1 April 2011

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

Dear David

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AASB comments on IASB Supplement to Exposure Draft ED/2009/12
Financial Instruments: Impairment

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The Australian Accounting Standards Board (AASB) welcomes the opportunity to provide comments on the Supplement to Exposure Draft ED/2009/12 *Financial Instruments: Impairment* (Supplement ED). In formulating its comments, the AASB sought and considered the views of Australian constituents through comment letters and other consultation. The comment letters received are published on the AASB's website.

The AASB supports the IASB's efforts to develop an operational impairment model as proposed in the Supplement ED, as compared to the model in ED/2009/12. The AASB also understands the IASB's decision to introduce more 'forward-looking' information in determining financial asset impairment on the basis that some banks in some jurisdictions showed themselves slow to acknowledge that the collectability of loans was deteriorating during the recent financial crisis. However, the AASB has concerns about the proposed approach that seeks common ground between the IASB's time-proportionate loss method and the FASB's foreseeable future loss method.

The AASB is concerned that the proposed approach, employing both the time-proportionate loss method and the foreseeable future loss method lacks a conceptual basis. The AASB considers that the absence of a clear measurement concept could result in non-comparable application of the proposed approach. In addition, the AASB considers an impairment model that incorporates forecast and reforecast information is not consistent with an amortised cost measurement attribute. The AASB considers it more conceptually appropriate for future loss estimation to be based on existing conditions and that requiring entities to 'speculate' on future conditions (via forecasts) is effectively asking them to try, at least in a number of respects, to 'outguess the market'.

The AASB considers it was premature for the IASB to conclude that the incurred loss model was 'broken', and is not convinced that a completely new impairment model based on the proposed 'expected losses' would result in better numbers than a properly applied incurred loss impairment model. The AASB considers the IASB could achieve its objectives by embracing an incurred but not reported loss (IBNR) model. That model, as often applied in relation to insurance claims liabilities, requires entities to make projections about expected losses based on the conditions that exist at reporting date and past claims experience. Accordingly, the AASB is of the view that the basis for recognising losses using the IBNR notion could readily be applied to arrive at a reliable estimate of impairment losses on a timely basis.

Nevertheless, the AASB supports the IASB's proposal to differentiate between the good book and the bad book financial asset portfolios for the purposes of determining the impairment allowance. The AASB considers the good book and bad book allocation is reasonably aligned with the way in which entities, particularly financial institutions, manage financial assets and credit risk. The AASB believes that the IBNR model, in conjunction with a good book bad book approach, would greatly improve the early identification of expected losses in financial asset portfolios, especially when compared with practice that focused on gross cash flows rather than the recoverable amounts of financial assets.

The AASB views, as summarised above, are explained in more detail in the attached Appendix.

Although not the subject of this ED, the AASB is concerned that the IASB has not yet addressed making its proposed impairment model operational for variable rate financial assets other than those in open portfolios. Variable rate loans are the predominant financial assets of Australian and New Zealand banks. As noted in the AASB's submission on ED/2009/12, changes in interest rates are a product of many factors other than changes in credit risks and a model that includes a catch up adjustment can treat factors such as changes in liquidity risk as giving rise to impairment losses when there has been no change in credit loss expectations. The AASB believes an IBNR model would be capable of being made operational for both open and closed portfolios of variable rate loans and open and closed portfolios of fixed rate loans.

If you have any queries regarding any matters in this submission, please contact me or Christina Ng (cng@aasb.gov.au) and Angus Thomson (athomson@aasb.gov.au).

Yours sincerely

Kevin M. Stevenson

Chairman and CEO

1 AASB preferred position

1.1 In many ways, the AASB considers the label 'incurred loss model' has wrongly been assigned a meaning by the IASB that implies the model has weaknesses that cannot be rectified. The AASB believes an incurred loss model remains relevant and the weaknesses relate to the manner in which it is being applied. The AASB believes this problem can be rectified by providing greater clarification about a wider range of events that could be taken to have occurred, and conditions that exist, and which give rise to losses now or in the future.

1.2 The AASB notes that the relevant recommendation of the FCAG is that the IASB explore alternatives to the incurred loss model in IAS 39 that use more forward-looking information. The AASB's view is that the IASB could follow the FCAG's recommendation by exploring amendments to the existing incurred loss model that would result in a greater use of current market inputs, or a greater consistency of the use of such inputs, than often occurs under the existing IAS 39 requirements.

1.3 Given that the focus is on determining the basis for amortised cost measurement, and given the FCAG's recommendation to explore models that use more forward-looking information, the IASB could usefully examine the notion of incurred but not reported (IBNR) losses. The notion of IBNR is widely used in accounting for insurance contracts, with insurers providing for claims liabilities that relate to events they know have occurred from general information about the claims environment, rather than from being advised of the occurrence of specific events.

1.4 In the context of the credit crisis of 2007/2008 it is probably fair to say that, although many banks found themselves under-provisioned, a number did not. Many Australian and New Zealand banks have a practice of considering general information about the economic environment on an IBNR principle, for example, rates of unemployment, property price movements, asset price inflation and rates of economic growth are used to infer the occurrence of specific events that give rise to credit losses. Accordingly, the AASB is of the view that the basis for recognising losses using the IBNR notion can readily be applied in an 'expected loss' context.

1.5 Accordingly, and consistent with its views on ED/2009/12, the AASB is not convinced that a completely new impairment model, in particular, one that uses a time-proportionate method or an expected cash flow method as in ED/2009/12 would resolve the issue of 'too little, too late'. The AASB considers that the IBNR model would achieve what the IASB wants an 'expected loss' model to accomplish, if the extent to which forward-looking information should be employed in the estimates of IBNR losses were properly explained. In addition, the AASB considers an IBNR model would better reflect an amortised cost measurement, consistent with the alternative views of Robert P Garnett and James J Leisenring [paragraph AV6, Basis for Conclusions of ED/2009/12].

1.6   If the IASB proceeds with the proposed supplementary impairment model, the AASB encourages the IASB to clearly identify its measurement attributes in the final standard, even if it combines amortised cost and fair value. The AASB considers the measurement basis is not clear under the proposed supplementary and ED/2009/12 impairment models and that lack of clarity might result in variability in impairment assessments and would not be an improvement on the current impairment model.

1.7   The AASB strongly opposes the IASB introducing measurement/impairment models into financial reporting that are based on forecasts, with its implication that the entity is required, at least in a number of respects, to 'outguess the market'. The AASB's preferred position is for the IASB to consider the notion of IBNR under which entities would make projections about expected losses based on the conditions that exist at reporting date and past loan loss experience.

1.8   The AASB's responses in the following paragraphs have been provided on the basis that the IASB proceeds with an impairment model along the lines proposed in the Supplement ED.

2   **The use of forecast information in an amortised cost model (Questions 3, 4, 5, 9 and 10)**

2.1   The AASB considers the proposed supplementary impairment model lacks a clear measurement attribute for financial assets held at amortised cost (as did the proposed model in ED/2009/12). In particular, the proposed supplementary model proposes that impairment (or expected loss) would be derived from using past, present and 'forecasted' information. However, the AASB considers that the use of 'forecasted' information would not be appropriate for an amortised cost-based financial asset. This view is consistent with the IASB's rationale in paragraph BC109 of IAS 39 for concluding "that it was inconsistent with an amortised cost model to recognise impairment on the basis of expected future transactions and events".

2.2   The AASB notes paragraphs B5 and B7 of the Supplement ED state that, for shorter-term and medium-term periods, entities may develop projections of expected losses on the basis of specific inputs, such as forecasts of future events and economic conditions. The AASB considers the implication that 'projections' include 'forecasts' to be inappropriate and potentially confusing, and that it could result in varied interpretations of the types of information that should be used when assessing for impairment losses. Consistent with the mainstream literature on the topic of projections versus forecasts, the AASB considers that:

(a)   a 'forecast' would involve identifying conditions that are expected to exist and trying to determine expected losses in the context of those expected conditions; while

(b)   a 'projection' would involve using existing conditions, based on available market evidence, and determining expected losses in the context of those existing conditions.

The AASB considers that, consistent with an amortised cost model, projections, and not forecasts are the best way to identify expected losses over the life of the relevant assets.

2.3   The AASB also considers the guidance in paragraphs B5, B6 and B7 of the Supplement ED is too broad and would not reduce diversity in application. The AASB considers similar guidance to that in paragraphs 44, 45, 48 and 49, and examples as in Illustrative Example 6 of IAS 36 *Impairment of Assets* should be provided in a final Standard to distinguish between:

(a)   information that provides the basis for determining that particular events and conditions have already occurred and which gives rise to impairments (or reversals of impairments); and

(b)   forecast information, which goes beyond an amortised cost measurement model.

2.4   The AASB also notes the proposed notion of 'reasonable and supportable' information when applying the proposed estimations of foreseeable future loss and the use of forecasted data. The AASB considers the IASB should clarify the notion of 'reasonable and supportable' and suggests the IASB includes guidance along the lines of paragraph 34 of IAS 36 in a final Standard.

2.5   The IASB appears to have given the words 'reasonable' and 'supportable' the status of qualifying characteristics, yet they are not among those identified in the IASB's work on its revised Conceptual Framework. In particular, the AASB considers the IASB should clarify whether the notion of 'reasonable and supportable' has any connection with:

(a)   the IASB's recently developed notion of 'verifiability' in the context of the Conceptual Framework project; and

(b)   the notion of 'objective evidence' in IAS 39. The AASB notes that paragraph BC110 of IAS 39 states "Possible or expected future trends that may lead to a loss in the future… do not provide objective evidence of impairment. In addition, the loss event must have a reliably measureable effect on the present value of estimated future cash flows and be supported by current observable data".

3   A time-proportionate method or foreseeable future loss method (Questions 3, 4, 5, 12 and 13)

3.4   The AASB considers the proposed model has fundamental weaknesses. As noted in section 2 of this Appendix, the proposed use of forecast information implies an entity

should attempt to outguess the market and the AASB considers this would result in inconsistent bases being used by different entities to determine loan losses.

3.2   As noted in section 2 of this Appendix, the AASB believes an IBNR model would be the best way to identify expected losses and that it would be capable of being made operational for both open portfolios of variable rate loans and open portfolios of fixed rate loans. The manner in which Australian and New Zealand financial institutions currently assess for impairment losses is broadly similar to an IBNR model, and this approach provided useful information, on a timely basis, about loan losses for those entities during the financial crisis.

3.3   Consistent with its views on the ED/2009/12 impairment model, conceptually, the AASB does not support the IASB's time-proportionate method in assessing for impairment losses. The AASB believes a time-proportionate method recognises losses via a smoothing mechanism over an asset's life. In this respect, the AASB shares the views of the FASB, that impairment reserves tend to be at their lowest level when they are most needed at the beginning of a downward-trending economic cycle [paragraph IN6 of the Supplement ED] and as such, even a time-proportionate loss approach would not be able to provide sufficient allowance to cover all estimated impairment loss for the remaining life of an asset.

3.4   The AASB notes that the FASB's foreseeable future loss approach would introduce a requirement to establish a minimum loss allowance balance, and should address the loss allowance adequacy concern. However, the AASB considers that the common approach developed jointly by the IASB and the FASB would not possess the measurement attributes of an amortised cost model, and accordingly, would be a mix of measurement models and not helpful for decision-making purposes.

3.5   From a practicability standpoint, the AASB supports the IASB's efforts to develop an operational impairment model as proposed in the Supplement ED, as compared to the model in ED/2009/12. However, the AASB considers the overall proposed supplementary impairment model to be complex as it would require the retention of two forms of systems or approaches when assessing for impairments on good book portfolios.

4   Minimum impairment allowance (Questions 9 and 10)

4.1   The AASB supports, in the context of the proposed approach, the proposal to establish a minimum impairment allowance amount of 12-months projected loss from reporting date for the reasoning provided in paragraph BC62 of the Supplement ED. The AASB also considers that a 12-month estimate is a common benchmark as required by other reporting and prudential requirements. Therefore, it might be reasonable to establish a similar benchmark for the purpose of estimating a minimum impairment allowance amount.

4.2 The AASB considers the IASB's proposed 'ceiling' on the projected term (which might limit the extent of incomparability) would conflict with the IASB's principles for proposing an expected loss model. That is, the AASB considers, if losses are estimated over the life of the asset under the proposed time-proportionate method, attaching a ceiling or a cap on those losses would undermine the proposed rationale for recognising lifetime losses. The AASB acknowledges there may be diversity in the assessments about future losses between sophisticated and less sophisticated entities. Nevertheless, the AASB considers that entities should not be restricted from making loss estimations (that relate to projections and not forecasts) as far out as feasible within the bounds of reliable measurement.

4.3 In the context of insurance contract accounting, the IBNR model is usually applied in relation to the expected life of the contract and the duration of the claims 'tail', whether in respect of contracts that cover one year or many years. The AASB considers that in the context of portfolios of financial assets, it would be feasible to require its application for a minimum 12-month period, but that it would be more relevant for it to apply over the expected life of the loans in the relevant portfolio.

5 Reflecting an entity's internal credit risk management (Questions 6, 7 and 8)

5.1 The AASB supports the IASB's proposal to differentiate between the good book and the bad book financial asset portfolios for the purposes of determining the impairment allowance. The AASB considers the good book and bad book allocation is reasonably aligned with the way in which entities, particularly financial institutions, manage financial assets and credit risk. The AASB considers that, in order to operationalise the proposed supplementary impairment model, it would be reasonable to identify the good book and bad book portfolios based on an entity's internal credit risk framework, so long as guidance is provided in a final Standard that distinguishes between a good book and a bad book along the lines of paragraph 3 of the Supplement ED.

6 Application of the proposed supplementary impairment model to other financial instruments (Questions 1, 2, 15Z and 16Z)

6.1 The AASB acknowledges the IASB's intention in focussing on developing an impairment model for financial assets that are managed on an open portfolio basis as a priority. The AASB would prefer an impairment model that can be applied to all financial assets and is concerned the complexity of the proposed supplementary impairment model would entrench the need for multiple impairment models for financial assets, including short-term trade receivables, lease receivables and other financial assets measured at amortised cost. This is a particular concern for entities that, for management purposes, do not distinguish between different types of long-term financial assets, such as financial institutions that manage loans and lease receivables together. The AASB also considers the proposed supplementary impairment model

would be particularly problematic for financial assets that are not managed on a portfolio basis.

6.2 The AASB also notes that an outcome of multiple impairment models for financial assets measured at amortised cost would indicate the IASB has not met the recommendation of the FCAG for greater simplicity in accounting for financial instruments.

7 Net interest margin presentation (Questions 14Z and 17Z)

7.1 In relation to revenue recognition, most Australian lenders and users of their financial statements focus on the margin between the lending rates and the cost of funding – sometimes called the 'net interest margin'. Consistent with the AASB's views on ED/2009/12 about the disconnect between financial institutions' pricing of financial assets and expected loss, the AASB agrees with the IASB's proposal to decouple (as compared to ED/2009/12) the effective interest rate and expected loss.

7.2 In addition, the AASB welcomes the IASB's decision to retain the existing presentation requirement in IAS 39 and supports the IASB's proposals in paragraph Z5.

8 Disclosure (Questions 18Z and 19Z)

8.1 The AASB received encouraging feedback from Australian constituents, including preparers and users of financial statements, for proposing disclosures that associate the impairment loss amounts and the entity's internal credit risk management. In particular, the AASB supports the IASB proposals to require:

(i) an allowance account showing the reconciliation of changes in credit losses during the period separately for the good book and bad book portfolios [paragraph Z7 of the Supplement ED]. This information is consistent with the principle of providing meaningful information about the quality of assets. The AASB would expect that a succinct reconciliation showing movements of credit losses, including any write-offs, to be helpful for users to appreciate the credit quality of assets. Furthermore, the mandatory use and disclosure of an allowance account would promote consistency compared with IAS 39;

(ii) information that explains estimates and changes in estimates pertaining to the impairment model [paragraphs Z9 and Z10 of the Supplement ED]. This information is important to an understanding of judgements that need to be made in determining impairment losses. However, the AASB notes this proposed requirement may duplicate paragraph 125 of IAS 1 *Presentation of Financial Statements*, which requires disclosure of information about the assumptions made on estimates of uncertainty. The AASB considers that, if the IASB proposes the

same disclosure requirement about 'estimates of uncertainty' relating specifically to financial assets at amortised cost, this requirement, and an explanation about the relationship with the IAS 1 requirement, would be best located in IFRS 7 *Financial Instruments: Disclosure*; and

(iii) information that explains an entity's internal credit risk management processes, in particular, an analysis that describes the criteria used to determine how financial assets are managed to distinguish between good book and bad book portfolio assets [paragraphs Z13 and Z15(a) of the Supplement ED].

8.2 The AASB was also advised that some of the proposed disclosures relating to internal credit risk gradings and credit loss development, in particular, paragraphs Z8, Z12, Z14 and Z15(b)-(d), would, in general, be of only moderate interest even to the most sophisticated users. In relation to credit loss development information, the AASB has been informed that historical data is generally not stored by Australian financial institutions in a manner that would readily enable the information proposed in paragraphs Z8 and Z12 to be prepared. As such, entities may face significant challenges and increased costs to establish and maintain the information systems to provide information for little or no benefit to users.

8.3 The AASB notes there was no basis provided in the Supplement ED for proposing these specific disclosures. Therefore, the AASB urges the IASB to reconsider the need for them.

8.4 The AASB supports the IASB's recent tentative decisions in February 2011 not to proceed with the ED/2009/12 disclosures on vintage information and stress testing.

8.5 Overall, the AASB considers the principle of 'through the eyes of management'—that is, information reviewed regularly by the entity's CODM—should be considered in formulating disclosure requirements. The AASB is doubtful that the proposed information mentioned in paragraph 8.2 is generally compiled, and regularly reviewed by the CODM.

8.6 In addition, the AASB is concerned about paragraph BZ17, which allows mandated disclosures to be provided in the financial statements or incorporated by cross-reference from the financial statements or other statements. Apart from the benefit to users in disclosing any relevant information in the same financial report, the AASB is concerned that auditors may need to audit the context of the cross-referenced information as well as the information itself in order to be satisfied that it is appropriately presented. Furthermore, due to the legal framework regarding the composition of financial statements, some jurisdictions would be unable to adopt (word-for-word) an IFRS requirement that allows information to be cross-referenced. As such, the AASB opposes any mandated information being able to be cross-referenced.