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To,

The Chairman,

International Accounting Standards Board (IASB),

30 Cannon Street, London EC4M 6XH,

United Kingdom

Dear Sir,

Sub: Supplement to ED/2009/12 - Financial Instruments Impairment

I would like to thank IASB for giving an opportunity to comment on the above mentioned supplementary document. I am pleased to note that this document and the key proposals therein are jointly issued by IASB and FASB (US Financial Accounting Standards Board) to achieve a common solution to the accounting for impairment of financial instruments. The views expressed herein are solely my individual views and do not necessarily indicate views of the organizations or entities I am associated with currently or associated in the past.

At the outset, I state that recent 'Global Financial Crisis' was not so much caused by the lacunae in the financial reporting standards but it was the result of other systemic failures and management deficiencies within the banks and financial institutions particularly those centred in the advanced economies. In my view, these deficiencies centred around three key areas viz (a)lack of recognition of, and timely attention to the underlying credit risk in various financial instruments (b)inability to understand the role and limitations of banking and finance sector in the larger economy resulting in reckless innovation/distribution of financial products and (c) serious flaws in employee recruitment (disregard for basic management principle of 'round peg in a round hole and square peg in a square hole') and compensation practices.

However, the global financial crisis brought to the fore certain potential areas for improvement in the financial reporting standards viz. recognition of credit losses on a prudent and timely basis and the adequate and suitable recognition of credit risk in all financial instruments regardless of their accounting classification/measurement category. I appreciate the efforts made by IASB and FASB to improve and enhance the quality of financial reporting standards for financial instruments on a priority basis and the continuation of the IFRS/US GAAP convergence initiative.

While the current supplementary document to the IASB's original exposure draft of November 2009 appears to be a big improvement towards reduction in operational complexity and provision of better

clarity around credit loss measurement and its timing of recognition, in my view, there is still a lot of scope for improvement i.e. communication of the key principles clearly & unambiguously, avoidance of unwarranted operational complexities which continue to occupy centre stage in the document and comprehensive solution for recognition and measurement of credit risk in all financial assets.

The key areas of my concerns and suggestions are given below. Please refer to Appendix I for my comments to specific questions asked by IASB/FASB. I have attempted to redraft the standard by amending the current supplementary draft (please refer Appendix II). The main features of the redrafted document are:

i)Credit loss estimation is based on a mixed approach viz. expected loss approach for 'good book' and incurred loss approach for 'bad book'.

ii)Full recognition of credit loss estimated under both the approaches at each reporting date.

iii)Financial assets measured at fair value will also be subject to impairment loss recognition in certain situations.

iv)Loan commitments, Guarantees, Letters of credit and similar credit commitments/obligations will also be part of this standard.

1) Scope:

- a) The standard should address both 'open' and 'closed' portfolios simultaneously. In fact, there is really no need to segregate the portfolio as 'open' and 'closed' as there is nothing like 'closed' portfolio in an entity preparing financial statements on a 'going concern' basis. In my view, the concept of 'open' portfolio itself is too theoretical warranting any special attention or perhaps, the standard has not defined the 'open' portfolio in a meaningful way.
- b) Recent global financial crisis brought to the fore one major weakness i.e. the underlying credit risk was not adequately recognized and monitored on timely basis in the case of traded synthetic instruments collaterized/backed/secured by underlying financial assets carrying predominantly the credit risk. Similar problem prevailed in case of Loans and Receivables classified and measured at fair value through profit or loss. In these situations, it seems that the underlying real risk viz. credit risk got lost in the glamourous world of 'fair value' and 'Value at Risk (VaR)' concepts. The option to address this weakness would be to extend the scope of the impairment standard to (i) financial assets that are designated at fair value through profit or loss which would otherwise have been measured at amortized cost and (ii) financial assets which are measured at fair value through profit or loss but the entity's fair value measurement techniques do not address comprehensive and timely recognition of underlying credit risk/loss in those financial assets.
- c) I am also of the opinion that the scope should include commitments or obligations involving credit risk such as loan commitments, guarantees, letters of credit which are generally risk managed and monitored in the same way as, and alongwith, with loan instruments. Please refer to my comments to question # 15Z for accounting policy excerpts from annual reports of few international banks which support my view..
- d) There is no convincing justification for excluding 'short term receivables' from the current exposure draft of impairment measurement of financial instrument. I believe impairment measurement process for such items is unlikely to be so complex and unique warranting a separate consideration and accounting standard prescription.

2) Credit loss estimation:

- a) Expert Consultation approach: I understand that the IASB/FASB has taken inputs from 'Expert Advisory Panel (EAP)' comprising of credit risk experts from banks and financial institutions, which approach I fully support and really appreciate. However, I am very much disappointed that the supplementary document as currently drafted is not at all satisfactory in articulating the measurement principles and giving practical approaches of measurement of credit loss and the timing of its recognition. Application guide would have benefited by some decent live examples and practices actually followed in entities e.g. banks and financial institutions, which will be hugely impacted by this subject.
- b) Overall concept: In my considered opinion, assessment and measurement of credit risk is a continuous and dynamic process throughout the life of a financial asset. Also, credit risk inherently is a subjective and judgmental area and cannot be viewed like Physics or Mathematics. Recent financial crisis has shown us the hazards of treating the subject that way. In fact, some of the authoritative prescriptions on credit risk measurement mandate use of 'human judgment' to challenge/validate the results thrown out by statistical models. I urge IASB, FASB and their staff to seek out to derive maximum advantage of the guidelines and prescriptions laid down by the relevant expert bodies such as Basel Committee on Banking Supervision (BCBS) in this regard.

IASB's primary objective (Paragraph IN5 of Exposure Draft) to reflect initial expected credit losses as part of determining the effective interest rate is overly theoretical and portrays a very narrow view in the larger context of measurement of entity's performance. IASB appears to have too much 'fixation' with linking the pricing of the financial assets with expected credit losses. In reality, actual credit losses whenever they materialize are seldom equal to the credit loss factor built into the pricing. Also, historical experience of many banks/financial institutions especially in the area of loan portfolios comprising large number of small to medium value accounts indicates that significant portion of loans written off get recovered sometime after the write off. Therefore, credit loss recognition has to be viewed in a much broader way delinked from the pricing and effective interest rate. At the same time, FASB's objective to ensure that the impairment allowance balance is sufficient to cover all estimated credit losses for the remaining life of an instrument (Paragraph IN6) is also flawed and appears excessively simplistic as it is practically impossible to estimate credit losses with reasonable degree of assurance beyond a next year or two for good book. Considering this practical aspect, the BCBS, an authority on the subject matter of credit risk for banks, requires estimation of 'probability of default (PD)' over next 12 months in the context of application of internal rating based approach for measuring credit risk under Basel II. Of course, these PD models/estimations are required to be supported by historical and empirical data of longer period say 5-7 years.

c) Approaches of estimation:

(i)Segregation into 'good book' and 'bad book': The proposed principle to differentiate the two groups (i.e. 'good book' and 'bad book') is a *critical feature* in ensuring reliable and accurate estimation of the credit losses. The segregation also provides very useful information to the users about an important aspect i.e. credit quality of financial instruments, which has a material bearing on the future cash flows and performance of the entity. Therefore, segregation principles should be robust and clear enough for practical application and also to enhance users understanding of the impact of credit quality and the impairment allowance. While I generally concur with IASB & FASB to avoid arbitrary & impractical 'bright line' prescriptions (BC 48 & 49), leaving the criteria entirely to the entities internal credit risk management or prescribing it at a very general level has its own share of shortcomings. Such an approach would lead to following weaknesses which does not augur well for the financial reporting framework intended to be of high quality, transparent, comparable and globally acceptable financial reporting standards.

 lack of uniformity and inconsistent application of the key principle, interpretation issues of term 'bad' book,

- potential for earnings management,
- poses difficulties in auditing the differentiation between the two books,
- Inability to properly rank order the credit quality of the financial assets(s) thereby leading to inaccurate and less reliable estimation of expected credit losses.

Key rationale behind the segregation of financial asset (s) into two groups should be to identify and segregate the financial assets (s) with higher probability of credit loss from those assets where it is lesser. Accordingly, there should not be any hesitation in prescribing specific parameters/criteria based on sound principles and well accepted practical considerations. Among the banks and financial institutions, specific criteria like '90 days past due' alongwith some subjective qualitative factors has been widely and globally accepted and generally embedded into their internal credit risk management policies to differentiate between 'good book' and 'bad book'. Accordingly, even if a specific bright line were prescribed it would be directionally consistent with the approach taken by the IASB for other phases of the IAS 39 replacement project and other standards such as IFRS 8, IFRS 7. Also, banking sector regulators worldwide generally regard '90 days past due' as a critical criteria in differentiating between the 'good book' and 'bad book'. Therefore, I strongly recommend an approach similar to the one adopted by (BCBS) to define 'default' in the context of credit risk measurement for capital adequacy framework (Basel II). I draw your attention to paragraphs 452 to 455 of the BCBS document titled 'International Convergence of Capital Measurement and Capital Standards' June 2006.

ii) Discounted versus Undiscounted estimates: In my opinion, credit loss estimate should be based on 'discounted' basis which recognizes time value of money. However, as a practical expedient, credit loss estimate for 'good book' may be permitted on undiscounted basis.

There is considerable merit in the flexibility allowed in the selection of a discount rate. In fact, I propose an additional parameter for inclusion viz. 'cost of funding' rate because many entities use it for internal credit risk management purposes or for the computation of Loss given Default (LGD), a critical component in computing credit risk capital of banks using advanced approaches for measurement of credit risk. Permitting use of cost of funding rate will be directionally consistent with the IASB's approach of recognizing entity's internal risk management processes and techniques for financial reporting standards.

- **iii) Techniques and approaches:** The application guide does not give sufficient explanations and clarifications on the techniques and approaches that can be followed in estimating the credit loss estimates. There is a need for some practical examples. Currently the document is focusing too much on operational complexity introduced by 'time-proportional' approach for recognition of expected loss for good book. As highlighted in previous paragraphs, IASB/FASB should explore seeking additional guidance from EAP or BCBS in order to strengthen the guidance material with illustrative examples. It should facilitate and encourage application of advanced techniques and practices (internal rating based approach (IRB)) used by some internationally active banks. At the same, it should build in flexibility to adopt simple techniques and practical expedients such as loss rate or provision matrix for others. *Please refer to Appendix II for illustrative examples suggested by me.*
- c) Timing of recognition: I do not consider it appropriate to recognize the impairment allowance on a time-proportional basis over the remaining life of the open portfolios. If such an approach is permitted, the issue and concern of delayed recognition of expected credit losses remains unresolved. Further, conceptually also, this approach is not 'prudent'. Conservative and prudent concepts of accounting warrant that all expected losses i.e. full amount of expected losses should be recognized as soon as those are expected and can be estimated. I agree with FASB's original view (Paragraph IN7) that 'if an entity expects not to collect all amounts, a loss exists and should be recognized immediately'. IASB/FASB should not get carried away by the management jargons like 'too much, too soon'.

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Additionally, the 'time-proportional' approach is fraught with significant operational complexities and challenges which are not worth the cost and effort expected to be involved.

- **d)** Interest income on impaired accounts: Interest income on the financial asset (s) segregated as 'bad book' should be recognized in profit or loss on cash basis.
- **3) Presentation and disclosure:** There is a need for reconsideration of some of the disclosure requirements. The key defects as I foresee are as follows:

i)Paragraph Z6 & Z7: disclosure requirements by class of financial assets is bit rigid and onerous and, therefore, entities may be permitted to adopt a higher level of disclosure say business segment or geographic area.

ii)Paragraph Z11 & Z12: requirements are unclear i.e. meaning of 'actual outcome', does it mean actual write offs or segregation of an account into 'bad' book ?. Disclosure requirements stipulated for 'back testing' do not seem to be aligned with actual practice and 'back testing' under credit risk may not be as straightforward/simple as performed in 'VaR' of market risk.

iii)Paragraph Z13 to Z14: The disclosure requirements under these paragraphs may be superfluous or duplicate as IFRS 7 also requires certain disclosures on this area.

I hope my suggestions and comments will be useful in finalizing a comprehensive and robust principle based standard for measuring and recognizing impairment allowance.

Please feel free to contact me for any clarification or further discussion on this subject.

Thank you

Yours faithfully,

Vidhyadhar Kulkarni

Comments on supplementary document to exposure draft on Financial Instruments: Impairment

Appendix I

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?

Response:

No. I believe the approach in the supplementary document does not comprehensively address the delayed recognition of expected losses. In my view, the full amount of the expected loss estimated at each reporting date should be fully recognized at each reporting date. As I have explained in the suggested model (Please refer Appendix II), expected credit losses should be reviewed at each reporting date and the loss amount recognized be revised accordingly.

IASB's primary objective (Paragraph IN5 of Exposure Draft) to reflect initial expected credit losses as part of determining the effective interest rate is overly theoretical and portrays a very narrow view in the larger context of measurement principle for financial instruments at amortized cost. IASB appears to have too much 'fixation' with linking the pricing of the financial assets with expected credit losses. In reality, actual credit losses whenever they materialize are seldom equal to the credit loss factor built into the pricing. Also, historical experience of many banks/financial institutions especially in the area of loan portfolios comprising large number of small-medium value accounts indicates that significant portion of written off loans get recovered sometime after the write off. Therefore, credit loss recognition has to be viewed in a much broader way delinked from the pricing. At the same time, FASB's objective to ensure that the allowance balance is sufficient to cover all estimated credit losses for the remaining life of an instrument is also flawed and appears excessively simplistic as it is practically impossible to estimate credit losses with reasonable degree of assurance beyond a next year or two. Considering this practical aspect, the BCBS (Basel Committee on Banking Supervision), an authority on the subject matter of credit risk for banks, requires estimation of 'probability of default (PD)' over next 12 months in the context of application of internal rating based approach for measuring credit risk under Basel II.

The proposed model should be revised to make it comprehensive and robust enough to capture **full** recognition of all credit losses, both expected and incurred, at reporting date. It is worth noting that recent global financial crisis brought to the fore the one major weakness that underlying credit risk was not suitably and adequately recognized and monitored on timely basis in the case of traded synthetic instruments collaterized/backed/secured by underlying financial assets carrying predominantly credit risk. Similar problem prevailed in case of Loans and Receivables classified and measured at fair value through profit or loss. In these situations, it appears that the underlying/ real risk viz credit risk got lost in the glamourous world of 'fair value' and 'VaR' concepts. Therefore, the scope of the supplementary document must be enhanced to include certain financial assets measured at fair value to ensure adequate and timely recognition of credit risk (issuer risk as well as counterparty credit risk) and expected credit losses thereof. Banking sector regulators in a few jurisdictions stipulate assessment and monitoring of credit risk in financial instruments measured at fair value (trading book) in a way similar to those in amortized cost category.

Please refer to Appendix II for my suggestions to address the above weakness.

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.

Response:

Yes. The standard should address both 'open' and 'closed' portfolios simultaneously. In fact, there is really no need to segregate the portfolio as 'open' and 'closed' as there is nothing like 'closed' portfolio in an entity preparing financial statements on a 'going concern' basis. In my view, 'closed' portfolio is likely to exist only in very limited circumstances such as when an entity is in the process of discontinuing a line of business or shutting down its operations.

I am of the opinion that it is important to have a single impairment approach for all relevant financial assets and also cover the commitments/obligations that give rise to financial assets at some point of time in future. I believe it is practically possible to have such a comprehensive model.

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?

Response:

No. I do not support the proposed approach for the following two reasons.

1)I do not consider it appropriate to recognize the impairment allowance on a time-proportional basis over the remaining life of the open portfolios. If such an approach is permitted, the issue and concern of delayed recognition of expected credit losses remains unresolved. Further, conceptually also, this approach is not 'prudent'. Conservative and prudent concepts of accounting warrant that all expected losses i.e. full amount of expected losses should be recognized as soon as those are expected and can be measured. I agree with FASB's original view (Paragraph IN7) that 'if an entity expects not to collect all amounts, a loss exists and should be recognized immediately'. No doubt, there is high level of estimation and application of management judgment in this kind of estimation process. But, this significant level of estimation and uncertainty is inherent in areas such as estimation of impairment allowance. Further, assessment and

measurement of credit risk and the impairment loss is a continuous and dynamic process throughout the life of a financial asset taking into the new factors and developments as the time passes. Accordingly, impairment allowance balance may require regular and periodic adjustments. The process of subjectivity and management judgment may give rise to concern of 'earnings management' by the entity's management. To address this concern key measurement principles should be robust, stipulate sound controls over estimation process and prescribe suitable disclosure framework. Also, there would be a concern similar to that stated in BC 59 i.e. immediate recognition of expected losses for the remaining effective lives of financial assets was potentially recognising an amount of impairment that is 'too much, too soon'. In my view, this should not be a concern always as the impairment allowance now proposed is expected to be estimated over foreseeable future and not over the entire life of the financial assets as proposed earlier.

Perhaps, at the time of first time adoption, there is likely to be material impact and this is expected to be addressed by Transition requirements to recognize initial first time adoption adjustment in the opening retained earnings. As a rough and high level estimation of the impact on opening retained earnings of few international banks & financial institutions as of 31 Dec 2010 & 31 Dec 2009 can be as in following table. The estimation is on the assumption that the expected losses (EL) for portfolios under Internal Ratings Based approach for credit risk computed under the capital adequacy framework (Basel II) would be more than adequate to meet the expected loss provision requirements under the proposed IFRS for impairment loss.

	HSBC Holdings		Barclays PLC		Standard		Deutche Bank		BNP Paribas	
	PLC				Chartered PLC		AG			
	USD	Mio	GBP Mio		USD Mio		Euro Mio		Euro Mio	
	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Dec	Dec
	2010	2009	2010	2009	2010	2009	2010	2009	2010	2009
Shortfall	6,228	6,750	336	50	1,328	1,004	854	2,090	(482)	(1,314)
(surplus) of										
IFRS										
provisions										
vis-à-vis EL										
(Basel II)										
Total equity	154,915	135,661	62,262	58,478	38,865	27,920	50,392	37,969	85,629	80,344
Shortfall	4.02%	4.98%	0.54%	0.09%	3.42%	3.60%	1.69%	5.50%	(0.56%)	(1.64%
(suplus) as a)
%ge of total										
equity										

Source of info: Regulatory Capital disclosures either in Annual Reports or Basel II Pillar 3 Disclosures of the above entities as of 31 December 2010.

2) The proposed approach of 'time-proportional' recognition of impairment allowance for good book has considerable 'operational' complexity in the form of computing weighted average age, weighted average life, 'higher of test' and so on and would require significant changes to the IT systems and processes. The added complexity and additional system costs do not justify the resultant 'value add' brought in by the 'time-proportional' approach.

Question 4

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

Response:

Please refer response to question # 3.

Question 5

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

Response:

Please refer response to question # 3.

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?

Response

No. The proposed principle to differentiate the two groups (i.e. 'good book' and 'bad book') is not robust and clear enough for practical application and does not enhance users understanding of the impact of credit quality and the impairment allowance. While I generally concur with IASB & FASB to avoid arbitrary & impractical 'bright line' prescriptions (BC 48 & 49), leaving the criteria entirely to the entities internal credit risk management or prescribing it at

a very general level has its own share of shortcomings. Such an approach would lead to following weaknesses which does not augur well for the financial reporting framework intended to be of high quality, transparent, comparable and globally acceptable financial reporting standards.

- lack of uniformity and inconsistent application of the key principle, interpretation issues of term 'bad' book,
- potential for earnings management,
- poses difficulties in auditing the differentiation between the two books,
- Inability to properly rank order the credit quality of the financial assets(s) thereby leading to inaccurate and less reliable estimation of expected credit losses.

Key rationale behind the segregation of financial asset (s) into two groups should be to identify and segregate the financial assets (s) with higher probability of credit loss from those where it is less. Segregation is a critical feature in ensuring reliable and accurate estimation of the credit losses The segregation also provides a very useful information to the users about an important aspect i.e. credit quality, which has a critical bearing on the cash flows and performance of the entity. Accordingly, there should not be any hesitation in prescribing specific parameters/criteria based on sound principles and well accepted practical considerations. Among the banks and financial institutions, specific criteria like '90 days past due' alongwith subjective qualitative factors has been widely and globally accepted and mostly embedded into their internal credit risk management policies to differentiate between 'good book' and 'bad book'. Accordingly, even if a specific bright line were prescribed it would be directionally consistent with the approach taken by the IASB for other phases of the IAS 39 replacement project and other standards such as IFRS 8, IFRS 7. Also, banking sector regulators worldwide generally regard '90 days past due' as a critical criteria in differentiating between the 'good book' and 'bad book'. Therefore, I strongly recommend an approach similar to the one adopted by Basel Committee on Banking Supervision (BCBS) to define 'default' in the context of credit risk measurement for capital adequacy framework (Basel II). I draw your attention to paragraphs 452 to 455 of the BCBS document titled 'International Convergence of Capital Measurement and Capital Standards' June 2006.

Please refer to Appendix II for my specific suggestions on the key principles to differentiate between 'good book' and 'bad book'.

Further, I request IASB to consider replacement of the terminology from 'good book' to 'Non –impaired' or 'Performing' book and 'bad book' to 'Impaired' or 'Non performing' book. Because, these terminologies have been in use for considerable period of time and are well understood by the various stakeholders viz. preparers, users and auditors of the financial statements. Additionally, the term 'bad' book, in some geographies, is interpreted as a situation of a write off case. But, there can also be intermediary groups or categories which, based on probability or likelihood of default, fall in between the 'good book' and bad book' and reflect high likelihood of impairment loss but not as much as that of a 'bad book'. In case of these middle categories, the internal credit risk management processes and the key impairment loss measurement principles are similar to 'bad book' and would most likely get included under 'bad book'. Accordingly, in order to provide more clarity and properly describe the nature/contents of the portfolios, renaming the terminologies on the lines suggested above would be beneficial.

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?

Response:

Please refer to my response to question # 6.

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?

Response:

Yes. I do agree with the proposed requirement to differentiate between the two groups for the purpose of determining the impairment allowance. This will help better application of the impairment allowance measurement principles by the entity and enhance its auditability. While impairment allowance measurement in both the cases will be subjective requiring estimation by the management, however, it is likely to be more objective and accurate estimation for 'bad' book vis-à-vis 'good' book. The key principles of measurement should be uniform but the techniques used and processes applied for 'bad' book have to be more robust, free of material errors and high certainty of the impairment loss estimation.

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?
- (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?

(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?

Response:

No. I do not agree with the approach as I do not support the 'time-proportional' allocation/recognition of impairment loss. I have suggested full recognition of impairment loss for 'good' book expected to occur over a foreseeable future (with a minimum of next twelve 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.

Response:

No comments.

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?

(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?

Response:

(a)I do not support complete flexibility to use either discounted or undiscounted estimate. In my opinion, credit loss estimate should be based on 'discounted' basis which recognizes time value of money. However, as a practical expedient, credit loss estimate for 'good book' may be permitted to be computed on undiscounted basis.

(b)I agree with flexibility allowed in the selection of a discount rate. Actually, I propose an additional alternative viz. 'cost of funding' because many entities use it for internal credit risk management purposes or loss given default (LGD) computation for regulatory credit risk measurement under Internal rating based (IRB) approach. Addition of this alternative will be directionally consistent with the IASB's approach of recognizing entity's internal management processes and techniques for financial reporting standards.

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?

Response:

No. I strongly recommend current recognition of full amount of losses expected to occur over a foreseeable future with a minimum of next twelve month.

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?

Response:

No. I strongly recommend current recognition of full amount of losses expected to occur over a foreseeable future with a minimum of next twelve month.

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?

Response:

Yes. IASB's original proposal is unnecessarily and overly concerned with linking the pricing of the financial asset and the expected credit losses over the life of the financial asset. This concern is too theoretical and in fact actual credit losses incurred would be significantly higher than the expected loss that were factored into the pricing of the financial asset and pricing is also not necessarily a one time event at the origination of the financial asset. Also, historical experience of many banks/financial institutions especially in the area of loan portfolios comprising large number of small-medium value accounts,

significant portion of bad loans written off get recovered sometime after the accounts are written off. Therefore, credit loss recognition has to be viewed in a much broader context delinked from the pricing.

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?

Response:

Yes. This approach will bring the impairment measurement and accounting requirements much closer to the way in which the entities, especially the banks/financial institutions, manage and measure the credit risk related matters including creation of impairment allowance. Credit related products such as loan commitments, guarantees, letters of credit, granted in isolation or in combination with other credit products (financial assets) such as term loan, overdraft are generally monitored and managed in the same way as these financial assets (term loans or other credit facilities). Further, loan commitments or guarantee contracts in a banking entity generally co-exist with other financial assets as it is quite common for commercial banks to grant to a borrower a package of credit facilities comprising both on balance sheet exposures (loans, overdrafts) as well as off balance sheet exposures (Loan commitments, Letters of credit, Guarantees-Financial/Non Financial). This change would require amendment to IAS 39/IFRS 9 & IAS 37 measurement principles subsequent to their initial recognition.

In support of my view, I offer following select excerpts of notes and disclosures from annual reports a few international banks.

Deutsche Bank (Annual Report 2010)

Loan Commitments Page # 167

Certain loan commitments are designated at fair value through profit or loss under the fair value option. As indicated under the discussion of 'Derivatives and Hedge Accounting', some loan commitments are classified as financial liabilities at fair value through profit or loss. All other loan commitments remain off-balance sheet. Therefore, the Group does not recognize and measure changes in fair value of these off-balance sheet loan commitments that result from changes in market interest rates or credit spreads. However, as specified in the discussion "Impairment of loans and provision for off-balance sheet positions", these off-balance sheet loan commitments are assessed for impairment individually and, where appropriate, collectively.

Impairment of Loans and Provision for Off-Balance Sheet Positions Page # 174

The process to determine the provision for off-balance sheet positions is similar to the methodology used for loans. Any loss amounts are recognized as an allowance in the consolidated balance sheet within other liabilities and charged to the consolidated statement of income as a component of the provision for credit losses.

Financial Guarantees Page # 180-181

Financial guarantee contracts are contracts that require the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payments when due in accordance with the terms of a debt instrument. Such financial guarantees are given to banks, financial institutions and other parties on behalf of customers to secure loans, overdrafts and other banking facilities.

The Group has chosen to apply the fair value option to certain written financial guarantees that are managed on a fair value basis. Financial guarantees that the Group has not designated at fair value are recognized initially in the financial statements at fair value on the date the guarantee is given. Subsequent to initial recognition, the Group's liabilities under such guarantees are measured at the higher of the amount initially recognized, less cumulative amortization, and the best estimate of the expenditure required to settle any financial obligation as of the balance sheet date. These estimates are determined based on experience with similar transactions and history of past losses, and management's determination of the best estimate.

Any increase in the liability relating to guarantees is recorded in the consolidated statement of income in provision for credit losses.

BNP Paribas (Annual Report 2010)

Impairment of loans and receivables and held-to-maturity financial assets, provisions for financing and guarantee commitments

Page # 18 An impairment loss is recognised against loans and held-to-maturity financial assets where (i) there is objective evidence of a decrease in value as a result of an event occurring after inception of the loan or acquisition of the asset; (ii) the event affects the amount or timing of future cash flows; and (iii) the consequences of the event can be reliably measured. Loans are initially assessed for evidence of impairment on an individual basis, and subsequently on a portfolio basis. Similar principles are applied to financing and guarantee commitments given by the Group, with the probability of drawdown taken into account in any assessment of financing commitments.

Page # 19 Impairment losses on loans and receivables are usually recorded in a separate provision account which reduces the amount for which the loan or receivable was recorded in assets upon initial recognition. Provisions relating to off-balance sheet financial instruments, financing and guarantee commitments or disputes are recognised in liabilities. Impaired receivables are written off in whole or in part and the corresponding provision is reversed for the amount of the loss when all

other means available to the Bank for recovering the receivables or guarantees have failed, or when all or part of the receivables have been waived.

UBS AG (Annual Report 2010)

Commitments Page # 277

Letters of credit, guarantees and similar instruments commit UBS to make payments on behalf of third parties under specific circumstances. These instruments, as well as undrawn irrevocable credit facilities, and irrevocable forward starting reverse repurchase agreements and securities borrowing transactions, carry credit risk and are included in the exposure to credit risk table in Note 29c, with their gross maximum exposure to credit risk less provisions.

Allowance and provision for credit losses

Page # 277

An allowance or provision for credit losses (refer to Note 9b) is established if there is objective evidence that the Group will be unable to collect all amounts due on a claim according to the original contractual terms or the equivalent value. A "claim" means a loan or receivable carried at amortized cost, or a commitment such as a letter of credit, a guarantee, a commitment to extend credit or other credit products.

Page # 278

An allowance for credit losses is reported as a reduction of the carrying value of a claim on the balance sheet. For an off-balance sheet item, such as a commitment, a provision for credit loss is reported in Other liabilities. Additions to allowances and provisions for credit losses are made through Credit loss expense.

Citigroup Inc (Annual report 2010 page # 164)

Allowance for Unfunded Lending Commitments

A similar approach to the allowance for loan losses is used for calculating a reserve for the expected losses related to unfunded loan commitments and standby letters of credit. This reserve is classified on the balance sheet in Other liabilities. Changes to the allowance for unfunded lending commitments flow through the Consolidated Statement of Income on the line Provision for unfunded lending commitments.

Bank of America (Annual report 2010 page # 150)

Allowance for Credit Losses

The allowance for credit losses, which includes the allowance for loan and lease losses and the reserve for unfunded lending commitments, represents management's estimate of probable losses inherent in the Corporation's lending activities. The allowance for loan and lease losses and the reserve for unfunded lending commitments exclude amounts for loans and unfunded lending commitments accounted for under the fair value option as the fair values of these instruments reflect a credit component. The allowance for loan and lease losses does not include amounts related to accrued interest receivable other than billed interest and fees on credit card receivables as accrued interest receivable is reversed when a loan is placed on nonaccrual status. The allowance for loan and lease losses represents the estimated probable credit losses in funded consumer and commercial loans and leases while the reserve for unfunded lending commitments, including standby letters of credit (SBLCs) and binding unfunded loan commitments, represents estimated probable credit losses on these unfunded credit instruments based on utilization assumptions.

HSBC Holdings (Annual Report 2010-)

Contingent liabilities, contractual commitments and guarantees Page # 359 - Note # 41

The amounts disclosed in the above table are nominal principal amounts and reflect HSBC's maximum exposure under a large number of individual guarantee undertakings. The risks and exposures arising from guarantees are captured and managed in accordance with HSBC's overall credit risk management policies and procedures. Approximately half of the above guarantees have a term of less than one year. Guarantees with terms of more than one year are subject to HSBC's annual credit review process.

Barclays Bank PLC (Annual Report 2010)

Note # 23 Provisions page # 90

Provision is made for undrawn loan commitments and similar facilities if it is probable that the facility will be drawn and result in the recognition of an asset at an amount less than the amount advanced.

Note # 16 Financial Guarantees page # 88

Financial guarantees are initially recognised in the financial statements at fair value on the date that the guarantee was given. Other than where the fair value option is applied, subsequent to initial recognition, the Group's liabilities under such guarantees are measured at the higher of the initial measurement, less amortisation calculated to recognise in the income statement any fee income earned over the period, and any financial obligation arising as a result of the guarantees at the balance sheet date, in accordance with policy 23.

Any increase in the liability relating to guarantees is taken to the income statement within the impairment charge. Any liability remaining is recognised in the income statement when the guarantee is discharged, cancelled or expires.

Question 16Z

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

Response:

Generally yes. There is a need for minor modification to the proposed requirements and the amendments suggested by me should take care of these.

Question 17Z

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

Response:

Yes. Presenting impairment loss on financial instruments as a separate line item in the Profit or Loss statement will provide very useful and critical information to the users of the financial statements.

Question 18Z

- (a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?
- (b) What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) for the proposed impairment model and why?

Response:

(a) & (b). Overall I agree with the disclosure requirements, however, in certain areas listed below I find it very excessive and of less relevance to the users of financial statements.

Paragraph Z6: Certain entities review and manage impairment allowances using a criteria higher than class of financial asset. Such criteria could be a business division or geographic segment. Therefore, it would be suitable to permit disclosure at such a higher level to align the disclosure with internal credit risk management.

Paragraph Z8: Certain portion of disclosure is excessive and less relevant.

Paragraph Z11: It is unclear what is the purpose and usefulness of this disclosure. Perhaps, this may be deleted when paragraph Z6 is amended as suggested above.

Paragraph Z12: Disclosure requirements are too onerous and unclear. Does this requirement refers to disclosure of trend of expected losses versus actual writes offs or expected losses versus movements from good book to bad book. It will be useful if application guide provides some guidance and examples in this area. In many cases, it takes many years before actual credit loss crystallize which results in significant gap between the accounts are segregated into 'bad book' and their actual write off. Also, certain types of accounts move between (into/out of) 'good' and 'bad' book As mentioned in response to question # 3, the expected credit loss is required to be estimated and adjusted on a dynamic basis regularly. Further, back testing approaches in credit risk may not be as straightforward and simple that applied in 'VaR' for market risk portfolio. Paragraph Z13 –Z15: Some of the disclosure requirements (e.g. Z13, Z15(b)) appear to be duplication as these are already required under IFRS 7.

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?

Response:

I do not see any benefit in this disclosure. It unnecessarily adds operational complexity in the recording and maintenance of impairment allowance for good book and bad book. Further, disclosure of this information may require entities to maintain/monitor impairment allowance for 'good book' at a granular individual account level which is operationally cumbersome. As a matter of practical expediency, some entities may not look at impairment allowance for 'good book' at individual account level but only at a higher level i.e. portfolio level based on class of financial assets say Mortgage loans, Credit cards, Term loans etc. As a result, this disclosure requirement poses additional operational burden without adding much value.

Comments on supplementary document of Financial Instruments -Impairment (March 2011) Appendix II

Uniform Impairment Model suggested for all financial assets within the scope of this standard

Format and text of the supplement jointly published by IASB & FASB has been modified by striking off the part not required/relevant and the new text introduced by me is highlighted in 'Red' colour. I have relied on the guidance and prescriptions in the following two publications also:

- a) 'International Convergence of Capital Measurement and Capital Standards' June 2006 (commonly referred to as Basel II Accord) published by Basel Committee on Banking Supervision
- b) IAS 39 published by IASB

Joint supplementary document Financial Instruments: Impairment

<u>Scope</u>

- 1 For the IASB, the proposals in this supplementary document would be applied to "
 - (a)all financial assets that are subsequently measured at amortised cost if they are managed on an open portfolio basis, except short-term receivables without a stated interest rate that are so short-term that the effect of discounting for the time value of money is immaterial. For the FASB, the proposals in this supplementary document would be applied to all open-portfolios of loans and debt instruments that are not measured at fair value with changes in value recognised in net income.
 - (b)financial assets that are designated as at fair value through profit or loss which would otherwise have been measured at amortized cost.
 - © financial assets which are measured at fair value through profit or loss but the entity's fair value measurement techniques do not comprehensively address the recognition of and the timeliness of recognition of underlying credit risk/loss in those financial assets.
 - (d)loan commitments, guarantees, letters of credit and similar instruments which are not measured at fair value through profit or loss.

Impairment of open portfolios (pools) of financial assets

- 2 At each reporting date, an entity shall recognise an impairment allowance that is the total of:
 - (a)credit losses incurred in respect of a financial asset (s) or financial instrument (s) which are identified and classified as 'impaired' or 'non-performing';
 - (b)credit losses expected for all other financial asset (s) and financial instrument (s).
 - (a) for assets for which it is appropriate to recognise expected credit losses over a time period, the higher of:
 - (i) the time-proportional expected credit losses; and
 - (ii) the credit losses expected to occur within the foreseeable future (which shall be no less than twelve months after an entity's reporting date); and
 - (b) for all other assets, the entire amount of expected credit losses.
 - (c)
- 3 The amount of impairment allowance shall be recognized in profit or loss. Subsequent changes, if any, increase or decrease, in impairment allowance shall also be recognized in profit or loss.
- For the purpose of impairment allowance estimation and recognition, a financial asset (s) or a or financial instrument (s) shall be identified and classified as 'impaired' or 'non-performing' if there is a objective evidence of impairment based on either or both of the following factors:
 - (a)The borrower or obligor is past due more than 90 days on any material credit obligation to the entity. *In rare and exceptional circumstances, national or regional standard setter, in co-ordination with industry sectoral regulator, 90 days may be substituted with 180 days.*
 - (b) The entity considers that the borrower or obligor is unlikely to pay its credit obligations to the entity in full, without recourse by the entity to actions such as realizing security (if held) or other recovery initiatives.
- 3 Whether it is appropriate to recognise expected credit losses over a time period depends on the degree of uncertainty about the collectibility of a financial asset. It is no longer appropriate to recognise expected credit losses over a time period if the collectibility of a financial asset, or group of financial assets, becomes so uncertain that the entity's credit risk management objective changes for that asset or group thereof from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset.

Credit loss measurement principles

- 5 Credit loss is measured as:
 - (i)In case of items referred to in paragraph 1 (a), (b) and (c) the difference between the financial asset (s) carrying amount and the estimated future recoveries. In case of financial instruments referred to in paragraph 1 (b) and (c), credit loss measurement shall not result into financial instruments carrying amount higher than its fair value.

 (ii)In case of items referred to in paragraph 1(d), expected outflow of resources embodying future benefits minus the estimated future recoveries and amount initially recognised
- The estimation of credit losses shall be on discounted basis. But, in case of impairment allowance for a financial asset (s) or financial instrument (s) classified as 'Non-Impaired' book or 'Performing' book, entity may estimate credit losses on undiscounted basis if is not practical to apply discounted cash flow method.
- 74 Expected credit losses referred to in paragraph 2 are estimated for a financial asset (s) or financial instrument (s) each portfolio (or group of portfolios) for their remaining expected weighted average life of the portfolio, or the foreseeable future, as applicable. All estimates of expected credit losses shall be updated, at a minimum, at the time an entity prepares its annual or interim financial statements (reporting date).
- 8 All estimates of credit losses shall be updated, at a minimum, at the time an entity prepares its annual or interim financial statements (reporting date).
- 9 Credit loss estimate techniques shall be robust and sound resulting in reliable and auditable estimates; credit loss estimates shall be primarily supported by high quality historical and empirical evidence; credit loss estimates shall be consistent with data/inputs/techniques used for internal credit risk management and employee/management performance evaluation.

Interest income after impairment recognition

10 Interest income shall be recognized in profit or loss in case of a financial asset(s) or financial instrument (s) segregated and classified as 'Impaired' only when cash is actually received and it is appropriated towards reduction in interest due as per entity's credit policy.

Appendix A Defined terms

This appendix is an integral part of the supplementary document.

For entities applying IFRSs, the following terms are defined in paragraph 11 of

IAS 32 Financial Instruments: Presentation, paragraph 9 of IAS 39 Financial Instruments: Recognition and Measurement or Appendix A of IFRS 7 Financial Instruments: Disclosures and are used in this supplementary document with the meanings specified in those IFRSs:

- (a) amortised cost of a financial asset or financial liability
- (b) credit risk
- (c) effective interest method
- (d) financial asset.

For entities applying US GAAP, the following terms are defined in the Master Glossary of the *FASB Accounting Standards Codification*™ and are used in this supplementary document with the meanings specified in the Master Glossary of the *FASB Accounting Standards Codification*™:

- (a) effective interest method
- (b) financial asset.

For entities applying either IFRSs or US GAAP:

portfolio

A grouping of financial assets with similar characteristics t hat are managed by a reporting entity on a collective basis. In an open portfolio, assets are added to the portfolio through its life by origination or purchase, and removed through its life by write-offs, transfer to other portfolios, sales and repayment. In a closed portfolio, assets are not added to the portfolio through its life, and are removed by write-offs, transfer to other portfolios, sales and repayment.

Appendix B Application guidance

This appendix is an integral part of the supplementary document.

Scope

- B1 The proposals apply to all financial asset (s) or financial instrument (s) within the scope of impairment allowance measurement regardless of which portfolio they belong to for internal risk management purposes. Some entities manage financial assets using portfolios for which financial assets are grouped on the basis of similar characteristics but irrespective of the time of their origination (open portfolios). In an open portfolio, financial assets are added through origination or purchase and removed through transfers to other portfolios, sales or transfers to external parties, repayment and write-offs each period. The characteristics used in defining a portfolio include asset type, industry, credit risk ratings, geographical location, collateral type and other relevant factors. The proposals in this standard equally apply to other portfolios termed by different names such as 'closed' portfolios.
- B2 There are certain financial instruments or products which are in the nature of financial commitments or obligations and may result into to recognition of financial asset at a future date and upon occurrence of certain events. Such instruments are in the form of guarantees or undertakings to honour financial claims arising out of non-fulfillment of financial or non-financial obligation of a third party. Existence of these instruments is a common feature in a bank or a financial institution, either individually or in combination with other loan products. These commitments or obligations entail credit risk and therefore the likelihood of credit loss. As a result, these instruments are credit risk managed in a way similar to loan instruments.
- B3 Certain financial instruments regardless of their classification for measurement purposes have underlying credit risk of the issuer or the borrower. E.g. debt instruments issued by an entity 'X' entail the credit risk of entity 'X' (called 'issuer' risk), loans carry the credit risk of the borrower and similarly, asset backed commercial paper or securitized paper where the underlying assets represent mortgage loans carry the credit risk of the mortgage borrowers. Where such instruments are classified and measured at fair value through profit or loss, there is a likelihood that fair value measurement techniques may not either adequately recognize the 'credit loss' element or may not recognize on a *timely* basis. Similarly, derivatives especially those transacted in the 'over the counter (OTC)' market carry counterparty credit risk which may not always be adequately recognized as part of fair value measurement. Therefore, entities should review the nature (issuer and counterparty) and extent of the underlying credit risk in the financial instruments which are classified and measured at fair value through profit or loss and apply the impairment allowance measurement requirements of the standard if the entity's fair value measurement techniques do not address the timeliness and adequacy of the credit loss.

Impairment of financial assets

Differentiation of a financial asset (s) or financial instrument (s) for credit loss recognition

- B4B2-In accordance with paragraph 2, **financial assets or financial instruments** assets that are managed on an open portfolio basis are differentiated into two groups for the purpose of determining the impairment allowance. The differentiation depends on whether there is an objective evidence of impairment based on either or both of the following factors:
 - (a) The borrower or obligor is past due more than 90 days on any material credit obligation to the entity. In rare and exceptional circumstances, national or regional standard setter, in co-ordination with industry sectoral regulator, may substitute the 90 days with 180 days.
 - (b) The entity considers that the borrower or obligor is unlikely to pay its credit obligations to the entity in full, without recourse by the entity to actions such as realizing security (if held) or other recovery initiatives.
 - whether the uncertainty about the collectibility of an asset has taken precedence over its profitability from the interest charged. For one group, time-proportional credit losses expected to occur for the remaining lifetime are recognised, unless the minimum amount of credit losses expected to occur in the foreseeable future period applies. For the other group, the entire amount of expected credit losses for the remaining life is recognised in the impairment allowance.
- B5 In certain geographies, there are few peculiar circumstances lending to obligors such as agriculturists, micro businesses, weaker sections, where income generation & repayment timeframe is highly subject to vagaries of the nature and cannot be accurately predictable. Such exceptional situations may warrant substitution of 90 days past due with longer threshold say 180 days past due.
- B6 In case credit exposures to individual borrowers (e.g. classified as Retail Credit or Consumer Finance facilities), an entity may apply the 90 days past due criteria at the level of an individual facility say Mortgage loan, Car loan etc. rather than at the level of the borrower.

- B7 Indicators of borrowers' unlikeliness or inability to pay his obligations could be many based on the observable data to the entity. Such indicators may be e.g.
 - Significant financial difficulty of the borrower or issuer as reflected by the recent financial statements or financial dealings of the borrower;
 - The entity (lender) sells material obligations of the borrower to a third party at a significant loss;
 - The entity (lender) significantly reduces the credit facilities or credit lines due to deterioration in the credit quality of the borrower or obligor;
 - Adverse account conduct or account operations of the borrower such as frequent past dues/delays in settlement of credit obligations, hard core overdrafts in a current account, request for frequent credit limit excesses, diversion of funds for purposes other than the sanctioned purposes and the like.
 - The entity (lender), for economic or legal reasons relating to the borrower's financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
 - Indications that the borrower has filed for or will be placed under bankruptcy or similar protection;
 - Significant credit downgrade by external credit rating agencies due to deterioration in credit quality;
 - The disappearance of an active market for the financial asset due to financial difficulty.
- B8 An entity's internal credit risk management shall be primary guide in segregating a financial asset (s) or financial instruments into two groups. It is likely that an entity's internal credit risk management systems/processes might use a sophisticated rating or grading scale to differentiate or rank order credit quality of the financial asset or group of financial assets. Accordingly, in such a sophisticated system the two groups mentioned in paragraph B4 above are likely to consist of sub-groups or sub-categories, which is likely to aid differentiation into two groups and also facilitate more reliable and accurate estimate of credit losses. Also, analysis and segregation of financial assets(s) performed in response to industry specific prudential or regulatory requirements e.g. in case of banks and financial institutions, may be relevant and useful in segregating the financial assets(s) into two groups.
- B9 The financial asset(s) requiring classification under 'Impaired' or 'Non-Performing' would exhibit poor credit quality and high uncertainty about the collectability of the outstanding amount. As a result, such financial asset(s) will be subject to active monitoring and supervision and actions leading to recovery of the financial asset(s) or mitigation of credit loss. Depending on the type of financial asset, examples are evaluating or taking actions such as the enforcement of security interests (eg foreclosure on real estate or seizing assets under collateral agreements), debt restructuring in order to avoid or resolve non-performance of the asset, exercise of a call option that becomes exercisable depending on breach of debt covenants that relate to credit risk or attempting to recover cash flows from an uncollateralized financial asset. Entities often manage those financial assets separately from other financial assets, however, this may not be the sole guiding factor.
- B10 As explained in paragraph B2 & B3 above, obligations/commitments having linkage to credit risk and financial instruments measured at fair value though profit or loss where fair value techniques do not adequately capture the underlying credit risk (issuer/obligor risk or counterparty credit risk) should also be included while segregating the financial assets(s) into two groups. Sound and robust internal credit risk management systems/processes generally facilitate comprehensive assessment of credit risk of the entity based on total credit exposures at borrowing entity/group level, product or product group, industry sector level.
- B3 An entity shall differentiate the two groups on the basis of its internal credit risk management. Some entities use a credit risk management approach for financial assets that has different objectives depending on the entity's assessment of the degree of uncertainty about the collectibility of the financial asset. As the credit quality of a financial asset, or group of financial assets, deteriorates its collectibility reaches a degree of uncertainty that results in the entity's credit risk management objective changing from receiving the regular payments from the debtor to recovery of the financial asset. If the objective is the recovery of the financial asset(s), the management of the financial asset(s) typically becomes more active. Depending on the type of financial asset, examples are evaluating or taking actions such as the enforcement of security interests (eg foreclosure on real estate or seizing assets under collateral agreements), debt restructuring in order to avoid or resolve non-performance of the asset, exercise of a call option that becomes exercisable depending on breach of debt covenants that relate to credit risk or attempting to recover cash flows from an uncollateralized financial assets on an individual basis and separately from the financial assets for which the credit risk management objective is receiving the regular payments from the debtor.
- B4 Entities that do not manage credit risk using an approach that differentiates the management of financial assets depending on the uncertainty about their collectibility in a way similar to the principle in paragraph 3 must still differentiate their financial assets into two groups for the purpose of determining the impairment allowance in accordance with paragraph 2. For example, an entity might comply with that principle using criteria such as days past due, whether the expected return is below the risk-free interest rate, or when management identifies loans as doubtful (sometimes also considered by an entity as 'problem loans').

Credit Loss estimates

- B11 The underlying key principles for estimation of credit loss are similar to financial asset(s) segregated into both the groups in paragraph 2. However, the approach is likely to different as the credit loss estimate is more certain (timing plus amount of loss) as the loss has been incurred in case of financial asset(s) grouped under 'Impaired' or 'Non-Performing' book whereas it is not yet certain (timing plus amount of loss) but expected in future in case of 'Non-Impaired' or 'Performing' book. As a result, estimation of recoveries and resultant credit losses is more objective and reliable in respect of the former category of financial asset(s) than the latter category. Nevertheless, in both cases credit loss estimate inherently involves subjective assessment and application of management judgment.
- B12 Conceptually, credit loss estimation involves estimation of four key components viz. Probability of Default (PD), Loss given Default (LGD), Exposure at Default (EAD), and 'Effective Maturity (M). PD is a measure of the likelihood of the borrowers' or obligors' default over a given future time horizon say 12 months, economic or credit cycle. LGD is a measure of the expected amount of loss in the event of actual default by the borrower. EAD is a measure of the potential exposure at the time of actual of default by the borrower. M is a measure used to factor in the higher likelihood of default in longer tenor exposures as compared to shorter tenor exposures. For the purpose of credit loss estimation required under this standard only the first two components viz. PD and LGD have relevance. These two components are expressed in percentage terms. Accordingly, the formula for credit loss estimation would be as follows:

Estimated credit loss = PD x LGD x Carrying amount of financial assets (s)

There are a number of different ways and methods to estimate the above risk components and ultimately, the credit loss estimates. An entity can chose the method (s) most appropriate to its circumstances. It is conceptually acceptable that when an entity estimates credit losses using a simple loss matrix (say 10%, 20% & so on) or expected cash flow approach, above components are inherent, though not specifically identifiable, in those estimates of loss matrices. Also, it is not expected that all entities measure credit loss by separately estimating the above components.

- B13B5- An entity shall develop its estimate of expected credit losses and incurred credit losses for the remaining lifetime or the foreseeable future as required by paragraph 2, considering all available information. All available information includes historical data, current economic conditions, and supportable forecasts of future events and economic conditions. Expectations of future conditions should be based on reasonable and supportable information to substantiate those inputs used in the expected loss estimate. Those expectations should be consistent with currently available information. Entities should consider both internal data (ie entity-specific information) and external data. For example, possible data sources are internal historical credit loss experience, internal ratings, credit loss experience of other entities, and external ratings, reports and statistics. Entities that have no entity-specific credit loss experience or insufficient experience may use peer group experience for comparable financial assets (or groups of financial assets) or pooled data from data bases of industry associations or prudential regulators or loss data consortiums or credit information bureaus.
- B14 In order to reliably and accurately estimate credit losses, an entity may require historical loss data and other relevant information (e.g. economic conditions, legal/recovery framework, credit risk management concepts) of at least 5 to 7 years. Historical data such as credit loss experience are adjusted on the basis of current observable data/circumstances to reflect the effects of current conditions that did not affect the period on which the historical data are based and to remove the effects of conditions in the historical period that do not exist currently. Also, historical loss data may require adjustment based on forecast events or conditions, however, prudence and conservatism should prevail in making the adjustments. Longer the historical data period used higher the numbers and types of adjustments required.
- B15 Credit loss estimate should consider recoveries or expected cash flows from borrower, guarantor as well as enforcement/realization of collaterals/securities. Cost of obtaining and selling the collateral and appropriate margins (hair cuts) against sale prices shall be considered while estimating the expected cash flows.
- B16B10— When computing using a discounted expected credit loss amount, an entity may use as the discount rate any reasonable rate between (and including) the risk-free rate, cost of funding and the effective interest rate (as used for the effective interest method in IAS 39). (Note: the FASB did not deliberate this issue. This was a decision reached by the IASB only.)
- B17 Credit losses may be estimated on a collective basis (eg on a group or portfolio level) or an individual basis. For the purpose of estimating on a collective, financial assets are grouped on the basis of similar credit risk characteristics that are indicative of the debtors' ability to pay all amounts due according to the contractual terms (eg on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status and other relevant factors). The characteristics chosen are relevant to the estimation of expected cash flows for groups of such assets by indicating the debtors' ability to pay all amounts due according to the contractual terms of the financial assets being evaluated.

- B18 When using historical credit loss rates in estimating credit losses, it is important that information about historical credit loss rates is applied to groups that are defined in a manner consistent with the groups for which the historical credit loss rates were observed. Therefore, the method used shall enable each group to be associated with information about past credit loss experience in groups of assets with similar credit risk characteristics and relevant observable data that reflect current conditions
- B19 There exist more than one approach and technique to arrive at credit loss estimates. The entity shall apply the approach best suited to its circumstances to provide best estimate of the credit loss and its recognition on a timely basis i.e. to ensure adequacy of impairment allowance as and when they occur. The approaches and techniques primarily vary based upon the sophistication of the entity's internal credit risk management system, regulatory requirements such as those under Internal Rating Based (IRB) approach opted by a bank under Basel Capital Accord, nature and complexities of the business operations and so on. Also, approaches and techniques may vary based on the credit quality of the financial asset(s) and its class or segment for internal credit risk management e.g. corporate, retail etc.
- B20 To further elaborate the explanation in paragraph B19, an internationally active bank using IRB for its capital adequacy framework may apply its sophisticated credit risk management framework such as risk grades, risk parameters such as 'Probability of Default' and 'Loss given Default (LGD') for estimation of credit loss for both the 'Impaired' or 'Non-Performing' and 'Non-impaired' or 'Performing' book. Further, such an entity may be able to estimate credit loss at individual financial asset level to ensure more reliable and accurate estimation of credit risk. it is also likely that such an entity may adopt a mixed approach such as sophisticated techniques for only some class of financial asset (s) or portfolios and simple historical loss rates for some class of financial asset (s) or portfolio.

At the same time, a medium size bank with less complex operations may estimate the credit loss by applying simpler approaches such as segregation of its 'Impaired' book into sub-categories based on severity if loss and 'Non-impaired book' based on other risk characteristics and credit loss estimate is computed by a loss rate matrix to the financial assets(s) carrying amount net collateral present value for each of those sub-categories.

Credit losses expected to occur within the foreseeable future period

- B21 B11 For the purpose of paragraph 2(a)(ii) 2(ii) i.e. estimating expected credit loss for 'Non-Impaired' or 'Performing' book, an entity would make its best estimate of credit losses expected to occur in the future time period. for which specific projections of events and conditions are possible and the amount of credit losses can be reasonably estimated based on those specific projections. That future period is referred to as the 'foreseeable future' for the purpose of this guidance.
- B22B16 For the purpose of estimating credit losses in accordance with paragraph 2(a)(ii) 2(ii), there is a presumption that entities can develop specific projections of events and conditions for at least a twelve-month future period. Therefore, a period of at least twelve months after the reporting date shall be used for the purpose of estimating credit losses in the foreseeable future (unless the weighted average life of the portfolio of assets is less than twelve months). It is expected that for many portfolios of financial assets, the foreseeable future period will be a period greater than twelve months after the reporting date.

- B23 Unlike financial assets (s) segregated as 'Impaired' or 'Non-Performing', there are no indicators or signs of impairment of the financial asset (s) grouped under Non-Impaired' or 'Performing' category. As a consequence, the process of estimation of credit loss here could be highly subjective and judgmental. Therefore, entities have option to compute credit loss estimates on undiscounted basis. Other guidelines and principles relating to use of historical for estimating credit losses
- B12 As discussed in paragraph B5, an entity would use all available information to develop its estimate of expected credit losses for the remaining life or foreseeable future, as applicable. In doing so, an entity uses all reasonable and supportable information to develop its forecasts of future events and conditions. The process of developing specific projections includes consideration of past events, historical trends, existing conditions, and current and forecast economic events and trends to evaluate and project the set of circumstances that will prevail in the future. Then, the estimate of credit losses for the foreseeable future is the estimated amount of losses that an entity expects as a consequence of those specific projections of future events and conditions.
- B13 Similarly to developing a remaining lifetime expected loss estimate, in developing the estimate of expected credit losses for the foreseeable future an entity would generally consider historical data, including loss occurrence patterns, and current and forecast economic events and trends. While historical data and trends are considered, development of the estimate relies heavily on an entity's ability to forecast events and conditions that will exist in the foreseeable future period.
- B14 As the period over which the entity can develop specific projections of events and conditions, the foreseeable future would be a fairly constant period that would not be expected to change significantly from period to period for a particular portfolio. However, the foreseeable future period may differ for different asset classes according to the characteristics of those asset classes. For some, but not necessarily all, asset classes, the estimate of expected credit losses in the foreseeable future period may correspond to historical loss occurrence patterns. The emphasis is not on the loss occurrence pattern but instead on the losses expected to occur within the foreseeable future period.
- B15 The foreseeable future period may be the same as or shorter than the remaining average expected life of a portfolio of financial assets. For classes of financial assets with a shorter-term expected life, the foreseeable future may encompass the full remaining average expected life of the portfolio, to the extent that the time horizon for which management can develop specific projections of events and conditions captures that full remaining average expected life. For other asset classes, the foreseeable future might be shorter than the remaining average expected life of the portfolio. If the foreseeable future is shorter than the remaining average expected life, then no further consideration is given to the time period outside the foreseeable future period to determine losses for the foreseeable future.
- B6 Depending upon the expected life of the open portfolio of financial assets, two loss estimates may be required to apply the credit impairment model set out in this document. The time proportional expected loss estimate is based on the expected losses for the remaining life of the pool of financial assets. The floor, based on expected credit losses for the foreseeable future, may encompass a shorter time period than the remaining expected life of the pool of financial assets.
- B7 This supplement does not mandate a specific approach for developing loss estimates for the expected life of an open pool of financial assets. As a practical matter, for pools of financial assets with longer expected lives, determining the time-proportional allowance amount would involve developing expected loss estimates for both shorter-term and medium-term time periods and for time periods that are farther into the future. For example, for shorter-term and medium-term time periods, entities may develop projections of expected losses on the basis of specific inputs, such as forecast information. At the end of that period for which specific projections of events and conditions can be developed, an entity could then revert to a long-term average loss rate for the more distant time periods.

Time-proportional expected credit losses

- B8 An entity shall determine the time-proportional expected credit losses in accordance with paragraph 2(a)(i) either:
 - (a) by multiplying the entire amount of credit losses expected for the remaining life of the portfolio by the ratio of the portfolio's age to its expected life (ie a straight-line approach using either a discounted or undiscounted estimate); or
 - (b) by converting the entire amount of the credit losses expected for the remaining life of the portfolio into annuities on the basis of the expected life of the portfolio and accumulating these annuities for the portfolio's age (which includes accruing notional interest on the balance of the allowance account) (ie an annuity approach, which by definition, uses a discounted estimate).

Note: the FASB did not deliberate this issue. This issue was a decision reached by the IASB only.

- B9 For the purpose of determining the time proportional expected credit losses, the age and the total expected life of the portfolio are weighted averages. At each reporting date, those weighted averages are updated. The age of a portfolio is based on the time that the financial assets within the portfolio have been outstanding since they were initially recognized by the entity. The total expected life of a portfolio is based on the time that the financial assets within the portfolio are expected to be outstanding from inception to maturity (for example, considering prepayment, call, extension and similar options and defaults).
- B10 When using a discounted expected credit loss amount, an entity may use as the discount rate any reasonable rate between (and including) the risk-free rate and the effective interest rate (as used for the effective interest method in IAS 39). (Note: the FASB did not deliberate this issue. This was a decision reached by the IASB only.)

Impairment allowance balances

B24 The standard requires certain disclosures in respect of the impairment allowance balances. An entity shall maintain suitable and separate accounts and records commensurate with its nature and complexity of operations.

Illustrative examples

These examples accompany, but are not part of, the supplementary document.

Examples of mechanics

IE1 Computation of expected credit loss (ECL) by a Bank called 'Dynamic'

- a) The bank is an international bank operating in over 75 countries. It has sophisticated credit risk management systems and process and has implemented sophisticated techniques/tools to measure credit risk and credit loss. Its techniques and tools have received necessary regulatory approval under advanced internal rating approach (AIRB) under Basel II Accord
- b) The bank accordingly has developed risk models to produce key credit risk parameters viz. Risk Grades, Probability of Default (PD), Loss given Default (LGD), Exposure at Default (EAD).
- c) The bank has evaluated IFRS xx principles for estimating expected credit losses and considers that its Risk Grades, PD and LGD models would meet those IFRS principles and enable estimation of expected credit loss. EAD models do not meet IFRS principles because those can produce exposure amounts higher than the carrying amounts of the financial asset (s) and may lead to excess expected credit loss.
- d) Illustration does not explain the mechanics of the computing or estimating the risk parameters or controls/process over those models. Also, expected credit loss computation requirements for regulatory capital purposes may be different from the approach shown below.
- e) The following table depicts the details of the banks' portfolio of financial assets measured at amortized cost as of reporting date and the computation of the expected and incurred credit loss thereof.

Borrower name	Nature of exposure	O/s exposure (CU)	Risk grade	PD (%)	LGD (%)	Collateral & value (CU)	Net exposure (CU)	Credit loss (CU)
1	2	3	4	5	6	7	8 = 3-7	9 = 5x6x8
Commercia	al banking division -Or	n balance she	et exposures	3	ľ			
Α	Term loan	1000	AAA	0.02%	60.00%	0	1000	0.12
В	Overdraft	500	AA	0.03%	60.00%	0	500	0.09
С	Import Loan	700	Α	0.10%	45.00%	0	700	0.32
D	Export Loan	500	BBB	0.40%	20.00%	Cash – 100	400	0.32
Е	Bills discounted	1000	BB	2.25%	40.00%	0	1000	9.00
F	Term loan	1000	В	10.00%	30.00%	Building - 300(2)	1000	30.00
G	Bonds	200	С	30.00%	60.00%	0	200	36.00
Н	Term loan	2000	D	100.00%	50.00%	0	2000	1000.00
	l	L		Total ECL fo	or 'Impaired' o	or 'Non-Perfo	rming' book	1036.00
			Т	otal ECL for	'Non-Impaire	d' and 'Perfo	ming' book	39.85
Commercia	al banking division -Of	f balance she	et exposures	;				
В	Loan commitment (3.1)	200	AA	0.03%	60.00%	0	0	0.00
С	Letter of credit issued (3.3 below)	1000	Α	0.10%	45.00%	0	200	0.09
G	Financial guarantee	1000	С	30.00%	60.00%	Cash – 200	800	144.00
		'		Total ECL fo	or 'Impaired' o	or 'Non-Perfo	rming' book	144.00
			Т	otal ECL for	'Non-Impaire	d' and 'Perfo	ming' book	0.09
				Total	ECL for com	mercial bank	ing division	1219.94

а	Residential mortgage	500	Aaa	0.10%	25.00%	House- 525 (2)	500	0.13
b	Personal loan	100	Aa	1.15%	45.00%	0	100	0.52
С	Car loan	100	Α	3.00%	40.00%	Car - 100(2)	100	1.20
d	Student loan	50	Baa	5.00%	70.00%	0	50	1.75
е	Residential mortgage	200	Ва	6.00%	25.00%	House- 225 (2)	200	3.00
f	Overdtaft	100	В	20.00%	60.00%	0	100	12.00
g	Sub-prime mortgage	150	С	40.00%	50.00%	House- 125 (2)	150	30.00
h	Credit card	100	D	100.00%	80.00%	0	100	80.00
	-	'	<u>'</u> ,	Total ECL for	'Impaired' or	'Non-Perform	ing' book	110.00
			To	otal ECL for 'I	Non-Impaired	' and 'Perform	ing' book	18.59
Total ECL for Retail banking division								
Total ECL for the bank								
Total ECL for 'Impaired' or 'Non-Performing' book								
			T	stal ECL for "	Non Impaired	' and 'Perform	ing! book	1,290.00 58.53
			10	olai EGE IOI I	Non-impaired	and Fenomi	iiig book	30.33
				Total	ECL for on ba	lance sheet e	xposures	1204.44
				Total	ECL for off ba	lance sheet e	xposures	144.09
Notes								
	ounts in Risk grades 'AA are segregated as 'Non							
perform	ning' book.	•	•			·		
	veries on account of no herefore, not reduced whi							
	alance sheet exposures sion factor' as follows:	are converted	into cred	it equivalent	s using perc	entage called	d ' credit	
	an commitments cancella	ole at bank's so	le discretion	on or in the e	vent of deteri	oration of cred	dit quality	0%
	in commitments other than	those in 3.1 a	ibove					100%
3.3) lm	port letters of credit secur	ed by underlying	g shipment	s/goods				20%
3.4) lm	port letters of credit other	than those in 3.	3 above					100%
- /								

IE2 Computation of total credit loss (Expected and Incurred) by a Bank called 'Simple'.

- a) The bank is an emerging market based bank with predominantly domestic operations and limited international presence. In view of the less complex nature of its operations and evolving nature of risk profile, it currently adopts simple credit risk management systems and processes.
- b) Its credit loss estimate process involves the following:
 - Segregation of borrowers and credit exposures into four risk buckets viz. Standard, Sub-standard, Doubtful 1, Doubtful 2 and Loss.
 - ii. Credit exposures in 'Standard' category are analysed into industry/business category for commercial credits or type of credit product for consumer credits.

iii. Credit loss estimate is computed by applying a standard provision matrix as follows.

Risk buckets	Commerc	cial credits	Consum	ner credits
	Industry type	Provison %ge	Facility type	Provision %ge
Standard	Textiles, Electronics	1.25%	Credit cards	4.0%
	Capital market	2.0%	Personal loans	3.0%
	Real estate & infrastructure	2.0%	Car loans	3.0%
	Manufacturing	0.75%	Residential Mortgage	0.5 - 1.0%
	Trading	1.0%		
	Services	1.0%		
	Financial services	1.5%		
	Others	1.0%		
Sub-standard		10% of exposu	ıre after collateral value	
Doubtful -1		30% of exposu	ıre after collateral value	
Doubtful – 2		50% of exposu	re after collateral value	
Loss		100% of expos	ure after collateral value	
Notes:	1)Value of non-cash c collateral and its liquidit		hair cut (margin) and varie	s based upon nature of

c) The following table depicts the details of the banks' portfolio of financial assets measured at amortized cost as of reporting date and the computation of the expected and incurred credit loss thereof.

Borrower name	Nature of exposure	O/s exposure (CU)	Risk bucket	Industry or facility type	Provision (%)	Collateral & value (CU)	Net exposure (CU)	Credit loss (CU)	
1	2	3	4	5	6	7	8 = 3-7	9 = 6x8	
Commercial banking division -On balance sheet exposures									
Α	Term loan	1000	Standard	Manufacturing	0.75%	0	1000	7.50	
В	Overdraft	500	Standard	Capital market	2.00%	0	500	10.00	
С	Import Loan	700	Standard	Manufacturing	0.75%	0	700	5.25	
D	Export Loan	500	Standard	Textiles	1.25%	Cash – 100	400	5.00	
E	Bills discounted	1000	Standard	Trading	1.00%	0	1000	10.00	
F	Term loan	1000	Sub- standard	Real estate	10.00%	Building - 300(2.2)	700	70.00	
G	Bonds	200	Doubful 1	Financial services	30.00%	0	200	60.00	
Н	Term loan	2000	Loss	Electronics	100.00%	0	2000	2000.00	
	Total ECL for 'Impaired' or 'Non-Performing' book								
Total ECL for 'Non-Impaired' and 'Performing' book								107.75	
Commerci	al banking divis	ion -Off bala	nce sheet ex	cposures					

В	Loan commitment (3.1)	200	Standard	Manufacturing	0.75%	0	0	0.00
С	Letter of credit issued (3.3 below)	1000	Standard	Manufacturing	0.75%	0	200	1.50
G	Financial guarantee	1000	Doubtful -1	Services	30.00%	Cash – 200	800	240.00
				Total ECL for	'Impaired' or	'Non-Perfor	ming' book	240.00
				Total ECL for 'N	Non-Impaired	l' and 'Perfor	ming' book	1.50
				Total E	CL for comr	nercial banki	ing division	2409.25
Retail b	oanking division -On	balance sh	eet exposur	es			•	
Α	Residential mortgage	500	Standard	Residential mortgage	0.50%	House- 525 (2.1)	500	2.50
В	Personal loan	100	Standard	Personal loan	3.00%	0	100	3.00
С	Car Ioan	100	Standard	Car loan	4.00%	Car - 100	100	4.00
D	Student loan	50	Standard	Personal loan	3.00%	0	50	1.50
E	Residential mortgage	200	Standard	Residential mortgage	0.50%	House- 225 (2.1)	200	1.00
F	Overdtaft	100	Sub- standard	Personal loan	10.00%	0	100	10.00
G	Sub-prime mortgage	150	Doubtful- 2	Residential mortgage	100.00%	House- 125 (2.2)	25	25.00
Н	Credit card	100	Loss	Credit card	100.00%	0	100	100.00
			•	Total ECL for	'Impaired' or	'Non-Perfor	ming' book	125.00
				Total ECL for 'N	Non-Impaired	l' and 'Perfor	ming' book	22.00
				٦	Total ECL for	Retail banki	ng division	147.00
						Total ECL fo	or the bank	2,556.25
				Total ECL for	'Impaired' or	'Non-Perfor	ming' book	2,425.00
				Total ECL for 'N	Non-Impaired	l' and 'Perfor	ming' book	131.25
				Total E	CL for on ba	alance sheet	exposures	2314.75
				Total E	CL for off ba	alance sheet	exposures	241.50
Notes								
division	ounts in Risk grades are segregated as ' ning' book.							
	ment of collaterals							
such a	case financial asset s building, plant etc ting net exposures to	are factor	red in comp	outing 'provision '	%ge', therefo	of non-cash ore, not red	collaterals uced while	
collater	case financial assets als such as building omputing net exposu	, plant etc	are not facto	red in computing	'provision %	n account o ge', therefor	f non-cash e, reduced	
	alance sheet exposion factor' as follows		onverted into	o credit equivaler	nts using per	centage cal	led ' credit	
	oan commitments caration of credit qualit			ank's sole discre	tion unilatera	ally or in the	e event of	0%
	an commitments other			ove				100%

3.3) Import letters of credit secured by underlying shipments/goods	20%
3.4) Import letters of credit other than those in 3.3 above	100%
3.5) Financial guarantees and other direct substitutes	100%

Basis for Conclusions on the supplementary document Financial Instruments: Impairment

This Basis for Conclusions accompanies, but is not part of, the supplementary document.

Text not reproduced here. The current text requires changes/modification based on the suggestions made for amending the standard.

Presentation and disclosure

Presentation

- Z5 The statement of comprehensive income shall include separate line items that present the following amounts for the period:
 - (a) interest revenue (calculated using the effective interest method).
 - (b) impairment losses (including reversals of impairment losses).

Disclosure

Classes of financial instruments and level of disclosure

When this appendix to the supplementary document requires disclosures by class of *financial asset*, an entity shall group financial assets into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those *financial instruments* (including their grouping into portfolios). An entity may use another criteria or parameter other than class of financial asset such as a business division or geographic segment provided it is in accordance with its internal credit risk management practices. An entity shall provide sufficient information to permit reconciliation to the line items presented in the statement of financial position.

Allowance account

- 27 For financial assets which are subject to impairment allowance measured at amortised cost an entity shall use an allowance account (s) to account for credit losses. An entity shall disclose for each class or other criteria used for disclosure, of financial assets:
 - (a) separate reconciliations of changes during the period in the allowances determined in accordance with paragraph 2(a) and (b);
 - (b) separate reconciliations of changes during the period in the allowances recognized for all financial assets (s) and financial instruments in accordance with paragraph 1(a), (b) and (c).
 - (b) if the amount determined in accordance with paragraph 2(a)(ii) is higher than that determined in accordance with paragraph 2(a)(i), the difference between those amounts; and
 - (c) a reconciliation of the nominal amounts of the financial assets for which the impairment allowance is determined in accordance with paragraph 2(ab). That reconciliation shall include disclosure of the nominal amount of financial assets for which the impairment allowance is no longer determined in accordance with paragraph 2(b) but instead in accordance with paragraph 2(a) and where the change is a consequence of a modification of contractual term(s).
- Z8 For financial assets for which the impairment allowance is determined in accordance with paragraph 4(b)2(a) an entity shall disclose in a tabular format for the current annual period and the previous four annual periods:
 - (a) the total nominal amount of the financial assets;
 - (b) the total amount of expected credit losses;
 - (c) the amount of the impairment allowance; and
 - (d) if applicable, the amount determined in accordance with paragraph Z7(b).

Interest income in respect of financial assets (s) segregated as 'Impaired or Non-performing' book.

An entity shall disclose reconciliations of changes during the period in the balances of interest due on impaired or non performing accounts.

Expected credit loss estimates

- Z9 An entity shall disclose information that explains the estimates and changes in estimates that are required to determine the impairment allowance.
- Z10 An entity shall explain the inputs and assumptions used in determining the entire amount of expected credit losses and the amount of credit losses expected to occur within the foreseeable future (which shall be at least twelve months), including the time period used as the foreseeable future and how that determination was made (see paragraph 2(a)(ii)). For this purpose an entity shall disclose, separately for both amounts:
 - (a) the basis of inputs (eg internal historical information or rating reports) and the estimation technique;
 - (b) an explanation of the changes in estimates and the cause of the change (eg loss severity, change in portfolio composition); and
 - (c) if there has been a change in estimation technique, disclosure of that change and the reason for the change.
- Z11 An entity shall disclose quantitative and qualitative analyses of significant positive or negative effects on impairment losses that are caused by a particular portfolio or geographical area.
- Z12 An entity shall disclose information about how previous estimates of expected credit losses compare with actual outcomes:

- (a) when an entity performs back testing, it shall disclose a quantitative analysis that compares the actual outcomes and the previous estimate of expected credit losses. The analysis shall enable users to understand the difference between the actual outcomes and the previous estimate. For that purpose, a qualitative explanation may be necessary in some instances (eg when the actual outcome is higher than previously expected for mortgages because of a worse than expected development in house prices).
- (b) when an entity does not perform back testing, it shall disclose a qualitative analysis of expected credit losses and the actual outcomes to enable users of its financial statements to understand the differences between the actual outcomes and the entity's previous estimate (eg when credit losses are more severe than previously expected for mortgages because of a worse than expected development in house prices).

Credit risk management

- Z13 An entity shall disclose information about its internal *credit risk* management processes in order to enable users of its financial statements to gain a better understanding of the relationship between how financial assets are managed and how expected credit losses are estimated.
- Z14 An entity shall disclose by credit risk rating grades:
 - (a) the nominal amount of financial assets in a grade; and
 - (b) other information including:
 - (i) the entire amount of expected credit losses for a grade; and
 - (ii) the amount of credit losses expected to occur within the foreseeable future (which shall be no less than twelve months after an entity's reporting date) (see paragraph 2(a)(ii))-for a grade.

The number of credit risk rating grades used for this disclosure shall be sufficient to enable users of the entity's financial statements to evaluate the extent of credit risk. The number of grades shall not exceed the number that the entity uses for internal credit risk management purposes. However, at a minimum the grades must allow differentiation between financial assets for which impairment allowances are determined in accordance with paragraph 42(a) and (b). Information about expected credit losses could include, for example, information about loss given default (amount expected to be impaired given a default), exposure at default and probability of default.

Z15 An entity shall also disclose:

- (a) a qualitative analysis that describes the criteria used to determine how financial assets are managed to distinguish between those for which impairment allowances are determined in accordance with paragraph 42(a) and (b), including the criteria that determine whether the entity applies paragraph 42(a) or paragraph 42(b);
- (b) when an entity uses internal credit rating grades, information about those rating grades. An entity could meet that requirement by providing, for example, the following information:
- (i) a comparison with external ratings, if available;
- (ii) a description of the credit rating grades used; and
- (iii) if an entity uses a watchlist, a description and the criteria for including or no longer including financial assets in the watchlist;
- (c) how the internal credit rating grades are assigned to financial assets for which impairment allowances are determined in accordance with paragraph 42(a) and (b); and
- (d) when applicable, how the watchlist relates to the criteria that determine whether the entity applies paragraph 42(a) or paragraph 42(b).

Appendix AZ

Defined terms

This appendix is an integral part of Appendix Z.

The following terms are defined in paragraph 11 of IAS 32 *Financial Instruments:Presentation*, paragraph 9 of IAS 39 or Appendix A of IFRS 7 and are used in this appendix to the supplementary document with the meanings specified in IAS 32, IAS 39 or IFRS 7:

- (a) amortised cost of a financial asset or financial liability
- (b) credit risk
- (c) effective interest method
- (d) financial asset
- (e) financial instrument.

Watchlist

A list that comprises financial assets or debtors for which information has indicated increased uncertainty about a financial asset's collectibility to such a degree that the entity considers the asset needs to be monitored more closely.

Appendix BZ

Application guidance

This appendix is an integral part of Appendix Z.

Presentation and disclosure

Disclosure

BZ17The disclosures required in this appendix to the supplementary document shall be either given in the financial statements or incorporated by cross-reference from the financial statements to other statements that are available to users of the financial statements on the same terms as the financial statements and at the same time. Without the information incorporated by cross-reference, the financial statements are incomplete.

Classes of financial instruments and level of disclosure

- BZ18 Paragraph Z6 requires an entity to group financial assets into classes that are appropriate to the nature of the information disclosed and that take into account the characteristics of those financial assets. These classes are determined by the entity and are, thus, distinct from the measurement categories of financial assets (which determine how financial assets are measured and where changes in fair value are recognised).
- BZ19 An entity decides, in the light of its circumstances, how much detail it provides to satisfy the requirements of this appendix to the supplementary document, how much emphasis it places on different aspects of the requirements, how it aggregates information to display the overall picture without combining information with different characteristics and whether users of financial statements need any additional information to evaluate the quantitative information disclosed. It is necessary to strike a balance between overburdening financial statements with excessive detail that may not assist users of financial statements and obscuring important information as a result of too much aggregation. However, when an entity determines the level of aggregation or disaggregation, it shall consider the level of aggregation or disaggregation it uses for other disclosure requirements in IFRS 7. For example, an entity shall not obscure important information by including it among a large amount of insignificant detail. Similarly, an entity shall not disclose information that is so aggregated that it obscures important differences between individual transactions or associated risks.
- BZ20 As an example for a financial institution, financial assets might be grouped into classes based on the following characteristics:
 - (a) government and central banks (further disaggregated into countries with AA ratings (or equivalent) and above, and countries with A ratings (or equivalent) and below);
 - (b) financial institutions;
 - (c) corporate;
 - (d) retail (further disaggregated into secured by real estate collateral, qualifying revolving retail, retail loans to small and medium-sized entities and other);
 - (e) securitised financial assets; and
 - (f) below investment-grade.
- BZ21 As an example for a non-financial institution, financial assets might be grouped into classes based on the following characteristics:
 - (a) collateralised wholesale;
 - (b) non-collateralised wholesale;
 - (c) collateralised retail;
 - (d) non-collateralised retail; and
 - (e) credit card business.

Allowance account

- BZ22 The disclosure requirements in paragraph Z7(a) (c) shall be presented by asset class in tabular format:
- BZ23 An entity shall include all write-offs in the reconciliation of changes in the allowance account (ie on a gross basis as both an addition to and a use of the allowance account). This applies even if a financial asset becomes impaired and is written off in the same period. Hence, direct write-offs against the contractual amount of financial assets without using an allowance account are prohibited.
- BZ24 When a financial asset is transferred between the two groups that are differentiated for the purpose of determining the impairment allowance in accordance with paragraph 2, the amount that is transferred between the impairment allowances for the two groups shall be determined in accordance with paragraph 2(a)(i).

BZ25 When a financial asset is transferred between the two groups that are differentiated for the purpose of determining the impairment allowance in accordance with paragraph 2 because it is no longer appropriate to recognise expected losses immediately, an entity shall disclose as part of the reconciliation in paragraph Z7(c) the nominal amount of those financial assets transferred if the contractual terms were modified in relation to that transfer. A modification of contractual terms is related to the transfer if it is the cause for transferring the asset. However, sometimes it is not obvious that the modification of contractual terms was the cause because the transfer might result from multiple factors (eg an improving economic outlook for the sector in which the debtor operates, a rise in the value of collateral, raising of equity by the debtor, restructuring of the debtor's debt by other creditors or a takeover of the debtor by another party). In such circumstances the modification shall be considered related to the transfer. Conversely, if for example the contractual terms of a financial asset were modified several years before the transfer while the financial asset had a high-credit grade, that modification of contractual terms would not be related to the transfer of the financial asset. Hence, an entity does not need to track and evaluate all modifications of contractual terms that were ever made from the date of entering into the contract.

Illustrative examples for Appendix Z

These examples accompany, but are not part of, the supplementary document.

Example of mechanics

Transfer between 'good book' and 'bad book'

- IEZ15 The supplementary document would require an entity to place its financial assets into two groups (the 'good book' and the 'bad book') depending on the entity's assessment of the degree of uncertainty about the collectability of the financial asset. At each reporting period, an entity must estimate expected credit losses for the remaining average expected life and the foreseeable future period, and determine the time-proportional allowance balance needed to be recognised based on the weighted average age and weighted average life of the portfolio for financial assets in the 'good book'. For the 'bad book' the entire amount of expected credit losses is recognised. Paragraph BZ24 of Appendix Z to the supplementary document requires the impairment allowance to be transferred between the two groups to be determined in accordance with paragraph 2(a)(i) of the supplementary document (ie the time-proportional amount).
- IEZ16 Therefore, an entity would determine the time-proportional amount for the allowance on the financial asset, or group of assets, that are being transferred to the 'bad book'. The weighted average age and weighted average life of the transferred financial assets should be used to determine the time-proportional amount. However, the age and life of the transferred financial assets may not be equal to the weighted average age and weighted average life of the portfolio.
- IEZ17 After the financial asset, or group of financial assets, is transferred between the 'good' and 'bad' book with the time-proportional allowance balance (based on the weighted average age and weighted average life of the transferred financial asset, or group of financial assets), the amount of expected credit losses is re-estimated for both the 'good' and 'bad' books. On the basis of those estimates, the allowance amount is adjusted (using the 'higher of' test set out in paragraph 2(a)).
- IEZ18 The following table illustrates the mechanics for transferring the time-proportional amount from the 'good book' to the 'bad book' and how the allowance balance for the 'bad book' is determined. The same concept would be used to transfer from the 'bad book' to the 'good book'.

Basis for Conclusions on Appendix Z to the supplementary document

Financial Instruments: ImpairmentThis Basis for Conclusions accompanies, but is not part of, Appendix Z.

Text not reproduced here. The current text requires changes/modification based on the suggestions made for amending