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Dear Sirs

Comments on Supplement to ED/2009/12  
Financial Instruments: Amortised Cost and Impairment  
Financial Instruments: Impairment

I appreciate the opportunity to comment on the Supplement to ED/2009/12 *Financial Instruments: Amortised Cost and Impairment, Financial Instruments: Impairment*.

The comments provide in this letter are purely my personal views and they do not reflect those of the firm in which I am a partner or the organisations with which I am associated in various capacities.

#### 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?**

I agree that the approach described in the supplementary document is a good attempt to address the criticism during the recent global financial crisis that credit losses on financial assets were recognised "too little and too late" under the present impairment model. However, in my view the Supplement still does not articulate the proposed approach with sufficient clarity. In particular, the commingling of the concept of expected loss with that of foreseeable loss makes the proposed approach rather difficult to understand and apply in practice.

In this respect, I wish to suggest some revision to the framework. In line with how information is being used in an active market to price financial instruments, I suggest that impairment of a financial asset be measured based on the information available to the entity holding the financial asset. It is my proposal that the impairment framework specifies a principle that an entity must use the following three categories of information in estimating credit losses.

- (1) Occurred loss evidenced by past events.

- (2) Foreseeable loss in the near future.
- (3) Expected loss derived from the initial pricing of the credit loss premium in the loan.

In short, it is my proposal that a credit loss must be recognised based on occurrence, foreseeability and expectation as opposed to a model built upon a single concept of either incurred loss, foreseeable loss or expected loss.

The first principle of occurrence largely retains the existing concept of incurred loss.

The second principle introduces foreseeability whereby the existing incurred loss concept is extended to allow an entity to use more forward-looking specific information in estimating credit losses. We can give foreseeability a practical meaning with a presumption that any loss foreseen in the next 12 months must be recognised immediately as if it were an incurred loss. The use of 12 months as a foreseeable period (instead of a longer duration) is operationally feasible and reasonable as entities will have more specific budgetary information for the next 12 months which takes into account both entity-specific factors and macroeconomic factors known to affect the business in the next 12 months. This is also in line with observed market behaviour that any foreseeable losses in the next 12 months (negative information) would be priced into traded credit instruments.

It is operationally difficult to use a longer period to assess foreseeable losses. We can argue that while any information relating to the period after 12 months is relevant to the estimation of fair value (likely to be volatile from day to day) the estimation of impairment should be based on information about the more immediate future.

The third principle is expectation. Statistically it is an expected value of a random variable (in this case, the quantum of credit loss) derived from the weighted average of all possible outcomes that this random variable can take on. For the estimation of credit losses, it is the probability of loss in the absence of specific loss information at the inception of the loan and possibly some period thereafter. It is based on the facts (empirical evidence) that the contracted interest rate contains a component to cover the expected credit loss (on top of the risk-free interest rate, administrative expenses and profit margin to the entity) and that such credit losses normally occur as expected subsequently.

In the insurance industry, the existence of an expected loss component in the insurance premium is well understood and no insurer thinks that the insurance premium is earned when received, without first setting aside a loss allowance, even in the absence of specific claims. This is true especially for long-tail business. We can use this analogy in accounting for the outcome of an entity's underwriting of credit risk.

By distinguishing between foreseeable loss and expected loss, we can develop a clearer principle and avoid commingling these two into a single expected loss model, such as the common solution put forward by the boards. For example, "credit losses expected to occur within the foreseeable future period" is a commingled concept that clouds both the meaning of expected loss and that of foreseeable loss.

How do we apply the principle of expected loss? The ED has taken a right step in proposing a time-proportional amortisation approach.

Under this approach, an impairment allowance is built up over the life of the loan in a systematic manner based on an **expected loss rate (ELR)** that has been priced, either explicitly or implicitly at the inception of the loan, into the effective interest rate (EIR) of the loan. If an entity's existing practice does not identify the ELP explicitly, it is required to do so in order to apply the time-proportional amortisation method of recognising credit losses over the life of the loan.

The ELR should be an input into the loan system along with the EIR for each loan at inception. The ELR will be used to derive the expected loss allowance perhaps in a separate database (under the proposed "decoupling" approach). It is then possible to track the cumulative expected loss allowance for each loan. On a loan by loan basis, this cumulative expected loss allowance may be a tiny fraction of the loan but its aggregation across many loans gives a meaningful total quantum of allowance for expected loss against the entire portfolio. This is more intuitive than explaining the time-proportional amount as one "based on the weighted average age and the weighted average life of that portfolio" (BC38).

The ELR is a subset of EIR and will be derived systematically in the same pattern as how the EIR is recognised over the life of the financial asset measured at amortised cost. The Supplement (BC40) deliberates at length whether a straight-line method for allocating the expected losses can be used in place of the annuity method and has decided to permit it for easy implementation by the less sophisticated entities. In my view, the IASB should have been more unequivocal about the theoretical merit of the annuity method.

The expected loss recognised through systematic amortisation is only the first step towards addressing the "too little, too late" concern, especially when a credit portfolio is riding through a cycle of economic upturn. The impairment allowance has to be trued up with actual loss experience during the life cycle of the portfolio. The loan portfolio may experience either an early loss pattern or a late loss pattern which I will explain further below.

It is my view that to keep the expected loss approach operationally simple to apply, we should avoid adjusting this systematic amortisation to fit the anticipated or actual loss pattern, either at the beginning or during the life cycle of the loan. This amortisation process is simply a way of setting aside the ELR as an impairment allowance (like depreciation) ahead of its occurrence. Under normal circumstances, we should avoid periodically adjusting for changes in loss expectations as this involves re-inputting the ELR for each loan, which is a massive and error-prone exercise. This adjustment should be performed only in rare circumstances when it is subsequently discovered that the loans were grossly under- or over-priced.

Under normal circumstance, we can have periodic adjustments to take into account actual credit loss experience by truing up the level of expected loss allowance to the level of incurred and foreseeable loss. The truing up re-shapes the pattern of recognised loss in two possible scenarios: (a) where the incurred and foreseeable loss is within initial expectations but the timing of which deviates from the systematic build-up of the expected loss allowance and (b) where the incurred and foreseeable loss is higher (the excess being an "unexpected loss") or lower than initial expectations.

Where a portfolio encounters early loss pattern that is assessed to be within the initial loss expectations, we have to decide whether to allow the systematic amortisation of expected loss to catch up over time or to immediately top up the loss allowance. In this respect, we can think of an analogy in accounting for start-up losses of a project where the start-up losses incurred is required to be recognised immediately, even if the initial investment of the project is believed to be unimpaired based on the present value of its projected cash flows. For financial institutions, there is an added objective that adequate capital is held at all times to buffer possible losses. It is therefore both prudent and desirable to require an immediate top-up of the loan impairment allowance to the level of incurred and foreseeable loss from the level of time-proportional amortisation in the early periods, notwithstanding the possibility that some of the recognised loss is likely to reverse in later periods. Hence for a credit product that normally exhibits an early loss pattern, the entity has to accept a skewed loss recognition pattern against the evenly spread-out credit loss premium embedded in the EIR over the life of the loan.

A portfolio experiences a late loss pattern when the incurred and foreseeable loss lags behind the time-proportional amortisation of expected loss. In this case, there is no need to cut down the allowance in the early periods as the time-proportional amortisation is intended to overcome the "too little, too late" concern.

The true-up process will reach its finality at some point in the future for a *closed* portfolio. As each loan rides through its life cycle towards maturity, the incurred (and foreseeable) credit loss recognised through profit or loss gradually replaces the cumulative expected loss, thus permitting the cumulative expected loss allowance to be freed up through profit or loss over time. A closed portfolio can be a group of loans of similar characteristics originated in the same year, quarter or month ("same vintage") or a group of such loans maturing in the same period ("same maturity date"). A closed portfolio is operationally feasible for fixed-term loans and may be less so for revolving loans (please refer to my further comments in the last paragraph under Question 1).

There are additional conceptual and operational issues under an *open* portfolio concept. First, without a termination date the portfolio does not facilitate a final true-up as well as easy tracking of loan loss development over the life of the portfolio. Secondly, the portfolio profile is constantly changed by new loans and there is a question of the extent to which an existing portfolio of loans found to be unfavourably priced (from the entity's perspective) is allowed to be buffered by new loans that are more favourably priced.

Fortunately, the "bad book" concept forces impairment to be assessed on an individual loan basis for problematic loans. For the "good book", ideally the entity should be required to divide the total portfolio into sub-portfolios (akin to the concept of cash generating units for assessing impairment of non-financial assets) for purposes of expected loss estimation and accounting. It is likely that the credit risk management systems of most financial institutions already categorise the "good book" into sub-portfolios by type, risk profile, vintage, maturity date etc and this provides a reasonable basis for expected loss estimation and accounting.

However, the two boards both intend the Supplement to apply to loans managed on an *open* portfolio basis. In my view, a closed portfolio should be the starting point for tracking loan loss development. Conceptually and operationally, if we view a

large open portfolio as one comprising a number of sub-portfolios each of which is a closed portfolio, we can have a greater insight into the loan loss development of each sub-portfolio over time.

We can then address separately the issue of whether or when to permit an entity to combine some of the sub-portfolios to achieve a more favourable pooling effect in estimating the expected loss.

If it can be agreed that a closed portfolio is a preferred methodology, we can consider whether revolving credit products can be thought of as loans with very short maturity such as one day, one month or some other behaviourally estimated duration.

## **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?**

As explained in my comments under Question 1, closed sub-portfolios are building blocks for analysing the behaviour of a large open portfolio comprising the sub-portfolios. Closed portfolios can be grouped by vintage or maturity or by some other characteristics. A closed portfolio has the benefits of a controlled group in an empirical study. An open portfolio, on the other hand, allows new loans to constantly change the portfolio profile and allows too many variables to move concurrently. This is likely to lead to measurement challenges.

## **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?**

The use of the time-proportional amortisation for recognising impairment allowance for the "good book" is appropriate when the expected life of the loan is longer than the "foreseeable future", as defined above. Time-proportional amortisation should not be made mandatory for short-term loans or long-term loans maturing within the foreseeable future as the loan impairment allowance will comprise entirely incurred or foreseeable loss (with the meaning in my comments under Question 1). However, the Standard should not prohibit entities in consumer lending business (such as credit card business) from opting for time-proportional amortisation of expected credit loss if it wants to improve the precision of its daily, monthly or quarterly results.

## **Question 4**

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

Yes, in my view it is operationally feasible. Upon the initial capture of the loan in the system, an ELR (see my comments under Question 1), along with the EIR, must be input into the system so that each loan has an accumulated allowance for expected loss. This accumulated allowance is tagged to the loan when it is transferred between the "good book" and the "bad book".

On a loan by loan basis, this is a tiny fraction of the loan but in aggregate it forms the average expected loss for the portfolio. In the "bad book", the accumulated expected loss allowance tagged to each loan being transferred from the "good book" is the base from which the allowance is topped up to the level of incurred and foreseeable loss.

#### **Question 5**

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

The expected loss approach assumes that the ELR is not earned until the loan loss experience for the portfolio is proven better than expected, whereupon it is allowed to unwind into profit or loss. It may never be earned if the loan loss experience is exactly within or worse than expectations. When this is well understood, the financial statements will be more useful to management and external users for decision-making (eg for assessing performance or valuing the reporting entity).

#### **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?**

The Supplement describes a good loan as one that receives regular payments from the debtor and a bad loan as one involving "recovery" through enforcement action. This may be too prescriptive and it may cause entities to argue over semantics. Different financial institutions use different grading systems to segment their loans but broadly loans are categorised as passed, special mention, sub-standard, doubtful and bad. Generally, the latter three types are transferred from the "good book" to the "bad book" where they are individually assessed for impairment. The entity may continue to receive regular payments on sub-standard loans before they worsen to recovery or enforcement status some time later. I am therefore of the view that adopting a more generic description such as "problematic" or "watch-listed" loans supplemented by some examples will avoid arguments over semantics.

#### **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?**

The determination of impairment allowance and the audit of the resulting accounting estimate are inherently judgemental and complex. In my view, the proposed

approach will not make it more difficult or complex to estimate or audit the impairment allowance.

#### 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?**

The requirement to move problematic loans to the "bad book" (known as classified loans) is a well established banking industry practice. This requirement should not pose any major implementation problem.

#### 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?**

In my view, the "floor" as a terminology is intuitively less appealing than the concept I have suggested in my comments under Question 1. I prefer to describe a requirement that where the incurred or foreseeable loss is more severe than the allowance for expected loss due to either an early loss pattern or an unexpected loss, the allowance must be immediately topped up through profit or loss.

**(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?**

Please see my comment under (a) above. "Invoking a floor" makes the principle sound more complex than it is.

**(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 12 months)? Why and why not? If you disagree, how would you prefer the minimum allowance to be determined and why?**

As stated in my comments under Question 1, "losses expected to occur within the foreseeable future" commingles the "expected loss" (an estimate derived from initial credit pricing information) and "foreseeable loss" (an estimate derived from more forward-looking specific information) and this commingling should be avoided.

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

The economic and political environment is becoming more volatile and unpredictable in recent times. Generally government policies and budgets which set the rules of the game are re-set every 12 months, making it rather difficult for entities to have a

good vision beyond 12 months. In my view, operationally it is both reasonable and feasible to use 12 months as the foreseeable future and in the absence of major structural changes in the economic environment in which the entity operates, it should rarely be necessary to change the period considered to be the foreseeable future.

- (e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than 12 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.

Please see my response under (d) above. While there may be little empirical evidence to support the postulation of 12 months, it may be possible to poll users of financial statements or conduct empirical research to determine what duration might be considered a "foreseeable future period". Arguably the bond market may be capable of looking beyond 12 months in pricing the credit but the bond investor's preoccupation with fair value is different from the entity's objective of estimating impairment. The objective of impairment accounting is different from fair value accounting and one of the differences may be the time horizon involved.

- (f) If you agree that the foreseeable future is typically a period greater than 12 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.

Please see my comments above. In my view, introducing more terminology such as "floor" or "ceiling" can make the impairment framework look more prescriptive and complex than it should be.

#### 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.

Please see my comments above. As a personal preference, I would avoid introducing the concept of a "floor" and terms such as "equal to" or "higher than". I hope there can be a move towards the use of plain language in accounting standards.

#### 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?**

To answer this question, it is useful to refresh the concept of discounting.

If an entity holds a three-year loan of \$100 at initial recognition, at an effective interest rate of 5% per annum with annual interest coupon, the total undiscounted contractual cash flows is \$115 and the present value is \$100 derived by discounting the undiscounted cash flows at the EIR of 5% per annum. If all the contractual (undiscounted) cash flows are assessed to be irrecoverable, there is only one rate which will discount the projected loss of (undiscounted) cash flows to \$100. That rate is the EIR of 5% per annum. The use of any other rate to derive the loss allowance will not achieve the desired result, which is to arrive at \$100 for a full impairment allowance.

The same reasoning applies to discounting of future cash flows assessed to be partially irrecoverable. The irrecoverable portion is always a subset of the full loan and the undiscounted cash flows of both must be discounted at a consistent EIR.

I suggest a simple example, such as the one I used above, be included in the Standard to illustrate why the EIR is the appropriate discount rate.

While IASB believes that for practical reasons any rate between the risk-free rate and the effective interest rate can be used as the discount rate (BC42), this flexibility may weaken the position of EIR as the only logical choice.

**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?**

Please see my proposed approach under Question 1.

**Question 13**

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

For a conceptual analysis of the FASB position, I would like to split a loan into two components. The first component is a virtually default-free loan at an interest rate sufficient to cover the cost of funds, administrative expenses and a normal profit margin and the second component is a credit insurance premium embedded in the contractual effective interest rate of the loan. The credit insurance is priced at an *expected* loss ratio of 1 (that is, the ratio of credit loss divided by credit premium is 1)

over the *expected* (which can be shorter than contractual) life of the loan. In this entity, the loan unit is required to enter into full credit insurance by paying away the credit insurance premium to an insurance unit within the entity.

At inception the loan unit assesses the virtually default-free loan to have an expected loss of zero.

The credit insurance unit assesses the net expected loss on day 1 to be zero as the expected loss is fully covered by the credit insurance premium receivable over the expected life of the loan. As the insurance premium is collected ahead of the occurrence of any claim loss, the amount is set up as an allowance for expected loss. The FASB approach appears to have taken into account the expected loss without taking into account the premium receivable to arrive at a day loss position.

If the real concern of FASB is about the financial strength of the entity undertaking credit losses, the appropriate solution is to require the entity, by regulation, to hold adequate capital before it starts its new business to underwrite credit risk. This is more appropriate than to distort the performance of the entity from day 1 so as to force the entity to maintain sufficient capital.

It is also conceptually clouding the issue by arguing that for an on-going entity, it can afford to buffer the day 1 loss arising from a new portfolio with the reversal of some of the previously recognised day 1 loss from an old portfolio. These offsetting errors are unlikely to be of the same quantum and the net result will be an arbitrary outcome.

This distortion is likely to reduce the understandability, comparability and usefulness of accounting information for decision-making.

I hope my comments are helpful and would be happy to provide any clarification if required.

Yours faithfully

Kim Chiu Chua