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Chairman

JH/NJ

Paris, 4 juin 2010

IASB
30 Cannon Street
LONDON EC4M 6XH
UNITED KINGDOM

n°28

Re : Exposure Draft ”Financial instrument : amortised cost and impairment”

Dear Sir or Madam,

I am writing on behalf of the Autorité des Normes Comptables (ANC) to express our views on the above-mentioned Exposure Draft.

Following its request for information on expected loss model, the IASB issued in November 2009 the second phase of the comprehensive project of replacement of IAS 39 regarding amortised cost and impairment for financial instruments.

1- The ANC supports the decision of the IASB to review the Incurred Loss Model currently included in IAS 39 and to propose an Expected Loss Approach that enables earlier and timelier recognition of credit risk and related losses. The ANC considers that the principles underlying an Expected Loss Approach can improve the representation of the economic effect of credit risk on revenues generated over the life of a financial asset measured at amortised cost. We therefore welcome the decision reached by the Board to reserve the credit risk premium of financial assets at amortised cost which was a long dated proposal of the ANC.

The ANC notes that developing expected losses provision responds to the concern of the G20, the ECOFIN and Basel Committee recommendation.

2- However, while the ANC agrees with the main objective of the impairment model proposed by the Board, we have concerns relating to the resulting application that is made of this objective for the following reasons :

a) Uncertainty related to “point in time” estimates : the use of “point in time” estimates of expected losses implies making assumptions on which phase of the economic cycle the entity is. This appears to be difficult to predict, as evidenced by the recent financial crisis, which was triggered by a misassesment of risks related to the subprime loans’ market, the beginning of the collapse of which most actors involved in this market had not anticipated.

The ANC is of the view that expected losses should rather be estimated on a long term average basis (i.e. based on statistical historical data which encompass an economic cycle) in order to ensure a reliable measure as a first stage, then adjusted if necessary by additional information that allows refining the expected losses estimate consistently with the characteristics of the existing portfolio. This is also what is recommended by the ECB and the Basel Committee.

b) The proposed approach could undermine its cost/benefits ratio :

- the proposed approach implies the use of effective interest rates (EIR) for each individual financial asset (or very thin closed portfolio), based on the initial estimate (amount and timing) of expected credit losses. The use of an EIR mechanism raises burdensome implementation difficulties and we believe that it is very difficult to estimate precisely the amount and timing of expected credit losses on an individual basis. Furthermore the proposed methodology implying to design "closed" portfolios would oblige financial institutions to distinguish and follow up a very large number of portfolios (several hundred thousands in big commercial banks). An expected loss model would be more reliable on a portfolio basis on which credit loss statistics would be more relevant to apply.
- Debt securities portfolio (typically held by insurance companies), which suffer from very rare defaults, are not well represented with the proposed approach. In addition the fact that most of these debt securities are quoted on active markets should not lead to determine the expected losses by referring to credit premiums as valued by the markets.
- The distinction between incurred and expected loss is very thin for very short term financial assets such as trade receivables held by corporate entities.

c) pro-cyclicality : the proposed approach may lead to pro-cyclical effects through the combined use of 1) "point in time" expected losses parameters very sensible to the short-term economic climate, and 2) the "catch up" method involving the immediate recognition in profit or loss in case of a revision of EL estimates, whereas a part of the change will affect future periods. This potential effect would clearly not meet the G20, ECOFIN and Basel committee recommendations.

Last but not least, regarding the effective date of this proposal, the ANC disagrees with the proposal to permit early application since it will undermine the comparability among IFRS reporting entities for 3 years. On the contrary, the ANC considers that all phases of IFRS 9 should be mandatory applicable at a single effective date with no earlier application permitted.

3- The ANC considers that an alternative expected loss impairment model must be based on the following main principles :

- to **base credit impairment on debt instrument portfolios** that share similar credit risk profiles;
- to allow the use of **open portfolio** instead of closed portfolio and additionally ;
- to make sure that the level of expected loss provision is **sufficient to cover incurred losses** on the existing loans ;
- to estimate the expected losses using a "**long term average**" approach (i.e. based on statistical historical data which encompass an economic cycle) as a basis, which may be then adjusted if necessary by additional information that allows refining the expected losses estimate consistently with the characteristics of the existing portfolio (e.g. due to change in the credit policy);
- to allocate the expected credit loss over the **average life of the portfolio** instead of using the EIR mechanism. The effect of changes in expected losses parameters should be recognised immediately in profit or loss for the part related to past periods whereas the part related to future periods should be spread on the remaining average life of the portfolio ;

- to **exempt very short term trade receivables** from the expected loss approach and maintain the incurred loss model (this exemption does not preclude from using statistical methods for portfolio made of small individual amount-trade receivables, as currently allowed by IAS 39).

Our detailed answers to the Exposure draft's questions are set out in the Appendix I to this letter and the main principles for an alternative expected losses model are detailed in the Appendix II to this letter.

If you have any questions concerning our comments, we would be pleased to discuss them.

Yours sincerely,

Jérôme HAAS

Appendix I
Detailed comments

Objective of amortised cost measurement

Question 1

Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?

Question 2

Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?

The ANC considers that the proposed objective of amortised cost, i.e. "to provide information about the effective return of a financial instrument", is appropriate only for the amortised cost category as a whole and not on an individual basis. The ANC supports the use of an expected loss approach for the amortised cost category in order to better reflect the credit loss estimate of debt instruments classified in this category. It will resolve the current timing mismatch between the recognition (as revenue) of the credit risk premium included in the interest charged to the borrower and the recognition of the related credit losses.

While we agree with the main objective of amortised cost measurement (par. 3), we have concerns relating to the resulting application that is made from this objective (par. 4 and 5, that implies the use of effective interest rates (EIR) for each individual financial asset, based on the initial estimate (amount and timing) of expected credit losses (as clearly stated in par. 5 of the ED).

Indeed, the ANC considers that :

- on an individual basis, it is very difficult to predict the amount of the expected loss and also quite impossible to estimate precisely the timing of expected credit losses ;
- whereas, on a portfolio basis, the amount of expected credit losses become more reliable, since it is based on statistical assessment, although the timing of losses remains difficult to assess. In other words, a loan portfolio exposes the lender to a global credit risk that is almost certain while the probability (and timing) of credit risk on each loan granted remains unpredictable.

For these reasons, we believe that the amortised cost category as a whole would provide an appropriate information of its effective return without implementing an **individual** EIR including an initial estimate of amount and timing of expected credit losses, as it is virtually impossible to assess the timing of losses, that depends heavily on the economic cycle. Instead, we believe that an impairment based on expected losses should be determined at a **portfolio** level (following the main principles detailed in the alternative approach in appendix II), apart from the EIR calculation as currently existing under IAS 39. This is indeed more consistent with the way credit risks are managed in practice.

Although on a conceptual basis, a portfolio approach to the EIR calculation could be considered, we think that the number of portfolios necessary to approximate the EIRs, that results from the constraint of loans with similar characteristics, leads to an unmanageable situation.

Moreover, we consider that the application of the amortised cost main principle should not undermine the cost/benefits ratio of the expected loss impairment approach.

Measurement principles

Question 3

Do you agree with the way that the exposure draft is drafted, which emphasises measurement principles accompanied by application guidance but which does not include implementation guidance or illustrative examples? If not, why?

How would you prefer the standard to be drafted instead, and why?

As already mentioned in our letter on the *IASB's request for information*[1], we recommend that the Board keep the approach principles based. As situations may be significantly different from one entity to another, especially between banking and non-banking activities but also within a given sector and depending on the type of credit considered, it is not desirable to define detailed technical prescriptions that would be mandatory for all preparers. The accounting provisions should only ensure that techniques used by preparers are compatible with the general principles of the Expected Cash Flow Approach and provide consistent results. As an example, preparers should be free to decide how to design portfolios on the basis of which expected losses will be estimated, provided that estimation techniques, recognition processes and timing, as well as follow up of the related expected losses are consistent with the general approach.

Therefore, we agree with the way the exposure draft is drafted, i.e. without any implementation guidance or examples.

However, we are concerned that the application guidances might be too prescriptive and prevent entities from using operational approaches adapted to their business model and information systems (see our responses to questions 11 and 12).

Question 4

(a) Do you agree with the measurement principles set out in the exposure draft? If not, which of the measurement principles do you disagree with and why?

(b) Are there any other measurement principles that should be added? If so, what are they and why should they be added?

The ANC supports the decision of the IASB to promote a credit risk impairment model based on expected losses rather than incurred losses. The ANC considers that the principles underlying the Expected losses approach can improve the representation of the economic effect of credit risk on revenues generated over the life of a financial asset measured at amortised cost.

Moreover, we note that public authorities, such as the FSB, the ECOFIN or the Basel Committee recommend to take expected losses into account in order to contribute to reduce pro-cyclical attitude in the financial system.

However, the measurement principles of the ED raise the following main concerns :

1. Uncertainty related to "point in time" estimates :

The exposure draft clarifies that an entity should use point-in-time estimates of expected losses (i.e. based on estimates considering in which phase of an economic cycle the related loans are granted). When expected losses are estimated using a "point in time" method, the main issue is to assess in which phase of the economic cycle the entity granting the loans is. This kind of exercise has proven to be extremely difficult to undertake, even by skilled and experienced economists. Therefore, calculating expected losses on credits (other than very short-term) using a "point-in-time" method seems very uncertain in practice. It may not result in a reliable assessment of the estimated credit loss of the loans concerned and may not provide other expected benefits, for example in terms of forward-looking information. On the contrary, when expected losses are estimated using a "**long term average**" method, the estimate may be more reliable, as there would be no need to make difficult assumptions on the current phase of the economic cycle where loans are granted. The long term average parameters may be then adjusted if necessary by additional information that allows refining

[1] See CNC's letter on IASB's *Request for Information (Expected Loss Model) Impairment of Financial Assets : Expected Cash Flow Approach* (9 September 2009).

the expected loss estimate consistently with the characteristics of the existing portfolio (e.g. due to a change in the credit policy).

2. cost/benefits ratio

The application method proposed by the IASB to apply the expected losses approach could make the costs outweigh the benefits resulting from this approach, mainly for the following reasons :

- **EIR Implementation costs** : it would be extremely costly to apply the Expected Losses Approach, as proposed in the ED, on individual loans when a very large number (millions) of loans are concerned, especially when using an effective interest rate method. This implies that portfolios of extremely homogeneous loans (in terms of credit risk profile) should be defined narrowly. Then, maintaining the homogeneity of these portfolios a well as ensuring the appropriate use or reversal of the expected loss provisions would be major issues. The application guidances of the ED imply designing portfolios by generation and/or by maturity. However, designing such kind of "closed" portfolios would oblige financial institutions to distinguish and follow up a very large number of portfolios (several hundred thousands in big commercial banks).

- **Debt securities portfolio :**

  Entities, such as insurance companies, hold portfolios composed of debt securities (bonds).
  To the extent that they are eligible to the amortized cost category under IFRS 9 phase 1 "classification and measurement", the expected cash flow model should apply to these instruments. The ED does not specifically address the case of such debt securities portfolios.
  Consistently with our response to Q1, we support the proposed objective of amortised cost, i.e. "to provide information about the effective return of a financial instrument" for these instruments as well as for any other debt instruments accounted for at amortized cost. However debt securities raise specific issues that differentiate them from bank loans as far as expected losses are concerned:

  - Debt securities usually are listed on a traded market. This position should not lead to assessing the expected loss by referring to credit spreads included in the market prices. Consistently with the amortized cost principle based on an expected cash flow measurement, the expected losses to be considered are those expected by the holder of the bonds whatever the market prices. For instance spreads observed in the CDS market prices should not be used as benchmarks to value the credit risk of bonds which are held for collecting cash flows and not for trading, as the liquidity of CDS market has a great incidence on the price of these instruments, unrelated to the credit risk of the underlying instruments. Consistently with an amortized cost principle, impairment criteria should remain entity-specific with the management using its own judgement. Market data or ratings issued by agencies should be only used as supplementary information helping the management to form its own views

  - Cost/benefit: as said in response to Q1, the application of the amortised cost main principle should not undermine the cost/benefits ratio of the expected loss impairment approach. Listed bonds suffer from very rare defaults, of limited volumes as illustrated by various studies [2] As a result, there is no ground for implementing a complex method if it does not produce any more relevant information for the readers of financial statement.

  - The ED does not suggest any practical simplification for this kind of instruments. Based on the above observation and consistently with our response to Q3 we consider that entities should be allowed to use operational approaches adapted to bond portfolios and information systems.

[2]For instance Standard and Poor's, *Default, Transition, and Recovery : 2008 Annual Global Corporate Default Study And Rating Transitions*: investment grade bond defaults remain well below 1%, even in recession years and even though only corporate issues are considered in the study. Besides, they are very infrequent (0,47% probability of default for a BBB issue in 2008). Furthermore, as shown in the *Largest Global Rated Defaults By Year* from S&P's study, large and significant defaults are very rare and cannot be anticipated. When considering a well diversified portfolio that would include government issues as well, such as those commonly held by insurance companies, frequency and volumes of defaults become all the more immaterial.

- **Trade receivables :** trade receivables are generally very short-term (i.e. less than 90 days). Therefore, the distinction between incurred and expected losses could be difficult and costly to assess. Moreover, the distinction between expected and incurred losses could be very thin and would not result in significant different amounts.

  Because of these undue efforts, the ANC believes that very short-term trade receivables should be exempt from the expected loss impairment model (similarly to the exception stated in IAS 39 AG79 for trade receivables). However, this exemption does not preclude from using statistical methods for portfolio made of small individual amount of trade receivables, as currently allowed by IAS 39.

3. Pro-cyclicality : If expected losses on a loan whose duration is equal or longer than an economic cycle are estimated using this approach, it may have counter-cyclical effects, as the calculation of these expected losses will automatically encompass an economic cycle. However, if the loan's duration is shorter than an economic cycle, counter-cyclical effects may be reduced. **The "point in time" approach could even result in pro-cyclical effects** if the initial estimate of the expected losses subsequently appears wrong and therefore has to be revised (with all the effect recognised directly in P&L through the "catch-up method", whereas a part of the change will affect future periods). Therefore, the "point in time approach" proposed by the IASB would limit the benefits of the replacement of the incurred loss approach by an expected loss approach.

An estimate of the expected losses using a "long term average" approach (i.e. based on statistical historical data which encompass an economic cycle) at the first stage may instead have more counter-cyclical effects.

We also would like to mention the issue of the appropriate measurement of guarantees, collaterals or mortgages, that has not yet been largely discussed although they appeared to have been a significant issue of concern during the crisis. These items have often been overestimated before the crisis occurred, which may have delayed the identification and recognition of credit losses.

Moreover, to draw a sound picture of the credit risk inherent to financial assets held by an entity, the measurement principle for impairment should take into account credit losses effectively supported by the entity (i.e. incurred loss on individual instruments as defined under IAS 39 excluding incurred but not yet reported losses). Hence, these incurred losses should be charged against the expected loss provision and if necessary the entity should complete the expected loss impairment for the reporting period in order to make sure that the level of provision is sufficient to cover incurred losses. In other words, the ANC is not comfortable with a negative provision which could arise according to the model proposed in the ED (e.g. when credit losses occur early in the life of a loan portfolio).

As a conclusion, the ANC considers that, while reaffirming its support to an expected losses approach, the impairment method should not mandatorily be recognised through an EIR mechanism and based on "point in time" parameters. A simplified method should be presented in the exposure draft, following the main principles detailed in the appendix II of this letter.

Objective of presentation and disclosure

Question 5

(a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?

(b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?

We welcome the IASB's proposal to state an objective of presentation and disclosure in relation to financial instruments measured at cost. We consider that the objective described in paragraph 11 is clear and relevant.

We consider that disclosures must be led by principles instead of checklists. Therefore, we disagree with the requirements made in paragraph 12 to "*provide as a minimum the information required by par. 13-22*", i.e. a checklist, in order to meet the objective stated in paragraph 11.

Entities should be allowed to adapt their disclosures to their economic sector specificity (such as corporate entities with very short term receivables or insurance companies with mainly listed bonds investments). However, entities must provide disclosures on credit risk which are consistent with the way they manage and assess their credit risk exposures for internal or regulatory needs. For instance, disclosures must be segmented consistently with geographical, industry or other relevant factors used to assess credit risk impairments.

Presentation

Question 6

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

The ANC considers that it is consistent with an expected loss approach to present expected credit losses as a reduction of gross revenues that include the credit risk premium charged to the borrowers. The ANC also considers that the effect of changes in expected losses estimates must be isolated from gross revenue on a separate line.

Flexibility should be given to the way entities present their margin and the effect of credit risk. For instance, the IASB should take into account that banks will still have to present an interest margin separately from credit risk effect. Other entities may also present their gross revenues from sales separately from credit risk provision.

Hence, a bank should be allowed, for instance, to present the following separate lines :

- Gross interest revenue
- Gross interest expense
- Gross interest margin (subtotal of the items above)
- Expected losses impairment
- Effect of changes in expected losses estimates
- Incurred losses (*or presented in the disclosures*)

Disclosure

Question 7

(a) Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?

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

In addition to the comments in relation to disclosures made in response to question 5, we have the following concerns :

- the volume and degree of details of the proposed disclosure for which the costs to provide such information exceed the benefits for users (for instance origination and maturity [vintage] information [§22] or the evolution of credit loss allowance year-by-year [§19a]).
- stress testing information is not relevant since this information is not standardized and thus not comparable among entities.
- The definition of non-performing assets (90 days past due) is too restrictive to provide useful information. The definition of non-performing assets should be consistent with the incurred losses defined above (incurred loss as defined under IAS 39 excluding IBNR losses).

Moreover, disclosure requirements must be consistent with the impairment method and practical expedients used by the entity. For instance, if an impairment method is based on open portfolio (see alternative approach in appendix II), detailed information on “vintage” is not relevant.

Effective date and transition

Question 8

Would a mandatory effective date of about three years after the date of issue of the IFRS allow sufficient lead-time for implementing the proposed requirements? If not, what would be an appropriate lead-time and why?

We agree that preparers will need significant time to implement any new impairment approach based on expected losses since it is a huge challenge in term of information system. Our abovementioned comment letter on the IASB's *request for information* reported that "the implementation period may require up to 3 years". Therefore, we believes that the proposed 3-year time period until mandatory application is sufficient for implementing a new impairment method.

However, the ANC disagree with the proposal to permit early application since it will undermine the comparability among IFRS reporting entities. On the contrary, the ANC considers that all phases of IFRS 9 should be mandatorily applicable at a single effective date with no earlier application.

Question 9

(a) Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why?

(b) Would you prefer the alternative transition approach (described above in the summary of the transition requirements)? If so, why?

(c) Do you agree that comparative information should be restated to reflect the proposed requirements? If not, what would you prefer instead and why? If you believe that the requirement to restate comparative information would affect the lead-time (see Question 8) please describe why and to what extent.

Consistently with our concerns on the EIR impairment method proposed by the Board (see above), we disagree with the EIR approximation transitional provisions proposed by the IASB.

We consider that transition requirements are complex and difficult to implement. An impairment allowance model built apart from the EIR calculation would simplify transition issue.

Question 10

Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

Entities should be required to explain the effect of the initial application of a new impairment method.

Practical expedients

Question 11

Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?

The ANC considers that the conditions to use practical expedients are too restrictive since the overall effect must be immaterial (B15 & B17). This requirement prevents entities to depart from a loan-by-loan assessment of credit risk and EIR. As mentioned in our response to Q3, the accounting provisions should only ensure that techniques used by preparers are compatible with the general principles of the Expected Cash Flow Approach and provide consistent results.

Instead the Board should propose an impairment approach based on the principles detailed in the appendix II.

Question 12

Do you believe additional guidance on practical expedients should be provided? If so, what guidance would you propose and why? How closely do you think any additional practical expedients would approximate the outcome that would result from the proposed requirements, and what is the basis for your assessment?

Instead of providing additional guidance on practical expedients, the Board should propose an impairment approach based on the principles detailed in the appendix II.

Appendix II : Main principles for an alternative expected loss impairment model

The main principles of an alternative impairment method based on expected loss would be :

- to **base credit impairment on debt instrument portfolios**, that share similar credit risk profiles at inception with an appropriate degree of initial homogeneity of the designed portfolios ; entities should be allowed to design homogenous portfolios consistently with their business (e.g. banks should be allowed to use the same portfolios than those used for regulatory requirements) ;
- to allow the use of **open portfolios** instead of closed portfolio (i.e. continuously renewed with loans falling due removed and newly granted loans included), which would avoid a very large number of portfolios to be distinguished and followed up and which is consistent with the way loan portfolio are managed in practice ; and additionally
- to make sure that the level of expected loss provision is **sufficient to cover incurred losses** on the existing loans (i.e. incurred loss as defined under IAS 39 excluding IBNR losses) ;
- to estimate the expected losses using a "**long term average**" approach (i.e. based on statistical historical data which encompass an economic cycle) as a basis ; this would avoid the difficulty of assessing in which phase of the economic cycle the entity granting the loan or holding the debt instrument is. These long term average parameters may then be adjusted if necessary by additional information that allows refining the expected losses estimate consistently with the characteristics of the existing portfolio (e.g. due to change in the credit policy) ;
- to allocate the expected credit loss on the **average life of the portfolio** instead of using the EIR mechanism. The effect of changes in expected losses parameters should be recognised immediately in profit or loss for the part related to past periods whereas the part related to future periods should be spread on the remaining average life of the portfolio (the global effect should be explained in the disclosures) ;
- to **exempt very short term trade receivables** from the expected loss approach and maintain the incurred loss model. **However, this exemption does not preclude from using statistical methods for portfolio made of small individual amount-trade receivables, as currently allowed by IAS 39**.

Those principles are overall similar to the alternative approaches developed by the EBF or the Basel Committee (except for the use of the EIR mechanism).