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Dear Sirs

File Reference No. 2011-150
Supplement to ED/2009/12
Amortised Cost and Impairment

We welcome the opportunity to provide comments on the supplemental document (‘the SD’) to the IASB’s exposure draft (‘the ED’) ‘Amortised Cost and Impairment’.

HSBC is one of the largest banking and financial services organisations in the world, with assets of US$2,455 billion at 31 December 2010. Headquartered in London, HSBC serves customers worldwide from more than 7,500 offices in 87 countries and territories in six geographical regions. HSBC’s businesses encompass a very broad range of financial services and products, including personal financial services, commercial banking, global banking and markets, private banking, asset management and insurance.

Summary

We support the efforts of the Boards to reach a converged solution and welcome the progress in addressing the operational concerns with the ED. However, we are concerned that the proposals are based on inconsistent principles and are not yet complete. Key areas remain undeveloped, most significantly the accounting treatment of interest and discounting, which are of particular importance to the financial and operational impacts of the standard.

There has been insufficient time to properly evaluate the proposals, given the timing and short length of the comment period and so the comments provided below should be considered as preliminary. It is clear, however, that the proposals would represent a radical change in accounting and are likely to entail potentially very significant levels of expenditure to implement and maintain on an ongoing basis. Given the high impact and systemic importance of impairment accounting, it is essential that field testing is carried out to understand how the proposed model is likely to perform in practice under different economic conditions and for different types of financial asset, and sufficient time should be allowed for this evaluation.
The allotted time remaining before finalisation of the standard is insufficient to allow this to take place.

We are also troubled that the proposals may only be available in their entirety for evaluation on the date of publication as a final standard. HSBC believes that a full exposure period for a complete standard will be necessary, with roundtable discussions, given the critical importance of the proposals to the financial services industry and to the economy as a whole.

Convergence

HSBC continues to believe that convergence to high quality international accounting standards must remain an overarching goal and that convergence on impairment accounting is an essential part of this. We note that the different objectives of the Boards reflect very clearly in the common approach, as explained below. We believe that the compromise results in a number of significant weaknesses in the proposals. It should be possible to reach a high quality converged solution, although this will require further work on the principles on which the approach is based. We understand that it will be necessary to seek compromises to deliver a converged standard, however it will be necessary to allow sufficient time to ensure that the converged approach is based on consistent principles and is of sufficiently high quality to form the basis for genuine convergence.

Timetable

The SD was published on 31 January 2011 with a 60 day comment period which coincided with many financial institutions’ reporting periods, truncating what was already a very challenging deadline. Furthermore the proposals were not, as suggested by the IASB, a limited re-exposure of elements of the ED, because significant new concepts have been introduced (in particular the notion of ‘foreseeable future’). Given the radical nature and high potential impact of the revised proposals, there has not been sufficient time for the industry to carry out the necessary steps to evaluate the proposals, including:

- development of a full understanding of the proposals
- analysis of the impact on different portfolios
- discussion of the proposals within the industry, both nationally and internationally, to agree a common position
- assessment of implementation costs.

Therefore, the comments and observations in this letter are based on the work we have been able to carry out in the short time period since publication.

Furthermore, the timescale proposed by the Board in finalising this important area of financial accounting will result in entities not being able to fully review and consider the complete proposal before it is issued. This includes areas that have yet to be finalised such as interest recognition, discounting of credit losses and disclosures which have a significant impact on the assessment of the proposals as a whole. This fragmented approach to meet an arbitrary
deadline is not conducive to the development of a high quality standard. We would also highlight that entities within the EU are unlikely to be able to adopt the impairment proposals until all elements of the financial instruments standard (including portfolio hedging) are in place and endorsement is given. Therefore, we do not support this accelerated deadline to finalise proposals that are unlikely to be able to be adopted for several years.

We are aware that the Boards’ timetable reflects the objective set by the G20 and Financial Stability Board to complete the convergence agenda in 2011. Nonetheless, we strongly recommend reconsideration of the timetable over which the impairment proposals will be finalised to enable entities to fully consider and field test the proposals and the possible alternatives with the goal of developing a practical and conceptually robust impairment framework.

Expected loss estimates

The fundamental element of any expected loss model is the determination of the expected loss estimates. There are likely to be significant challenges in arriving at those estimates. Even entities with data on probabilities of default, for example under Basel II, will need to adjust that data to meet the requirements of the expected loss model, and other entities will also need to adapt existing systems and data, if possible, or develop new systems and data. It is not clear what the implementation costs would be as we have not had sufficient time to fully evaluate the requirements.

Furthermore, we are concerned about the IASB’s recent tentative decision to measure expected losses on the basis of probability-weighted outcomes, which may involve significant additional systems and data resources for estimates which, we believe, are not superior to a best estimate approach.

Common Approach

The Boards’ individual models seek to address the weakness of the existing incurred loss model of ‘too little too late’ provisioning by applying different concepts, and as a result of the combination of these concepts, the common model is overly complex. The IASB’s objective is to reflect the economics of a lending transaction by recognising expected credit losses over the life of a financial asset or group of financial assets, and to avoid the front-loaded interest recognition of the incurred loss approach. The FASB’s objective, in contrast, is that losses should be recognised as soon as there is an expectation that credit losses will occur. These contrasting objectives are not compatible in a common impairment model.

This dual provisioning method for the good book could obscure the financial results as the basis may change from one reporting period to another, depending on which approach produces the higher impairment allowance at any given reporting period end. This would present difficulties in explaining the movement in the carrying values of assets measured at amortised cost. Furthermore, the income statement charge would be impossible to explain in the context of an entity’s performance during the reporting period as it represents the balancing number between two conceptually different balance sheet provisions. This is likely
to result in investor confusion and loss of confidence in the reported results, particularly when the factors which affect the basis are highly judgemental.

We also believe that the foreseeable future element of the common model is likely to dominate loss recognition in the model, rendering the time-proportional component redundant.

Consequently, we do not support the common approach as proposed in the SD as this would result in unnecessary operational complexity, at potentially significant expense, with no improvement in financial reporting.

FASB approach

HSBC believes that the foreseeable future concept has significant drawbacks, and may result in counterintuitive outcomes including:

- more sophisticated entities may have longer foreseeable future forecasting periods and will therefore recognise larger credit loss provisions
- day one losses will be reported in growing portfolios and for certain types of lending
- the foreseeable future period may shorten in an economic crisis as uncertainty increases.

Therefore, the concept requires considerable further development before its effect can be properly understood and tested. As articulated, it is not clear what it means for a credit loss to occur within a given time period called the foreseeable future, nor what causes that expectation to be formed. The foreseeable future period, as defined, does not address the issue of the decay in the reliability of forecasts of future conditions as one lengthens the forecast horizon, and how that degree of reliability is likely to vary with economic conditions. Therefore, the amount of credit losses expected to occur in the foreseeable future has a potentially very wide interpretation, and significant variations are likely in practice as a result of varying expectations of future losses, and different views of the period over which losses are foreseeable.

Notwithstanding these concerns around the clarity of the concept, it is generally considered that the foreseeable future is likely to be a period longer than 12 months. This will result in a significant disconnect between expected loss recognition and interest income recognition, moving away from the IASB’s objective of reflecting the relationship between pricing and expected credit losses. The consequence of this is that it may result in a day one loss on performing portfolios, which may be particularly large for higher risk assets which carry a higher yield, where the business objective is for the future net interest margin to compensate for the expected losses over time. We question the value of such information to the users of the financial statements.
IASB approach

In principle, we support the time-proportional approach as this is consistent with the original concept of the ED to reflect the economics of a lending transaction by recognising expected credit losses over the life of an asset. We believe this concept is more consistent with amortised cost measurement than the foreseeable future concept. We believe that this method is capable of being made operational, although it will require significant data and may be expensive to implement.

We understand that there are some concerns that this approach alone may not adequately deal with patterns of early loss recognition and therefore there may be a need for a foreseeable future floor. The method does not distinguish between the near-term and longer term losses because the conceptual basis for the method is the recognition of expected losses over the life of the financial assets. However, we believe that this method will, in many cases, provide adequate provision for those near-term losses, because a proportion of losses over the entire life will be recognised. However, we recognise that this may not always be the case, particularly for new or strongly growing portfolios, and therefore a practical case could be made for some form of floor although such a floor would be a practical expedient and we believe it should not exceed 12 months.

We support the requirement to differentiate between the ‘good book’ and ‘bad book’ as in principle this is consistent with the way in which financial institutions manage their businesses, and should provide useful information to the users of financial statements. The criteria for making this differentiation are critical to understanding how the impairment model will operate in practice. We support the general principle in the SD that the differentiation should reflect internal credit risk management practices, as this should provide more useful information to users on how credit risk is being managed. However, the credit risk management process reflects various stages and degrees of uncertainty about collection, and care should be taken to ensure that the point at which a loan may be classified as part of the bad book does not occur too late in the credit risk management process, as this could leave significant amounts of loans in the good book for which the conditions resulting in impairment losses are likely to have occurred. Paragraphs B2 to B4 could be open to a wide range of interpretation and B3 could be interpreted to mean that a loan should be classified in the bad book on commencement of recovery proceedings, which is relatively late in the credit risk management process.

We believe that the differentiation would benefit from a clearer underlying principle that the bad book should contain financial assets for which the degree of uncertainty about collectability is such that it is likely that the contractual cash flows will not be recovered in full as a result of known or probable events and conditions. We believe an entity should define the bad book using a methodology which best represents that principle for the types of asset it holds. This principle would help address the issue that credit risk management practices relating to the recovery of amounts from debtors vary between different institutions, market sectors, and national jurisdictions, most significantly as a result of legal and regulatory requirements, and such requirements are subject to change over time. We acknowledge that
there will be differences between entities on how the bad book is defined, however we believe that it is important for the users of financial statements to understand these differences and their impact on the financial position of entities, and disclosures will play an important role in enabling users to understand the criteria used by the entity to make the differentiation.

Areas still to be developed

As detailed in the SD there are significant areas that have yet to be developed that are fundamental to the overall impairment proposals and equally require consultation and consideration before finalisation of a standard.

In particular, we are concerned that it is not clear how interest income should be recognised and provided for and whether credit losses should be discounted. These areas are fundamental to our assessment of the overall proposals and will affect how complex and costly the final standard would be to implement.

Disclosures will be very important and should be harmonised; we note that the disclosure proposals have only been exposed for comment by the IASB. As detailed in our response to the ED we have significant concerns about the requirements originally proposed and we are unclear at this stage how those disclosure requirements will interact with those in the SD. The interaction with the information provided in IFRS 7 also needs to be considered to avoid any duplication (for example regarding credit quality and the management of credit risk) and to ensure disclosures remain balanced and focused. Therefore, adequate time will be necessary for disclosures to be properly evaluated once the key elements of the impairment model have been finalised as they, in turn, could result in the need for expensive systems development.

HSBC would like to take part in further field testing of the proposals. Given the critical importance of these developments to the financial services industry, HSBC recommends that field testing includes a study of experience of forecasted and actual loan impairment charges over, say, the last 5 or 6 years for selected areas of the banking industry. Furthermore, adequate time must be given to evaluate the results, supplemented with roundtable discussions so that the outcomes of the field testing can be shared and discussed in public.

Our responses to the questions set out in the SD are provided in the Appendix. As always, we would be pleased to discuss our comments and concerns in further detail if this would be helpful.

Yours faithfully

[Signature]
APPENDIX:

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 agree that the common model will result in the earlier recognition of expected credit losses and we support the concept of the good book and bad book distinction to resolve the ‘negative provision’ criticism of the original IASB model by ensuring that losses on the bad book are not deferred and recognised in future periods.

It is generally considered that the foreseeable future is likely to be a period longer than 12 months, resulting in the recognition of potentially very significant additional impairment allowances. This will result in a disconnect with the interest recognition on those assets, moving away from the IASB’s objective of reflecting the relationship between pricing and expected credit losses. The consequence of this is that it may result in a day one loss on performing portfolios, for example for high yielding and high credit risk assets, where the objective is for the greater future interest margin earned to compensate for the higher level of expected losses over time. We question the value of such information to the users of the financial statements.

Furthermore, the common model, by including the three elements of good book and bad book, time-proportional approach and the foreseeable future floor to accelerate loss recognition, is operationally complex. Therefore, we believe that further consultation and field work is necessary to determine whether this level of complexity is necessary to ensure that the objective to recognise sufficient credit loss provisions, whilst maintaining the link with income recognition, is achieved.

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.

We support a single impairment model for all financial instruments measured at amortised cost and believe the proposed model would be operational for both open and closed portfolios.
However, we would highlight that the term ‘closed portfolios’ needs to be used carefully in the context of the proposals. The original ED required the artificial construction of ‘closed portfolios’ by vintage for the model to be operational. However, a portfolio that is in run off (i.e. no new loans originated, but existing loans are repaid) is a closed portfolio from a risk management perspective but would still require this artificial construction of portfolios by origination date to make the original ED proposals operational. Therefore, we believe that the original ED proposals would only have been operational for portfolios in very limited circumstances.

In respect of individual assets, including large corporate loans and many types of debt security, the expected loss provisions will have little meaning because the actual outcome will be binary with either no loss, or a significant loss on transfer to the bad book. Therefore, an expected loss approach for individual assets in the good book is conceptually flawed, particularly if those expected losses are based on probability weighted cash flows as those expected losses will never reflect the actual outcome, even with perfect information. Therefore, the proposed approach can only be made operational for individual assets where they are grouped with assets of similar risk characteristics, where possible, and the expected losses are derived on a portfolio basis.

Furthermore for individual loans, particularly large corporate loans, the incidence and severity of losses will be hard to predict, as the factors driving losses are primarily entity specific. Therefore, the foreseeable future approach may not be operational, because, although the expected losses over the life of the instruments on a portfolio of large corporate loans could be estimated, the timing of such losses is very difficult to predict.

**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 support the IASB’s efforts to develop a more operational approach with the decoupling of credit losses from the effective interest rate and the consistent treatment of initial estimates of expected losses and subsequent changes in those estimates.

We acknowledge that the time-proportional approach is intended to be a practical expedient to address the operational issues of open portfolios, and support this approach as the one closest to the original principle of the ED that expected losses should be recognised over the life of the portfolio, although we are still concerned about implementation and maintenance costs.

However, the foreseeable future approach is based on a different objective, and breaks the relationship between pricing and expected credit losses. Furthermore, in many types of portfolio, a floor based on a foreseeable future of 2-3 years is likely to dominate the time-proportional approach in the recognition of losses.
Therefore, as previously stated, we believe that the complexity in a model that combines two different concepts is not justified, particularly if the outcome is that one recognition method will prevail in most instances. However, as discussed further in Question 6, we believe that in some circumstances there may be a need for a simpler floor mechanism to capture early stage arrears.

**Question 4**

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

The fundamental basis of any expected loss model is the determination of the expected loss estimates. We would highlight that intrinsically there are significant difficulties in arriving at those estimates. For entities that currently calculate probability of default (PD) data under Basel II, significant adjustments will be required to that data for use in the expected loss model, which will involve considerable development of models and systems. These adjustments include, extrapolating the information over the expected lives of the assets, based on how PD factors develop over time, and the overlay of future economic factors. Entities that do not have PD information will be required to develop their existing systems for incurred losses, if possible, or develop new systems and sources of data incorporating assumptions around future economic and credit conditions. It may be particularly challenging to obtain this information for developing markets.

We believe that it would be possible to determine weighted average ages and weighted average lives of portfolios to calculate the time-proportional impairment allowance. However, the data requirements are likely to be significant and could be very complex for some portfolios, for example credit cards (see Question 15Z).

Therefore, although we believe the proposal can be made operational we have not had sufficient time to fully evaluate this, including the likely costs of implementing and maintaining the processes necessary to derive these estimates.

**Question 5**

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

The time-proportional approach provides useful information on the relationship between interest income and credit losses as analysts typically want to know the extent to which net interest margins cover the cost of credit losses.

Furthermore, the bad book distinction, if the differentiation is based on sound principles reflecting how those assets are managed, provides useful information on financial assets which an entity perceives as having credit quality issues.
However, the dual provisioning method for the good book in the common approach could obscure financial results as the provisions could be based on different bases from one reporting period to another. This would present difficulties in explaining the movement in the carrying value of assets measured at amortised cost. Furthermore, the income statement charge would be impossible to explain in such scenarios as it will have no meaning in the context of the entity’s performance during the period as it is merely the balancing number between two conceptually different balance sheet provisions. This is likely to result in investor confusion and loss of confidence in the reported results, particularly when the factors which affect the basis are highly judgemental.

**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?

We support the requirement to differentiate between the good book and bad book as in principle this is consistent with the way in which financial institutions manage their businesses. The criteria for making this differentiation are critical to understand how the impairment model will operate in practice. We support the general principle in the SD that the differentiation should reflect internal credit risk management practices, as this should provide more useful information to users on how credit risk is being managed. However, the credit risk management process reflects various stages and degrees of uncertainty about collection, and care should be taken to ensure that the point at which a loan may be classified as part of the bad book does not occur too late in the credit risk management process, as this could leave significant amounts of loans in the good book for which the conditions resulting in impairment losses are likely to have occurred.

Paragraphs B2 to B4 could be open to a wide range of interpretation. B3 could be interpreted to mean that a loan should be classified in the bad book on commencement of recovery proceedings, which is relatively late in the credit risk management process. We believe that the differentiation would benefit from a clearer underlying principle that the bad book should contain financial assets for which the degree of uncertainty about collectability is such that it is likely that the contractual cash flows will not be recovered in full as a result of known or probable events and conditions. We believe an entity should define the bad book using a methodology which best represents that principle for the types of asset it holds. This principle would help address the issue that credit risk management practices relating to the recovery of amounts from debtors vary between different institutions, market sectors, and national jurisdictions, most significantly as a result of legal and regulatory requirements, and such requirements are subject to change over time. We acknowledge that there will be differences between entities on how the bad book is defined, however we believe that it is important for the users of financial statements to understand these differences and their impact on the financial position of entities, and disclosure will play an important role in enabling users to understand the criteria used by the entity to make the differentiation.
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?

We believe that if a clear definition is adopted by reporting entities, based on clear principles, this should generally be both operational and auditable.

However, as explained in Question 6, Paragraphs B2 to B4 could be open to a wide range of interpretation, and we believe that the differentiation in B3 would benefit from a clearer statement of the underlying principle.

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?

We agree with this distinction and that it is appropriate to recognise immediately lifetime expected losses on the bad book. However, as explained in more detail in Question 6, the definition and application of the bad book is crucial to ensure that it is the most appropriate split of assets, and therefore the loss recognition, is achieved.

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?

The floor mechanism adds an additional degree of complexity and therefore should only be introduced if it is necessary to achieve an appropriate loss recognition pattern. In addition to the operational complexity, it may also be difficult for users to understand the meaning of the balance sheet number as the provision switches between the two methodologies which have different objectives. Similarly, the income statement charge is potentially the balancing number between two allowances derived from those differing concepts.

A foreseeable future element that dominates the loss recognition pattern is not conceptually justified as the link between interest income and credit losses is lost. This is most evident where the floor will result in the immediate recognition of losses, and therefore a day 1 loss, for example for high yielding and high credit risk assets, where the objective is for the greater future net interest margin earned to compensate for the higher level of expected losses over
time, and for shorter dated instruments where the lifetime expected losses could be recognised immediately.

As articulated, it is not clear what it means for a credit loss to occur within a given time period called the foreseeable future, nor what causes that expectation to be formed. The foreseeable future period, as defined, does not address the issue of the decay in the reliability of forecasts of future conditions as one lengthens the forecast horizon, and how that degree of reliability is likely to vary with economic conditions. Therefore, the amount of credit losses expected to occur in the foreseeable future has a potentially very wide interpretation. It would be counterintuitive that an entity less well equipped to determine the foreseeable future period would recognise lower provisions on a similar portfolio than an entity which has invested in systems, data and procedures in order to forecast credit losses over a longer period.

Therefore, we have serious concerns, given its likely dominance in the loss recognition pattern, over the application and comparability of the foreseeable future floor.

(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?

We understand the objective to ensure the earlier recognition of losses based on more forward looking information. The concept of the bad book should address one of the problems with the IASB’s original ED, which would have resulted in the deferral of losses in early loss pattern portfolios.

We also understand that there are some concerns that this approach alone may not adequately deal with patterns of early loss recognition and therefore there is a need for a foreseeable future floor. The method does not distinguish between the near-term and longer term losses because the conceptual basis for the method is the recognition of expected losses over the life of the financial assets. However, we believe that the method will, in many cases, provide adequate provision for those near-term losses, because a proportion of losses over the entire life will be recognised. However, we recognise that this may not always be the case and therefore a case could be made on practical grounds for some form of floor in certain circumstances, although we believe such a floor would be a practical expedient and should not exceed 12 months.

Furthermore, impairment patterns on large corporate loans are likely to be different, with impairment based on entity specific events. For these loans the bad book identification is likely to be earlier in the credit risk management process than for retail loans, therefore the requirement for a floor may be less.
(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?

As previously stated, we have concerns with the additional complexity and operational burden of the foreseeable future floor, which in practice may well dominate the loss recognition pattern. We believe that this model of accounting is not conceptually justified, as the link between interest income and credit losses is lost.

However, as detailed in question 9(b) a case may be made for some form of floor in certain circumstances, although any such a floor should not exceed 12 months as a practical matter.

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

In practice, the foreseeable future period would change on the basis of changes in economic conditions. This is because economic conditions affect the time period over which specific projections of events and conditions are possible, the degree of judgement necessary in relation to uncertainties, and the level of confidence which management have over the reliability of projections. It is difficult to understand how the foreseeable future period can be defined in practical terms that will allow consistency amongst preparers (when appropriate) and be understandable to users.

(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.

As previously discussed we have concerns over the foreseeable future concept and how this can be defined in practical terms to allow consistent application between entities.

However, the stipulation of a minimum period to the foreseeable future seems arbitrary, and is contrary to our understanding of the concept. For portfolios with an average duration of more than 12 months, the foreseeable future may in normal conditions extend beyond 12 months, but in times of heightened uncertainty, the foreseeable future may be shorter. The foreseeable future for a revolving credit instrument such as a credit card will depend on whether this concept is applied to the drawn amount at the balance sheet date or the facility, and may be a very short period given the nature of the instrument, and depending on the customer behaviour patterns observed on particular products or portfolios.
(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.

The introduction of a ceiling will add further complexity to the model and further obscure the explanation of the impairment provision. Furthermore, it is difficult conceptually to understand how a limit can be placed on the foreseeable future period, which would represent an arbitrary rule, similar to, for example, requiring the amortisation of goodwill over 20 years.

It is possible that the imposition of bright line rules such as a ceiling on impairment allowances over the foreseeable future will encourage the structuring of credit products with terms that influence the timing of loss recognition, for example products in which no interest or principal is contractually payable for a certain period of time.

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.

If the foreseeable future is greater than 2 years, it would generally be expected to result in higher provisions than the time-proportional amount even in the unlikely event that losses occur on a straight line basis.

This can be illustrated in the following example:

| An open portfolio has an average expected life of 8 years. This is the average expected life of the loans in the portfolio calculated from the inception of each loan through to its repayment or write-off. Losses of CU80 are assumed to occur evenly over the average expected life of the portfolio (CU10 of losses per year). The average age of the portfolio is 2 years and therefore the remaining average life is 6 years. |
| The time-proportional provision will be CU15 (1.5 years of losses) (60 of expected losses over the remaining average life multiplied by the average age (2) divided by the average expected life (8)). |
| Therefore, the foreseeable future period would have to be less than 1.5 years (CU15 of losses) to not exceed this time-proportional provision. |
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?

IFRSs generally require cash flows that will occur in the future to be discounted unless they are short-term. The discounting of credit losses captures changes in expected losses resulting from changes in the timing of expected cash flows. However, we acknowledge the Boards’ concerns that there are practical issues in requiring credit loss estimates to be discounted (for example, where the approach requires the allocation of credit losses to specific time periods).

However, there are additional implications of discounting credit losses and the interaction with interest recognition. If interest continues to be recognised for assets on which we do not expect to collect all the contractual cash flows, interest which is not expected to be recovered should be included within credit losses. In these circumstances discounting must be applied to arrive at a meaningful present value of those credit losses. Alternatively, interest could be excluded from credit losses, however, there should also be a ‘non-accrual’ or suspended interest concept applied to loans within the bad book to ensure consistency.

Therefore as interest recognition is intrinsically linked to impairment and an important issue for financial institutions, we would urge the Boards to carry out further outreach and field testing in this area. This is a critical area and therefore there must be an opportunity for constituents to view and comment on the proposals prior to the finalisation of the impairment standard.

(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?

We understand the Boards’ motivation to reduce the operational burden of the proposals. However, it is difficult conceptually to understand why such flexibility is permitted within an accounting standard without providing an overall principle upon which to base the chosen discount rate. Such flexibility would impede comparability between reporting entities.

Therefore, as detailed in our response to Question 11(a), discounting is part of a wider consideration with the recognition of interest income recognition and should be considered further before any proposals are finalised.
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?

As detailed above, we have concerns over the combination of two separate objectives in the common approach and in particular the concept of the foreseeable future floor. We believe that there must be a single approach to impairment for all financial instruments measured at amortised cost.

In principle we support the IASB approach, but as discussed earlier we recognise that a practical case may be made for a floor of no longer than 12 months, as an additional safeguard to ensure that losses in early stage arrears cases are adequately provided.

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?

As discussed previously we do not support the concept of the foreseeable future and therefore do not support the FASB approach.

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?

We agree that in order to make the original proposals operational the expected losses should be separated from the effective interest rate calculation.
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?

We believe that loans and loan commitments are often managed within the same business model and therefore a common approach to impairment should be applied.

As detailed in our response to the ED ‘Insurance Contracts’ we believe that the classification of Financial Guarantee Contracts should also be based on management’s business model for writing such contracts and therefore, those managed on a credit risk basis should fall under financial instruments standards and a common impairment proposal.

Loan commitments and revolving credit facilities represent another outstanding area with significant implications for the reporting of credit losses and the systems to capture the necessary information. Furthermore, it will be important to consider the proposed changes in the context of broader implications for other areas of IFRSs. Considerations include the determination of the expected life of drawn balances and undrawn facilities, which may have a significant impact on the amount of expected losses and the period over which these losses are recognised. Further consideration should be given to the impact on credit cards and other revolving credit products, for example corporate loan facilities, however our initial thoughts on revolving credit products are set out below.

Expected losses could be estimated on the balance outstanding at the balance sheet date ignoring future draw downs, being the losses expected over the life of the outstanding balance. However, there is a credit risk exposure on the undrawn facility, not just the drawn amount, so expected losses could be estimated on the total facility at the reporting date, which may be significantly greater than the outstanding balance, and determined over the expected life of that facility, which may be significantly longer than the drawn balance. Credit card facilities typically have no contractual maturity, but are capable of being withdrawn or reduced at short notice to mitigate the effects of adverse customer behaviour. We believe it will generally be necessary to adopt behaviouralised assumptions regarding the average life of active accounts in order to apply an expected loss impairment approach under the proposed model.
Question 16Z

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

In principle, the proposed requirements should be applicable to such contracts, however, as detailed in our response to Question 15Z, there are some practical issues to be resolved around such facilities and further work needs to be carried out before any proposals are finalised.

Question 17Z

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

We welcome the separate presentation of credit losses and the effective interest rate as this maintains the clarity of disclosure for net interest income and the net interest margin, which is a key performance measure.

Question 18Z

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

Our comments are limited to the disclosures included within the SD, however as detailed in our response to the ED we have significant concerns about the requirements originally proposed. We are unclear at this stage how those disclosure requirements will interact with those in the SD and would welcome further consultation from the Board on the complete disclosure requirements.

We welcome the clarity provided on the level of granularity required for disclosures purposes, which is important in managing the volume and meaningfulness of disclosures for large institutions with diverse portfolios in multiple geographies.

However, disclosure of nominal amounts, the entire amounts of expected credit losses and expected credit losses in the foreseeable future by credit risk grading are very granular (albeit at a minimum entities are only required to distinguish between good and bad book amounts in providing this analysis by credit risk grading).

Furthermore, it is not clear how the disclosure requirements for back testing could be provided in a concise and understandable form for large and complex financial institutions with many portfolios with differing characteristics in multiple geographies.
The interaction with the information provided in IFRS 7 also needs to be considered to avoid any duplication (for example regarding credit quality and the management of credit risk) and to ensure disclosures remain balanced and focused.

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

We are not in a position to answer at this stage as it is not clear what the whole suite of disclosures will look like once the disclosures from the ED and the SD are combined.

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?

The method of transfer of the bad book allowance from the good book (all, none or the time-proportional amount) will, mathematically, not affect the amount reported in the income statement. This is because the provisioning method is driven by the balance sheet amounts and the income statement charge is in effect the amount required to arrive at those provisions from one reporting period to the next.

We believe it is simpler to transfer the required bad book allowance from the ‘good book’ provision when the related asset is transferred to the bad book. The good book provision will then be replenished to the required level as determined by the time-proportional or foreseeable future methods.