, is available and has been properly tested in practice.

**Question 18Z**
(a) **Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?**

We believe that disclosure requirements can only be fully considered when an alternative model, which addresses the key issues identified above, is available and has been properly tested in practice.

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

None.

**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 to transfer only an amount of the related allowance reflecting the age of the financial asset when transferring the financial assets between the two groups. We believe that the entire estimated incurred loss at the date of transfer should be transferred from the good book to the bad book (provided that sufficient provisions are available on the portfolio in the good book), as such incurred loss as essentially the crystallisation of the expected loss on the portfolio. Otherwise the model results in building EL provisions that cannot be used when needed, which would defeat the whole purpose of creating an EL provision. This would also not resolve the criticism of volatility in the P&L since the provision in the bad book would be similar to the current incurred loss model.