

Patrick Mommens

From: Christina Andersen [chra@nykredit.dk]
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The Nykredit Group today sent a comment letter regarding The Supplementary document to the exposure draft Financial Instruments: Amortised Cost and Impairment to the IASB. For your information we attach a copy of the comment letter.

Kind regards,

Christina Andersen

Christina Andersen

Senioranalytiker
Økonomiafdelingen
Direkte tlf. 44 55 20 52

Nykredit
Kalvebod Brygge 1-3 - 1780 København V
Tlf. 44 55 10 00 - Fax 44 55 18 88

Besøg os på internettet: <http://www.nykredit.dk>

Sent via email to director@fasb.org

Technical Director
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

International Accounting Standards Board
30 Cannon Street
London EC4M 6XH
United Kingdom

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Impairment of Financial Assets Supplementary Document (File Reference No. 2011-150)

First of all, we would like to thank you for the opportunity to respond to the IASB's consultation. We believe that accounting rules are a very important factor in the communication between banks and their stakeholders, and we fully support the continuing efforts of the IASB to improve the current standards.

Summary

We would like to stress that we support the IASB's efforts to replace for financial assets measured at amortised cost the existing impairment model (the incurred loss model) with an expected loss model.

We would also like to emphasise that we support an expected loss model based on a time proportional expected loss, but as a matter of principle we do not support including a floor. However, we might accept a floor on the condition that it is a 1-year floor only.

We support that the effective interest is calculated excluding expected credit losses (decoupled effective interest rate). We are supportive of the introduced change that the determination and timing of expected credit losses becomes more consistent with credit risk management systems. It should be mentioned that we prefer to have one single impairment model for both open and closed portfolios.

Key principles

With respect to replacing the incurred loss model, we generally support the key principles expressed by the EBF:

1. Expected losses should be recognised over the life of the portfolio
2. Expected losses should be determined on a portfolio basis
3. Expected losses are the best estimates of the losses on the financial assets existing in the portfolio at balance sheet date
4. No change in the EIR calculation from the current IAS 39 (essential also for closed portfolios)
5. Impaired loans are treated as in the current IAS 39
6. Incurred losses are the crystallisation of expected losses, so expected loss allowances are built to be used

We are very pleased that the IASB has specifically considered impairment for open portfolios, as day-to-day risk management of banks is usually based on open portfolios, and banks' systems, databases, etc will be set up for this type of computations. This approach is therefore more in line with banks' internal risk management.

We believe that the combined effects of the simultaneous revision of the capital adequacy rules and provisioning rules have not been properly analysed. We are therefore concerned that the rules could lead to an excessive build-up of provisioning allowances and capital buffers.

The pricing option

For most loan types in Denmark, the rate of interest payable by the customer is adjustable during the term of the loan – depending on an institution's costs of losses, capital, etc. We refer to this contractual, legal right as the pricing option.

Danish institutions have the option (possibility) of changing the credit margin on loans as the credit risk of the loans changes. When loss estimates for individual lending categories rise, institutions will compensate for the expected losses by raising credit margins. In practice, this means that earnings from lending (and consequently its real value) can be kept fairly stable in the long term. For instance, the interest margin tends to be low in periods of recovery and high in periods of recession.

In our opinion, it would be misleading to users of financial statements to include only the revised loss estimates, and not the expected credit margin adjustments, when measuring this type of lending. During an economic downturn, when loss estimates increase, downward revisions of the ex ante value of the loan portfolio would be far more substantial than if calculations had been based on the actual ex post cash flows, including credit margin adjustments.

All in all, measurements are of no use to users of financial statements if only revised expectations in relation to losses are taken into account. As a consequence we believe that all relevant factors – including expected future credit margins – ought to be taken into account when determining the effect of expected losses.

We believe that one operational way of achieving this is to cap the foreseeable future period as we believe that expected losses on the good book beyond this period will be reduced by the pricing option.

Flexibility

The above comments and specific impairment principles should be evaluated in conjunction with the fundamental accounting objective of fair presentation. In order to meet this objective the standard should be flexible enough to allow companies to reflect the underlying economics of their business model in their financial statements.

The high level of flexibility and use of judgement in the proposals in the supplement are valuable to allow for portraying the business model and for combining with risk management practices, but it also reduces comparability between entities, and it may even give rise to misleading information.

Generally, we believe that the risk of loss of comparability increases when calculations are based on very long-term expected cash flows that may vary over time from what was expected. Even small changes in the assumptions may cause considerable changes in the assets' carrying amounts. In such cases, the calculation assumptions should be disclosed clearly and detailed in a company's financial statements.

We therefore propose that it be specified that expected cash flows should be based on the knowledge available at the balance sheet date, including management's expectations for future market conditions on a 1-year horizon. Beyond this horizon, the expectations can be assumed to match long-term expectations. We also propose that it be specified that expectations must be based on the banks' own experience and data.

Other comments

Many banks have made significant investments in IRB models. These models can be assumed to be the banks' best estimate of losses over a 1-year horizon. We propose that it be explicitly specified that banks can base their provision calculations on their IRB models.

We also propose that it should be possible to allocate expected losses to cash flows according to simple allocation keys if the accounting consequences are assessed by management to be insignificant (eg linearly or according to the principles applied as part of an institution's internal management).

Often, calculations will be more robust if based on simpler assumptions which are easier to verify statistically and therefore imply lower model risk.

In our experience, it is rarely possible to prepare detailed rules covering all situations in a relevant way. We consider the risk of misleading financial statements as a result of such detailed rules too high. We therefore propose that the transparency in calculations and calculation assumptions be increased.

We support the IASB's consultation activities, and we believe that it would provide more helpful feedback to the IASB if the ED included more practical exam-

ples to base the responses on. We believe that this would better enable constituents to provide more valuable input to the IASB. Furthermore, this would also enable companies to assess the implications for different accounting set-ups making sure that there are no loopholes or unforeseen problems in the proposals. However we agree not to have too detailed requirements in the final standards in order to keep them principle-based.

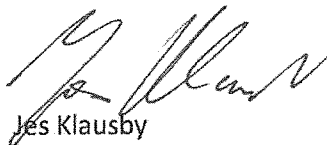
We find it difficult at this point to properly assess the proposed disclosure requirements as the appropriateness will depend on the final standard. We tentatively agree with the proposed presentation requirement and we support the removal of some of the disclosures proposed in the original ED. Generally, we find that disclosures should be subject to a materiality principle as opposed to prescriptive checklists.

We have set out our responses to the specific questions in the Supplement to ED/2009/12 Financial Instruments: Amortised Cost and Impairment in Appendix A to this letter. These comments should be read in the context of our overall comments above.

Yours sincerely



Søren Holm
Group Managing Director, CFO



Jes Klausby
Executive Vice President, Group Finance

Appendix A

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?

Answer:

Yes, we believe that an impairment model based on an expected loss model by its very nature should lead to a higher level of provisions at an earlier date compared with the current situation.

Motivation:

We would like to add that we support an expected loss model based on a time proportional expected loss (TPEL), but as a matter of principle we do not support including a floor. We believe that a TPEL model alone will lead to higher impairment allowances. Please see our comments related to the floor in the response to Q3.

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?

Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

Answer:

We favour a single, consistent impairment model for open and closed portfolios.

Motivation:

We believe that the level of provisions should, in principle, be independent of the way the portfolio is segmented, ie "the size of the cake shouldn't depend on the way you cut it".

We believe our proposal is more operational because it is more consistent with the normally used risk management practices, and we believe it is important that the standard is flexible enough to allow companies to implement their own risk management practices within the framework of a single, consistent impairment model.

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?

Answer:

We support the efforts of the IASB to develop an operational and simplified approach to the expected cash flow model and particularly we support an expected loss model based on a time proportional expected loss, but as a matter of principle we do not support including a floor. However we might accept a floor on the condition that it is a 1-year floor only.

Motivation:

We strongly oppose any model where the foreseeable future period in a model with a floor must be, or can be, more than twelve months.

We propose that – in relation to the floor – it be specified that expected cash flows should be based on the knowledge available at the balance sheet date, including management's expectations for future market conditions on a 1-year horizon. Beyond this horizon, the expectations can be assumed to match long-term expectations. We also propose that it be specified that expectations must be based on the banks' own experience and data.

For most loan types, the rate of interest payable by the customer is adjustable during the term of the loan – depending on an institution's costs of losses, capital, etc. We refer to this legal right.

Danish institutions have the option (possibility) of changing the credit margin on loans as the credit risk of the loans changes. When loss estimates for individual lending categories rise, institutions will compensate for the expected losses by raising credit margins. In practice, this means that earnings from lending (and consequently its real value) can be kept fairly stable in the long term. For instance, the interest margin tends to be low in periods of recovery and high in periods of recession.

In our opinion, it would be misleading to users of financial statements to include only the revised loss estimates, and not the expected credit margin adjustments, when measuring this type of lending. During an economic downturn, when loss estimates increase, downward revisions of the ex ante value of the loan portfolio would be far more substantial than if calculations had been based on the actual ex post cash flows, including credit margin adjustments.

All in all, measurements are of no use to users of financial statements if only revised expectations in relation to losses are taken into account. As a consequence we believe that all relevant factors – including expected future credit margins – ought to be taken into account when determining the effect of expected losses. We believe that one operational way of achieving this is to cap the foreseeable future period as we believe that expected losses on the good book beyond this period will be reduced by the pricing option.

Furthermore, we are not convinced that a floor is the best way to deal with front-loaded loss patterns. We encourage the IASB to explore other solutions.

Question 4

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

Answer:

Yes, we find that the approach will be operational.

Motivation:

While the approach is still quite complex as it requires tracking of historical data and two sets of calculations (to determine the floor and the time proportional expected credit losses), we find that it is a major step forward with respect to being operational.

Many banks have made significant investments in IRB models. These models can be assumed to be the banks' best estimate of losses over a 1-year horizon. We propose that it be explicitly specified that banks can, with minor adjustments, reuse IRB models for provisioning purposes.

We are, however, concerned that the TPEL method could contain a "damaging" incentive structure caused by the effect of the life of the assets. For example: Revolving corporate credits will typically have very short contractual maturities (1-5 years), but the (real) expected life of the credit could be significantly longer as they are continuously prolonged. It is our understanding that the allowance will be higher if the expected life is used instead of the contractual life. Contrast this with long-term lending for the housing market, which typically has both a long contractual life and a long expected life. In this example we are concerned that banks which issue revolving credits will have an incentive to use the contractual life instead of the expected life when they calculate the allowance, thereby creating a non-level playing field.

We urge the boards to take the overall incentive structure of the model into consideration when finalising the standard. One possibility to mitigate the above-mentioned problem is to introduce a cap on the length of the remaining life of assets.

Question 5

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

Answer:

Yes, we find that provisions calculated according to the proposed model will provide useful information.

Motivation:

Generally, we find that provisions calculated according to the proposed time proportional expected loss model provide information more aligned with the underlying economics of the banking business than according to the incumbent incurred loss model.

Generally, we believe that the risk of loss of comparability increases when calculations are based on very long-term expected cash flows that may vary over time from what was expected. Even small changes in the assumptions may cause considerable changes in present values. In such cases, the calculation assumptions should be disclosed clearly and detailed in a company's financial statements.

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?

Answer:

Yes, we find that the requirement is clearly described.

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?

Answer:

Yes, we find that the requirement is operational.

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

Answer:

Yes, we agree with the proposed requirement to differentiate between the two groups.

Motivation:

We generally favour accounting principles which allow the reporting entities to reflect their internal risk management practices. In our current risk management set-up it is normal to have a distinction between performing loans and non-performing loans.

Question 9

The boards are seeking comment with respect to the minimum allowance amount (floor) that would be required under this model. Specifically, on the following issues:

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

(b) Alternatively, do you believe that an entity should be required to invoke a floor for the impairment allowance related to the 'good book' only in circumstances in which there is evidence of an early loss pattern?

(c) If you agree with a proposed minimum allowance amount, do you further agree that it should be determined on the basis of losses expected to occur within the foreseeable future (and no less than twelve months)? Why or why not? If you disagree, how would you prefer the minimum allowance to be determined and why?

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

(e) Do you believe that the foreseeable future period (for purposes of a credit impairment model) is typically a period greater than twelve months? Why or why not? Please provide data to support your response, including details of particular portfolios for which you believe this will be the case.

(f) If you agree that the foreseeable future is typically a period greater than twelve months, in order to facilitate comparability, do you believe that a 'ceiling' should be established for determining the amount of credit impairment to be recognised under the 'floor' requirement (for example, no more than three years after an entity's reporting date)? If so, please provide data and/or reasons to support your response.

Answer:

We generally agree with the EBF that the introduction of a floor is conceptually unjustified. The floor also distorts the IASB objective to link the EL with the pricing and will not be reflective of economic substance. The floor would lead to creation of some form of day 1 loss that is outside the concept of the IASB model and is particularly disturbing for large investment loan portfolios and disadvantageous when entering new markets.

We also generally agree with the EBF that should the floor be unavoidable as a political compromise, it should be capped at the level of 12 months. This compromise would ensure that the floor would not dominate loss recognition and enable the use of existing data (with appropriate adjustment) for many preparers.

Motivation:

Firstly, we are sceptical of whether point-in-time losses can be reliably estimated beyond a 12-month horizon, and we find that the recent financial crisis supports our view. On the other hand, we are reasonably confident that we can reliably predict losses within a 1-year horizon based on our models used for capital adequacy calculations, and we are also confident that we can reliably predict our long-term losses based on through-the-cycle loss experience. Secondly, if expected losses are to be recognised over a longer term than 1 year without at the same time recognising the related expected changes in revenue (interest margin), we do not believe that the financial statements will be reflective of the underlying economics of banking.

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.

Answer:

We believe that the floor will be the higher of the two in times of economic downturns, and vice versa in times of economic booms.

Motivation:

Our preliminary models based on a 12-month foreseeable future floor suggest that for long-term loans the TPEL will be the higher, for very short-term loans the floor will always be the higher and for relatively short-term loans it will depend on the economic cycle which will be the higher: In times of economic downturns the floor will be the higher and vice versa.

Question 11

The boards are seeking comment with respect to the flexibility related to using discounted amounts. Specifically, on the following issues:

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

(b) Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?

Answer:

Yes, we agree with the flexibility permitted.

Motivation:

In our experience the effects of discounting are insignificant, but for certain long-term loan types we believe that it is relevant in some cases.

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?

Answer:

Yes, we prefer the IASB approach for open portfolios (actually all portfolios), but we acknowledge that for other reporting entities a floor might better align with the underlying economics of their business models.

Motivation:

Generally, we believe that in the banking business there is an essential link between pricing and credit losses which is important to reflect in the financial statements. In other businesses, or in banking limited to "short-term loans", the link is less important or may even be insignificant.

Question 13

Would you prefer the FASB approach for assets in the scope of this document to the common proposal in this document? Why or why not? If you would not prefer this specific FASB approach, do you prefer the general concept of this FASB approach (ie to recognise currently credit losses expected to occur in the foreseeable future)? Why or why not?

Answer:

No, we do not support the FASB approach, but at the same time we accept a floor defined by a foreseeable future period of 12 months could have merits.

Motivation:

Our primary concern with the floor is that it does not reflect the economics of lending transactions. In addition, we have concerns about the application of the concept of "foreseeable future". If the foreseeable future is allowed to be more than 1 year, we believe that there is an increased risk of misinformation and even manipulation in the financial statements. At the same time, we cannot rule out that the floor approach might be relevant for other preparers.

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?

Answer:

Yes, we agree with the proposed separation.

Motivation:

We believe that the proposed model in the SD strikes a good balance between the principle in the original IASB proposal and an operational model.

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?

Answer:

We have no comments at this time.

Motivation:

We find that it is an interesting idea to explore further, but we have not yet had the time to perform a proper analysis.

Question 16Z

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

Answer:

We have no comments at this time.

Motivation:

See our reply to Question 15Z.

Question 17Z

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

Answer:

Yes, we agree that the following line items should be presented separately in the statement of comprehensive income:

- (a) interest revenue (calculated using an effective interest rate that excludes expected credit losses); and*
- (b) impairment losses (including reversals of impairment losses).*

Question 18Z

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

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

Answer:

We support the recent board decisions to eliminate the requirements for some of the disclosures as proposed in the original ED, in particular those relating to loss triangles and stress testing.

Motivation:

Generally, we find it difficult at this point to properly assess the proposed disclosure requirements as the appropriateness will depend on the final standard. Due to the limited comment period we also support the EBF in its recommendation that the Board re-expose on a limited basis the proposed final standard.

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?

Answer:

We tentatively agree with the proposed method.

Motivation:

We generally support the principle also expressed by the EBF that "incurred losses are the crystallisation of expected losses, so expected loss allowances are built to be used".

We believe that the combined effects of the simultaneous revision of the capital adequacy rules and provisioning rules have not been properly analysed. We are therefore concerned that the rules could lead to an excessive build-up of provisioning allowances and capital buffers.