



African Development Bank Group

Comments on IASB's Supplement to the Exposure Draft on Financial Instruments: Amortised Cost and Impairment-Impairment of Financial Assets Managed in an Open Portfolio

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We are pleased to comment on the IASB Supplement to Exposure Draft, Financial Instruments: Amortised Cost and Impairment - Impairment of Financial Assets Managed in an Open Portfolio. Our specific comments and responses to the Supplementary ED's questions to respondents are set out in Part II of this paper. In Part I, we provide a summary of our general comments.

PART I

General Comments and Summary of Responses:

We commend the Board for its efforts not only to address the weaknesses inherent in applying the expected cash flow approach to financial assets managed in an open portfolio, but also for working with FASB in order to come up with a common approach for accounting for impairment losses. This will enhance international comparability in this very challenging area of accounting for financial assets held at amortised cost. Overall, while we support proposals by the Board, we have certain concerns that revolve around the following:

- The limited re-exposure means that respondents may not be in a position to provide comprehensive feedback as there are many aspects of the impairment project yet to be deliberated on by the Board which are not included in the supplement.*
- There is likely to be a reduction in comparability due to the proposal in the supplement for reporting entities to link the recognition of impairment loss to their internal credit risk management thereby offering wider scope for judgment on how the proposals are implemented in practice. The Board needs to weigh carefully the tradeoff between comparability and simplicity in formulating the final standard.*
- Further, the issue of comparability also arises due to the definition of foreseeable future in the proposal “**as the time period over which specific projections of events and conditions are possible and can be used as the basis for reasonable estimates of expected credit losses**”. This definition offers very wide scope for judgment with*

entities with financial assets of similar characteristics in their portfolio likely to have different views about the length of time over which they can be able to make specific projections. Thus, those with better credit risk management systems are likely to be able to make specific projections over longer time periods than those whose systems are less sophisticated leading to the former entities carrying larger expected loss allowances than the latter entities. Expected impairment losses should reflect the underlying credit risk associated with a financial asset rather than the level of sophistication of an entity's credit risk management systems.

- Finally, there is lack of clarity on how the proposed model is to be applied in cases where loan products with different loan terms- fixed and variable- are extended to the same obligor. Since the risk of default of the obligor in this situation is the same should the reporting entity have multiple "good" and "bad" books based on the different loan interest rate terms?*

PART II

Comments on the Specific Questions to Respondents

General

Question 1

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

COMMENTS: Yes, the proposed model provides for earlier recognition of impairment losses in a manner that adequately addresses the weaknesses of the current incurred loss model in IAS 39.

Scope- Open Portfolios

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?

COMMENTS: It is proposed that the impairment model should be applied for closed portfolios, single assets and other instruments as well in order to reduce complexity that would arise from adoption of multiple impairment models. Since financial institutions manage their business and credit risk on a portfolio basis the impairment methodology should be applied on a portfolio basis in line with the credit risk management practices of the entity whether the portfolio is closed or not and whether the financial asset is a portfolio of one or more financial assets. The distinction between closed and open portfolio does not seem to add value. The impairment methodology should follow the business model of each entity as the primary driver and allow application on a single asset basis, open or closed portfolios basis, etc depending on how the reporting entity manages its business and credit risks.

Differentiation of credit loss recognition (paragraphs 2, 3 and B2–B4)

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?

COMMENTS: The recognition of the impairment allowance for the “good book” on the basis described above is appropriate. First because the distinction between “bad book” and “good book” is consistent with the way many financial institutions currently manage credit risk in their loan books.

Question 4

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

COMMENTS: Whereas the time proportional basis for determining the impairment allowance is theoretically appealing, from an operational standpoint it would present substantial challenges particularly with regard to

the system changes needed to capture and track weighted average total lifetime and the weighted average life of the portfolio. The Board is urged to explore an alternative approach.

Question 5

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

COMMENTS: The proposed approach provides information that is useful for decision making. This is because when a loss has been incurred on a financial asset and it is moved to the “bad book” because it is considered nonperforming the only useful information is the amount of the incurred loss. This is reflected in the recognition of the entire amount of expected credit losses in the impairment allowance. For the “good book” the recognition of the life time expected losses over the remaining life of the portfolio provides decision useful information on the entity’s expectations.

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?

COMMENTS: Yes, the requirement for differentiation of the “good book” and the “bad book” is clearly defined as this is to be dependent on management’s expectations about the collectability of the cash flows of the financial asset.

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?

COMMENTS: The requirement to differentiate between the two groups for the purposes of determining the impairment allowance is auditable because it is based on the management’s objectives for the financial asset. The management’s objectives are reflected in their credit risk objectives which are documented and which can be easily verified.

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?

COMMENTS: Yes, the proposed differentiation between the “good book” and the “bad book” for purposes of determining the impairment allowance is tenable. This enables the expected losses to be identified in line with the entity’s credit risk management objective and is in line with the way entities in the financial services sector manage their financial assets.

Minimum impairment allowance amount (paragraph 2(a)(ii))

Question 9

(a) Do you agree with the proposal to require a floor for the impairment allowance related to the ‘good book’? Why or why not?

COMMENTS: Yes, it is appropriate to require a floor for the impairment allowance as this will ensure that in the case of the “good book” the impairment allowance for any reporting period is able to cover all losses expected to occur in the near future.

(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?

COMMENTS: The floor should be required in all situations to ensure consistent treatment by all entities and to facilitate comparability. However if exceptions were to be allowed we would propose that entities be required to make disclosures to justify the non-application of a floor in the interest of comparability and transparency.

(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?

COMMENTS: Yes, the proposal of a minimum allowance amount is fine, however we urge the Board to define the floor based on a simple fixed time period which would apply to all entities. This will dispense with the need for entities to make subjective judgments in determining the length of the foreseeable future period for each of its category of open portfolios.

Question 9

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

COMMENTS: Consistent with our comment on 9(c) above the period will be fixed so the foreseeable future period considered in developing the expected loss estimate will not change.

(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.

COMMENTS: Yes, the foreseeable future period is typically a period greater than twelve months. If it weren't there would be a situation where the foreseeable future period was always shorter than the expected life of a portfolio which would be conceptually untenable. One would expect the period to be equal to or higher or shorter than the expected life of the portfolio and in any case it is expected that entities can develop projections of events and conditions for at a least the following 12 months.

(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.

COMMENTS: Yes, an appropriate ceiling should be established for determining the amount of credit impairment to be recognized under the floor in order to facilitate comparability. Without a ceiling, reporting entities

would be tempted to “earnings-manage” by selecting periods which show their results in a more favorable light.

Finally, the Board is urged to carry out field tests to determine the feasible range for the foreseeable future period and the typical behavior of the minimum allowance floor for different types of open portfolios and hence the reasonable level at which to set the proposed ceiling.

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.

COMMENTS: As in the response above, the Board is urged to undertake some field testing in order to address this question and to inform the proposed guidance. Without the benefit of empirical evidence any ideas on the level of the floor would be largely hypothetical.

Flexibility related to using discounted amounts (paragraphs B8(a) and B10)

Question 11

(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?

COMMENTS: The proposal to permit flexibility in the decision whether or not to apply a discounted estimate or undiscounted estimate is not conceptually sound. First, we believe not discounting is not consistent with the time value of money notion applied in the measurement of financial assets at amortised cost. Although the flexibility is intended to eliminate some difficulties in applying the proposals we propose that IASB develops a simplified basis to enable entities to determine discounted estimates.

(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?

COMMENTS: Rather than permitting a range of possible discount rates IASB should, in line with our comment above, develop guidance to enable

entities to determine the most appropriate rate unless this is impracticable in which case the impracticality should be explained and disclosed.

Approaches developed by the IASB and FASB separately

Question 12

Would you prefer the IASB approach for open portfolios of financial assets measured at amortised cost to the common proposal in this document? Why or why not? If you would not prefer this specific IASB approach, do you prefer the general concept of the IASB approach (ie to recognise expected credit losses over the life of the assets)? Why or why not?

COMMENTS: The general concept of the IASB approach of recognizing expected credit losses over the life of the assets is well founded because this best reflects the economics of the lending transaction as the actual credit losses normally occur over the life of the financial assets. This approach therefore provides consistency.

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?

COMMENTS: The FASB approach for the assets within the scope of this document of requiring the recognition of all the expected credit losses expected to occur in the foreseeable future at or after the reporting date, is not supported. This is because the approach does not reflect the economics of lending transactions.

Comments to Appendix Z

Impairment of financial assets

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?

COMMENTS: Yes, the effective interest rate should be determined separately from the expected losses to make the model more operational and easy to apply. This is also consistent with the way entities currently manage interest rates and expected losses.

Scope – Loan commitments and financial guarantee contracts

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?

COMMENTS: Yes, all loan commitments that are not accounted for at fair value through profit and loss should be subjected to similar impairment requirements as for loans held at amortised cost since the credit risk management approach and the business objective for holding them are the same.

Question 16Z

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

COMMENTS: The requirements should apply equally to accounting for expected losses on loan commitments and financial guarantee contracts because the credit exposure is usually managed in the same way as with loans. It is proposed that the current option in IAS 39(2)(e) which makes the requirements of IAS 39 applicable to issuers rights and obligations giving rise under an insurance contract which meets the definition of a financial guarantee contract in paragraph 9 of IAS 39.

Presentation (paragraph Z5)

Question 17Z

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

COMMENTS: Yes, the proposed presentation requirements whereby there will be two line items - gross interest revenue and impairment losses is appropriate.

Disclosure (paragraphs Z6–Z15)

Question 18Z

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

COMMENTS: The disclosure requirements proposed are acceptable as they will likely increase transparency and comparability given that the expected loss model will require the application of more judgment than currently obtains under the incurred loss model in IAS 39.

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

COMMENTS: It is proposed that where entities decide not to use discounted estimates and or where they choose a discount rate within the range proposed the entity should be required to disclose why discounted estimates cannot be used and the basis on which the applicable discount rate has been selected or arrived at, in situations where a discount rate has been selected within the proposed range.

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?

COMMENTS: Yes, a transfer of an amount related to the allowance reflecting the age of the financial asset should be made when transferring a financial asset between the “good” and the “bad” book as this is consistent with the matching principle.

END