



European Financial Reporting Advisory Group ■

EFRAG's position on the IASB
Supplementary Document
Financial Instruments: Impairment

Final comment letter 8 April 2011

EFRAG's overall assessment



EFRAG's position

Support for a common operational impairment approach for all financial assets based on decoupling of interest income and expected credit losses

- EFRAG welcomes the IASB's efforts to find operational solutions for the difficulties identified in respect of the model exposed in the November 2009 proposals.
- EFRAG supports the development of an operable impairment approach based on the separate allocation (decoupling) of interest income and expected credit losses.
- EFRAG strongly believes that a consistent accounting treatment should be applied to similar economic events. Therefore, EFRAG believes that decoupling of interest income and credit losses should be applied consistently to all financial assets measured at amortised cost.
- EFRAG welcomes the IASB's and the FASB's efforts to develop a common approach to the accounting for the impairment of financial assets.

EFRAG's overall assessment (continued)



	EFRAG's position
<i>EFRAG disagrees with the floor</i>	<ul style="list-style-type: none">• EFRAG disagrees with the proposals to set a floor that reflects credit losses expected to occur within the foreseeable future.• EFRAG acknowledges the need to provide for front loaded patterns of expected losses. However, EFRAG does not believe that a floor is the only way to deal with this issue. In our view, if an entity expects losses to materialise in the near future, it should be required to provide immediately for expected losses in excess of the time-proportionate amount that is expected to arise over the same time period.• However, if the IASB were to retain a floor in the model, EFRAG suggests that it would not be based on the notion of some indeterminate 'foreseeable future', rather EFRAG would recommend that it be a fixed 12-month period. Indeed, a 12-month period would best serve comparability and also avoid that the impairment model would be dominated by the floor.

EFRAG's overall assessment (continued)

	EFRAG's position
<i>Concerns about the significant changes to the impairment model</i>	<ul style="list-style-type: none">• EFRAG believes that in developing an operational impairment approach for open portfolios the board has made significant changes to the original model. Therefore EFRAG believes that the board should clarify the objectives of the revised model.• In the context of the impairment aspect of the model, EFRAG believes that it is appropriate to provide in full for “incurred” losses. Equally, EFRAG agrees that it is appropriate to apply a time-proportionate approach to “expected” losses in the revenue recognition aspect of the model. However, EFRAG is concerned that the proposed good book/bad book distinction does not adequately cater for losses that are “incurred but not yet reported/recognised” (IBNR).• The model has been designed primarily to cater for the loan portfolios of banks and the board should further develop the guidance and the model to make it more suitable for non-lending businesses, closed portfolios and individual items.• As a result of the heavy changes made to the original model, EFRAG believes it would be inappropriate to permit entities a free choice between the proposed model and the original expected cash flow model.

EFRAG's overall assessment (continued)

	EFRAG's position
<i>Field-testing and an holistic approach to the IAS 39 replacement project are needed</i>	<ul style="list-style-type: none">• EFRAG noted a number of application issues which, together with the short comment period, made it impossible for preparers to do a proper quantitative assessment. Therefore, EFRAG believes that before issuing the final standard the IASB should conduct field-testing.• EFRAG urges the IASB to consider the proposals in the Supplementary Document in the context of the existing disclosure requirements in IFRS 7 and to ensure that the level of guidance included in the disclosure standard remains consistent and balanced across topics.• The IASB has split the revision of IAS 39 into a number of phases. However, considerable interdependencies exist among the phases of this project and other projects that the IASB is currently working on. Therefore, EFRAG believes that the IASB will need to consider the entire package of proposals before finalising the resulting standard.

Delayed recognition of credit losses under IAS 39 (Question 1)



	EFRAG's position
<i>Earlier recognition of credit losses</i>	<ul style="list-style-type: none">• To ensure that credit losses are recognised earlier than under current practices, EFRAG believes that incurred losses should be fully provided for under the proposed model, supplemented by a time-proportional allocation of expected credit losses for the good book assets.

Scope of the model in the Supplementary Document (Question 2)



	EFRAG's position
<i>Consistent impairment model for all financial assets</i>	<ul style="list-style-type: none">• EFRAG supports a consistent impairment model for all financial assets carried at amortised cost.• Due to the significant changes to the original model, EFRAG believes that the IASB should clarify the objectives of the model and, in particular, be more explicit as to the extent it represents a revenue recognition and/or impairment model.• If the IASB were to adopt the model in the Supplementary Document, we believe it would be inappropriate to permit entities a free choice between that model and the original expected cash flow model because the revised model is not a practical expedient to implement the original model, but a different model. Users may find it difficult to understand the information resulting from the different approaches and issues of comparability or accounting arbitrage could arise.

Appropriateness for 'good book' (Q3)

Operationality of time-proportional approach (Q4)

Useful information (Q5)



	EFRAG's position
<i>Developing a simplified approach to the expected cash flow model</i>	<ul style="list-style-type: none">• EFRAG supports the efforts of the IASB to develop a more operable impairment approach.• EFRAG agrees that the proposed time-proportional approach for the good book should be modified to mitigate the risk of inadequate provision balances for portfolios with front-loaded loss emergence patterns.• EFRAG believes that before issuing the final standard, the IASB should conduct field-testing to confirm that the model overcomes the weaknesses in IAS 39 and that the guidance is robust.

Differentiate between 'good book' and 'bad book' (Q8), Clearly described (Q6), Operational or auditable(Q7)



	EFRAG's position
<i>Requirement to differentiate between 'good book' and 'bad book'</i>	<ul style="list-style-type: none">• EFRAG agrees that an approach based on the two groups is appropriate, as it is aligned with the way lending businesses manage their loan portfolios. Given the diversity in credit risk management practices, the proposed disclosures are essential to ensure a measure of comparability between entities.• In order to avoid a delayed classification of incurred losses into the bad book, EFRAG believes that the IASB should clarify that incurred losses under IAS 39 should be provided for in full under the new impairment model.• The proposed guidance is drafted from the perspective of a lending business and does not consider the vast majority of IFRS issuers that are not lending businesses or do not have similar credit risk management practices. Therefore, the IASB should ensure that the guidance is also appropriate for entities other than lending businesses.

Minimum allowance amount (floor) (Question 9) Higher of the two amounts calculated in accordance with paragraph 2.1(a) (Question 10), the FASB model (Question 13)



	EFRAG's position
<p><i>EFRAG disagrees with the floor</i></p>	<ul style="list-style-type: none"> • EFRAG agrees that the proposed time-proportional approach should be modified to mitigate the risk of inadequate provision balances for portfolios with front-loaded loss emergence patterns. However, EFRAG disagrees with the proposals to set a floor at a level reflecting credit losses expected to occur within the foreseeable future because the impairment model should reflect the link between the pricing of the asset and the expected credit losses. Instead, EFRAG believes that the IASB should consider an approach requiring a time-proportional approach, based on expected loss profiling that ensures that an allowance is built up faster. • If the IASB were to retain a floor in the model, we suggest that it would not be based on the notion of some indeterminate 'foreseeable future', rather we would recommend that it be a fixed 12-month period. Indeed, a 12-month period would best serve comparability and also avoid that the impairment model would be dominated by the floor.
<p><i>Concerns about the foreseeable future concept</i></p>	<ul style="list-style-type: none"> • We have the following concerns about the application of the concept of 'foreseeable future': <ol style="list-style-type: none"> a) As the foreseeable future period is not clearly articulated it is likely to result in significant divergence in practice;

Minimum allowance amount (floor) (Question 9) Higher of the two amounts calculated in accordance with paragraph 2.1(a) (Question 10), the FASB model (Question 13)(continued)



EFRAG's position

Concerns about the foreseeable future concept

- Concerns about the application of the concept of 'foreseeable future' (continued):
 - b) A floor based on the foreseeable future would result in the immediate recognition of an impairment allowance on performing portfolios that have an average life of between 12 months and 3 years, effectively providing for impairment losses on these portfolios as if they were comprised entirely of bad book loans;
 - c) The flexibility in selecting and changing the foreseeable future period may result in earnings management and a loss of comparability;
 - d) The length of the foreseeable future can change with the phases of a business cycle or reacting to changes in the conditions of the financial markets;
 - e) Fair value estimates often require events and conditions to be projected up to the end of the life of an asset and are not limited to an assessment of merely the foreseeable future.
- The above reasons explain why EFRAG disagrees with the FASB model.

Discounting and discount rates (Question 11)



	EFRAG's position
<i>EFRAG does not support discounting nor use of the annuity approach</i>	<ul style="list-style-type: none">• One of the main challenges in implementing the expected cash flow model for open portfolios was the impossibility to predict reliably when losses will occur. Therefore, EFRAG believes that requiring or permitting discounting and use of the annuity approach would over-complicate the model and that the benefits of doing so would be outweighed by the costs of application and the loss in comparability.

Decoupled EIR (Question 14Z)



EFRAG's position

EFRAG supports the separate allocation of interest income and expected credit losses

- EFRAG considered that an integrated effective interest rate approach could be operationally burdensome and therefore supports the separate allocation (decoupling) of interest income and expected credit losses.
- EFRAG believes that decoupling of interest income and credit losses should be consistently applied to all financial assets carried at amortised cost.

Loan commitments and financial guarantee contracts (Question 15Z and 16Z)



	EFRAG's position
<i>Same impairment approach for loans and loan commitments</i>	<ul style="list-style-type: none">• EFRAG supports the view that the same impairment approach should apply for both loans and loan commitments, since they are often managed within the same business strategy.
<i>Proposed impairment approach operational for financial guarantee contracts?</i>	<ul style="list-style-type: none">• EFRAG noted in its comment letter on the Exposure Draft <i>Insurance Contracts</i> that financial guarantee contracts, as issued by banks, and credit insurance contracts, as issued by insurers, could both meet the definition of an insurance contract. While we acknowledge that it is generally desirable to have similar accounting for similar contracts, the existing guidance that only requires insurers to apply insurance accounting has worked well in practice. Given the practicability concerns regarding the application of the insurance contract proposals by non-insurers, we believe it is better to retain the current option in paragraph 2(e) of IAS 39.

Presentation (Question 17Z)



	EFRAG's position
<i>Gross interest revenue and impairment losses</i>	<ul style="list-style-type: none">• EFRAG agrees with the proposed presentation, as it is consistent with the decoupling of interest recognition and credit loss recognition proposed in the Supplementary Document.

Disclosures (Question 18Z)



EFRAG's position

EFRAG supports the proposed disclosures

- EFRAG supports the proposed disclosure, but urges the IASB to consider the proposals in the Supplementary Document in the context of the existing disclosure requirements in IFRS 7 and to ensure that the level of guidance remains consistent and balanced across topics.
- The IASB should develop disclosures on experience adjustments that allow users to understand the quality of earlier accounting estimates.

Allowance account transfers (Question 19Z)

	EFRAG's position
<i>EFRAG disagrees with the proposed allowance transfer</i>	<ul style="list-style-type: none">• EFRAG believes that, in case of an open portfolio, the attribution of the good book allowance to the loans that are transferred to the bad book would generally have little informational value because it does not reflect (1) the actual loss incurred; (2) the expected losses; or (3) the time-proportionate amount that would have been calculated on a “sub-portfolio” basis. Consequently, EFRAG believes that there should be no transfer between the respective allowances, but rather that they both be adjusted to reflect the loans contained in each of the two groups.