



March 31, 2011

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

Dear Board Members:

Consejo Mexicano para la Investigación y Desarrollo de Normas de Información Financiera (CINIF), the accounting standard setting body in Mexico, welcomes the opportunity to submit its comments on the Supplement to the Exposure Draft on *Financial Instruments: Impairment* (the ED), issued for exposure in January 2011. Set forth below you will find our comments on the topics included in the ED, as well as our responses to the questions included therein.

We have divided our letter in two sections. In the first section you will find our general comments on the ED. The second section includes our responses to the specific questions raised in the ED.

General comments on the ED

In general, we support the efforts of the IASB to establish principles on which an allowance for losses will be provided based on expected losses. This will improve the reliability of the financial information presented in the financial statements regarding financial instruments.

We prefer that all loan commitments be accounted at fair value through profit or loss, since this will capture not only impairment issues, but also interest rate issues. If not, we believe that all loan commitments that are not accounted for at fair value through profit and loss should be subject to the impairment requirements proposed in the supplementary document. Our rationale is described in our answer to Question 15Z.

Due to the complicated and laborious implementation of this standard, we recommend that its effective date be delayed. Further, as the modifications that this standard will require are, to a large extent, changes in estimates, we believe that retrospective application would be neither appropriate nor advisable. We note that paragraph 35 of IAS 8, *Accounting policies, changes in accounting estimates and errors*, indicates that "When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate." Accordingly, prospective recognition is called for in this case.

The original exposure draft required that the balances be adjusted as of the earliest period presented. We believe that what should be done is to recognize the effect in the year of adoption of the new standard as a change in accounting estimate pursuant to IAS 8.

Our concerns are explained in the response to the specific questions raised in the ED.

Our responses to the specific questions raised in the ED

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?

Yes, we believe that this supplement will avoid deferring recognition of credit losses until the end of the life of the loans, which in most cases occurs well before the end of the life of a vintage of an open portfolio. Recognizing losses in the “foreseeable period” will improve the timeliness of their accounting recognition.

However, absent nonrecurring circumstances such as the recent financial crisis, a question we have is if a provision can or should be recognized during the latter years of the life of loans that are paid in installments, since what would be provided for those years would be for the ‘good book’, which is rarely subject to default in the latter years.

We believe that, in such cases, the provisions should not continue up through the latter years, but rather be discontinued when experience indicates that defaults do not occur in such years. For instance, in the case of mortgage loans, the owners of the house will rarely default in the latter years, since they are close to owning a house free of any encumbrance. For other types of loans, such as commercial loans, loans granted for agricultural and cattle raising activities and to housing builders and promoters, where losses often arise when the loan has to be renegotiated in order for the borrower to continue operations, or when the product it was intended to finance is no longer available, provisions should continue to be accounted for in the latter part of the life of the loans.

When a financial crisis arises, there are generally changes in the usual patterns, and therefore the recognition of the provisions should be over a shorter period for those recognized on a time-proportional basis, and the foreseeable future may have to be extended.

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.

Yes, we believe that the methodology proposed in the supplement will be as useful and operational for closed portfolios and other instruments as it is for open portfolios, since each of these could be considered as an individual vintage on which an allowance is

being provided. However, a problem in the case of closed portfolios is that they may represent a single transaction, as for instance when a group of loans is purchased by a fund. Therefore, there may be little or no prior experience on which to determine the expected losses. This may be problematic unless there are statistics on the amount of losses incurred on similar loans.

Generally, this information will be available for loans the banks maintain for their full life, but if a portfolio of loans is purchased by funds to obtain revenue on their contractual cash flows, information might not be available.

However, when a loan portfolio is purchased, the acquirer and/or its advisors make projections of the expected losses to set the price of the transaction. These expectations are the ones that should be used to provide for the expected losses.

Also, regarding scope, the supplement scopes out trade receivables. We believe that trade receivables of department stores that are financed and managed as consumer loans should be included in the scope. This may be implied, but we recommend it to be explicit.

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?

Yes, we believe that the expected losses of loans that are transferred to the 'bad book' should be recognized in their entirety upon transfer and that the allowance should be periodically reviewed and adjusted. Regarding the 'good book', the allowance should be recognized over the life of the loans in proportion to the interest earned, and, in addition, those losses expected to occur in the foreseeable future should be the minimum allowance recognized at any time.

Question 4

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

We believe that recording the allowance on a time-proportional basis will be operational, since entities can determine, based on the future payments of principal and interest, the estimated cash flow of interest to allocate the expected losses in a proportion that will match the interest earned for each vintage of loans. We do not believe that recognition of the impairment provision on a straight-line basis is appropriate, since it will not match the interest earned in all cases, which is generally higher at the beginning of the life of the loans that have amortization of principal throughout their life.

We propose that as a practical expedient, an inverse sum-of-the-digits method be used to allocate the time proportional allowance in those cases where the loans are paid in installments that decrease the amount of principal with each installment, and, therefore, the basis on which interest is computed. For instance, in the case of a 20-year mortgage loan, the sum of the digits for 20 years would be 210: accordingly, in the first year the allowance allocated to such year would be 20/210, the second year it would be 19/210 and so forth. In fact, using this method, regardless of the term of the loan, the approximate amortization by quarter of the total term would be as follows: Q1 = 40%; Q2 = 30%; Q3 = 20%; and Q4 = 10%. This would appear to allow a reasonable matching of the impairment provision with interest earned over the life of the loan.

This could also be applied to loans acquired during their life, since what would have to be done is determine the number of years to final maturity. If a loan was acquired eight years before its final maturity, the sum of the digits would be 36 and result in an allocation by quarter of the total term of 42%, 30%, 20% and 8%, respectively.

Also, discounting the amount of expected losses on a straight-line basis, as shown in examples IE 13 and IE 14, would increase the provisions recognized in the latter years of a loan. Even if this procedure might be considered adequate for loans that have a single payment of principal at the end of their life, we believe it would not be appropriate to defer the recognition of part of the provision, when the interest is recognized on a different basis.

In such cases the input from the risk managers as to the pattern to provide a provision on a portfolio that has a single principal payment at the end of its life should be considered.

Question 5

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

Considering the above comments, the proposed approach would provide information that would be useful for decision making, since the allowance would be provided over the years in which there are expectations that loans will default in proportion to the revenues that are being recognized.

In this regard, each entity will have to explain its assumptions to provide both on a time-proportional and a foreseeable future basis.

Question 6

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

We believe that the principle set out in paragraph 3 is clearly described and will be very useful since it will guide when a loan should be considered to be transferred to the 'bad book', instead of following the myriad of rules that are being followed today by banks that are regulated by financial authorities. We understand that those rules are imposed by regulators and that they will continue to do so; however, they will be able to do it based on a principle followed internationally and not solely on each country's experience. We urge that the principle in paragraph 3 be written in bold letters to highlight its importance.

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?

In order for the principle of "credit risk management objective" stated in paragraph 3 to be operational, the standard should provide guidelines to be used by regulators, starting with the Basle Committee, and permeated to the local regulators to have global consistency and uniformity. Also, in this way standardized audit procedures can be designed to verify that bad loans are transferred to the 'bad book' on a timely basis.

Guidelines are also necessary for all non-regulated entities, such as department stores that give financing to their customers and certain financial entities of industries that facilitate the financing of their products. In addition, such entities will have to provide sufficient explanation of their criteria to distinguish the “good book” from the “bad book”.

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?

Yes, we believe it is imperative to differentiate the ‘good book’ from the ‘bad book’, both in their total amount and in the amount of the related allowance, and it should be made by class of loans (homogeneous loans). This will provide very useful information about the credit risk management capabilities of each entity.

We also believe that when a loan is transferred to the ‘bad book’, the primary objective of management is no longer to collect interest but rather the entire amount due, and accordingly, interest should no longer be accrued when the loan is transferred to the ‘bad book’. This would align interest recognition with management’s actions regarding a loan.

This should be adequately explained in the standard, with reference to the proposed revenue recognition standard, which establishes that “an entity shall reduce the amount of promised consideration to reflect the customer’s credit risk”, thereby including the uncertainty of collectibility in the measurement of revenue.

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?
- (d) For the foreseeable future, would the period considered in developing the expected loss estimate change on the basis of changes in economic conditions?
- (e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.
- (f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a ‘ceiling’ should be established for determining the amount of credit impairment to be recognised under the ‘floor’ requirement (for example, no more than three years after an entity’s reporting date)? If so, please provide data and/or reasons to support your response.

Regarding the minimum allowance proposed:

- a) We agree that the minimum allowance should cover the losses expected to occur in the foreseeable future, since it is common that losses occur more

frequently in the early years of the life of the loans. Most likely, this minimum allowance will disappear in the latter years of the loans, when fewer defaults are expected.

- b) We believe that a minimum allowance should be required in all cases. If there is an early loss pattern, that will increase the minimum allowance since the foreseeable future will have to consider such pattern.
- c) We agree that the minimum allowance should be determined based on the foreseeable future, which should include at least twelve months, which is the usual term for which banks make a detailed forecast. Beyond that term generally refers to a business plan. However, the business plan may be sufficiently detailed for the medium term and have supportable information to consider that the foreseeable future goes beyond one year. This is the case in which the forecast is prepared on a monthly basis in the first year and on a quarterly basis (with sufficient detail and support) for the second year, and in some cases even for a third year. This happens very often, as management wants to have a forecast for more than one year, even if it is not as detailed after the first year.
- d) Yes, we believe that changes in economic conditions may require revision of the forecast period used for the foreseeable future. If it is clear that a downturn in the economy is imminent and may continue over more than one year, that would be sufficient to consider that the foreseeable future for the loss pattern be at least two years.
- e) We believe that in most cases the foreseeable future exceeds one year, since businessmen, especially bankers, want to have a medium-term view that would enable them to make better projections and, in the case of bankers, to fine tune their credit granting policies. Also, depending on the type and term of the loan, the foreseeable future may be different. For mortgage loans the foreseeable future may be longer than for consumer loans that have a term not exceeding two years.
- f) We believe that the ceiling on the foreseeable future should be the one covered by a forecast and a detailed business plan. We agree that typically that will be two to three years.

Question 10

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

We believe that the minimum allowance will typically be higher than the amount provided in proportion to interest earned in the early years of the life of the loans in a vintage, as loans tend to default more in those years. However, it will tend to be lower in the latter years when the rate of defaults in the 'good book' decreases. This will allow a proper allowance to be provided in the years when there is a higher occurrence of defaults.

Many bankers believe its implementation will be more difficult, due to the increased complexity of the operating models that will be necessary to determine the amount for each vintage in each portfolio.

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?

As previously indicated, we believe that the use of discounted amounts should not be permitted, since, as shown in the examples in paragraphs IE 13 and IE14, there would be a higher provision at the end of the life of the loans when it is no longer needed. In that respect:

- a) We believe that the best way to allocate the time-proportional allowance is in proportion to the stream of revenues of the vintage. In those cases where loans are paid on installments, such as mortgages, consumer loans and certain commercial loans, the allowance will be front-loaded, as is the recognition of revenue.
- b) Regarding the discount rate, as we believe that the allowance should not be discounted, we prefer not to answer such question.

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?

Regarding which method we would prefer, we have concerns that the original IASB method would be too theoretical without a minimum allowance that experience indicates should exist. We therefore believe that the minimum allowance provides a practical expedient, without diverging significantly from a proper matching of the recognition of revenues and credit losses.

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?

We believe that the FASB approach will overly front-load the recognition of losses and would be far from having a proper matching of revenue and expense recognition. Therefore, it would be overly conservative, benefiting future shareholders at the expense of current shareholders. It is a natural human reaction to the crisis that caught many banks in the United States with very low allowances for loan losses, but it may not be good for financial information and recognition of the allowance.

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?

Yes, we believe that the determination of the effective interest rate should be separate from the consideration of expected losses. This was one of our comments on the original IASB proposal.

Question 15Z

Should all loan commitments that are not accounted for at fair value through profit or loss (whether within the scope of IAS 39 and IFRS 9 or IAS 37) be subject to the impairment requirements proposed in the supplementary document? Why or why not?

We prefer that all loan commitments be accounted at fair value through profit or loss, since this will capture not only impairment issues, but also interest rate issues. If not, we believe that all loan commitments that are not accounted for at fair value through profit and loss should be subject to the impairment requirements proposed in the supplementary document. Our rationale is because an irrevocable loan commitment will likely lead to granting the loan in the near future and, if there are problems with the credit standing of the borrower, it is likely that losses will be incurred on such loan. A decision should be made if the loan, since inception, will be in the 'good book' or the 'bad book', to determine if the allowance should include only the foreseeable losses or all the expected losses over the life of the loan.

Alternatively, if there are penalties for not honoring a loan commitment, provision for such penalties should be made, instead of determining a loss on a loan that the entity can avoid granting.

Question 16Z

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

Yes, because what will be required is to determine if the loan will be part of the 'good book' or the 'bad book' to provide the required allowance, as indicated in our answer to question 15Z.

Question 17Z

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

Yes, we agree that impairment should be presented as a separate line item in the statement of comprehensive income. However, we suggest that a subtotal of both line items be presented to show the net revenue from contractual interest. In any case, these two line items, less interest paid, will be shown as financial margin.

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?

We agree with all the proposed disclosure requirements, except for certain disclosures that we believe are excessive, such as the one required by paragraph Z8, which we believe should be presented only for the current year's financial statements and not for five years, especially in the year when this standard will be implemented, since it will be very difficult to prepare such information going back for five years. There will be no problem once the new standard has been implemented for several years. Also, the information by credit risk rating grades requested by paragraph Z14 is excessive. We suggest that it be limited to the 'good book'.

Regarding the disclosures about criteria to determine if a loan will be classified in the 'good book' or the 'bad book', as well as credit rating grades, we believe that entities will be reluctant to give more information than how the criteria established by the regulator is being followed.

We do not envisage any additional disclosure requirements.

Question 19Z

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

We have concerns about transferring only the amount of the related allowance reflecting the age of the financial asset when transferring assets between the two groups. We believe that if the allowance has been created considering the expected losses in the foreseeable future, the related portion of such allowance also must be transferred. It would not be logical that if expected losses have been provided on such basis, that when the loan is transferred to the 'bad book', the related allowance not also be transferred.

Should you require additional information on our comments listed above, please contact Juan M. Gras at (52) 55 5596 5633 ext. 105, William Biese at ext 113 or me at ext. 103 or by e-mail at jgras@cinif.org.mx, wbiese@cinif.org.mx or fperezcervantes@cinif.org.mx, respectively.

Sincerely,

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