

Comment Letters
IASB
30 Cannon Street
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United Kingdom

La Défense, April 1st, 2011

Supplement to ED/2009/12: Financial instruments: Amortised Cost and Impairment

Dear Sir or Madam.

MAZARS welcomes the opportunity to comment on the IASB supplementary document, *Financial Instruments: Impairment*. Our answers to the Supplementary Document questions are shown in the appendix to this letter which summarises our concerns and opinion.

We welcome the Board's proposal to organise the impairment approach around the distinction between a "good book" and a "bad book". We are convinced that this approach is consistent with the way most entities manage their credit risk exposure. In this regard, we support the proposal to rely on the actual risk management of the entity to define the boundary between the two books.

Applying the model proposed by the Boards, it is critical that the transfers of doubtful loans from the good book to the bad book occur soon enough to avoid any situation of "delayed loss recognition". We consider that the examples provided in paragraph B3 of the supplementary document would result in a late transfer of doubtful loans to the bad book. Such a late transfer is not in line with the way most entities actually manage their credit risk. Nevertheless the criteria proposed may give a wrong signal to some entities. We therefore encourage the Board to remove these examples and provide additional guidance on the triggers to be envisaged for this good book / bad book distinction with a view of giving examples which would invite to an earlier recognition of bad loans, such as those currently used when applying IAS 39.59.

We welcome the Board's decision to retain a time proportionate recognition approach of the expected credit losses on the good book. We are very supportive of the IASB objective to create symmetry between the recognition pattern of expected credit losses (not incurred losses) and credit risk revenue.



We fully support the Board's decision to retain an impairment approach operationally disconnected from the interest rate revenue recognition mechanism (ie a "decoupled" approach). We consider that this decision is a critical improvement compared to the IASB initial Exposure Draft. This "decoupling" will definitely help the approach to be more operational for preparers.

However we have very strong concerns on the proposed floor mechanism embedded in the process for determining credit allowances on the good book. This floor determined as the credit losses expected to occur within the foreseeable future is in our view ruled based and without sufficient conceptual background. Moreover it contradicts the initial fair value measurement of any financial instrument as it would results in "day one losses". We acknowledge that this floor mechanism is a kind of compromise that is expected to permit convergence with the FASB's views. Nevertheless, as we have always favoured the quality of accounting standard to convergence objective, we do not support this mechanism.

As an alternative to the proposal by the Boards, we would recommend an approach where the expected loss recognition pattern could be adjusted in order to take into account the loss pattern of the underlying portfolio. Typically, an entity would be required to:

- 1- recognise its expected losses on a time proportionate basis by default (ie in a pattern similar to the interest revenue recognition),
- 2- accelerate this expected loss recognition pattern where there is evidence of an earlier loss-emergence pattern on the portfolio.

In our opinion, compared to the mechanism proposed in the supplementary document, this type of approach would:

- Provide a principle based approach consistent with the economic credit exposure of the entity.
- Avoid any undue "front loaded" loss recognition.
- Ensure the entity not to under-estimate its impairment allowance account on the good book.

Besides, we draw the Boards' attention to the fact that a 60 days comment period is not enough to perform adequate simulation. Thus answers by the constituents may not have considered all the potential practical implications of the Boards' proposals. Therefore we recommend the Boards to take time to perform relevant field testing before issuing any final statement. We consider that the robustness of the approach proposed and the comprehensive analysis of its impact in different situations is more important than the arbitrary 30 June deadline.



With the same view, we encourage the Boards to consider a comprehensive re exposure of their proposals on impairment in order to clarify the way this Supplementary Document interacts with the requirement of each Board's initial Exposure Draft.

Do not hesitate to contact us should you want to discuss any aspect of our comments.

Best regards,

Michel Barbet-Massin

Head of Financial Reporting Technical Support



General

Question 1

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

We welcome the Boards' proposal to organize the impairment approach around the distinction of a "good book" and a "bad book". We are convinced that this approach is consistent with the way most entities manage their credit risk exposure. Please refer to our comment letter to the original IASB Exposure Draft *Financial Instruments: Amortised cost and Impairment* for more details in this regards.

Whether the approach proposed in the supplementary document will deal with the "delayed recognition of expected credit losses" issue will notably depend on:

- Where the line is drawn between the "good book" and the "bad book"
- The recognition pattern of expected losses in the "good book"

We consider that the proposed approach would not address properly the "delayed recognition" issue if the bad book is not at least composed of instruments found to be individually impaired under current IAS 39 provisions. We support the principle proposed by the Boards based on the degree of uncertainty about the collectability of the financial asset. We are convinced that it is an improvement compared to current "objective evidence of impairment" condition as it relies on the actual risk management of the entity. However we consider that the examples provided in paragraph B3 of the supplementary document ("enforcement of security interests, [...] debt restructuring...") could result in a very late transfer of individually impaired loans from the good book to the bad book. We consider that these examples are not consistent with the type of criteria actually used by financial institutions to classify loans between good and bad books which are more similar to those mentioned in paragraph 59 of the current IAS 39. We therefore encourage the Board to clarify these examples.

We are very supportive of the IASB objective to create symmetry between the recognition pattern of expected credit losses (not incurred losses) and credit risk revenue. We accordingly support the Boards' proposal to spread the recognition of expected losses on the good book over the life of the portfolio. However we disagree with the "floor at the credit losses expected to occur within the foreseeable future" proposed the Boards for the following reasons:

- The 12 month floor at a minimum is ruled based and without sufficient conceptual grounds. For example it would equally apply to short or long term loans, whatever their loss recognition pattern.
- This floor mechanism contradicts the initial fair value measurement of any financial instrument as it would results in "day one losses",
- The concept of foreseeable future is either:
 - o very difficult to apply in practice as it will change from one entity to another, from one portfolio to another within a given entity, and from time to time depending on the economic environment for a given portfolio.
 - o Or ruled based and arbitrary if it is said to be a fixed period of say 12 month



Moreover, this approach would penalize entities with reliable forecasting models resulting in perverse results: the less the entity is able to foresee its expected credit losses, the smaller its allowance account would be.

- If the foreseeable future is extended to 24 months, we understand from the banks in Europe that the impairment allowance would be driven by the floor in most situations which makes the time apportioned method an additional cost with little benefit in terms of impact on the allowance.

Therefore, we recommend that the Boards remove this floor from their common proposal.

However, in order to avoid any situation of underestimated impairment allowance in cases such as open portfolios with early loss patterns, we would recommend that the Boards consider an approach where the expected loss recognition pattern is adjusted in such situations. Typically, an entity would be required:

- to recognize its expected losses on a time proportionate basis by default (ie in a pattern similar to the interest revenue recognition),
- to accelerate this expected loss recognition pattern where there is evidence of an earlier loss-emergence pattern on the portfolio.

In our opinion, compared to the mechanism proposed in the supplementary document, this type of approach would:

- Provide a principle based approach consistent with the economic credit exposure of the entity,
- Avoid any undue "front loaded" loss recognition,
- Ensure the entity not to underestimate its impairment allowance account on the good book.

Scope - Open Portfolio

Ouestion 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 encourage the Boards to propose one single principle based approach for all financial assets measured at amortised cost.

The proposed approach seems much more operational to us than the original IASB exposure draft proposal, although the cost and effort involved in operating the model should not be underestimated. In this regards, the "decoupling" is a critical improvement.

However attention should be paid to individual assets as expected losses are generally more difficult to predict on an individual basis than on a portfolio basis (either open or closed). Please refer to our comment letter to the Exposure Draft.



Differentiation of credit loss recognition

Ouestion 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?

As mentioned in our answer to question 1, we are supportive of the time apportioned recognition of expected losses for loans within the good book. In our view this is consistent with the recognition pattern of credit revenues thus enhancing transparency on the economic performance of the entity on these assets.

However we have concerns about the floor mechanism which seems both ruled based and in contradiction with the IFRS 9 requirement to recognize financial instruments initially at fair value (please refer to our answer to question 1). Therefore we suggest removing this floor from the proposed approach and introducing a mandatory adjustment of the default expected loss recognition pattern (ie straight line basis) each time that the anticipated loss-emergence pattern of the portfolio requires to accelerate the recognition of the expected losses.

Question 4

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

We consider that the proposed approach is much more operational than the one initially proposed in the original IASB exposure draft, although it will require significant systems changes for entities. In this regards, the "decoupling" approach retained is a critical improvement.

Ouestion 5

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

We are convinced that this time proportional expected loss recognition provides the best decision-making information as it reflects the economic performance of the entity on its lending activity. However the floor mechanism as currently drafted would disturb this transparency as it would result in up front loss recognition which does not match the related revenue recognition pattern. It can also lead to "day one loss" recognition which contradicts the IFRS 9 principle to recognise initially any financial instrument at fair value. Therefore we recommend the Boards to consider the alternative described in our answer to question 1.

But apart from our concerns related to this floor mechanism, we are convinced that the information resulting from the proposed approach would provide much more useful information to users than the current IAS 39 requirements.



However, the proposed approach will require judgment in many areas such as the good book / bad book distinction, the expected loss estimates and the foreseeable future, if the Boards finally chose to retain this concept. Therefore we believe that this approach should imply relevant disclosures to facilitate comparability between entities.

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?

As mentioned in our answer to question 1, we support the principle proposed by the Boards based on the degree of uncertainty about the collectability of the financial asset. We agree with the Boards' decision to classify in the bad book any loans for which the entity has changed its management objective from regular payment collection to recovery of all or a portion of the financial asset.

However we are concerned by the proposed wording of examples in paragraph B3 and B4. Examples of paragraph B3 seems to require the entity taking active recovery decision such as "enforcement of security interest", or "debt restructuring" before transferring a loan into the bad book. Conversely, examples of paragraph B4 may rely on indicators (eg "days past due") which may occur earlier than the active management decision mentioned in paragraph B3.

In our opinion it is critical that the proposed approach virtually requires through appropriate guidance on the way credit risk should be managed any non-performing loans with significant objective evidence of impairment to be classified in the bad book in order to meet the objective of dealing with the "delayed loss recognition" issue mentioned by the Boards in question 1.

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 consider that this requirement is operational as the distinction between a good and a bad book is consistent with the way most entities actually manage their credit risk exposure.

Moreover, even if the proposed approach implies extensive use of judgement, we consider that it will be auditable as it relies on the actual risk management of the entity.



Ouestion 8

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

Yes we agree. We are convinced that this approach ensures consistency between the risk management approach of the entity and the performance reflected in its financial statements.

Minimum impairment allowance amount

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?

No we do not agree with this approach for the reasons explained in our answer to question 1.

(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 Boards' concerns related to early loss pattern portfolios. Instead of creating an arbitrary rule by introducing a floor in some portfolios and not in other, we recommend the Boards to consider our proposal detailed in our answer to question 1.

We are convinced that presenting the answer to early loss pattern issue as an adjustment of the loss recognition pattern consistent with the economic analysis of the underlying portfolio would result in a more principle based and robust approach than the proposed foreseeable concept with a minimum time period of 12 months.

(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

We disagree with the proposed floor mechanism. Please refer to our answer to question 1 regarding our proposed alternative.

However, should the Boards elect to retain this concept, we would favour a bright line positioned at 12 months which we feel is the only viable solution to be combined with a time-proportioned loss recognition approach.



Indeed, we are convinced that a floor positioned around 24 months would be the major driver of the impairment allowance evaluation. As a result, the time-proportioned recognition of the good book allowances would be useless in practice or at least, would provide a marginal cost / benefits ratio compared to the original FASB approach (see our answer to question 13 regarding the FASB approach).

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

It is our understanding that, as currently drafted, the foreseeable future would change depending on the economic environment (it will be shorter in an economic crisis context).

However for the reasons detailed in our answer to question 1 and 9(c) we recommend the Board to remove this foreseeable future concept from the proposal.

(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.

Based on our experience, the foreseeable future period can move from a few months in bad economic environment (albeit with higher expected losses) to more than 24 months in stable economic environment.

However, a 60 days comment period may be insufficient to perform simulations to support this assumption. Should the Board retain this foreseeable future concept, we would recommend performing in depth field testing with entities from the banking sector to better assess the outcome of this concept.

(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.

We disagree with the introduction of a 'ceiling' as it would be ruled based and overly complex to implement.

Should the Board elect to retain a floor mechanism in the good book, we would recommend a fixed floor at 12 months.



Question 10

Do you believe that the floor will typically be equal to or higher than the amount calculated in accordance with paragraph 2(a)(i)? Please provide data and/or reasons to support your response, including details of particular portfolios for which you believe this will be the case.

We have been told by our banking clients that the floor would be the key driver of the impairment allowance evaluation notably in the following situation:

- Portfolio based on short to medium term loans (less than 5 years)
- Portfolios with early loss pattern loans
- Each time the economic environment is sufficiently stable to get a foreseeable future longer than 12 months.

However a 60 days comment period may not be sufficient to perform relevant simulations in this regards. Therefore we recommend the Board to take sufficient time to perform field testing before implementing such an approach.

Flexibility related to using discounted amounts

Ouestion 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?
- (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 are convinced that using discounted amount results in a more robust conceptual approach.

However we are convinced that using discounted amounts is very challenging operationally as it is very difficult to determine the timing of expected cash flows. If large financial institutions may have sufficiently robust IT and historical information to retain a discounted expected losses approach, most medium sized entities will not be able to implement it.

We therefore recommend the Boards to permit flexibility in this regard. Comparability could be enhanced by disclosing the discounted effect on expected losses.

We also encourage the Boards to clarify how the discounting issue is addressed for bad book expected losses estimates.

Besides, this question raises the issue of interest revenue recognition on impaired loans which is not clearly dealt with under IFRS 9.



Approaches developed by the IASB and FASB separately

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not?

If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?

We consider that the common proposal and the IASB approach share several positive elements such as:

- The distinction between good book / bad book
- The time-proportional recognition of expected losses in the good book
- The accelerated expected losses recognition for loans transferred to the bad book
- The "decoupling" approach which makes the proposal more operational compared to the IASB original exposure draft approach.

But we disagree with the floor mechanism of the common approach for the reasons explained in our answer to question 1 and 9.

Therefore we would favour the IASB approach with an adjustment to deal with early loss pattern portfolios. Please refer to our proposal in question 1.

Question 13

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

The FASB approach is certainly the most simple and consequently the most operational.

However it raises the following concerns:

- It results in a "day one loss" recognition which conflicts with other IFRS 9 requirements such as the initial recognition of any financial instrument at fair value
- It disconnects the performance presentation from the economic reality as it is false that a bank suffer an upfront loss each time it originates a loan.
- It opens the door to significant profit or loss artificial volatility as, in a stable economic environment, an entity simply has to purchase or originate loans to recognise a loss, and sell loans to recognise a gain (through the reduction of the expected loss allowance account).
- It is disconnected from the actual risk management of entities which is usually based on a good book / bad book distinction.

For all these reasons we do not support the FASB approach.



Impairment of financial assets

Ouestion 14Z

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

Yes we welcome this decision which is a major improvement compared to the original IASB proposal.

We encourage the IASB to clarify that this decision is also extended to closed portfolios and individual assets impairment approach.

Scope – Loan commitment and financial guarantee contract

Ouestion 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 support the development of a single impairment methodology that can be applied to all financial assets measured at amortised cost.

It is our experience that all these instruments are commonly managed on a same risk management strategy.

Consequently we encourage the Board to extend this approach to loan commitments and financial guarantee contracts carried at amortised cost.

Ouestion 16Z

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

At this stage we have not identified any reasons to consider that the proposed approach would not be operational for loan commitments and financial guarantee contracts.

However, extending this approach to loan commitments raises specific issues:

- Presentation issues: how should the impairment allowance on a loan facility which has not been drawn be presented?
- Matching between expected loss recognition and commission fees which are included in the effective interest rate of a future loan in accordance with paragraph 14 (a) ii of IAS 18 Appendix.

Therefore we encourage the Board to provide additional guidance if the proposed approach were to be extended to loan commitments and financial guarantee contracts.



Presentation

Question 17Z

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

Yes we agree that separate line items for presenting interest revenue and impairment losses provide useful information to users.

We encourage the Board to clarify that this presentation requirement supersedes the IASB original Exposure Draft proposal.

Disclosure

Ouestion 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?

The proposed approach relies on the actual risk management of the entity and therefore requires extensive use of judgment. We support this approach.

In order to grant comparability to users, it has to be accompanied by relevant disclosures especially in the following areas:

- Where the line is operationally drawn by the entity between good book and bad book.
- Information on the differences between the losses expected by the entity on the date of the transfer from the good book to the bad book and the actual final losses. This information will help financial statement users to assess the quality of the entity's expected losses.
- Should the Board retain the foreseeable concept, the entity would have to be required to disclose its assumption in this regards

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We draw the Board's attention on the fact that clarity, relevance and quality is more important than quantity with regards to disclosures.

We also encourage the Board to clarify the way its requirements interact with the already existing requirements of IFRS 7.



Ouestion 19Z

Do you agree with the proposal to transfer an amount of the related allowance reflecting the age of the financial asset when transferring financial assets between the two groups? Why or why not? If not, would you instead prefer to transfer all or none of the expected credit loss of the financial asset?

We do not consider that the amount of the transfer is a meaningful information for users.

Moreover the proposed calculation is not necessary for accounting purposes if the entity simply ensures that it has sufficient impairment allowance on each book at the end of the reporting period. This way the transfer will be realised "automatically" without having to be calculated. Eventually calculating an amount to be transferred on an individual basis contradicts the mutualisation approach typically used in the context of portfolio credit risk management.

Should the Board retain the requirement to identify the amount of allowance transferred from the good book to the bad book together with the related loan, we would encourage the Board to define this amount of allowance transferred as 100% of the loan expected loss (provided that the total allowance amount of the good book is sufficient) at the date of transfer. Based on this principle, any subsequent adjustment of the Bad book allowance would represent adjustment of the entity's loss expectation. This approach would provide useful information to users who would be in a position to assess the reliability of the entity's expected losses..