

XX August 2009

International Accounting Standards Board
30 Cannon Street
London
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United Kingdom

DRAFT COMMENT LETTER

Comments should be sent to Commentletter@efrag.org by 21 August 2009

Dear Sir / Madam

Re: Request for Information ('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach

On behalf of the European Financial Reporting Advisory Group (EFRAG) I am writing to comment on the *Request for Information ('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach* dated June 2009 ('the IASB paper'). This letter is submitted in EFRAG's capacity of contributing to IASB's due process and does not necessarily indicate the conclusions that would be reached in its capacity of advising the European Commission on endorsement of the definitive interpretations/amendments on the issues.

The IASB explains in its paper that it has added to its active agenda a project to improve the reporting requirements for financial instruments; that the project will be a multi-phase project; and that one of the phases will deal with the impairment of financial assets. Currently IAS 39 requires an incurred loss impairment approach for financial assets measured at amortised cost (the Incurred Loss Model), and the impairment phase of the project will, inter alia, explore other possible approaches, including the expected loss model or expected cash flow approach. The purpose of the IASB paper is to ask for information on the feasibility of the expected cash flow approach. The IASB is not at this stage asking for views on the relative advantages and disadvantages of the various approaches.

EFRAG supports the IASB's decision to carry out this IAS 39 replacement project, and in particular to review the Incurred Loss Model in the context of other impairment approaches. We have some concerns about the existing Incurred Loss Model approach, and can see merit in the Expected Cash Flow Approach as it seems likely to address many of those concerns (including identifying when a loss has been incurred) and perhaps better represents the economics of income generated over the life of a financial asset held at amortised cost.

Our detailed comments on the questions asked in the IASB paper about the feasibility of the Expected Cash Flow Approach are set out in Appendix 1 but, to summarise, our initial view is that implementation of an Expected Cash Flow Approach will involve significant

operational challenges in Europe. However, that is not in our view a reason at this stage to abandon work on such an approach, because we think it could also result in significant potential benefits. What we think the challenges do mean however is that care needs to be taken to try to 'get the requirements right' at the outset, so that further expensive changes are not required later. For that reason, we agree with the feasibility focus of the IASB paper and commend the IASB for seeking such advice early in the development of these proposals. We consider that this type of request is in line with the IASB's commitment to prepare and publish impact assessments for all new accounting standards. We urge the IASB to continue to canvas views broadly and to develop any proposals on loan loss provisioning carefully to ensure that the benefits of any final amendment outweigh potentially significant costs to preparers.

We hope these comments are of use to you. If you would like to discuss them further, please do not hesitate to contact either me or Kristy Robinson.

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1

EFRAG's response to questions asked in paragraph 11 of the IASB's paper

EFRAG's request to constituents

EFRAG recognises that the IASB paper is asking questions about feasibility and those questions can best be answered by preparers. With that thought in mind, EFRAG has been canvassing views from its constituents and, in preparing this draft letter, has focused largely on trying to convey the views heard to date.

EFRAG is still seeking views and more detailed information. It therefore requests that constituents please forward any further relevant information for consideration in developing our final response.

EFRAG would also like to draw its constituents' attention to the fact that the current thinking is that any new model will apply to all entities, not just financial institutions. We would therefore also be interested in hearing the views of non-financial institutions (henceforth 'corporates').

Question 1—Is the approach defined clearly? If not, what additional guidance is needed, and why?

EFRAG View

- Additional guidance is needed on:
 - What information to use in circumstances when historical data is not available;
 - Unit of account, diversification and correlation;
 - How to deal with movement in and out of portfolios and revolving credits; and
 - Transition provisions.

Notes for EFRAG's constituents

1 *Broadly, the expected loss model has the following features*

- (a) *Expected future credit losses on a financial asset are treated as adjustments of future cash flows (e.g. interest revenue) at the outset. As a result, the effective interest rate calculated upon initial recognition takes into account estimated future credit losses. Using a very simple example (and ignoring the time value of money), if an entity issued a loan for a fixed term of 1 year with a principal of €100, interest of 5% per annum and expected credit losses of 2% the interest rate expected to be received, taking into account credit losses, is 3%. In contrast, the incurred loss model would only incorporate the 5% into its initial effective interest rate calculation.*
- (b) *The gains and losses recognised subsequent to initial recognition will be interest and adjustments to the carrying amount resulting from changes to the expected future cash flows. Impairment losses will thus be recognised in profit or loss when the expectations as to future cash flows change adversely, not when losses are actually incurred (i.e. there is no "incurred loss" threshold for recognising impairment losses). Similarly, gains will be recognised in profit*

or loss when there is a favourable change in expected credit losses up to the full contractual cash flows discounted at the expected interest rate.

- (c) *Although the starting point for making estimates about the timing and amount of future cash flows will often be historical data, the expected loss model is a forward looking model and therefore needs to be based on expectations about the future. Factors such as the length and depth of the current economic cycle (and, depending on when the assets are expected to mature, future economic cycles) will therefore also be relevant.*
- (d) *The focus is on the losses and cash flows expected in respect of financial assets currently held. Unexpected losses are not taken into account, nor are losses and cash flows expected in respect of assets not yet acquired or issued.*

EFRAG's comments

- 2 The description of the Expected Cash Flow Approach contained in IASB staff papers¹ is at a reasonably high-level and therefore by its nature lacks some detail. The areas where we think clarity could be improved by additional guidance are described briefly in the paragraphs below.

Components of the Expected Loss Model

Historical data

- 3 We understand that there will be circumstances when historical loss data is unavailable, even for financial institutions that are granting loans at interest rates defined to compensate for the risk of credit loss. In some cases that will be because data is available only at a portfolio level or is unavailable for a specific market or type of asset (such as consumer receivables held by corporate preparers). In other circumstances data may be available, but as a proxy only. For example it is our understanding that in preparing regulatory expected loss calculations in some markets preparers have had to use local bond rates as a proxy for individual credit risk. Obviously the use of proxies is not ideal, but illustrates how preparers may need to consider appropriateness of available data. It would be helpful therefore for the IASB to refer to the types of data sources that may be acceptable in a range of circumstances.

Future economic conditions

- 4 As already mentioned, although expected losses calculated using historic data will typically form the basis of an expected loss calculation, the cash flow projected using this historic information will need to be adjusted for management's view on future economic conditions and other differences expected in the future compared to the past. Incorporating data about future economic conditions will be complex—not only in terms of how the model will be built, but also in respect to choice of data and substantiation of that data against objective criteria—and could result in significant shifts in profit or loss resulting from unobservable inputs into the expected loss model. Again, in some cases the data might not be available in an appropriate form. Given this, again it would be helpful for the IASB to refer to examples of data sources that may be acceptable and to provide guidance on the steps an entity might take to minimise the use of unobservable inputs.

¹ In particular, Agenda Paper 5A of the May 2009 IASB Meeting.

Unit of account, diversification and correlation

- 5 The 'unit of account' is often important when measuring assets and liabilities and it is particularly important in this case because of diversification and correlation.
- (a) Diversification is the mixing of different investments, types of industries, categories of risk or companies in order to achieve some offsetting of risk and therefore to reduce the risk in a portfolio, relative to the risk in the individual items making up a portfolio. Diversification benefits can of course also arise through the inter-action of separate portfolios.
- (b) Correlation is the inter-dependence (i.e. the relationship) between one financial instrument and another. For example if a move in the share price of one company is always accompanied by a move in the same direction of another company's share price, then the share prices of both companies are positively correlated. If the share prices consistently move in opposite directions then they are negatively correlated. The share prices of companies in the same sector or in the same country tend to be correlated. Similarly, losses in one area of the economy can be a direct cause of losses in another area of the economy. Correlation can be a measure of diversification. An entity with a well diversified portfolio would have instruments whose values are uncorrelated or have negative correlation (i.e. move in opposite directions).
- 6 We think the IASB should provide more guidance on how a reporting entity should take into account correlation and diversification between individual financial assets or portfolios when calculating an expected loss. For example, correlation can impact the price a reporting entity charges for issuing a financial asset. If the individual asset is taken as the unit of account, given that correlation is not specific to that individual asset, we are currently presuming that the impact of correlation would not be taken into account when calculating the financial asset's expected loss even though—as recent experience has shown us—it could be an important factor in determining the losses eventually incurred.

Portfolios

Movement in and out of portfolios

- 7 Although it would seem that the intention is to provide some guidance on how to deal with movements in and out of portfolios (see paragraphs 35 to 41 of IASB Staff Paper 5A for the May 2009 IASB Meeting (IASB Staff Paper 5A))², there remains some uncertainty on the issue. For example, although the IASB Staff paper seems to assume that financial assets that have been specifically identified as 'doubtful' will not share the same risk characteristics as other financial assets, we think that need not necessarily be the case. Furthermore, where it is not the case, we do not see any reason for requiring such doubtful assets to be moved to a 'doubtful assets' portfolio as long as the expected loss model can still be applied appropriately. We think some additional, non-prescriptive guidance on this issue would be useful, particularly on the practicalities. In particular it would be useful if the explanation in footnote 10 of the IASB Staff Paper 5A³, that describes the movements of financial assets out of portfolios, could be expanded and illustrated as a numerical example.

² This guidance is set out in appendix 2 for ease of reference

³ This footnote is set out in appendix 2 for ease of reference.

Revolving credits

- 8 There is some uncertainty as to how it is intended that the expected loss model should be applied to portfolios containing financial assets that are replaced on a regularly occurring short-term basis (for example portfolios of credit card receivables, over-drafts and certain trade receivables). Expected losses on these types of portfolios could relate to financial assets not yet on an entity's balance sheet and the level of expected loss will be impacted by the nature of the customer relationship. We think it would be helpful were the IASB to provide more guidance about how these aspects of revolving credits should be incorporated into an expected loss model.

Transition provisions

- 9 We also think the transition provisions will be very important since they could significantly impact the financial result of a reporting entity. As a result it would be helpful to have clear and operational guidance on the proposed transition provisions of the Expected Loss Model.

Question 2—Is the approach operational (ie capable of being applied without undue cost)? Why or why not? If not, how would you make it operational?

EFRAG View

- Implementation of an Expected Loss Model will be operationally challenging.
- Operational Challenges include:
 - Lack of data;
 - Control process needs to be extended;
 - Effective Interest Rate calculation increases in complexity; and
 - Unit of account and correlation.

EFRAG's comments

- 10 Based on the discussions we have had so far with EU preparers, EFRAG understands that the implementation of an Expected Loss Model is likely to be operationally challenging. There are a number of issues that will be particularly challenging, and they are set out below. It would be helpful if the IASB could try to address these operational challenges at the next stage in its project:

Lack of data

- 11 A major concern of some constituents regarding the implementation of the Expected Loss Model is the potential lack of data for certain types of financial assets held at amortised cost. Unlike the Incurred Loss Model where an entity could use information and judgment to identify a population of financial assets in order to substantiate that losses had been incurred, the Expected Loss Model will require an entity having to obtain historical loss data for all of its financial assets held at amortised cost. Although it is often argued that this data is needed in order to price a loan correctly, it is clear that financial institutions do not always have historical loss data—particularly for some types of financial assets or some types of markets. Similarly, for corporates there are concerns about the availability of data

to calculate expected losses on consumer receivable and other types of lending activities.

- 12 As mentioned previously, data will also be needed about differences expected in the future compared to the past, and that too might be difficult to obtain initially.

Control processes

- 13 Further, the implementation of an Expected Loss Model would require an extension of the control process over the use and reporting of credit data. In particular, it will be important to break out the credit spread from the interest rate spread. This split would need to be tracked from pricing, to origination, to performance measurement and to accounting. Each different phase would require consistency and alignment and therefore would need an effective control structure. Thus, implementing an Expected Loss Model will not involve just a few spreadsheets; it will involve changes to a wide-range of inter-linked information systems and control structures and will therefore involve both time and significant cost.

Effective Interest Rate

- 14 The existing Effective Interest Rate requirements of IAS 39 *Financial Instruments: Recognition and Measurement* can be difficult to implement, particularly when fees are involved. However, we believe the calculation will be more complicated under the Expected Loss Model when credit losses have to be factored in and continually reassessed. With respect to financial institutions, one of the difficulties in applying the effective interest rate is that the amount reported for financial reporting purposes does not necessarily align with the systems that report balances to customers. The Effective Interest Rate Calculation therefore creates an additional reporting burden on entities and increasing its complexity will only increase this burden.

Unit of account and correlation

- 15 We also believe that the unit of account—and in particular the effects of diversification and correlation—will also cause operational difficulties. If an entity decides to treat a portfolio of financial assets as its unit of account for impairment purposes, that will mean presumably the Expected Loss Model should consider the impact of negative correlation (diversification) and positive correlation between the individual assets of that portfolio. As a measure of relationships between financial instruments correlation can be difficult to value and uses information that can be unobservable.

Question 3—What magnitude of costs would you incur to apply this approach, both for initial implementation and on an ongoing basis? What is the likely extent of system and other procedural changes that would be required to implement the approach as specified? If proposals are made, what is the required lead time to implement such an approach?

EFRAG's request to constituents

EFRAG is still seeking information on the magnitude of costs associated with implementing an Expected Loss Model. We would therefore be grateful if preparers could forward to us information about their cost estimates so that our final letter can take into account a broad spectrum of cases.

Question 4—How would you apply the approach to variable rate instruments, and why? See the Appendix for a discussion of alternative ways in which an entity might apply the expected cash flow approach to variable rate instruments.

EFRAG View

- On the amortisation of upfront fees on variable rate instruments, EFRAG supports using the effective interest rate calculated upon initial recognition of the instrument.
- On the amortisation on impaired variable interest rate loans: EFRAG supports recalculating the effective interest rate so that the still expected future interest and principal receipts are discounted to the carrying amount.

Notes for EFRAG's constituents

16 *Under the Expected Loss Model described in the IASB paper, for fixed rate instruments the effective interest rate would be calculated on initial recognition (and would be based on expected future cash flows) but would not subsequently be recalculated as those expectations, and other factors, change. However, variable rate instruments present challenges when applying the Expected Loss Model. These challenges relate, in part, to the need to update the effective interest rate to reflect movements in market rates of interest, the resulting amortisation pattern for upfront costs (ie fees, points, transaction costs and other premiums or discounts) and how receipts of interest are treated post an impairment event.*

EFRAG's comments

Amortisation of upfront costs

- 17 Under the Expected Loss Model there are two main approaches for amortising upfront costs on variable rate instruments:
- (a) Approach A: Amortise upfront costs using the original effective interest rate calculated upon initial recognition of the instrument. The initially determined amortisation pattern would then remain constant; or
 - (b) Approach B: Recalculate the amortisation pattern for upfront costs on the basis of revised variable interest rate movements. This would mean the amortisation pattern for upfront costs would change in response to variable interest rates.
- 18 EFRAG supports Approach A. In our view this Approach would be operationally easier to implement. We also believe that the difference in amortisation profiles is

supportable since upfront fees can be differentiated from yield on the basis they are fixed and do not necessarily relate to notional size.

Impairment of Variable Rate Instruments

- 19 When a financial instrument becomes impaired, future interest cash flows are in effect treated as repayments of principal rather than interest revenue. Under the Expected Loss Model there are two possible approaches to treating this ‘repayment of principal’ to variable rate instruments:
- (a) Approach A: Recalculate the effective interest rate (based on the forward curve as updated from time to time) so that the still expected future interest and principal receipts are discounted to the carrying amount; or
 - (b) Approach B: Keep the effective interest rate constant after impairment and treat changes in the carrying amount resulting from changes in variable benchmark interest rate as a “catch-up” reflecting the fact that changes in cash flows more appropriately reflect repayments of principal rather than variable interest receipts.
- 20 EFRAG supports Approach A. EFRAG considers that interest paid after a financial instrument has been impaired should result in the split between interest and credit losses being clear in the financial statements. Approach A recalculates the effective interest so that the still expected future interest receipts and the still expected principal receipts are discounted to the carrying amount. However, we also note that, although a similar recalculation occurs under the current incurred loss model, these will increase in regularity and range of application across instruments under the expected loss model and that will probably mean that Approach A is the more complex and costly of the two approaches for preparers to implement

Question 5—How would you apply the approach if a portfolio of financial assets was previously assessed for impairment on a collective basis and subsequently a loss is identified on specific assets within that portfolio? In particular, do you believe:

- (a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?**
- (b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?**

EFRAG View

- EFRAG believes that the eventual standard should adopt a principle-based approach to this issue; as long as there is no double-counting and satisfactory assessments are being made of expected loss, a reporting entity should be able to choose whether it removes a financial asset for which an impairment loss has been identified from a portfolio of performing assets.

EFRAG’s comments

- 21 When a financial asset is part of a portfolio that has been subject to collective impairment, the question arises as to how that asset should be treated when its performance becomes increasingly doubtful. The two alternatives are:

- (a) Take the individual financial asset out of the portfolio on the basis that it no longer shares the same risk characteristics as the remaining financial assets in the portfolio. Under this approach, the collective impairment needs to be allocated to the individual asset, and going forward an individual impairment assessment (or as part of another portfolio) needs to be performed on that specific asset.
 - (b) Keep the individual financial asset as part of the portfolio on the basis that the losses identified are reflected in the portfolio cash flow expectations.
- 22 EFRAG considers that the key issue here is whether satisfactory assessments of expected losses can still be made if the assessments continue to be done on a collective basis when a portfolio comprises some 'doubtful assets' and some that are not yet doubtful. If that is possible, the standard should not be prescriptive and a reporting entity should be able to choose whether it removes a financial asset, for which performance has become more doubtful, from a portfolio of performing assets. This choice should be based on whether the reporting entity manages under-performing financial assets separately (whether individually or as part of a portfolio of similar assets) or whether continued inclusion in the performing portfolio undermines its management. The choice should be subject to the more doubtful assets being included in the portfolio assessment of expected cash flows and resulting in no double-counting of losses.

Question 6—What simplifications to the approach should be considered to address implementation issues? What issues would your suggested simplifications address, and how would they be consistent with, or approximate to, the expected cash flow model as described?

EFRAG's request to constituents

EFRAG is still seeking suggestions from preparers on whether there are any simplifications to the expected cash flow approach that would make implementation easier. We would therefore be grateful if preparers could forward to us suggestions to simplify the model and/or simplifications in the implementation approach.

Appendix 2

Extracts from relevant IASB staff papers

Paragraph 4's reference to paragraphs 35 to 41 of IASB Staff Paper 5A

Application to portfolios and individual financial assets

35. Existing IFRS requirements relating to application of impairment requirements to portfolios and individual financial assets (which the IASB deliberated at great length during the 2003 Improvements project) are based on:
- (a) an individual assessment of a financial asset for impairment; and
 - (b) a collective assessment of a group of financial assets, which:
 - (i) is eligible in lieu of an individual assessment if:
 - the financial assets in the group are not individually significant;
 - the financial assets in the group have similar credit risk characteristics; and
 - there is no information yet that specifically identifies losses for an individually impaired asset (as soon as such information is available, the asset is moved from the collective to an individual assessment);
 - (ii) accompanies the individual assessment if:
 - no objective evidence of impairment exists for an individually assessed financial asset; and
 - the entity has a group of assets with similar risk characteristics.
36. The complexity of this interplay between individual and collective assessments results from the threshold used by the incurred loss model for recognising impairment losses (ie 'objective evidence of impairment' or 'loss event'). It is this 'incurred' threshold that requires much of the differentiation regarding the collective assessment.⁹ Not only does it result in complexity but also in arbitrary outcomes.
37. For example, requiring the accompanying collective assessment (see paragraph 35(b)(ii) above) if an entity has a group of assets with similar risk characteristics, but prohibiting it if the entity does not have such a group, is obviously not directionally consistent with an objective of identifying impairment losses, which do not depend on whether or not an entity has other financial assets with similar risk characteristics. Instead, it reflects the difficulty of applying the notion of a loss event, which results in a systematic bias because the application to groups results in a different (earlier) timing of identifying loss events than on an individual basis. This is for example the case of 'incurred but not reported' losses (IBNR).
38. An expected cash flow approach would eliminate the complexity and arbitrariness of the existing requirements. Because the expected cash flow approach does not involve a threshold for impairment testing (see paragraph 8 above) the interplay between a collective and an individual assessment would be principle-driven: the type of assessment that better facilitates the cash flow estimate would be used.
39. Let us illustrate that. For financial assets that have similar characteristics estimating future cash flows on a group basis essentially allows making use of the law of large numbers, which improves the accuracy of the overall estimate. However, as the performance of an individual financial asset becomes increasingly doubtful it becomes less likely that it still shares the characteristics of the group it was included in before. Thus, that financial asset

would either be included in another group that now offers a good fit of characteristics (eg a type of non-performing loan portfolio or cascade down a provision matrix) or it may have developed such individual characteristics making it so dissimilar that an individual assessment gives the better estimate.

40. Switching from a group- to an individual instrument-based cash flow estimate would not cause an automatic profit or loss impact just because of changing the approach. The financial instrument's carrying amount at the time of switching the approach already reflects the expected cash flows as most recently revised (ie the last time the estimate for the group was revised). Thus, if for example an entity uses a 'portfolio allowance' for the purpose of recording the adjustments for a group of financial assets resulting from revisions of cash flow estimates, the portion of that portfolio allowance that is attributable to the individual financial asset that is switched to an individual assessment would be taken out of that portfolio allowance and be attributed to that individual financial asset.^(See footnote 10) That is not to say that the new cash flow estimate on an individual financial asset level might not result in a revision of the previous (group level based) estimate.
41. Another feature of the expected cash flow approach is that the same principle for estimates using a collective or individual approach would also apply to other aspects of cash flow estimates than credit risk related ones. As noted previously in this paper, for example, an estimate of prepayment patterns for prepayable instruments is already required as part of the EIM under currently existing requirements. That estimate may be based on an individual financial instrument or a group of financial instruments. However, this estimate is not subject to a threshold like the one for credit losses under the incurred loss model. Thus, an expected cash flow model would use the same principle for choosing between group- or individual instrument-based cash flow estimates irrespective of the type of uncertainty (ie whether or not credit loss related). However, for disclosure purposes, different types of uncertainties and how they affect the estimates may have to be disaggregated (eg to allow a reconciliation of changes related to credit risk).

Footnote 10

In terms of bookkeeping this can be effected in different ways. For example, one way of achieving this is to remove the nominal amount of the financial asset from the total of nominal amounts that feed into the portfolio assessment, which ceteris paribus reduces the portfolio allowance (against profit or loss). The carrying amount of the financial asset would then be adjusted for the entire effect of the latest cash flow estimate made at the level of the individual financial asset (against profit or loss). Thus, the adjustment made at the level of the individual level would be offset to the extent of the adjustment that was already made previously at the portfolio level. (For disclosure purposes that link between the portfolio level adjustment and the individual level adjustment when switching the approach might need to be tracked, though. This is because, to the extent of the offset, a gross presentation as a reduction and an increase in the different adjustments might be misleading).