EFRAG
European Financial Reporting Advisory Group ■

8 September 2009

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

Dear Sir / Madam

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

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

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

EFRAG supports the IASB's decision to carry out this IAS 39 replacement project, and in particular to review the Incurred Loss Model in the context of other impairment approaches. We have some concerns about the existing Incurred Loss Model, but have not yet had an opportunity to debate and reach a view on the relative merit of the Expected Loss Model. As a result, this letter does not express a view on whether the Expected Loss Model provides sufficient additional benefits over the Incurred Loss Model to warrant the costs of its implementation and maintenance. Instead, as requested by the IASB, our comments focus on the feasibility of the Expected Loss Model in isolation of its perceived advantages or disadvantages.

Our detailed comments on the questions asked in the IASB paper about the feasibility of the Expected Cash Flow Approach are set out in Appendix 1 but, to summarise, our initial view is that implementation of an Expected Cash Flow Approach will involve significant operational challenges in Europe, such as the need for systems changes and new control processes over an increased use of management judgement involved in estimating future cash flows, and the lack of relevant historical data. However, that is not in our view a

reason at this stage to abandon work on such an approach, because we think it could also result in potential benefits. What we think the challenges do mean however is that care needs to be taken to try to 'get the requirements right' at the outset, so that further expensive changes are not required later. For example, we think the IASB needs to consider the implications of the model for all preparers, not just financial institutions. This is important because, as we highlight in our letter, we do not believe the Expected Loss Model fits well within the context of commercial short-term receivables, and we think the IASB needs to consider simplifications to the model for these types of financial asset.

For these reasons, we agree with the feasibility focus of the IASB paper and commend the IASB for seeking such advice early in the development of these proposals. We consider that this type of request is in line with the IASB's commitment to prepare and publish impact assessments for all new accounting standards. We urge the IASB to continue to canvas views broadly and to develop any proposals on loan loss provisioning carefully to ensure that the benefits of any final amendment outweigh potentially significant costs to preparers.

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

Yours sincerely

Stig Enevoldsen
EFRAG, Chairman

Appendix 1
EFRAG's response to questions asked in paragraph 11 of the IASB's paper

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

EFRAG View

- Additional guidance is needed on:

  ○ What information to use in circumstances when historical data is not available;

  ○ Unit of account, diversification and correlation;

  ○ How to deal with movement in and out of portfolios and revolving credits;

  ○ Transition provisions; and

  ○ Presentation and disclosures.

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1 The description of the Expected Cash Flow Approach contained in IASB staff papers[1] is at a reasonably high-level and therefore by its nature lacks some detail. The areas where we think clarity could be improved by additional guidance are described briefly in the paragraphs below.

Components of the Expected Loss Model

Historical data

2 The Expected Loss Model will require an entity to estimate future cash flows. Even though these estimations will need to take into account expected future economic conditions, it is nevertheless likely that in most cases the best estimates will be based heavily on historical loss data. However, we understand that there will be circumstances when historical loss data is unavailable, even for financial institutions that are granting loans at interest rates designed to compensate for the risk of credit loss. In some cases that will be because data is available only at a portfolio level or is unavailable for a specific market or type of asset (such as consumer receivables held by corporate preparers). In other circumstances data may be available, but as a proxy only. For example it is our understanding that, in preparing regulatory expected loss calculations in some markets, preparers have had to use local bond rates as a proxy for individual credit risk. Obviously the use of proxies is not ideal, but the example illustrates how preparers may need to consider the appropriateness of the data that is available. We think it would be helpful therefore for the IASB to refer to the types of data sources that may be acceptable in a range of circumstances.

Future economic conditions

3 As already mentioned, although expected losses calculated using historic data will typically form the basis of an expected loss calculation, the cash flow projected using this historic information will need to be adjusted for management's view on future economic conditions and other differences expected in the future compared

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

to the past. Incorporating data about future economic conditions will be complex—not only in terms of how the model will be built, but also in respect to choice of data and substantiation of that data against objective criteria—and could result in significant shifts in profit or loss resulting from unobservable inputs into the Expected Loss Model. In some cases the data might not be available in an appropriate form. Given this, again it would be helpful for the IASB to refer to examples of data sources that may be acceptable and to steps an entity might take to minimise the use of unobservable inputs.

<u>Unit of account, diversification and correlation</u>

4   The 'unit of account' is often important when measuring assets and liabilities and it is particularly important in this case because of diversification and correlation.

     (a)   Diversification is the mixing of different investments, types of industries, categories of risk or companies in order to achieve some offsetting of risk and therefore to reduce the risk in a portfolio, relative to the risk in the individual items making up a portfolio. Diversification benefits can of course also arise through the inter-action of separate portfolios.

     (b)   Correlation is the inter-dependence (i.e. the relationship) between one financial instrument and another. For example if a move in the share price of one company is always accompanied by a move in the same direction of another company's share price, then the share prices of both companies are positively correlated. If the share prices consistently move in opposite directions then they are negatively correlated. The share prices of companies in the same sector or in the same country tend to be correlated. Similarly, losses in one area of the economy can be a direct cause of losses in another area of the economy. Correlation can be a measure of diversification. An entity with a well diversified portfolio would have instruments whose values are uncorrelated or have negative correlation (i.e. move in opposite directions).

5   It is sometimes argued that, if an entity has one hundred identical loans and assessed each loan individually, it might conclude that its expectation is that each loan will be repaid in full; however, assessing the portfolio as a whole, its expectation is that only 95% of the present value of the contractual cash flows will be recovered. Our understanding is that in such circumstances, the IASB's Expected Loss Model would require a 5% loss to be recognised. Furthermore, we understand that if the entity only had one such loan, the Model would still require a 5% loss to be recognised. In other words, the expected cash flows should be probability-weighted. To that extent the unit of account is not important, and neither is the existence of portfolios that mix different investments and therefore diversify risk. On the other hand, correlation <u>is</u> important. For example, if losses on two loans are highly correlated, calculating the probability-weighted loss of each loan separately and adding those losses together would not achieve the same result as calculating the probability-weighted loss of a portfolio containing both loans.

6   We think the Expected Loss Model should acknowledge that correlation needs to be considered when estimating expected cash flows and that judgment will be required in determining the make-up of homogenous portfolios to which that correlation relates.

Portfolios

<u>Movement in and out of portfolios</u>

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

<u>Revolving credits</u>

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

Transition provisions

9   We also think the transition provisions will be very important since they could have a significant impact on the financial result of a reporting entity. As a result it would be helpful to have clear and operational guidance on the proposed transition provisions of the Expected Loss Model. In determining the transition provisions, such as retrospective application, the IASB should limit the potential use of hindsight as well as carefully considering the operational complexities of those provisions to ensure that the additional information provided to users justifies the additional one-off costs.

Presentation and disclosures

10 We consider that the IASB has not yet clearly defined the type of additional disclosures or presentation required to support use of an Expected Loss Model. For example it is not clear whether entities will be required to report interest gross of expected credit losses on the face of the income statement or the notes to the accounts and/or continue to disclose incurred losses or actual defaults. Such additional presentation and disclosure requirements could have a significant impact on the feasibility of adopting the new model.

11 In addition, it is implied that the Expected Loss Model will result in credit losses being presented as part of "interest revenue". Although this might make sense in the context of a financial institution, we think it could be misleading for expected credit losses on normal trade receivables held by commercial or industrial

companies to be presented in this way. We therefore urge the IASB to consider a wide range of reporting entities when developing its presentation and disclosure principles in order to ensure that meaningful information will be provided that will outweigh the cost of reporting such information.

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

EFRAG View

- Implementation of an Expected Loss Model will be operationally challenging.

- Operational Challenges include:

  ○ Lack of data;

  ○ Control process needs to be extended;

  ○ Probability of expected cash flows;

  ○ Effective Interest Rate calculation increases in complexity; and

  ○ Unit of account and correlation.

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

Lack of data

13 A major concern of some constituents regarding the implementation of the Expected Loss Model is the potential lack of historical data for certain types of financial assets held at amortised cost. Unlike the Incurred Loss Model where an entity could use information and judgment to identify a population of financial assets in order to substantiate that losses had been incurred, the Expected Loss Model will require an entity to estimate future cash flows based on management's estimate for all of its financial assets held at amortised cost. Where available, management will generally use historical credit loss data. Although it is often argued that this data is needed in order to price a loan correctly, it is clear that financial institutions do not always have historical loss data—particularly for some types of financial assets or some types of markets. Similarly, for corporates there are concerns about the availability of data to calculate expected losses on consumer receivable and other types of lending activities.

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

Control processes

15 Further, the implementation of an Expected Loss Model would require an extension of the control process over the use and reporting of credit data. In particular, it will be important to break out the credit spread from the interest rate spread. This split would need to be tracked from pricing, to origination, to performance measurement

and to accounting. Each different phase would require consistency and alignment and therefore would need an effective control structure. Thus, implementing an Expected Loss Model will not involve just a few spreadsheets; it will involve changes to a wide-range of inter-linked information systems and control structures and will therefore involve both time and significant cost.

16   In addition, it is anticipated that the Expected Loss Model will incorporate management's estimates of future economic conditions and therefore might result in an increased use of judgment involving unobservable parameters. Controls and review procedures would need to be enhanced to support the increased use of such judgments.

Probability of expected cash flows

17   We understand that financial institutions' internal risk systems may currently produce information based on expected losses that incorporates a notion of "loss given default" (i.e. the magnitude of the likely loss). The Expected Loss Model however requires information on expected cash flows incorporating both loss given default information as well as probability of default (i.e. includes estimates of timing). Incorporating "probability-weighting" into existing risk models could be challenging.

Effective Interest Rate

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

Unit of account and correlation

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

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

EFRAG View

• The view from our constituents is that the cost of implementing an Expected Loss Model could be significant and that it will take many entities several years to be in a position to implement such a model.

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20   As EFRAG is not a preparer we are unable to provide direct information relating to implementation costs, lead times and systems issues. However we understand from our constituents that implementation of the Expected Cash Flow Approach will require new systems and/or modification of existing systems.   Therefore the implementation costs and time needed to implement the model could be significant. Indications are that the Expected Loss Model will take 2 to 3 years to implement.

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

EFRAG View

• On the amortisation of upfront fees on variable rate instruments, EFRAG supports using the effective interest rate calculated upon initial recognition of the instrument.

• On the amortisation on impaired variable interest rate loans: EFRAG supports recalculating the effective interest rate so that the still expected future interest and principal receipts are discounted to the carrying amount.

Amortisation of upfront costs

21   Under the Expected Loss Model there are two main approaches for amortising upfront costs on variable rate instruments:

   (a)   <u>Approach A:</u> Amortise upfront costs using the original effective interest rate calculated upon initial recognition of the instrument. The initially determined amortisation pattern would then remain constant; or

   (b)   <u>Approach B:</u> Recalculate the amortisation pattern for upfront costs on the basis of revised variable interest rate movements. This would mean the amortisation pattern for upfront costs would change in response to variable interest rates.

22   EFRAG supports Approach A. In our view this Approach would be operationally easier to implement. We also believe that the difference in amortisation profiles is supportable since upfront fees can be differentiated from yield on the basis they are fixed and do not necessarily relate to notional size.

Impairment of Variable Rate Instruments

23   When a financial instrument becomes impaired, future interest cash flows are in effect treated as repayments of principal rather than interest revenue. Under the

Expected Loss Model there are two possible approaches to treating this 'repayment of principal' to variable rate instruments:

(a)   Approach A: Recalculate the effective interest rate (based on the forward curve as updated from time to time) so that the still expected future interest and principal receipts are discounted to the carrying amount; or

(b)   Approach B: Keep the effective interest rate constant after impairment and treat changes in the carrying amount resulting from changes in variable benchmark interest rate as a "catch-up" reflecting the fact that changes in cash flows more appropriately reflect repayments of principal rather than variable interest receipts.

24   EFRAG supports Approach A. EFRAG considers that interest paid after a financial instrument has been impaired should result in the split between interest and credit losses being clear in the financial statements. Approach A recalculates the effective interest so that the still expected future interest receipts and the still expected principal receipts are discounted to the carrying amount. However, we also note that, although a similar recalculation occurs under the current incurred loss model, these will increase in regularity and range of application across instruments under the Expected Loss Model and that will probably mean that Approach A is the more complex and costly of the two approaches for preparers to implement.

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

(a) changing from a collective to an individual assessment should be required? If so, why and how would you effect that change?

(b) a collective approach should continue to be used for those assets (for which losses have been identified)? Why or why not?

EFRAG View

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

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

(a)   Take the individual financial asset out of the portfolio on the basis that it no longer shares the same risk characteristics as the remaining financial assets in the portfolio. Under this approach, the collective impairment needs to be allocated to the individual asset, and going forward an individual impairment assessment (or as part of another portfolio) needs to be performed on that specific asset.

(b)   Keep the individual financial asset as part of the portfolio on the basis that the losses identified are reflected in the portfolio cash flow expectations.

26   EFRAG considers that the key issue here is whether satisfactory assessments of expected losses can still be made if the assessments continue to be done on a collective basis when a portfolio comprises some 'doubtful assets' and some that are not yet doubtful. If that is possible, the standard should not be prescriptive and a reporting entity should be able to choose whether it removes a financial asset for which performance has become more doubtful from a portfolio of performing assets. This choice should be based on whether the reporting entity manages under-performing financial assets separately (whether individually or as part of a portfolio of similar assets) or whether continued inclusion in the performing portfolio undermines its management. The choice should be subject to the more doubtful assets being included in the portfolio assessment of expected cash flows and resulting in no double-counting of losses.

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

27   We think the IASB should consider simplifying the Expected Loss Model in respect of commercial short-term receivables on the basis that short-term receivables do not fit easily within the model as currently described. As stated previously, "interest revenue" is generally not presented separately for commercial short-term receivables. Spreading credit losses on the same basis as an effective interest rate therefore might not provide more relevant information than the recognition of credit losses on an incurred basis.   At the same time, implementation costs are likely to be significant due to a lack of historical data and the necessity to implement new systems since industrial and commercial companies would not currently manage credit losses in the same way as would be reported under the Expected Loss Model.

28   We also encourage the IASB to meet with a wide range of constituents to understand whether further simplifications could be appropriate.