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April 1, 2011

International Accounting Standards Board
30 Cannon Street, 1st Floor
London EC4M 6XH
United Kingdom

Dear Sirs:

Re: Financial Instruments: Impairment, Supplement to ED/2009/12

This letter is the response of the Canadian Accounting Standards Board (AcSB) to the January 28, 2011 *Financial Instruments: Impairment* Supplement to the Exposure Draft, *Financial Instruments: Amortised Cost and Impairment,* issued in November 2009 (ED 2009/12).

The views expressed in this letter take into account comments from AcSB members and staff but do not necessarily represent a common view of the AcSB. Views of the AcSB are developed only through due process.

We appreciated the efforts of your staff to clarify the proposals with Canadian constituents on their recent visit to Toronto. We hope they gained a better understanding of Canadian financial institutions and their approach to managing credit risk.

We are pleased that the proposal in the Supplement has been issued jointly with the Financial Accounting Standards Boards (FASB). We think that a converged standard for recognition of impairment of financial assets will help promote more efficient flows of capital. We agree with the FASB's proposed approach to recognizing and measuring impairment on financial assets measured at amortized cost and encourage the IASB to consider its merits further. Convergence of IFRS and US GAAP is of critical importance to Canadian financial institutions. Accordingly, the only basis on which we would find the common proposal acceptable is if that is the only avenue to achieve a converged standard.

We disagree that calculating expected losses over the life of an asset or portfolio of assets, as proposed in ED 2009/12, will provide better information about the quality of those assets or future cash flows than the model proposed by the FASB. We think that recognizing losses expected to occur in the foreseeable future would create allowances sufficient to result in realistic reporting of periodic net income. However, we are concerned that there would be numerous, divergent interpretations of "foreseeable future" in the absence of increased guidance and, consequently, a lack of comparability across entities. We encourage the boards to consider an alternative approach, possibly one that is closer to the notion of providing for losses that are "incurred but not reported" as used in the insurance industry. We think this concept is easier for preparers to understand and apply, and more widely understood by users.

We also think that the original proposals in ED 2009/12 and the time-proportional modification proposed in the Supplement sacrifice simplicity and practicality for an unnecessary degree of conceptual purity. We have seen no evidence that the proposed IASB model would result in more realistic estimates of credit losses than the FASB model nor produce a substantially better measurement of revenue. However, in our view, it would be far more complex to apply.

We agree that an entity's risk management model should factor into the determination of impairment losses. We also agree that it is appropriate for an entity to estimate impairment for some assets on a portfolio basis, in particular when credit risk is managed in aggregate. However, we are concerned that the model proposed in ED 2009/12 and in the Supplement would impose unnecessary complexity on reporting entities for assets that are not managed on a portfolio basis. Further, for portfolios managed on a portfolio basis but not on a "good book/bad book" basis, the proposals in the Supplement would, in effect, force the entity to change its risk management practices solely to accommodate an accounting standard. We are not convinced that the model would provide better information to users or management than a much less complex method, such as that originally proposed by the FASB. We think that the objective of accelerating the recognition of losses on problem assets could be met by removing the barriers to recognizing impairment that are present in IAS 39 and US GAAP, or by simply adopting the FASB model of recognizing expected losses for the foreseeable future.

Should the IASB decide to proceed with the proposed provisions, we think that the FASB model should be the default and the "higher of" model should be optional. This would provide a practical expedient for entities with limited ability to apply the time-proportional method.

We are encouraged that the IASB has addressed some of our concerns with the original Exposure Draft. We disagree with adjusting effective interest rates to reflect estimates of lifetime losses, regardless of any theoretical justifications. Although we understand from discussions with your staff that the IASB prefers this blended approach to recognizing interest income and credit losses on loan assets, we reiterate that doing so would be onerous for preparers and confusing to users. We think this concession should be extended to individual assets and closed portfolios.

We have included in the Appendix our responses to the questions set out in the Exposure Draft.

We would be pleased to elaborate on our comments in more detail if you require. If so, please contact me, Peter Martin, Director, Accounting Standards (+1 416 204-3276 or email peter.martin@cica.ca) or Kate Ward, Principal, Accounting Standards (+1 416 204-3437 or email kate.ward@cica.ca).

On behalf of the Board

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APPENDIX

***Question 1**:*

The AcSB agrees that the proposed approach would generally accelerate recognition of expected credit losses compared to practice under IAS 39. However, we do not agree that the complex model proposed is necessary to accelerate recognition. As noted in our comment letter to the Exposure Draft *Amortised Cost and Impairment* (ED 2009/12), we think that removing the requirement in IAS 39 to identify objective evidence of impairment would be sufficient to avoid delayed recognition of losses on problem assets.

Question 2:

We think that it is important to have a single approach to recognizing and measuring impairment based on a clearly articulated principle. Multiple models increase complexity and costs for preparers because rules determining the scope of each model must be built into reporting systems and reconciliation processes developed to ensure proper application. It is also more difficult to report the results of multiple models and the dividing lines between models in a manner that informs users of asset quality and expected cash flows.

We are uncertain whether the proposed model could be implemented for a closed portfolio, for significant individual assets or for purchased portfolios of distressed assets. We think that the FASB model could be applied to these types of assets, but with clarifications to the concept of "foreseeable future". Should the IASB decide to proceed with either the original proposal or the modified version in the Supplement, we strongly encourage field testing to ensure that operational issues are resolved and the results of the model make intuitive sense.

We understand that the IASB is considering applying the original model to closed portfolios to retain the ability to incorporate expected losses into the calculation of the effective interest rate. We do not agree that the effective interest rate should be used to accumulate allowances for credit losses for any assets. It is too complex for preparers to implement efficiently and interferes with users' ability to apply common analytical metrics.

Question 3:

We think that it is unnecessary to distinguish between a good book and a bad book. We think that entities that currently do not manage credit risk in a portfolio on a good book/bad book basis will, in effect, be forced to implement that approach solely to satisfy an accounting standard. We also think that it is not necessary to adopt the time-proportional method of recognizing losses in the good book. We think that immediate recognition of expected losses is appropriate regardless of whether the entity manages assets for yield or for collection. We think that the estimate of expected losses for the assets that would be in the good book should be calculated on a basis similar to the incurred-but-not-reported notion used in the insurance industry. As the concern shifts from maintaining or improving yield to

maximizing collection, we think that the estimate of expected losses will become more asset-specific. This method would be more operationally flexible than the model proposed and would accommodate portfolios that are not managed on a good book/bad book basis. We think that the standard should permit, but not require, portfolio methods to calculate expected losses when such methods are consistent with the entity's risk management processes.

Question 4:

As stated in our response to ED 2009/12 and above, we do not think that it is necessary to adopt a time-proportional approach to recognizing credit losses as it sacrifices simplicity and practicality for an unnecessary degree of conceptual purity. However, we think that statistical methods of estimating expected credit losses are appropriate for credit cards and other small personal loans but that the proposed time-proportional method would be difficult to apply to these portfolios because the loans often are revolving and do not have fixed maturity dates. We think that the time-proportional method of determining an impairment allowance could be operational for large portfolios of relatively small, homogeneous loans such as residential mortgages with fixed or determinable maturity dates. We also think that the time-proportional model is unnecessarily complicated for larger commercial and corporate loans. Statistical modelling is less likely to provide meaningful loss estimates because these credits are not generic in nature. We think that the time-proportional model will force entities to attempt to make somewhat meaningless estimates of lifetime expected credit losses for each individual asset when their risk management processes are designed to identify and actively manage individual accounts at risk. Impairment allowances should be based on the application of judgement and experience to these larger loans, consistent with the way they are managed.

Question 5:

We do not agree that the proposed approach provides information that is more useful for decision-making than an approach that recognizes losses expected in the foreseeable future. Members of the AcSB's User Advisory Council were interested in accelerating recognition of losses on problem assets but were not convinced that the model would provide more useful information. These analysts use both balance sheet and profit and loss information to assess the credit quality of an entity's assets. The proposed model appears to sacrifice information about net asset values to conservative income estimates.

Question 6:

Based on feedback we have received from several constituents, we do not believe the differentiation between "good book" and "bad book" is sufficiently clear to promote consistency and comparability. Participants in roundtable meetings with your staff expressed views that the proposed guidance is unclear on the distinction. They were concerned about inconsistent application among peers that would impede global comparability of reported results. We think that entities that actively manage financial asset portfolios would have little difficulty distinguishing between good book and bad book assets but

we agree with the concerns about comparability. We also think that entities other than financial institutions with portfolios of interest-bearing assets might have difficulty making the distinction.

Question 7:

We do not think that the good book/bad book approach is operational for many portfolios of financial assets carried at amortized cost. We think that it would force entities that currently do not manage credit risk in a portfolio on a good book/bad book basis to implement that approach solely to satisfy an accounting standard, and the requirement to classify assets could be an operational distraction. We also do not agree that it is necessary to distinguish between good book and bad book financial assets.

We leave it to others to comment on the auditability of the proposed good book/bad book approach.

Question 8:

We do not agree with the proposed requirement. As stated above, we think that the proposed requirement is unnecessarily complicated and will force entities that currently do not manage credit risk in a portfolio on a good book/bad book basis to implement that approach solely to satisfy an accounting standard. There is some risk that the distinction would result in an artificial discontinuity in loss allowances on the basis of an arbitrary classification. For example, we are unclear from the proposal how to account for the change in an allowance for an asset transferred from the good book to the bad book. We think that credit allowances should increase as concerns about collectability increase. Overall, the allowance should be a combination of specific provisions for identified problem assets and losses that are expected calculated in a similar manner to "incurred but not reported" losses in the insurance industry. It should not be necessary to distinguish between a good book and a bad book.

Question 9:

(a) We think that in many circumstances the floor will apply. Due to the fact that 100% of the floor is recognized immediately and the time-proportional amount is only recognized over the average life of the portfolio, the only circumstance that we can conceive of where the recognized portion of the time-proportional amount would exceed the floor is where the entity's interpretation of "foreseeable future" is a period of time substantially shorter than the remaining average life of the portfolio. For many portfolios, we expect that entities would estimate losses beyond the foreseeable future using long-term average loss ratios. Although many Canadian financial institutions have sophisticated statistical models for portfolios of smaller homogeneous loans, they note difficulties with long term forecasting of economic conditions. Because they are able to predict near term losses with greater confidence, the time-proportional amount would often be lower than the floor. Depending on one's interpretation of "foreseeable future", any estimate of longer term losses that exceeds a long-term average could be viewed as "foreseeable". This type of circular reasoning is not helpful toward achieving the objective of measuring financial assets at appropriate amounts or recognizing profit or loss in appropriate periods. Further, the ambiguity of the proposed model could be used to manipulate reporting of earnings.

We also think that the good book floor plus the lifetime expected losses in the bad book will likely be equivalent to the FASB's proposed "foreseeable future" model in most scenarios. However, the common proposal is much more complex to apply, as it requires running two models – the time-proportional lifetime expected losses and the floor. Thus, we think that the common approach adds significant complexity to arrive at essentially the same provision for credit losses.

(b) We do not agree with the "higher-of" model or distinguishing between assets on the basis of "good book" or "bad book". We think that appropriate allowances can be determined with a single model linked to a risk management process. As explained above, we think the boards should explore adapting the incurred-but-not-reported approach to recognizing expected losses for assets that have not been specifically identified as being at risk of loss. We are also concerned about inconsistent interpretation of foreseeable future. A requirement to assess for evidence of an early loss pattern would have the same interpretive challenges as "foreseeable future" and the current requirement in IAS 39 to identify objective evidence of impairment, so it would not be a reliable condition on which to base an alternative measurement.

(c) We think that it is difficult to estimate with precision when losses will be realized. There is some risk that twelve months will be interpreted as a bright line. If the IASB continues to work with the notion of "foreseeable future", we think that it should be more clearly defined in qualitative terms to minimize disparity in applying that term in practice. We encourage the boards to work together to develop an approach that would recognize expected losses without the subjectivity and ambiguity of determining "foreseeable future".

(d) We were unable to agree on a consensus view of "foreseeable future". Some note that in a crisis, the period over which an entity is willing or able to forecast becomes very short. Others do not think that "foreseeable future" changes with changes in economic conditions. These people think that loss expectations, or probability distributions of loss estimates, fluctuate with changes in economic conditions with higher losses expected as conditions deteriorate. We agree that "foreseeable future" is not an appropriate metric on which to base the estimation of credit losses.

(e) We disagree with bright lines because many people seem to lose sight of the objective these guidelines try to articulate. We do not think that a quantitative definition of foreseeable future period is an appropriate substitute for the application of experience and judgement. We encourage the boards to work on a more operational approach to estimating credit losses.

(f) We do not agree with basing allowances or provisions for credit losses on anything that involves defining "foreseeable future". Accordingly, we do not agree with the notion of a corridor.

Question 10:

We think that, conceptually, in a closed portfolio, the floor will likely be greater than the time-proportional amount early in the life of the portfolio. The time-proportional amount may catch up to

the floor near the end of the life of the portfolio. However, we think that the floor amount and the time-proportional amount might be similar in a mature open portfolio. In a portfolio of homogeneous loans that is constantly turning over, loss experience should be fairly constant over time unless economic conditions deteriorate. In our experience, loss experience in an open portfolio reverts to the mean over time. The time proportional amount would be similar to the floor unless a downturn is expected in the foreseeable future.

Question 11:

(a) We are very confused as to whether the proposal is to permit discounting of the expected cash flows, after factoring in expected defaults; or whether the proposal is to discount the expected defaults.

In our view, the rational approach to using discounting to measure credit losses is to calculate the amount of expected credit loss by discounting the expected cash flows, after factoring in expected defaults; and comparing this amount to the amortized cost of the asset.

In an undiscounted model, it appears to us that the allowance equals the amortized cost carrying amount of the asset(s); less the undiscounted amount of the contractual cash flows not expected to be collected.

Thus, it appears to us that using an undiscounted model results in a larger initial allowance than a discounted model; followed by higher subsequent "interest income" recognized through collection of the expected cash flows.

However, under both models, over the term of the life of the asset, the absolute amount of the contractual cash flows not collected is recognized in profit and loss; only the pattern of recognition is different.

We think that the discounting model is conceptually superior, but could accept the undiscounted approach as being simpler to apply and more practical for many portfolios, where the impact might not be materially different.

(b) As explained in the response to Question 11(a), we think that a discounted approach is conceptually superior; however, this view is premised on use of the effective interest rate on the asset. When flexibility is permitted in the selection of the discount rate, then the result becomes less conceptual and more random. It is "neither fish nor fowl". We think that the accounting policy choice should be either (i) discounting using the effective interest rate on the asset; or (ii) not discounting.

Question 12:

We do not prefer the IASB approach. We think that the IASB approach sacrifices simplicity and practicality for an unnecessary degree of conceptual purity. We think that the approach might be useful for credit card portfolios and possibly very large portfolios of smaller consumer loans that are already

managed on a good book/bad book basis. However, we think that the approach is inconsistent with credit risk management for portfolios of larger loans. We also think that the IASB's approach would force entities that currently do not manage credit risk in a portfolio on a good book/bad book basis to implement that approach solely to satisfy an accounting standard.

The IASB model has several similarities to the model required to determine capital adequacy by many prudential bank regulators. We think that the objectives of an accounting standard for impairment are to ensure that assets are not overvalued and that net income is not overstated from the perspective of investors and creditors. The standard should not be driven by the preferences of any other user group such as regulators.

We also disagree that the IASB model is appropriate for organizations that do not have both the volume of loans and debt securities and the experience in a particular market to develop statistically significant expected loss estimates in order to apply the time-proportional portion of the IASB model. The standard will apply to entities that purchase asset portfolios and those that make or hold few assets compared to major banks. The model for recognizing and measuring impairment should not pose barriers to reporting entities on the basis of their size or level of sophistication, the nature of their assets or their approach to credit risk management.

Question 13:

We prefer the FASB approach. We are not convinced that the modeling required to apply the IASB approach to all open loan portfolios would consistently achieve the objective of recognizing impairment better than the application of judgement to estimate expected losses. We think the FASB approach is simpler and more practical than either the common proposal or the IASB model. We also think that the FASB approach will likely produce realistic estimates of credit losses that we suspect would not be materially different from the other two approaches.

Question 14Z:

We agree that the effective interest rate should be separate from the consideration of expected losses. The original rate on a loan or the purchased yield on a debt security should incorporate expectations of credit losses. Users evaluate the quality of an entity's portfolio of loans on the basis of average yield, interest margins and, separately, on loan loss provisions. Adding a line to adjust the interest rate for the entity's estimates of expected future losses complicates the user's ability to analyze a loan portfolio without contributing new information to the analysis. We think that the analysis of portfolios of debt securities is similar but depends on the entity's purpose for holding these assets.

Question 15Z:

We think that the same impairment model should apply to funded loans and unfunded loan commitments.

Question 16Z:

We defer to preparers' views on this question.

Question 17Z:

We strongly agree that interest revenue should be separate from the presentation of loan losses. We think that users analyze net interest margin separately from impairment and that the original proposal would have caused confusion and loss of key performance indicators.

Question 18Z:

We think the proposed disclosures are excessive. We disagree with splitting portfolios into a good book and a bad book. We do not think that lenders will want to disclose detailed information about the composition of their portfolios at the level of their internal risk grading systems. We think that users will be interested in most of the proposed disclosures but do not think that they will necessarily help them analyze the activities and risks of the reporting entity. We think that information about the weighted average term to maturity and weighted average risk rating by product group would be useful to assess trends. Additional information should be provided about the proportion of each group that is in default or expected to default.

Question 19Z:

We disagree with segregating the portfolio into two groups.