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Dear IASB and FASB members

Joint Invitation to comment - Financial Instruments: Impairment

The global organisation of Ernst & Young is pleased to submit its comments on the joint supplementary document (SD) on impairment issued on 31 January 2011.

We strongly believe in the need for a converged solution to accounting for credit impairment under IFRS and US GAAP, and are encouraged by the outline of a common approach published in the joint SD. The approach set out in the SD would generally result in earlier recognition of credit losses than the current incurred loss models under IFRS and US GAAP. In addition, we believe the proposed approach addresses many of the concerns with the original separate proposals of the Boards. For the IASB, this includes decoupling the calculation of interest income and the allocation of credit losses and the move to a proportional basis for the recording of catch-ups when there is a change in the estimate of expected losses, making the approach more operational for open portfolios. With respect to the FASB, the proposed approach addresses the concerns raised by some regarding the immediate 'upfront' recognition of lifetime expected credit losses and the prohibition on recognition of future economic events and conditions when estimating expected impairment losses.

In our view, the common approach represents a conceptual compromise. It is not consistent with the separate and different objectives of the IASB and the FASB as expressed in their respective exposure drafts (EDs) and the alternative approaches each Board was separately redeliberating before convergence discussions. Rather, the common approach includes elements of each. The application of the floor under the joint approach would result in some 'upfront' recognition of losses in the reporting period in which a financial asset is originated or acquired, and is therefore not consistent with the IASB objective to provide 'information about the effective return' on an amortised cost asset. Also, the incorporation of the 'bad book' concept into the SD departs from the original objective to provide information about the effective return. On the other hand, the time-proportional allocation of losses in the joint
approach differs from the FASB's objective to more fully address the 'too little, too late' concern.

Notwithstanding the conceptual compromise, we are very supportive of the Boards' efforts to arrive at a converged approach to impairment under IFRS and US GAAP. Accordingly, we support the joint approach.

Nevertheless, there are a number of operational issues with the joint approach which we have set out in the appendix. These include, amongst others, the difficulties of defining 'foreseeable future' (set out in our response to question 9 (c)) and determining when an asset should be transferred from the 'good book' to the 'bad book' (and vice versa) (set out in our responses to questions 6, 7 and 8). We are especially concerned that, without a common view as to the foreseeable future periods for different classes of assets, there will be considerable diversity in practice across the globe. These issues, as well as a number of other practical challenges, will benefit from robust field testing and will require the development of additional guidance. To this end, it would be useful for the Boards to reconvene the Expert Advisory Panel to assist with an evaluation of the implementation challenges inherent in the proposal. In addition, these same areas will pose challenges for auditors, and we believe it important for the Boards to collaborate with various audit standard setters (including the IAASB and the PCAOB) to help address such challenges.

Consequently, we reserve our full support on the Boards' adoption of the proposed approach until the necessary guidance is prepared and the Boards conduct appropriate field testing among a variety of entities (both large and small) in a number of jurisdictions. In addition, although the Boards have requested comments on the suitability of the proposed approach to closed portfolios and other instruments, it is difficult for constituents to make more than preliminary observations since the Boards have not provided their views as to how the approach should be applied in those circumstances. In that regard, we believe appropriate due process would require re-exposure of any final impairment model(s), which should include guidance on how the model(s) should be applied to all financial assets subject to impairment.

The final standard should only be published after the proposed model has been properly field tested by both preparers and auditors and appropriate feedback has been obtained on the final impairment model(s). We have concerns whether robust field testing can be completed, its results appropriately evaluated, and feedback obtained on the final impairment model(s), in time to meet the planned 30 June 2011 project due date. In this regard, even if the due date has to be extended by a few months, we believe the Boards should take the time necessary to allow these various steps to occur, before making the model(s) final.
As we indicated in our responses to the IASB’s Request for Views - Effective dates and transition methods and the FASB’s Discussion Paper, Effective dates and transition methods, we believe that entities will need a minimum of 24 to 30 months before the beginning of the comparative period when the changes are first applied, in order to properly prepare for the new standards. Because SEC registrants are required to provide two years of comparative information, the mandatory effective date for the financial instruments standard for US GAAP preparers should be no earlier than 1 January 2016. Because IFRS preparers are only required to provide one year of comparative information, the mandatory effective date for IFRS 9 should be no earlier than 1 January 2015. Consistent with our previously mentioned comment letter to the IASB on effective dates, we would support early adoption for IFRS preparers. However, for reasons outlined in our comment letter to the FASB on effective dates, we believe early adoption should not be permitted for US GAAP preparers.

Finally, as noted above, a converged solution to this important accounting area is critical, and we would not be supportive of any actions by the individual Boards to make unilateral adjustments to the joint approach such that the approach to the impairment of loans adopted by one board is not identical to the impairment approach adopted by the other.

Our responses to the questions in the SD and the IASB-only appendix to the SD are set out in Appendices 1 and 2 to this letter, respectively. Should you wish to discuss the contents of this letter with us, please contact Tony Clifford on +44 (0)20 7951 2250 or Kevin Guckian on +1 212 773 1051.

Yours faithfully,

Ernst & Young
Appendix 1 - Responses to the questions in the IASB's Supplement to Exposure Draft Financial Instruments: Impairment and the FASB's Supplementary Document Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities - Impairment

General

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

The approach in the SD, with full provision for all expected losses on financial assets in the bad book and the recording of the higher of the time-proportional amount and the floor as the provision for the good book, would result in earlier recognition of credit losses than the current loss models under IFRS and US GAAP for the majority of entities.

However, given the current diversity in practice, the application of the SD approach could result in lower allowances for credit losses for some entities. These include entities with current collective provisions that are higher than the losses expected in the foreseeable future (either because they apply an emergence period of more than a year or make provisions against 'watchlist' loans for losses which would be expected to occur beyond the foreseeable future period).

**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.

Conceptually, the impairment allowance for a group of single assets or assets managed in a closed portfolio should be similar to that for a group of the same assets managed in an open portfolio. Since any difference would result in inconsistency in the recognition of impairment losses for financial assets, we believe it is important to develop a common approach for open portfolios, closed portfolios and, to the extent possible, single assets. However, we have concerns as to whether the proposed approach is operational for closed portfolios and single assets without additional guidance.
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Operationally, the estimation of expected losses for closed portfolios may be no more complex than for open portfolios. Similar to open portfolios, expected losses for closed portfolios can be estimated based on long-term average loss rates and shorter-term specific projections. For single assets, in principle, a calculation of the probability-weighted possible loss expected to occur could also be estimated based on specific projections and by reference to long-term average loss rates for financial assets with similar characteristics. This is essentially applying a portfolio concept to the individual asset, in that the probability-weighted loss estimate would be based on average losses expected on a portfolio of similar assets. This is an area where there would be a need for more outreach and field-testing to ensure that the approach can be made to operate for a range of entities of different sizes in different industries.

While the estimation of expected losses could be performed for closed portfolios and single assets, we have concerns as to how the floor should be applied and how the time-proportional allowance should be calculated for such portfolios and assets. Additional guidance would be necessary on these areas, so that the resulting impairment allowances for a group of closed portfolios or single assets would be similar to that for an open portfolio containing the same assets. Specifically, we have the following concerns and proposals:

- Because the application of the floor requires a ‘higher of’ assessment, applying the floor to each closed portfolio or a single asset would result in aggregate allowances that are different from applying the floor to a larger, open portfolio with the same assets. In general, the overall provision would be higher if the floor is applied to a smaller number of assets (either a single asset or a closed portfolio). In order to increase comparability, closed portfolios and single assets with similar characteristics should be grouped together and the floor applied only to the larger group. Hence, the floor should be required to be assessed at the aggregate level for a portfolio of assets with similar characteristics.

- The issue of comparability is not limited to the application of the floor. Performing the time-proportional allowance calculation for an open portfolio at the portfolio level could result in a time-proportional balance that is different from aggregate allowances derived from separate calculations performed for closed portfolios. For instance, the calculation of the time-proportional allocation would give rise to smaller provisions if the calculation is made for portfolios structured by loan vintage. A simple example to demonstrate this point is included in Appendix 3.
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It is our understanding that the time-proportional approach was not intended to be used for closed portfolios. In the event that the Boards decide to apply a consistent, time-proportional, approach to open and closed portfolios, it would be helpful to require that the time-apportionment be determined at a higher, aggregate level, even if the expected losses are calculated for smaller, closed portfolios. This issue is similar to the effect of calculating the floor at a lower level. Also, as it offsets, to a degree, the effect of calculating the floor at a lower level, a further question that needs to be addressed is whether entities should be required to assess the floor and the time-proportional calculation at the same level, to avoid ‘cherry picking’ the lowest (or highest) result.

These issues are not limited to closed portfolios and single assets. They also apply to open portfolios. The levels of both the floor and the time-proportional amount will vary with open portfolios of different sizes. Depending on the characteristics of the financial assets and the risk management processes, entities will often segregate an open portfolio into sub-groups, such as by vintage of origination or by expected repayment date, or by credit rating, in order to estimate the credit losses for each sub-group and then add these together to determine the aggregate losses of the portfolio. Other entities would simply estimate losses for the entire portfolio without segregation. Should the time-proportional allowance calculation be performed at the same level that expected losses are estimated? Or should the calculation only be performed at the higher portfolio level?

In addition, while the scope of the joint approach clearly excludes closed portfolios, there is some confusion as to whether or not debt securities would be in scope. Although paragraph 1 (i.e., the Scope paragraph) does not appear to exclude debt securities, paragraph IN20(a) indicates that ‘any issues specific to investments in debt securities’ have not yet been redeliberated. As a result, some entities have taken the view that the joint approach does not apply to investments in debt securities and, therefore, have not taken the time to consider how the joint approach might be applied to those investments. The following are some observations on the application of the approach to debt securities.

While it would be possible, in theory, to apply the SD approach to debt securities, this would be a significant change for many US GAAP preparers, which have been accustomed to assessing impairment on an instrument-by-instrument basis. In addition, from the US perspective, most debt securities would be measured at fair value through other comprehensive income (OCI) in accordance with current proposals, rather than at amortised cost. The cost of applying a complicated impairment approach to financial assets with losses that are already recorded in OCI would be regarded by some constituents as outweighing the benefits.
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On the other hand, from an IFRS perspective, there would be considerable benefit in adopting a single methodology for both loans and securities. Under IAS 39 and IFRS 9, both loans and securities may be measured at amortised cost if the relevant criteria are met. In addition, there is already a requirement to determine a collective allowance for held-to-maturity securities under IAS 39. Consequently, we are of the view that, in principle, the approach applied to loans should also be applied to investments in debt securities under IFRS. We note that application may generally be easier for debt securities, given that there is a wider variety of available data, such as external credit ratings and default histories, which entities could use to estimate expected credit losses. However, like US GAAP, this would be a significant change in practice, affecting many other entities in addition to banks. Therefore, it is an area that would benefit from further outreach to users and preparers, to explore the value and practicability of the proposed solutions.

We have offered our preliminary views as to how the joint approach might be applied to closed portfolios and single assets in response to the Boards’ request for comments on the suitability of the joint approach to closed portfolios and other instruments. However, without providing the Boards’ views as to how the joint approach should be applied in these circumstances, it is difficult for constituents to make more than preliminary observations. In that regard, we believe appropriate due process would require re-exposure of any final impairment model(s), which should include guidance on how the model(s) should be applied to all financial assets subject to impairment. Also, as stated above, whatever impairment model is chosen for debt securities, it will be important to obtain constituent feedback on the appropriateness of the model chosen.
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Differentiation of credit loss recognition

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<th>Question 3</th>
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<td>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?</td>
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In our responses to the IASB and FASB EDs, we supported the objectives of a time-proportional approach with an incurred loss overlay, so that the minimum allowance for credit losses includes all incurred losses (similar to the concept of a bad book). In fact, we suggested, as an alternative to the approaches originally proposed by the Boards, a model that is very similar to the joint approach without the floor in the good book (in this way it is most similar to the IASB alternative included in the SD). Although the addition of a floor to the computation of the allowance in the good book results in an approach that is different from the alternative approach that we suggested in our responses, we are supportive of the joint approach and the Boards' efforts to arrive at a converged approach to impairment under IFRS and US GAAP. Hence, subject to robust and satisfactory field testing, we are supportive of the joint solution that includes a floor.

More specifically, we have the following comments about the proposed approach:

- The recognition of expected credit losses using a time-proportional approach better reflects the pricing of the portfolio of assets, which includes a component for expected credit losses.

- We agree with the decision to decouple expected credit losses from the effective interest rate. Because interest income is recognised each period, including the component that represents compensation for expected credit losses, a mechanism is necessary to recognise expected credit losses.

- The effect of any change in estimates of expected losses would be recorded on a time-proportional basis, consistent with the allocation of the initial estimate of expected credit losses. This is consistent with the principle in the Boards' ED Revenue from Contracts with Customers (published in June 2010) of recognising as revenue a change in transaction price to the extent the change is allocated to performance obligations already satisfied.
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- The joint approach is operationally more feasible than the approach in the IASB ED, which would require the tracking of cash flows by loan vintage in order to allocate the credit losses and to determine the catch-up adjustments required by the ED.

- The application of a further allowance for the bad book addresses, to a significant degree, the concerns of some constituents that the IASB ED approach could result in 'negative provisions' when losses are expected to arise earlier in the portfolio life. However, we appreciate that there will always be losses in a portfolio that are 'incurred but not reported' and that the time-proportional approach may not give rise to a sufficient allowance for such losses as they arise, if they do so early in the portfolio life. As a result, we understand why the floor for the good book is proposed, although we have some operational concerns with how it is to be calculated, as set out in our response to question 9(c).

However, for credit card receivables (and similar short-term revolving arrangements), overdrafts and other shorter-term receivables that are within the scope of the SD, the time-proportional calculation would be too complex to implement, because it is difficult to estimate the portfolio life. Meanwhile, for these assets, the time-proportional amount for the good book would exceed the floor only in rare circumstances. For credit card receivables (and similar short-term revolving arrangements), overdrafts and other similar short-term receivables, we believe that entities should be allowed to record an impairment allowance equivalent to the credit losses expected to occur within the foreseeable future period at any reporting date without the need to perform the 'higher of' assessment. Since the lives of such assets are relatively short as compared to those of other financial assets subject to impairment, the amount of losses expected on these assets in the foreseeable future would be almost equivalent to the entire amount of losses expected over the remaining lives of the assets. This approach may also be suitable for other financial assets, such as automobile loans, that, although having longer lives, tend to experience most of their credit losses in early years. For such assets, the Boards should consider developing a principle that there is no need to perform the 'higher of' assessment if the majority of the lifetime credit losses are expected to occur in the foreseeable future period.

It is also worth noting that, for credit card receivables, the decision to grant the customer the borrowing facility may have been made many months before the amount is drawn down. Consequently, there will, in practice, be receivables which are impaired as soon as they are first recognised (even if there is no direct evidence that this is yet the case), which helps provide theoretical justification for provision for losses on initial recognition of such credit card receivables.
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Question 4

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

Questions of operability are best left to preparers. We do note, however, that the proposed approach addresses many of the practical concerns raised by constituents regarding the original approach in the IASB ED, by decoupling the calculation of interest income and the allocation of loan losses and moving to a proportional basis for the recording of catch-ups when there is a change in the estimate of expected losses, making the approach more operational for open portfolios. Nevertheless, there remain a number of operational issues with the joint approach. These include the difficulties of defining 'foreseeable future' (set out in our response to question 9(c)) and determining when an asset should be transferred from the 'good book' to the 'bad book' (and vice versa) (set out in our responses to questions 6, 7 and 8). These issues, as well as a number of other practical challenges that are set out in our response to question 2, will benefit from field testing and the development of additional guidance for both preparers and auditors. Finally, while the proposed approach could be operational, it will require significant changes to information systems, procedures and controls to estimate the credit losses, compute the time-proportional amount and the floor, and comply with the extensive disclosure requirements (in particular, as most of the disclosures require analysis by class of financial asset).

Question 5

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

Overall, we believe that the proposed approach provides information that is an improvement from that provided by the current incurred loss model, as it uses more forward-looking information about credit losses. For users of IFRS financial statements, the proposed approach could provide useful information if the disclosures in the IASB-only appendix to the SD are made, to enable the users to understand the impact of applying the proposed approach to different entities. The FASB has yet to deliberate the presentation and disclosures for the proposed approach. Without the ability to consider the FASB disclosures, we are unable to provide any views in this letter as to whether the proposed approach would provide more useful information for users of US GAAP financial statements.
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Question 6
Is the requirement to differentiate between the two groups (i.e., 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

Question 7
Is the requirement to differentiate between the two groups (i.e., 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If no, how could it be made more operational and/or auditable?

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

Taking these questions in the reverse order, we agree with the requirement to differentiate between the two groups, and to recognise all expected losses on assets in the bad book. Ignoring the application of the floor, the proposed approach would allocate future expected losses over the expected life of any portfolio on a time-proportional basis. This time-proportional allocation would similarly apply to a portfolio where there is evidence of an early loss pattern, and so would result in the recognition of the expected losses over the entire life of such a portfolio, instead of the period in which most of the losses are expected to occur. This would arguably result in delayed recognition of credit losses in circumstances where there is evidence of an early loss pattern. This weakness is partially mitigated by the requirement to have a bad book since most of the assets in the good book that have an early loss pattern would presumably be transferred to the bad book early in the life of the portfolio. The floor also helps to address this concern regarding delayed recognition of credit losses. See our response to question 9 on the floor.

We believe that the criteria to differentiate between the two groups, as currently worded in paragraph 3 (with further elaboration in B2 to B4) of the SD, to determine when an asset should be transferred from the good book to the bad book will lead to varying views as to when such a transfer should occur. More specifically, we have the following concerns:

- The SD does not provide adequate guidance as to how loans or other financial assets that have been renegotiated/restructured, those to which a forbearance strategy is applied, or those on a 'watchlist' should be classified. Some entities may classify such
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assets in the bad book. However, as paragraph B3 of the SD is worded, others may classify these assets in the good book. For example, in cases of forbearance, there may be an expected economic loss for the lender even though the risk management objective has not changed from receiving regular payments from the debtor to recovery of the financial asset.

- In addition, the risk management objectives included in paragraph 3 of the SD to distinguish between the good book and the bad book are at extreme ends of the continuum of how financial assets are managed by entities, and do not provide adequate guidance as to how to classify a financial asset that is managed in accordance with an objective that is between the two extreme ends. For example, an entity may determine that the probability of collection of the principal on a long-term loan has deteriorated so significantly that it believes an immediate transfer to the bad book is warranted, despite the fact that the debtor is still making regular payments on the asset and the current actions of the entity are consistent with the objective of receiving regular payments. Paragraph 3 and the application guidance in paragraphs B2 to B4 do not seem to provide adequate guidance as to whether such an asset should be classified in the good book or the bad book.

These concerns could be addressed by providing additional guidance and examples in the final standard that are based on established industry practices for managing financial assets and explaining how those common practices fit into the Boards’ view of how the good book and the bad book split should be done. Absent additional guidance, we are concerned there will be wide diversity in application. Additional guidance and examples should be developed by the Expert Advisory Panel (EAP) and included in the final standard to help entities apply the credit risk management criteria more consistently.

The concerns regarding the differentiation between the good book and the bad book may be partially mitigated by the application of the floor for the good book. Take an example of an entity that has a portfolio of financial assets that includes loans with losses that are expected to fully occur in the foreseeable future. Even if such loans are not classified in the bad book, the entity would record an impairment allowance that is the entire amount of losses expected on these loans if the floor is applied for the good book, which has the same effect as classifying these loans in the bad book. Nevertheless, the issue regarding the criteria to differentiate between the good book and the bad book is still important as the floor is only applied when it is higher than the time-proportional amount.
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Minimum impairment allowance amount

Question 9

The boards are seeking comment with respect to the minimum allowance amounts (floors) 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 the entity should be required to invoke a floor for the impairment allowance related to the ‘good book’ only in circumstances where 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 responses.

(a) In our responses to the IASB and FASB EDs, we supported the objectives of a time-proportional approach with an incurred loss overlay, so that the minimum allowance for credit losses includes all incurred losses (similar to the concept of a bad book). In fact, we suggested, as an alternative to the approaches originally proposed by the Boards, a model that is very similar to the joint approach without the floor in the good book (in this way it is most similar to the IASB alternative included in the SD). Although the addition of a floor to the computation of the allowance in the good book results in an approach that is different from the alternative approach that we suggested in our responses, we are supportive of the joint approach and appreciate the Boards’ efforts
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to arrive at a converged approach to impairment under IFRS and US GAAP and hence the joint solution that includes a floor.

(b) If a floor is required in the final standard, we believe it should be applied in all circumstances, regardless of whether there is an early loss pattern. This is because an approach that depends on the determination of loss patterns would add further complexity and judgment to what is already a complex and judgmental exercise, as well as the fact that loss patterns could change due to changing economic circumstances and other factors.

(c) The foreseeable future period is defined in the SD as the future time period for which the ‘best estimate of credit losses for the period for which specific projections of events and conditions are possible and the amount of credit losses can be reasonably estimated based on those specific projections’. As defined, we are concerned that the foreseeable future period will differ from one entity to another, one country to another and one period to another, and will be so subjective that it would be difficult to verify.

We agree that, in practice, the ‘development of the estimate relies heavily on an entity’s ability to forecast events and conditions’ (B13). However, this implies that more sophisticated entities may be able to forecast further into the future and so would calculate higher losses for the floor, resulting in diversity in practice. It is also probable that, absent further clarity or guidance, local regulators will seek to define the foreseeable future period, resulting in considerable differences from one jurisdiction to another. Furthermore, the future period over which the entity is able to make specific projections will change as economic conditions change (see our response to question 9(d)). Therefore, the definition of foreseeable future is inherently inconsistent with the description in paragraph B14 of the SD that ‘the foreseeable future would be a fairly constant period that would not be expected to change significantly from period to period for a particular portfolio’.

In addition, we are concerned that the term ‘credit losses’ is not clearly defined for the purpose of determining the level of the floor. Preparers could have different interpretations of when credit losses occur, e.g., when there is a trigger event, when assets are transferred to the bad book, when there are shortfalls from contractual amounts that are due, or when assets are written off. The lack of clarity could result in significantly different amounts of ‘credit losses’ being determined for the foreseeable future.
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The diversity in application of the floor would make it difficult for investors to compare the impairment allowances of one entity to another. In order to avoid significant diversity in practice, we believe it is important for the Boards to define more clearly the concepts of ‘credit losses’ and ‘foreseeable future’. Also, the Boards should collaborate with regulators (or ask an Expert Advisory Panel that includes regulators) to develop guidelines as to the determination of the foreseeable future periods for different classes of financial assets. For preparers and auditors, determination and audit of credit losses will already be a major challenge without the additional difficulty of assessing the foreseeable future period. Without any guidance as to the foreseeable future periods for different classes of assets, there are significant issues that would need to be addressed by preparers as to how to determine the foreseeable future periods, and for the auditing profession as to whether it can verify what is the foreseeable future.

(d) As worded, the foreseeable future period considered in developing expected loss estimates could decrease if there is greater uncertainty about the future economic conditions, as such estimates could become less reliable during times of economic uncertainty. Unexpected economic changes can make current information about future economic conditions less reliable than in the past.

However, we don’t believe that a shorter foreseeable future period (and thus a lower floor) during a period of economic uncertainty, is what the Boards intend. A lower floor during such a period would seem inconsistent with the objectives of both Boards. See our response to question 9 (c) for our recommendations as to how to address this issue.

(e) Under various regulatory regimes, many banks are already making specific projections to determine credit loss parameters for a future period of one year. It is thus reasonable to believe that all entities can, with time, develop processes and systems to make reasonable estimates of credit losses over a one year future period.

More sophisticated financial institutions may be able to make specific projections reliably for certain classes of financial assets for a future time period greater than twelve months. But other entities, especially less sophisticated financial and non-financial entities, may be unable to make specific projections reliably for many types of financial instruments beyond the one-year horizon, especially for new financial products with which entities have no historical data, either internal or external.
Appendix 1 - Responses to the questions in the IASB's Supplement to Exposure Draft Financial Instruments: Impairment and the FASB's Supplementary Document Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities - Impairment

Although some entities currently perform calculations for collective provisions using emergence periods that are more than one year, these calculations are usually based on historical loss experience rather than any specific projection or forecast of future economic conditions. In addition, while impairment of individual financial assets under IAS 39 may require estimation of cash flows over a period greater than twelve months, this is for a much smaller portfolio of assets which are already troubled, and where the main judgments are specific to the performance of the asset rather than of the wider economy. Consequently, entities would benefit from additional guidance and best practices that could be developed by the EAP as to how the specific projections are performed. Also, see our response to question 9(c).

(f) See our response to question 9(c).
Appendix 1 - Responses to the questions in the IASB's Supplement to Exposure Draft Financial Instruments: Impairment and the FASB's Supplementary Document Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities - Impairment

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.

For an open portfolio of long-lived assets in a steady state with losses that are expected to occur evenly over the lives of the assets, the time-proportional allowance based on the losses over the remaining lives of the assets (especially if it is based on a straight-line undiscounted allocation) will typically be higher than the losses in the upcoming shorter-term period. However, the time-proportional amount could be lower than the floor for the following types of portfolios and situations:

- Growing portfolios to which the amount of new assets that are added exceeds the amount of old ones that are removed from the portfolios, resulting in a lower time-proportional multiple (ratio of the portfolio's age to its expected age) and thus a lower time-proportional allowance

- Portfolios of assets with early loss patterns

- Portfolios of shorter-term assets

- Portfolios for which an entity can develop specific projections of events and conditions over a longer foreseeable future period, resulting in a higher floor

- Portfolios with assets for which collectibility has deteriorated (resulting in higher losses expected in the foreseeable future) but which remain in the good book, for example, because the assets are still managed to receive regular payments

- Adverse changes in forecasts at the beginning of a downward trending economic cycle, resulting in higher losses expected in the foreseeable future period
Appendix 1 - Responses to the questions in the IASB’s Supplement to Exposure Draft Financial Instruments: Impairment and the FASB’s Supplementary Document Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities - Impairment

Flexibility related to using discounted amounts

<table>
<thead>
<tr>
<th>Question 11</th>
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</thead>
<tbody>
<tr>
<td>The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:</td>
</tr>
<tr>
<td>(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?</td>
</tr>
<tr>
<td>(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?</td>
</tr>
</tbody>
</table>

(a) Paragraph IN20 indicates that the Boards have not yet deliberated the methods for measuring credit losses or the objective of amortised cost measurement and how the proposed impairment model relates to that measurement. Without an understanding of the measurement objective, it is difficult to respond to this question. However, we offer the following observations:

**Bad book**

For the bad book, we believe that assets should be accounted for in a manner that is consistent with how financial assets with incurred losses are currently treated under IAS 39 and ASC 310-10. That is, the cash flows of assets in the bad book should be discounted to determine the impairment allowance for those assets. The use of discounted amounts is especially important for renegotiated/restructured loans in the bad book. For such loans, we are concerned that no loss would be recorded despite an 'economic' loss if there is no discounting, and the repayment of such loans are extended or interest is contractually reduced.

We note that the table in IEZ18 of the SD does not reflect the use of discounted amounts for the bad book allowances. The table would need to be revised appropriately if the Boards decide to use discounted amounts to determine the impairment allowance for the bad book.

**Good book**

With respect to the good book, we agree in principle with the Boards’ decision to provide entities the flexibility to use either a discounted or undiscounted estimate.
Appendix 1 - Responses to the questions in the IASB's Supplement to Exposure Draft Financial Instruments: Impairment and the FASB's Supplementary Document Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities - Impairment

We imagine that most entities would choose to use a straight-line undiscounted computation for the time-proportional allowance as it is easier to compute and to explain to users. However, for the benefit of those entities that may choose to use discounted estimates for the time-proportional allocation of losses, it would be useful to clarify what is meant by 'losses' for this purpose.

One possibility would be to define them as the shortfall from contractual cash flows and thus, by definition, would be deemed to occur at the time the contractual cash flows are due. The period of discounting would therefore be from the date that the cash flows are contractually due to the reporting date. Such a definition would be consistent with the expected cash flows approach in the IASB ED.

The limitation of defining losses as suggested in the previous paragraph is that economic losses can be expected to be incurred even if all the contractual cash flows are collected, if some are expected to be collected later than initially due. Discounted estimates of losses should therefore also take into account the expected timing of receipts.

In addition, since discounted estimates of expected losses would take into account when the lost cash flows were due to occur, they should conceptually include shortfalls in interest as well as principal. This is in contrast to the straight-line undiscounted computation, where we believe there would be merit in taking into account only the shortfall in principal since there is no discounting. (Inclusion of the expected loss of interest without discounting involves an inconsistent treatment of the time value of money and arguably overstates the expected losses. This is an issue that needs to be explored further through the outreach process.)

(b) As mentioned in our response to (a) above, we believe few entities would choose to use a discounted estimate when performing the time-proportional calculation due to the operational complexities of doing so. However, we agree with the Boards that any entity that chooses to do so should be permitted flexibility in its selection of a discount rate as long as the same basis for determining the discount rate is applied from one period to another, and that basis is disclosed. Flexibility to use rates other than the effective interest rates would enable the calculation to be made operational for open portfolios. It would also remove the perceived problem arising under IAS 39 in which credit card and similar receivables are, in effect, required to be discounted at a lending rate, which in practice is a penalty rate that does not reflect the time value of money and credit risk of the asset.
Appendix 1 - Responses to the questions in the IASB's Supplement to Exposure Draft Financial Instruments: Impairment and the FASB's Supplementary Document Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities - Impairment

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 (i.e., to recognise expected credit losses over the life of the assets)? Why or why not?

Question 13
Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (i.e., to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

In our responses to the IASB and FASB EDs, we supported the objectives of a time-proportional approach with an incurred loss overlay, so that the minimum allowance for credit losses includes all incurred losses (similar to the concept of a bad book). In fact, we suggested, as an alternative to the approaches originally proposed by the Boards, a model that is very similar to the joint approach without the floor in the good book (in this way it is most similar to the IASB alternative included in the SD). Although the addition of a floor to the computation of the allowance in the good book results in an approach that is different from the alternative approach that we suggested in our responses, we appreciate the Boards' efforts to arrive at a converged approach to impairment under IFRS and US GAAP. Consequently, we are supportive of the proposed approach with a floor as a possible common solution for IFRS and US GAAP, if the significant concerns described in our responses to questions 6, 7, 8 and 9 (c) are addressed. Once such concerns are addressed, the Boards should take time to robustly field test the proposed model among various entities, including financial (both large and small) and non-financial (i.e., commercial) institutions. The proposed model should only be included in the final standard after the proposed model has been thoroughly field tested.
Appendix 1 - Responses to the questions in the IASB's Supplement to Exposure Draft Financial Instruments: Impairment and the FASB's Supplementary Document Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities - Impairment

Other issues

As a minor drafting point, we note that both the terms 'pool' and 'portfolio' are used in B6 and B7 of the SD. The heading before paragraph 2, 'impairment of open portfolios (pools) of financial assets', implies that they are used interchangeably. In order to avoid confusion, we suggest that the word ‘pool’ be replaced by ‘portfolio’, which is defined in the SD (whereas ‘pool’ is not), throughout the final standard.
Appendix 2 - Responses to the questions in Appendix Z to the IASB's Supplement to Exposure Draft Financial Instruments: Impairment

IASB only Appendix Z

Our responses to the questions in this appendix are only applicable to IFRS and in respect to the IASB's proposals in its ED Financial Instruments: Amortised Cost and Impairment and the SD. We understand that the FASB has yet to deliberate the presentation and disclosures for the proposed approach. Consequently, none of our views in this appendix are in relation to US GAAP or in connection with the FASB's proposals on impairment.

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 incorporates expected credit losses in the calculation of the effective interest rate? Why or why not?

We agree that the determination of the effective interest rate should be separate from the consideration of expected losses. Operationally, we agree that the original proposed integrated effective interest rate would be very costly and time-consuming for entities to implement. This is because the accounting systems that currently calculate effective interest rates are not integrated with the loss information that is contained in credit risk systems. Consequently, we support decoupling of interest income and impairment expense.

**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?

Loans, commitments and guarantees to a customer are often all entered into under the same facility, and managed under the same business model, drawing on the same risk assessment process and data. In practice, many financial institutions estimate the measurements required by IAS 37 by using their loan portfolio impairment systems to value and account for loan commitments and financial guarantee contracts by applying the impairment principles of IAS 39, as if they were loans recorded at amortised cost.

For financial guarantee contracts, we note that the IASB has tentatively decided to retain the existing approach in IFRS that requires an issuer to account for a financial guarantee contract in accordance with the financial instruments standards (IAS 39 and IFRS 9) in all cases where the issuer has not previously asserted that it regards the contract as an insurance contract.
Appendix 2 - Responses to the questions in Appendix Z to the IASB’s Supplement to Exposure Draft Financial Instruments: Impairment

With respect to loan commitments, we believe that loan commitments that are not currently in the scope of IAS 39 (for example, because they are not expected to result in loans that are sold shortly after origination) should be included in the scope of IFRS 9 and their measurement should be harmonised as far as possible with the measurement for loans recorded at amortised cost.

Given that loans, loan commitments and financial guarantee contracts all have similar risk characteristics, it would be highly desirable to permit the use of common principles, systems and data and a similar impairment approach for all these instruments. Consequently, we are supportive, in principle, of applying the impairment model proposed in the SD or a similar approach to loan commitments and financial guarantees.

**Question 16Z**

Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

While this question on operability is best left to preparers, we have provided some general comments as to how to apply the proposed approach to loan commitments and financial guarantee contracts.

**Loan commitments**

Loan commitments in a portfolio could be split into a good book and a bad book on the basis of the entity’s credit risk management objectives for such commitments. The expected losses in relation to loan commitments would be the amount of losses expected on the loans that result from draw-downs on those commitments. For the bad book, while many of the loan commitments will be drawn-down, this may not always be the case. The computation of the impairment provisions for the good book and the bad book could be performed as follows:

(a) **Good book**

Given that the objective of amortised cost measurement in the IASB ED is to provide information about the effective return, there is a related question as to whether the commitment fee received by the provider of the loan commitment would be recognised in the income statement when they are received, or deferred and recognised over the life of the resulting loan. In practice, in accordance with the guidance in IAS 18 and IAS 39, many entities defer the fees received on commitments that they expect to be drawn-down and include them in the amortised cost of the resulting loan. Under the
Appendix 2 - Responses to the questions in Appendix Z to the IASB's Supplement to Exposure Draft Financial Instruments: Impairment

effective interest method in IAS 39, these deferred fees are recognised over the life of the loan.

If the new revenue recognition standard continues to require such commitment fees to be deferred, the expected losses on loan commitments should, presumably, also be allocated over the lives of the loans (by applying the proposed approach to the loans), consistent with the period over which the loan commitment fees are recognised. Doing so will provide information that best reflects the effective return.

On the other hand, if the accounting for the loan commitment fees changes as a result of the requirements in the new revenue recognition standard, such that fees are required to be recognised over the lives of the commitments instead of being deferred, it follows, conceptually, that the entire amount of losses expected on the loan commitments should be allocated over both the lives of the loan commitments and the resulting loans. Applying such an allocation approach would mean that the loans that result from draw-downs on commitments would be measured at amounts that are different from the cash disbursed upon origination of the loans. Operationally, it would be difficult to perform the time-proportional calculation for an open portfolio of such loans as the lives of the loan commitments from which they originate are not tracked.

There is a related issue as to whether a loan that results from the draw-down of a loan commitment is regarded as a new financial instrument, which should be recorded at its fair value, or whether it is viewed as a continuation of the loan commitment and so recorded based on the amount of loan extended. The latter approach is that most generally applied under IAS 39 and is most consistent with an amortised cost business model, but there is some diversity in practice. If the Board chooses to clarify that loans should be recorded at fair value on draw-down (an approach we would not recommend), it would be consistent to record the commitments at fair value as well.

(b) Bad book

Commitments which are expected to result in a loss would be classed as 'bad book'. The bad book provision would comprise the entire amount of losses expected to occur on the loans, once drawn-down, after assessing the extent to which some of the commitments may not be drawn-down as loans and therefore, not result in any losses. Expected losses would be calculated in the same way as for the bad book of loans.
Appendix 2 - Responses to the questions in Appendix Z to the IASB’s Supplement to Exposure Draft Financial Instruments: Impairment

Financial guarantee contracts

Financial guarantees in a portfolio would be split into a good book and a bad book on the same basis as loans and loan commitments. The expected loss would be the portion of the amount the entity expects to pay to the beneficiary of the guarantee that is not recoverable from any other party. The computation of the impairment provisions for the good book and the bad book could perhaps be performed as follows:

(a) Good book

The losses expected on guarantees in the good book would be recognised over the weighted average life of the guarantees by the application of the time-proportional approach, which would coincide with the period over which the guarantee fee revenue is recognised. The floor would be applied if the amount of losses that is expected in the foreseeable future is higher than the time-proportional allowance.

(b) Bad book

The bad book provision would comprise the entire amount of losses expected to occur on the ‘bad’ guarantees, discounted at a rate that takes into account the risk assumed on the guarantee.

Presentation

Question 17Z

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

We agree that interest revenue (calculated using an effective interest rate that excludes expected credit losses) should be retained as a separate line item in the statement of comprehensive income, as it is a familiar performance indicator that is useful for decision-making. With respect to the presentation of impairment losses, for an open portfolio, we acknowledge that it is not possible to present separately the effect of allocating the initial credit loss estimates and changes in those estimates, as the initial expected loss assumptions of newly originated instruments are not tracked in such a portfolio. We therefore agree that all impairment losses for the reporting period should be presented as a single, separate line item in the statement of comprehensive income.
Appendix 2 - Responses to the questions in Appendix Z to the IASB's Supplement to Exposure Draft Financial Instruments: Impairment

Disclosure

Question 18Z

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

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

(a) We are concerned that the proposed disclosures in Z12 would not be operational for open portfolios. For an open portfolio, where new assets are added and old ones removed without individual asset tracking, the actual outcomes are similarly not tracked. Also, if the estimation of expected losses for a pool of assets have been made at a portfolio level, it would be difficult to perform a comparison of actual outcomes with previous estimates of expected credit losses at a more granular level, e.g., by groups of assets with similar vintage. We believe that the proposed disclosures in Z12 should not be required in the final standard, unless the proposed disclosures are revised so as to be made operational.

(b) We have no other proposals.

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 believe that the amount to be transferred should be the portion of the collective allowance in the good book that is attributable to the transferred asset. Consequently, since the collective allowance is based on the assumption that any asset in the good book has a chance of going bad, the amount transferred in table IEZ18 should be based on the nominal amount of the transferred asset rather than what seems to be the 'specific' expected loss of the transferred asset. For example, the allowance transferred from the good book to the bad book for portfolio T should be a proportional amount that is based on time as well as the nominal amount of the transferred asset, determined as follows:

\[
\frac{A}{\text{total nominal amount of good book}} \times \text{impairment allowance of good book} \times \frac{C}{D}
\]
Appendix 3 - Illustrative example: time-proportional allowance calculation for closed portfolios structured by vintage

As mentioned in our response to question 2, performing the time-proportional allowance calculation for an open portfolio at the portfolio level could result in a time-proportional balance that is different from aggregate allowances derived from separate calculations performed for closed portfolios. The following is a simple example to demonstrate this point:

Example

Assume that an entity has an open portfolio with five vintages of BB rated lending of $10,000 per year (bullet loans). Each of the five vintages has approximately the same total losses expected over the lives of their loans. This example shows that the ‘top down’ (open portfolio) and ‘bottom up’ (sub-portfolios or closed portfolios structured by loan vintage) calculations are significantly different when the age / life ratio is weighted by balance.

Bottom Up Assessment of Time-proportional Approach

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<th></th>
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</thead>
<tbody>
<tr>
<td>Good Book</td>
<td>9,950</td>
<td>9,890</td>
<td>9,660</td>
<td>9,380</td>
<td>9,100</td>
<td>47,970</td>
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<tr>
<td>Bad Book</td>
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<td>120</td>
<td>340</td>
<td>620</td>
<td>900</td>
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<td><strong>Total Balance</strong></td>
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<td><strong>10,000</strong></td>
<td><strong>10,000</strong></td>
<td><strong>10,000</strong></td>
<td><strong>10,000</strong></td>
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<tr>
<td>Life (years)</td>
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<td>5.0</td>
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</tr>
<tr>
<td>Age (years)</td>
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<td>3.5</td>
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<td>2.5</td>
</tr>
<tr>
<td>Age / Life</td>
<td>10%</td>
<td>30%</td>
<td>50%</td>
<td>70%</td>
<td>90%</td>
<td>49%</td>
</tr>
<tr>
<td>Bad Book</td>
<td></td>
<td></td>
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<tr>
<td>Bad Book Proportion</td>
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<td>9.0%</td>
<td>4.1%</td>
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<tr>
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<td>0.5%</td>
<td>1.5%</td>
<td>2.8%</td>
<td>4.1%</td>
<td>1.8%</td>
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<tr>
<td>Bad Book EL</td>
<td>20</td>
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<td>150</td>
<td>280</td>
<td>410</td>
<td>910</td>
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<tr>
<td><strong>Bad Book Allowance</strong></td>
<td><strong>20</strong></td>
<td><strong>50</strong></td>
<td><strong>150</strong></td>
<td><strong>280</strong></td>
<td><strong>410</strong></td>
<td><strong>910</strong></td>
</tr>
<tr>
<td>Good Book</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Remaining Life PD</td>
<td>11.12%</td>
<td>10.60%</td>
<td>8.40%</td>
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<td>LGD (Loss Given Default)</td>
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</tr>
<tr>
<td>Remaining EL %</td>
<td>5.0%</td>
<td>4.8%</td>
<td>3.8%</td>
<td>2.5%</td>
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<td><strong>Time-proportional EL (Good Book)</strong></td>
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<td><strong>142</strong></td>
<td><strong>184</strong></td>
<td><strong>164</strong></td>
<td><strong>98</strong></td>
<td><strong>538</strong></td>
</tr>
<tr>
<td><strong>Total Allowance</strong></td>
<td><strong>70</strong></td>
<td><strong>192</strong></td>
<td><strong>334</strong></td>
<td><strong>444</strong></td>
<td><strong>508</strong></td>
<td><strong>1,548</strong></td>
</tr>
</tbody>
</table>

Top Down Assessment of Time-proportional Approach

- Good Book Total Remaining EL: 1,683
- Age / Life: 49%
- Time-proportional EL (Good Book): 524
Appendix 3 - Illustrative example: time-proportional allowance calculation for closed portfolios structured by vintage

Analysis

In the example, sub-portfolios of later vintages (e.g., 2011 and 2010) have higher remaining lifetime losses than those of earlier vintages since they have loans with longer remaining lives. Under the bottom up approach, the higher losses of these portfolios are ‘weighted’ by a smaller age to life ratio due to the vintage of the loans, resulting in a smaller aggregate provision than the top down approach.

In general, calculation of the time-proportional allocation would give rise to smaller provisions if the calculation is made for closed portfolios structured by loan vintage.