

No.C&I/2010-11/2842
April 1, 2011

The Chairman
International Accounting Standards Board (IASB)
30 Cannon Street
London
EC4M 6XH
UK

31 March 2011

Dear Sir

Comment letter on IASB Supplement to Exposure Draft ED/2009/12 Financial Instruments: Amortised Cost and Impairment (ED)

We refer to the exposure draft released by you in January 2011 relating to Financial Instruments: Amortised Cost and Impairment.

We are grateful for the opportunity to respond to the ED issued by the IASB. We have consulted within the members of the Indian Banks' Association (IBA) Sub Group on IFRS Transition in respect of this ED. The comments below represent the views of our members.

- **Question 1**

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

Yes, the ED deals with the weakness of delayed recognition of expected credit losses. Banks, in India, presently make provisions on performing loans by applying a percentage rate stipulated by its regulator, the Reserve Bank of India (RBI). The methodology adopted by RBI is not available to us. However, any scientific approach which is based on probability of default can be devised along with a relevant materiality threshold. In respect of material advances, a ratings method for each account could also be adopted and for items below the relevant threshold, portfolio approach could be considered.

- **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?

No, we do not agree. The impairment model may not be suitable for individual assets and may be difficult to implement practically because they may not be homogeneous in nature or have similar characteristics. Further, in this case, historical data of the life cycle may also be difficult to capture.

The approach given in standard is for allocation of expected losses. However, the standard does not detail how expected losses are to be arrived at (i.e. the methodology). It can be made applicable to closed portfolios though the method of arriving at the expected losses should be different for open and closed portfolios.

As per para BC13 of the present ED, IASB has not yet decided on the direction, it intends to take in relation to short-term trade receivables, loan commitments and financial guarantee contracts. But, we consider that, one of the objectives of the IAS 39 replacement project was to simplify accounting for financial instruments. Therefore, it is necessary to have a single impairment approach for all relevant financial assets. Therefore, it is better to have a single impairment approach for all relevant financial assets as it will be practically difficult and complicated to make system changes and work on different impairment models at the same time.

- **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?

In the case of the good book, it is proposed that expected credit losses would be recognised on a portfolio basis over a time period at the higher of the time-proportional expected credit losses (depending on the age of the portfolio) and the credit losses expected to occur within the foreseeable future period (being a minimum of twelve months). Portfolio basis is appropriate for good book since it will reduce operational complexity. Recognising the higher of time proportional and immediately expected credit loss is in line with principle of prudence.

- **Question 4**

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

Yes, the proposed approach would be operational. There may not be significant difficulty in classification of the assets into good book and bad book category. However, para IE4 relating to measurement of expected losses, needs further clarification.

Further, the extent to which it will be operational will also depend on the credit risk data base of the bank. A bank which has complied with the data base requirement for Internal Ratings Approach for measuring capital requirement for credit risk as per Basel II norms ~~will~~may find the requirements ~~easy~~easier to implement.

- **Question 5**

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

The proposed approach (of bifurcating loan book into good book and bad book and different treatment for these books) is in line with how credit risk is managed in enterprises.

This is also relevant to asset liability management (ALM) and other business strategies. The proposal takes care of both good book as well bad book with a flexibility to consider changes in the objective of credit risk management. Since the expected credit loss is linked to the objective of credit risk management, it would provide adequate and useful information for decision-making.

One more suggestion is to consider introducing a third and in-between category i.e. accounts causing concern but not considered bad as yet and for this category the treatment of expected loss approach can be moderate i.e. in between bad and good book.

- **Question 6**

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

In India, RBI has specified the method to differentiate between good book and bad book based on a 90 day delinquency norm. The ED may give the banking regulator of the country the discretion to specify a method.

Further, in case existing methodologies in this regard implemented by the regulator is well defined and already stabilised over a period of time, the ED can permit the existing system to be continued.

- **Question 7**

Is the requirement to differentiate between the two groups (i.e. '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?

If the differentiation between the two groups is identified / bifurcated as per the guidelines stipulated by the RBI, even though it is rule based, it must be permitted. Such a system, is currently working well and it is also auditable. The basic essence of IFRS is transparency and standardisation/ uniformity and in India, by virtue of following the RBI guidelines in this regard, it is already ensured.

- **Question 8**

Do you agree with the proposed requirement to differentiate between the two groups (i.e. 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

The proposal for the concept of 'bad book' is realistic and prudent. However, in respect of 'good book', the dual calculation of time proportional and floor impairment allowances may have some conceptual problems. These aspects should be addressed and the methodology should be made simpler and easily understandable.

- **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.**
- (a) We agree with the proposal to require a floor for the impairment allowance related to the ‘good book’ since it is in line with the principle of prudence.

A ‘floor’ is one of the methods of ensuring adequate impairment allowances for portfolios which covers expected credit losses within the foreseeable future. One issue with the floor is the subjective definition of ‘foreseeable future’ period. Since subjectivity is involved, it leads to inconsistency and corresponding lack of comparability. Due to this reason, alternate simpler methods to ‘floor’ may also be considered.

- (b) We do not agree since there will be lot of subjectivity as to what will constitute evidence of an early loss pattern since it is not defined in the ED.

Alternatively, the floor may be kept at a lower level for asset / class of assets,(defined or stipulated by the Regulator) where early loss pattern is not evident.

- (c) Yes, we agree that the foreseeable future period should not be less than 12 months subject to our answers against 9(a) and (b) above.

- (d) Arriving at the foreseeable future based on economic conditions may be ideal but looking to the operational complexity and subjectivity, it is suggested and advisable to have the foreseeable future based on time period.
- (e) Foreseeable future period is typically upto 12 months. In India, all term loans have to be reviewed once a year and all working capital limits renewed once a year. This corroborates the use of 12 month period as minimum estimate of foreseeable future. However, banks can specify trigger events as per their policy and whenever the trigger takes place, the foreseeable future can be less than 12 months.
- (f) Please refer to our response in 9(e).

- **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.

No, it can be lower as well and will depend on factors like product life cycle of the Company, economic cycle, duration and maturity of the portfolio etc. and it may vary from case to case.

- **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?**
- (a) The flexibility permitted to use either a discounted or undiscounted estimate as contained in B8(a) can be accepted so long as the decision as to which method to use is justified. The discounted estimates are realistic as we generally allow for the time value of money when considering comparable future cash flow items. However, in India, banks have got substantial low value loan portfolios. For these low value portfolios, undiscounted estimates may be used and for high value, above a specified materiality threshold, the discounted method must be used.
- (b) Yes, permitting flexibility in the selection of a discount rate which may be one risk-free rate for all the loan portfolios would reduce the operational complexity in arriving at the discounted expected loss amount. Hence, it may be accepted.

- **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?

The common proposal is different from the IASB approach in that the floor of expected credit losses in foreseeable future is considered. The common proposal is more conservative than IASB approach. We prefer the general concept of the IASB approach, since it is in line with the basic objective of revising the impairment approach from incurred loss model and will result in scientifically arriving at the expected loss based on probability of default and it is not appropriate to recognise all expected credit losses immediately.

- **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 (i.e. to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

The expected loss model developed by FASB requires an entity to recognise immediately all credit losses expected to occur in the foreseeable future. Every effort is made to ascertain the antecedents and creditworthiness of a customer and subsequently financial assets are originated. Thereafter, without any triggering event it would be difficult to conclude that there are immediate losses on such type of financial assets and that too within foreseeable future. The period of foreseeable future is further subject to present economic conditions and future expectation. Therefore, we do not prefer the general concept of the FASB approach.

- **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, It is preferable that determination of effective interest rates should be separate from the consideration of expected losses.

- **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 agree with the proposal. Banks in India manage their credit risks after giving due consideration to both drawn as well as undrawn loan commitments. Hence, we believe that this proposal would meet the dual objective of decision usefulness and also align financial reporting with the way entities manage their credit risk in practice. For internal credit assessment, often the entire exposure i.e. the drawn and the undrawn limits are considered in unity on account of the nature of these instruments. Adequate consideration is also required for terms and conditions inherent in loan commitments that provide an opportunity for the lender to curtail/ cancel the commitment on the occurrence/ non-occurrence of certain events.

For example, when overdrafts are assessed, the entire limit is considered i.e. drawn and undrawn. This is because when an overdraft goes bad, it usually goes bad after the entire amount is drawn. Hence, consideration of the entire limit gives an idea of the expected losses.

- **Question 16Z**

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

Yes. The proposed requirements would be operational to all financial guarantee contracts as the same will cater to the provisioning of the financial guarantees not fully backed by margins in the form of deposits or collaterals. Further, the commitments to provide a loan at a below market interest rate, the expected loss method is not applicable as at the time of initial recognition, the same will be measured at fair value.

- **Question 17Z**

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

We agree with the proposed presentation requirements.

- **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 disagree with the disclosure requirement of nominal amounts of financial assets since it will not be of relevance in the case of installment based loans. We would prefer in place of nominal amount, 'exposure' as defined by RBI (i.e. limit or balance whichever is higher where there is scope for redrawing of limit and balance outstanding in case where there is no scope for redrawing as in the case of installment based loans).

Further, the requirement as per Z8 requiring details for current and previous four annual periods is considered excessive. We propose that the date for the current year and the previous should suffice.

- **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 agree with the proposal. When the classification of the assets i.e. loans, advances are changed from say, good book to bad book then the existing provision already made for the good book is automatically transferred to the bad book.

If you have any questions relating to our comments, please contact me at +91 22 22174002 or email me at murthy@iba.org.in.

With kind regards,

Yours faithfully,

(S S N Murthy)
Sr. Vice President