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Sir David Tweedie
International Accounting Standards Board
30 Cannon Street
London EC4M 6XH

1 April 2011

Dear Sir David

Supplement to Exposure Draft ED/2009/12 *Amortised Cost and Impairment*

Deloitte Touche Tohmatsu Limited is pleased to respond to the IASB's Supplement to the exposure draft ED/2009/12, *Amortised Cost and Impairment* ('the Supplement').

We support the IASB and FASB's joint efforts to reach a consensus on amortised cost and impairment accounting. We also support the IASB's broader effort to develop IFRS 9 *Financial Instruments* as a replacement to IAS 39 *Financial Instruments: Recognition and Measurement*. The amortised cost and impairment requirements are a critical part of this project.

We appreciate the efforts both Boards have made in developing proposals for a more operational expected loss model. Clearly understood and operational amortised cost and impairment measurement requirements are critical to the success of a mixed-measurement model. The Boards are to be commended in trying to develop proposals that cater for complex open portfolios.

We are generally supportive of an approach that recognises lifetime expected credit losses for performing assets ('the good book') on a time proportional basis with a minimum floor and recognises immediately lifetime expected credit losses for assets that are identified as non-performing ('the bad book') in full. This approach is a compromise by the two Boards and balances the objectives of deferring income for the credit risk premium associated with non-payment of the borrower and the objective of ensuring that when credit losses occur they are recognised in full. We recognise that a minimum floor is necessary with a time proportional approach as there will be scenarios in which the losses recognised under the time proportional approach will not result in a faithful represention in the balance sheet of the amount of impairment. However, we are not supportive of the inclusion of a 'higher of' test based on an assessment of credit losses expected in the 'foreseeable future' for assets in the good book. We believe that neither which losses this test is trying to capture nor how to determine the foreseeable future time horizon is clear from the Supplement. We are also concerned that the time horizon will be subject to change and that there will be a lack of comparability across entities. As noted above, we appreciate, however, the need for a 'higher of' test to ensure that impairments are recognised on a timely basis for non-performing loans that have not yet been identified as 'bad loans' by an entity's risk management. To achieve this, we believe that accelerated loss recognition should be required when the time proportional approach does not result in sufficient recognition of impairments, but that this acceleration should be based on an incurred basis similar to that currently applied in IFRSs and US GAAP. This will have the benefit of utilising existing concepts and methodologies. We also believe the current incurred loss model can be enhanced with

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further implementation guidance on when losses are incurred and how such losses should be measured.

We are concerned though that, should both Boards develop a finalised standard applicable to single loans and closed portfolios based on their proposed model or an amended model, and conclude on all the other aspects of the project, such as the measurement of credit losses, that are not included in this Supplement, that there will be application issues and unintended consequences which cannot currently be foreseen. We therefore believe that, following the Boards' re-deliberations, the entirety of amortised cost and impairment proposals should be re-exposed in their entirety, with a relatively short comment period, to give constituents the opportunity to understand the full picture. This would also allow some field testing of the final proposals. We consider that a small delay in finalisation of IFRS 9 will be worthwhile if it reduces the number of application issues that will arise from the finalised standard.

If you have any questions concerning our comments, please contact Veronica Poole or Andrew Spooner in London at +44 (0) 207 007 0884 or +44 (0) 207 007 0204 respectively.

Yours sincerely,

Veronica Poole
Global Managing Director
IFRS Technical

Appendix

Responses to Invitation to comment

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?

We note the Boards are proposing an expected loss model that is very different from the present incurred loss models in IAS 39 and US GAAP and is designed to recognise expected credit losses earlier. The model for determining the allowance on assets in the 'bad book' (immediate recognition of expected lifetime losses) is an appropriate and effective way of dealing with credit losses in respect of those assets. For assets in the 'good book' we believe the time proportional element of the model (an allocation of lifetime expected losses) also helps to overcome the weakness of an impairment model based solely on incurred losses by accelerating the recognition of expected credit losses. We note that the minimum allowance amount for the 'good book' as proposed in the Supplement is an attempt to accelerate further the recognition of expected credit losses (specifically those expected to occur in the foreseeable future). However, as detailed in our response to Question 3 we have major concerns with the inclusion of a floor based on credit losses expected in the foreseeable future on conceptual grounds, as well as with the auditability and comparability of the resulting allowance. As detailed in our response to Question 9(c) in circumstances of macroeconomic turmoil the approach proposed in respect of the good book could result in the allowance being reduced through the foreseeable future time horizon being judged to have shortened. Therefore, the Boards should consider a modification to the proposed model in the form of a minimum allowance for the good book that is based on incurred losses similar to that under current GAAP rather than losses expected in the foreseeable future.

The issue of measurement of expected credit losses (as opposed to the timing of their recognition) is not within the scope of the Supplement and is subject to further Board discussion. We believe that this outstanding piece is critical to understanding how the model will function in practice and whether it will overcome the criticisms of the incurred loss model and be operational and understandable. Specifically, as noted in our response to Question 4, and contrary to the tentative decisions made at the Boards' joint meeting on 22 March 2011, we continue to believe that a full probability weighted expected value approach, whilst being permitted, should not be the minimum requirement in all circumstances and that recognition of credit losses should be subject to an appropriate probability threshold.

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?

We support applying the same impairment model to single assets, closed portfolios and open portfolios. Having multiple impairment models would be unduly complex and potentially allow arbitrage between different models depending on how a portfolio is structured. Further, it would be inconsistent with one of the aims in reforming impairment being to remove the multiple impairment methodologies in IAS 39 and US GAAP.

The principle behind the approach in the Supplement of differentiating how impairment is recognised depending on how the credit risk is managed is relevant to closed portfolios and single assets. We believe that this approach could be made operational for such assets. However, consistent with our view on the approach applied to the good book for open portfolios (as expressed in our response to Question 3) we believe that in the case of single assets and closed portfolios the minimum allowance should be based on incurred credit losses rather than losses expected in the foreseeable future. Also, additional application guidance may be necessary. In particular, we encourage the Boards to provide clarification about the following issues:

- For a closed portfolio, whether the approach would result in a zero allowance for the 'good book', if all of the expected lifetime losses were originally (and continue to be) due to assets that have been moved to the 'bad book'. We encourage the Boards to observe that this may be an appropriate outcome.

- For single assets, whether an entity should include financial assets held in hypothetical portfolios of similar items (that it does not hold) to ensure that the assessment of recoverable cash flows factors in any risks arising at the portfolio level that might not yet be present at the single asset level (we also noted this issue in our response to ED/2009/12 in June 2010). We encourage the Boards to clarify that an entity shall test for impairment based on what the entity holds (that is, not based on hypothetical portfolios). An entity that holds only a single asset should not be required (or permitted) to assume that it holds a portfolio of assets. The risk profiles of these two circumstances are different.

- For single assets, how expected credit losses are measured. We note that at their joint meeting on 22 March, the Boards tentatively decided that expected losses should be estimated using a probability weighted expected value (albeit there were some differences of views between FASB and IASB members). Consistent with the view expressed in our response to ED/2009/12 in June 2010, we believe that, whilst such an approach should be permitted, it should not be the minimum requirement as this would introduce unnecessary complexity in many cases including those of some individual assets. Also, the recognition of expected credit losses should be subject to a probability threshold (such as it being more likely than not that an entity will not collect the full contractual cash flows). This would eliminate the burden of estimating and re-estimating expected credit losses in cases where there is a very low probability of losses (e.g. certain debt securities, short-term receivables due from highly credit rated entities, lending secured on assets where the security's value is a multiple of the nominal of the loan, debt guaranteed by a highly credit rated parent, etc). Whilst such a threshold would also be desirable for open and closed portfolios it would be particularly important to making any expected loss model (both the one proposed in the Supplement and the alternative model we propose in our response to Question 3) operational in the case of single assets.

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?

We support the objective of an amortised cost and impairment model that aims to depict faithfully the economics of lending transactions. The time proportional element included in the proposed 'good book' attempts to achieve this. We also believe that there is the need to supplement the time proportional element with a mechanism for accelerating loss recognition in order to avoid assets with incurred losses being measured at amounts that are not conceptually justified. However, we have concerns about the actual good book approach described in the Supplement, and specifically the floor as proposed in the Supplement (i.e. credit losses expected in the foreseeable future). Our major concerns are as follows:

- We are concerned that the concept of the foreseeable future is difficult to define adequately. Paragraph of B11 of the Supplement defines the foreseeable future as "the future time period for which specific projections of events and conditions are possible and the amount of credit losses can be reasonably estimated based on those specific projections". We believe that it will be difficult for preparers to determine how specific projections have to be, what qualifies as an 'event' and 'condition' and how in practice to apply a threshold for a 'reasonable' estimation of the amount of credit losses. It is not clear how forecasting these loss events and their impact on the amount of credit losses is distinguishable from determining credit losses for the full life of the portfolio (i.e. loss events beyond the foreseeable future). Whilst we acknowledge that establishing an appropriate impairment allowance is inherently judgemental we believe the lack of clarity over the concept of foreseeable future will result in lack of comparability to an undesirable extent and difficulties in terms of auditing the judgements made.

- As noted in our response to Question 9 (d), we note that the time horizon for 'the foreseeable future' could be subject to change due to macroeconomic circumstances. In particular, in circumstances such as the recent global financial crisis this period of time may well be judged to have shortened. In many scenarios this would have the effect of a decrease in the allowance amount which we believe was not the intention of the Boards.

- We note that the floor as proposed in the Supplement would in some circumstances result in the recognition in profit or loss of expected credit losses at initial recognition as the losses expected in the foreseeable future will be greater than the time proportional amount (which will be zero). Upfront recognition of credit losses would not be consistent with the objective that the allowance depicts the economics of lending which is a concept that underpins the time proportional approach.

- We believe the Supplement is not clear what credit losses are intended to be included in the minimum allowance. It is not clear whether it is only contractual cash flows due in the foreseeable future that are not expected to be paid by the borrower (i.e. cash losses), or whether it is losses that will arise due to credit events that are expected to occur in the foreseeable future (i.e. incurred losses).

Our further comments on the floor proposed in the Supplement are detailed in our response to Question 9. In summary, the floor proposed in the Supplement is not conducive to meeting the objective of amortised cost measurement as proposed in the ED/2009/12 to *"provide information about the effective return on a financial asset or financial liability by allocating interest revenue or interest expense over the expected life of the financial instrument"*. Whilst we accept the need for a time proportional allowance to be subject to a minimum, we believe the floor as proposed is not a conceptually well defined, appropriate or auditable minimum. Given the shortcomings of the proposed approach as described above, we are concerned about it as a basis of establishing allowances for the 'good book' and would strongly encourage the Boards to consider other approaches such as the one described below.

Alternative approach

General outline

To address our concerns we believe that the Boards should explore an approach for the good book that retains the time proportional element but makes it subject to a minimum allocation requirement of a different nature to that proposed in the Supplement. Specifically the alternative model would establish an allowance for the good book that is the higher of:

(a) the time proportional amount (as per the proposed approach); and

(b) incurred credit losses determined on a similar basis to current IAS 39 and US GAAP.

Under this approach, recognition of expected losses is accelerated in certain cases to ensure that the level of allowance is sufficient to absorb incurred credit losses that have taken place to date. We also believe that for the purposes of the above requirements the Boards should consider enhancing the current incurred loss model (as per current GAAP) with further implementation guidance on when losses are incurred and how such losses should be measured.

Application of the "higher of" determination

In applying the 'higher of' concept as laid out above we believe an entity would have to make a judgement as to whether any incurred losses affected only a specifically defined group of assets within the 'good book' (e.g. based on geography) or the whole 'good book'. If the former were true then the 'higher of' calculation would be applied separately to the group of loans affected by the event and separately to the remaining loans in the 'good book'. If a loss event did not affect a discrete, well defined segment of the 'good book' the 'higher of' determination would be made at the level of the 'good book' as a whole.

For instance an entity may have an open portfolio of consumer loans that includes loans made to individuals throughout a country but a loss event (e.g. closure of the city's major employer) has affected expectations of cash flows only on loans made to individuals in a particular city. In such a case an entity would apply the 'higher of' determination separately to the loans made to residents of the city in question and to all other loans in the 'good book'. In respect of the loans made to residents of the particular city the entity would compare the incurred loss amount as a result of the loss event with the time proportional allocation of lifetime expected losses in respect of that population of loans. In respect of the loans not affected by the loss event, applying the 'higher of' approach as laid out above would generally mean establishing a provision equal to the time proportional amount for that population of loans (assuming the incurred losses for that segment are less than the time proportional amount). By contrast if a loss event were a nationwide rise in unemployment the ‘higher of’ determination would be made at the level of the ‘good book’ as whole.

Advantages of the alternative approach

We believe that such an approach would retain a strong element of spreading lifetime expected losses. This would provide a way of addressing the criticism of the present model in IAS 39 and US GAAP (delayed recognition of expected credit losses) and better depict the economics of lending. Like the proposed approach, it would prevent scenarios of negative reserves (i.e. allowance amount smaller than incurred losses to date) from arising and ensure adequate provisioning for portfolios with patterns of early losses. In addition we believe it would have a number of advantages (relative to the proposed approach in the Supplement).

The alternative approach would avoid the difficulties in interpreting the concept of foreseeable future (and underlying notions of ‘specific events and conditions’ and ‘reasonable’ estimation of cash flows) and determining the difference between credit losses expected in the foreseeable future and the lifetime expected losses. Whilst we acknowledge that the incurred loss approach itself is subject to judgement (as to whether and when a loss event happens) we believe the alternative model would nonetheless result in more comparable allowances for equivalent loan portfolios. Also the undesirable scenario of allowances potentially being reduced at times of economic turmoil due to a shortening of the foreseeable future time horizon would not occur.

The minimum allowance under the alternative approach would make use of the familiar concept of recognition of credit losses due to loss events that have occurred (as per current IAS 39 and US GAAP) that many preparers and auditors will have experience of, rather than the new, untested and potentially very unclear concept of credit losses expected in the foreseeable future.

Question 4
Would the proposed approach to determining the impairment allowance on a time-proportional basis be operational? Why or why not?

We believe that preparers are better placed to answer the question of how operational the proposals are. However, we noted in our response to ED/2009/12 in June 2010 that we believe there would be operational issues in the implementation of a full probability weighted expected value approach in all circumstances. We note the tentative decision made in the Boards’ joint meeting on 22 March 2011 in favour of requiring the use of an expected value measure with regard to credit losses. Consistent with our response to Question 2, we continue to believe that this should not be the minimum requirement in all cases and that a recognition threshold (such as it being more likely than not that an entity will not collect all the contractual cash flows) should be applied to expected credit losses for open portfolios (as well as closed portfolios and single assets). We do believe that if an expected value measurement is required and is not combined with such a minimum threshold this will make the determination of the impairment allowance on a time proportional basis very burdensome in the case of assets with very high credit quality (e.g. some sovereign debt securities).

Question 5
Would the proposed approach provide information that is useful for decision-making? If not, how would you modify the proposal?

Investors are best placed to judge the usefulness of the information provided by the proposed approach. However, we note that the approach provides different (and potentially more useful) information to users than a model based solely on incurred losses. Supplemental disclosures about total expected losses not yet recognised and other information about the methodologies used to recognise and measure impairment (e.g., information about actual defaults and loss severities) would also appear to be useful.

It would be useful if the Boards provided (in the basis of conclusions to the final guidance) a better explanation of why they believe the information provided by the time proportional approach is useful for decision-making. This is particularly important given the fact that the time proportional approach appears to derive from a revenue recognition perspective whilst the Boards proposals with respect to the Conceptual Framework seem to give primacy to a balance sheet and asset driven perspective.

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?

We consider that a single 'good book' and 'bad book' differentiation should be applied to single assets and closed portfolios as well as open portfolios. We believe that the description provided in the proposed application guidance B3 will be understandable and familiar to both financial reporting and credit risk management professionals in most instances (which is particularly important given that the proposed approach closely links accounting and risk management). The list of examples of the more active modes of credit risk management typical for assets in the 'bad book' will also be generally helpful in applying the requirement in practice. The guidance could usefully be supplemented by a statement that the change in the objectives of credit risk management (and therefore transfer from the 'good book' to the 'bad book') will typically take place when a specific loan has been identified as one for which the entity does not expect to collect all contractual cash flows (or in the case of purchased assets all cash flows expected upon initial recognition) when due. Additionally some specific concerns about the description are listed below.

Terminology

We understand that the terms 'good book' and 'bad book' are not in common use in certain territories and could lead to confusion. Further, the use of 'good' to describe a part of portfolio is misleading as that part of the portfolio may have incurred losses as we described above. We believe the Boards should consider using more neutral terminology such as 'performing'/'non performing' book to ensure the requirements are interpreted consistently in all territories and all languages. We note that the terms 'good book' and 'bad book' are not used in the proposed main body of the standard or the proposed application guidance (Appendix B).

Acquired portfolios of distressed debt

Entities which purchase debt with incurred credit losses (e.g. distressed consumer debt) may operate within a business model where the aim is to collect contractual cash flows and therefore would account for the distressed debt at amortised cost (providing the other criterion in IFRS 9:4.2(b) or the US GAAP equivalent requirement is met). While the debt may be distressed it may be performing as expected relative to the purchase price and initial expectations of cash flows. The Boards should clarify whether such assets could be within the 'good book'.

The distinction between the books is explained in paragraph B3 of the Supplement as one of "the entity's credit risk management objective changing from receiving regular payments from the debtor to recovery of financial assets". Some of the indicators of the latter objective provided (such as attempting to recover cash flows from an uncollateralised financial asset by making contact with the debtor or enforcement of security for collateralised debt) could be present immediately upon purchase of a portfolio of distressed debt. The entity's objective in that sense may well not be 'receiving regular payments from the debtor' even at date of purchase.

However, in paragraph B2 of the Supplement it is stated that the differentiation between books depends on 'whether the uncertainty about the collectability of an asset has taken precedence over its profitability from the interest charged'. In the case of a purchase of loans with incurred credit losses, the discounted price paid is intended to ensure that the holding of such portfolios is profitable despite considerable uncertainty about collectability and does not depend only on the interest charged by the originator. Therefore it is unclear how the 'good book' or 'bad book' approach should be applied to a purchased portfolio of loans with incurred credit losses and the Boards should clarify this through further application guidance.

If the Boards do envisage that in some cases portfolios of loans with incurred credit losses do initially belong in the 'good book' we also believe that better guidance is needed in respect of the point at which for accounting purposes the transfer from the 'good book' to the 'bad book' should occur. In explaining the differentiation and movement between the books paragraph B3 of the Supplement refers to the point when 'management of the financial asset(s) typically becomes more active' and then provides examples of such 'more active' management. The management of a portfolio of loans with incurred credit losses may be 'more active' from the point of initial recognition and that, therefore, more guidance may be required on the application of this principle in such circumstances.

Securities

We do not believe that the differentiation between the 'good book' and 'bad book' reflects credit risk management practices in the case of many portfolios of securities. Two common scenarios are corporate entities investing surplus cash in a portfolio of sovereign and high quality corporate bonds and insurance entities holding a portfolio of similar assets in order to provide an economic hedge against long-dated insurance liabilities. In such cases, typical risk management procedures (based on monitoring of external credit ratings) would require the disposal of securities suffering from a deterioration in credit quality well before the stage at which the credit risk management objective would become 'recovery of the financial asset'. The entities in question may not engage in any of the more active credit risk management practices listed in paragraph B3 of the Supplement. We therefore believe that if the Boards wish to apply a differentiated approach (depending on credit quality and credit risk management) to establishing an impairment allowance for portfolios of securities as well as loans, more application guidance will be necessary.

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?

We consider that preparers are best placed to answer the question of whether differentiation of good and bad books is operational. However, those entities with clearly defined credit risk management procedures that already operate using this distinction will incur the least effort in making the requirement operational. From an auditor perspective the requirement will place even greater emphasis on the definition, processes and implementation of risk management activity. This varies considerably across entities.

Although not commenting as preparers we do have the following observations:

Consistency of differentiation between ‘good book’ and ‘bad book’

As the differentiation of good versus bad books is so reliant on an entity’s credit risk management, entities with different policies in managing credit risk will have different impairment outcomes. We do not object to these differences as long as the basis for determining the differentiation between the ‘good’ and ‘bad’ books is made clear in disclosure as required by paragraph Z15. To support these disclosures we would expect that the good versus bad book distinction would be consistent for similar assets and constant over time, unless there were objective circumstances to justify any differences (in which case these should be disclosed). Therefore, paragraph Z15 should be supplemented with an additional subparagraph to require specifically that if there has been any change in the criteria used to determine how financial assets are managed and the criteria to distinguish between those for which impairment allowances are determined in accordance with paragraph 2(a) and 2(b) then this change and the reasons for it should be disclosed. Additional guidance and disclosure would help to foster consistency in application and make the differentiation more auditable, while still preserving the link to the entity’s own individual credit risk management policies.

Application to entities with less well defined credit risk management policies

We welcome the proposal in paragraph B4 of the Supplement for entities that do not manage credit risk on a ‘good/bad book’ basis to distinguish between the two groups of assets for the purposes of determining an impairment allowance. We appreciate that the application of the distinction may prove problematic for entities with less well defined or documented credit risk management policies (particularly smaller entities), yet we believe that the principle that underlies the good and bad book approach can still be applied. To limit a ‘good’ and ‘bad’ book approach to entities that differentiate on that basis for credit risk management could result in arbitrage or potentially deferred recognition of credit losses because of a lack of credit risk management. This would not be acceptable. However, we think there is a need for further guidance on the application of the distinction to less sophisticated risk management practices that would foster more consistency of application and make the distinction more auditable.

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?

We agree that the differentiation of the two groups of assets is a reasonable basis for determining the impairment allowance. However, we believe the distinction between the two groups is more intuitive in the case of loans that are originated. Please refer to our response to Question 6, which discusses our concerns about differentiating in the proposed manner for debt securities and acquired distressed debt.

Question 9
(a) Do you agree with the proposal to require a floor for the impairment allowance related to the 'good book'? Why or why not?

As noted in our responses to Questions 3 and 9(c), we do not believe that the minimum allowance should be based on credit losses expected in the foreseeable future. However, as set out in our answer to Question 3, we believe that there is a need for the requirement for accelerated recognition of expected losses in respect of the 'good book', which is different from the proposed 'floor'. We believe that the mechanism of accelerated recognition of expected losses is useful in ensuring a sufficient allowance that covers the incurred losses.

(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?

We do not support such a requirement as it would add additional complexity and cost to the operation of the model for little benefit. Such a requirement would need to be backed by detailed guidance on how to identify and evidence an early loss pattern. Having made such a determination, we are not convinced as to whether the outcome would differ substantively from that where a minimum (floor) would be required unconditionally. We believe this to be the case regardless of whether the minimum (floor) is in the form of credit losses expected in the foreseeable future (as proposed in the Supplement) or incurred losses under current IAS 39 and US GAAP (as per the alternative approach we propose in our response to Question 3).

(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?

As detailed in our response to Question 3 we do not support a minimum allowance determined on the basis of losses expected to occur in the foreseeable future. We do not believe that the concept of foreseeable future is clearly defined in such a way as to make it operational. We believe that a floor on this basis would produce information that is neither auditable nor comparable (for entities with equivalent loan portfolios). In addition, application of such a minimum could result in the undesirable outcomes of losses upon origination of lending (or purchase of loans) as well as allowances decreasing at times of economic turmoil due to the time horizon of the foreseeable future being judged to have shortened.

Therefore, as detailed in our response to Question 3 we would urge the Boards to consider an alternative basis for the minimum allowance, and specifically one similar to that for incurred losses under current IAS 39 and US GAAP. We believe this form of the minimum allowance would avoid the above mentioned disadvantages of the floor as proposed. We also note that such a minimum relies on a concept that is familiar to preparers, users and auditors.

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

We note that the proposed guidance in paragraph B14 of the Supplement suggests that the foreseeable future 'would be a fairly constant period that would not be expected to change significantly from period to period'. As we note in our response to Question 3, we not believe the concept is clearly defined so it is difficult for us to comment on this question definitively. However, we suspect that a fundamental upgrading of an entity's forecasting ability based on major investment in modelling as part of its credit risk management procedures could lead to an increase in the period over which the entity can forecast credit losses. We also note that there may be some severe changes in economic conditions which could give rise to changes in the length of this period (for example, the introduction of severe cuts in public spending and/or increases in taxation levels phased in over a number of years). Furthermore, one of our concerns about the appropriateness of the concept as a basis for the minimum allowance is the fact that entities could judge the period to shorten during times of economic turmoil therefore in many cases leading to a decrease in allowance levels, which we do not believe was the Boards' intention.

(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.

As noted in our response to Questions 3 and 9(c), we do not believe the foreseeable future time horizon is defined in a clear enough way to be operational and therefore it is difficult to comment on whether the period is typically greater than twelve months. However, we suspect that there may be instances in which this is the case, for instance, loan portfolios with very stable historical patterns of losses that are less sensitive to the economic cycle where it can be judged easier to predict future credit losses.

(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.

As detailed in our response to Question 3, we believe that the way to facilitate comparability as regards the minimum allowance for the 'good book' is to determine it on the basis of incurred losses under current IAS 39 and US GAAP rather than expected losses in the foreseeable future subject to any minimum or maximum. Even with a minimum and a ceiling (e.g. no more than three years) a floor of the foreseeable future would still in practice suffer from the disadvantages in terms of lack of clarity about the underlying concept, lack of comparability and difficulties in auditing. In contrast, a minimum based on incurred losses - whilst involving some judgement - would utilise an existing concept that should be familiar to preparers and users and therefore foster a greater level of comparability. It would also avoid the outcome of decreasing allowances at times of macroeconomic stress, which is possible with the floor as proposed but subject to a ceiling in cases where the foreseeable future is judged to have shortened.

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.

The lack of clarity in the concept of the foreseeable future (as explained in our response to Question 3) makes it difficult to determine both the time horizon that the floor covers and the size of the losses expected in that period. Additionally, the differing risk management capabilities in terms of forecasting and the stage of the economic cycle that the foreseeable future covers at any point in time will also have an impact on the level of the minimum allowance. All of these factors make it difficult to provide a general answer as to when the floor will be higher than the amount calculated per paragraph 2(a)(i). However, based on our understanding of credit risk management practices we believe this will be the case for many short-term loans (including many consumer loans), many mortgages, and other portfolios displaying a pattern of early losses. We note however that there are also some distinct asset classes such as portfolios of long-term corporate loans, long-dated corporate bonds, or sovereign bonds where this may not to be the case.

Question 11
(a) Do you agree with the flexibility permitted to use either a discounted or undiscounted estimate when applying the approach described in paragraph B8(a)? Why or why not?

Conceptually we believe that it would be appropriate to use a discounted estimate in applying the approach described in paragraph B8(a). However, we recognise that there may be a number of instances in which it can be shown without actually making a precise calculation that using an undiscounted estimate would not provide a materially different outcome. We would therefore suggest that rather than providing guidance that simply states that an undiscounted amount can only be used in instances where it results in materially the same result as a discounted estimate the Boards could help preparers and auditors to avoid unnecessary cost and effort by identifying generic situations where this will be the case.

We would suggest that the list of examples of situations where using an undiscounted estimate would be permitted should include secured short-term consumer lending, secured short-term corporate lending (e.g. short-term bridging loans) and steady state open portfolios (i.e. those where the assets are removed and added to the portfolio such that the average age of the portfolio is relatively constant over time) where in each case the discount rate used is low. We believe it is important for the guidance to make reference to a low discount rate (for example as a result of a macroeconomic environment in which risk free rates are low) as with high discount rates (for instance as a result of high levels of risk free rates) the assertion about the immaterial effect of discounting may not necessarily be valid. The Boards may want to make enquiries with preparers and auditors to establish whether there are other specific examples that should be added to this generic list. We note that in addition to the above list, for the IASB short-term trade receivables are outside the scope of the proposals in the Supplement.

(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?

We understand that the Supplement focuses on the timing of credit loss recognition with issues of measurement of the amount (including the discount rate) yet to be deliberated by the Boards. Accordingly, our ability to comment in this area at this stage is limited. However, we are concerned that flexibility in the selection of discount rates could result in an unnecessary lack of comparability.

We note that in line with the principles in other IFRSs (IAS 37 for instance) the discount rate used should be adjusted for risk if, and only if, that risk is not reflected in the cash flows being discounted. In the case of discounting expected credit losses, the exercise is one of discounting contractually due cash flows that are not expected to be received but the same principle applies.

In cases where a probability weighted expected value approach to measuring expected losses is used, this uncertainty will be taken into account in estimating the cash flows not expected to be received and hence the use of the risk free rate will be appropriate (if discounting is applied). Specifically we believe the ‘frozen’ risk free rate at the point of initial recognition of the asset should be used. We note that the application guidance in the Supplement (B10) simply uses the term ‘risk free rate’ without specifying if this is the ‘frozen’ rate as described here or the current rate at the point of remeasuring the impairment allowance. Use of the current rate would amount to fair valuing the cash flows expected not to be received for movements in the risk free rate, which is not consistent with the objective of amortised cost measurement. We believe that application guidance should make this point clear.

In other cases where the uncertainty is not taken into account in the determination of the measurement of expected losses we believe the required discount rate (if discounting is applied) should be a rate that is risk adjusted which in certain cases would equate to the effective interest rate (EIR) determined in accordance with current IAS 39 or its US GAAP equivalent (or the contractual rate if this is a close approximation thereof).

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?

See response to question 13.

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 approach (ie to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

We prefer the model proposed in the Supplement (subject to suggested revisions discussed in our response to Question 3) over both the IASB or FASB only approaches. We believe that the IASB only approach is in line with the objective of amortised cost measurement and thus has the merit of better representing the economics of lending transactions, but suffers from the drawbacks of not creating a sufficient allowance in an early loss emergence scenario and allowing the possibility of a negative reserve. The FASB only approach overcomes the early loss emergence problem and is operationally simpler, but it does not appropriately reflect the economics of lending transactions as it does not reflect the link between the pricing of financial assets and expected credit losses. It also gives rise to the undesirable outcome of losses (in relation to expected credit losses) being recognised immediately upon origination of lending, which is not consistent with the objective of amortised cost measurement proposed in ED/2009/12, which we support.

We believe that, subject to the important revision of replacing the floor based on losses expected in the foreseeable future with an accelerated recognition requirement based on incurred losses consistent with current IAS 39 and US GAAP, the common proposal combines the advantages of the IASB only and FASB only proposals, minimises or eliminates their drawbacks, and also provides a model that is operational, auditable and results in more comparable information. We therefore believe that the Boards should consider this modification to their common proposals (explained in detail as the alternative model in our response to Question 3) with a view to creating a single high quality, operational and converged approach to the determination of impairment allowances.

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?

We believe that the determination of the EIR should be separate from the consideration of expected losses. Such an approach will make an expected loss model more operational given the difficulties that determining and using a credit risk-adjusted EIR would pose for many entities.

Specifically with regard to the determination of the effective interest rate, we note that the final guidance on amortised cost accounting could usefully provide guidance in some areas that are not clear under current IAS 39. IAS 39.AG 7 states that “for floating rate financial assets and floating rate financial liabilities, periodic re-estimation of cash flows to reflect movements in market rates of interest alters the effective interest rate”. We note that in October 2008 the IASB, as part of the annual improvements process, decided to provide further guidance in this area to the effect that a floating rate instrument is any instrument with contractually variable cash flows arising from changes in observable market variables (which could include inflation variables in the case of inflation-linked debt). Additionally, the Board agreed to clarify that under IAS 39 expectations should not be considered when determining the effective interest rate of floating rate instruments. We believe similar clarity is essential in the amortised cost accounting guidance in IFRS 9.

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 believe that it is important that all written loan commitments not accounted for at fair value through profit or loss should be subject to the same impairment requirements as financial assets. Conceptually, such harmonisation is attractive as the underlying credit exposure of a loan commitment is fundamentally the same as that of the loan which will be created when the commitment is drawn down. It would eliminate a potential inconsistency between the measurement approach for losses under loan commitments and the losses that would be measured at origination of the loan when it is drawn down under the commitment (with a potential gain or loss in profit or loss at initial recognition of the loan due to the difference in measurement basis). Applying the same approach would also have the benefit of better reflecting the fact that credit risk management of loans to be originated (under commitments) and loans that are already originated is typically performed together by entities.

Consistent with our preference with regard to financial assets measured at amortised cost we believe a modified version of the approach proposed in the Supplement (as explained in our response to Question 3) should be applied to written loan commitments not accounted for at fair value through profit or loss. However, should the Board decide to proceed with the impairment requirements as proposed in the Supplement without change, or indeed another model we believe this should also be applied to written loan commitments not accounted for at fair value through profit or loss.

Question 16Z
Would the proposed requirements be operational if applied to loan commitments and financial guarantee contracts? Why or why not?

We believe preparers are better placed to determine whether it is operational to apply the proposed approach to written loan commitments and financial guarantee contracts. However, the following comments are supportive of treating these instruments consistently with recognised assets.

Loan commitments

We understand that many financial institutions consider the credit risk management of a drawn down facility, i.e. an amount lent, and the credit risk of a undrawn down facility, i.e. a commitment to lend, together, as both result in credit risk exposure to the counterparty. Also in calculations necessary to comply with Basel II regulatory requirements we understand loan commitments (and financial guarantee contracts, see below) are included alongside loans and securities in assessments of PD (probability of default) and LGD (loss given default) for EAD (exposure at default).
For risk management purposes we understand that the credit risk associated with a loan commitment takes account of the likelihood of drawdown (i.e. this probability is factored into the measure of 'exposure at default'). The Boards should consider how this might be reflected in making the approach proposed in the Supplement operational for loan commitments.

Financial guarantee contracts

We note that for written financial guarantee contracts the IASB tentatively decided at their March 2011 Board meeting to retain the existing approach in IFRSs with regard to the scope of financial guarantee contracts. This would permit an issuer of a financial guarantee contract to account for the contract as an insurance contract if the issuer had previously asserted that it regards the contract as an insurance contract. In all other cases an issuer would be required to account for financial guarantee contracts in accordance with the financial instruments standards. We believe that for entities that do not choose to account for financial guarantee contracts as insurance contracts there is a strong conceptual argument for applying the same requirements as for financial assets accounted for at amortised cost. The credit exposure inherent in a loan and a financial guarantee written over a loan are the same as in the case of non-payment by the borrower the writer of the guarantee will suffer a loss equal to the non-payment. Therefore, for those entities treating financial guarantee contracts as financial instruments, rather than insurance contracts, it is reasonable to use the same impairment approach. This approach would ensure that two entities, one of which had exposure through originating a loan and another which had written a financial guarantee contract over that same loan, would follow similar principles in reflecting expected credit losses in the accounting for the two instruments.

We therefore support applying the revised impairment approach, whether this is the proposed approach in the Supplement or our preferred alternative approach as described in Question 3, to written financial guarantee contracts (not within the scope of the insurance standard) and written loan commitments where a contract of either type is not measured at fair value through profit or loss.

Although purchased financial guarantee contracts are not in the scope of IFRS 9, we believe the Board should consider whether specific subsequent measurement guidance is needed on the accounting for financial guarantee contracts by the holder. To include guidance in this project would be timely as purchased financial guarantee contracts are used to mitigate credit risk on financial assets. It is not clear whether the accounting for purchased guarantee contracts will be consistent with the impairment approach for financial assets and therefore could result in an accounting mismatch between the time proportional approach during the period when the asset is in the 'good book' and the amortisation of the financial guarantee contract fee. As a purchased financial guarantee contract is an economic hedge of the credit risk of the asset, it would be beneficial if the recognition of the time proportional allowance were consistent with the amortisation of the financial guarantee contract fee.

Question 17Z
Do you agree with the proposed presentation requirements? If not, what presentation would you prefer instead and why?

Consistent with our response to Exposure Draft 2009/12 *Financial Instruments: Amortised Cost and Impairment*, which expressed a preference for presenting an EIR not adjusted for expected credit losses and a separate presentation of impairment losses, we agree with the proposal in this area. This presentation is consistent with the Board's proposals on 'decoupling' as referred to in Question 14Z. It will also allow users to note both the EIR on financial assets determined under the requirements of IAS 39 or US GAAP and appreciate the net economic position taking account of the changes in allowances under the approach proposed in the Supplement.

Question 18Z
(a) Do you agree with the proposed disclosure requirements? If not, which disclosure requirements do you disagree with and why?

Given the differences in entities' credit risk management policies, estimation techniques and inputs used to make estimates of expected credit losses, we welcome the broad direction of the disclosures proposed in Appendix Z. However, we believe that the IASB should work with the FASB to harmonise the disclosure requirements under US GAAP and IFRS in this area. Additionally, we have some specific concerns and comments.

We question whether the benefit of the historical time series disclosure for five years proposed in paragraph Z8 is adequately described in the basis of conclusions. We also note that as the requirement applies to the current period and the previous four annual periods the Boards will need to consider if there is need for some relief from this requirement on transition as entities may have difficulty gathering the necessary data. If the Boards were to modify the approach proposed for the 'good book' (as per our suggestion in response to Question 3) we note that the requirement in Z7(b) Z7(d) should require disclosure by the amount (if any) by which incurred losses for the 'good book' exceed the time proportional amount. References to the 'foreseeable future' would also need to be removed from paragraph Z10. Also, as noted in our response to Question 19Z, we believe the requirement to disclose the allowance associated with transfers from the 'good book' to the 'bad book' in the case of open portfolios is unduly onerous. Lastly, we would urge the Board to consider how the proposed disclosure requirements will interact with the current disclosure requirements for credit risk in IFRS 7 *Financial Instruments: Disclosure,* and in particular, the requirement in paragraph 37(b) of that standard.

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

As explained in our response to Question 7, we believe that an additional subparagraph should be added to paragraph Z15 to require disclosure of any change in the criteria used to determine how financial assets are managed and the criteria for distinguishing between those for which impairment allowances are determined in accordance with paragraph 2(a) and 2(b) and the reasons for that change. This should promote consistent application of an entity's policy, transparency of the policy and changes to it.

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 understand that in proposing this disclosure requirement the Board was responding to investor desire for a consistent approach to transfers between the 'good' and 'bad' books with respect to the associated allowances. However, we are concerned that the approach suggested is complex (in terms of the need to calculate the allowance reflecting the age of the financial asset transferred) and the benefit of such a disclosure is not clear. We concede that showing the amount of the allowance associated with an asset transferred between the books may be more useful in the case of closed portfolios. However, in the case of open portfolios we question whether the benefit exceeds the cost of obtaining this information. We therefore encourage the Boards to consider the simpler 'no depletion' approach (which featured in Board discussions) as an alternative. Under this approach, no allowance would be transferred but the allowances within the 'good' and 'bad' books would be 'trued up' immediately post the transfer given the new composition of each book. We believe this approach would be operationally far simpler and would not reduce significantly the information provided to investors.

Other issues

Transition & effective date

We support a requirement for limited retrospective application with the effects of the initial adoption of the standard shown as a cumulative effect adjustment to opening retained earnings of the period of adoption with no restatement of comparatives. We do not believe full retrospective application of an impairment analysis is operational or appropriate given the hindsight involved.

As noted in our response to Question 3, we urge the Boards to consider modifying the approach suggested for the 'good book' to replace the floor based on credit losses expected in the foreseeable future with a minimum allowance based on incurred credit losses. However should the Boards decide to proceed with a model including the floor proposed in the Supplement we note that this could result in a very significant effect on retained earnings upon transition for some entities. We understand that this could in some cases have significant regulatory consequences. We recommend that in such a case the Boards consult with preparers and regulators as to what the appropriate effective date should be so that entities have adequate time to address such issues.

First-time Adoption

We believe that amendments to IFRS 1 are also necessary for first-time adopters to exempt them from full retrospective application, consistent with our comments on ***Transition & effective date*** above.