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

Submitted electronically through the IASB website (www.iasb.org)

Dear Sir David

Re: Exposure Draft ED/2009/12 Financial Instruments: Amortised Cost and Impairment

Thank you for the opportunity to comment on Exposure Draft ED/2009/12 Financial Instruments: Amortised Cost and Impairment (the ED or Exposure Draft). Our comments on the specific questions included in the ED are addressed in the Appendix.

National Australia Bank Limited (NAB) is one of the four major Australian banks. Our operations are predominantly based in Australia, New Zealand, the United Kingdom and Asia. In our most recent annual results we reported net income of A$ 2.6 billion and total assets of A$ 654 billion.

We have the following general comments on the Exposure Draft:

We support the IASB's effort to develop improved impairment guidance, as we believe that this is one of a number of steps that need to be taken to improve the quality of financial reporting and consistent application of the guidance. We recognise that the incurred loss impairment model has been subject to criticism, with the key point being that losses may be recognised too late. We do want to emphasise however that our current impairment process is not 'broken'. Our processes, data, systems and procedures generate a robust, supportable and auditable provision for impairment which is reasonable and appropriate for the credit risk in our loan portfolio under the current impairment model.

We appreciate that the IASB has been under considerable pressure to improve the financial reporting for financial instruments following the financial crisis. However we are concerned that due process could be compromised as a result of the Financial Accounting Standards Board (FASB) and the IASB taking separate ways on this important initiative, even though the 2011 US GAAP / IFRS convergence date is rapidly approaching. The FASB's recently issued exposure draft of its full replacement standard for financial instruments proposes a different model for impairment than the IASB impairment proposals. This approach moves us away from convergence rather than getting us closer.

Given the aim of IFRS / US GAAP convergence with a 2011 target date, we are disappointed that both boards are producing different requirements. It is important that the IASB's constituents have the opportunity to comment on the IASB proposals in consideration of the FASB exposure draft. The current time scale, with the FASB exposure draft released only recently, does not allow for this. We encourage the boards to work more closely together in coordinating their work on joint projects and on the issuance of pronouncements.

In our view, the approach of both boards preparing their own exposure drafts on such significant pieces of work calls into the question the robustness of the standard setting process. The fact that the boards propose, so close to convergence target date, substantially different models to address criticism on the current impairment model that applies to both US GAAP and IFRS is a reason for concern. Even if a converged standard is achieved on the short term, how will the boards explain the shift of thinking that would be necessary to switch from one proposed model to the other? The risk with the current approach of the boards each publishing its own exposure draft (and possibly even final standard) is that once it comes to convergence, stakeholders may perceive this as a matter of 'compromising' which puts whatever the final outcome is on the back foot. We recommend the boards develop a converged solution for amortised cost impairment (and financial instruments accounting in general) *before* the issuance of a final standard.

Notwithstanding our concerns about differences in the IASB and FASB approach, we welcome proposals which will allow us to apply a greater level of professional skill, experience and professional judgement that would allow us to provide for losses we believe are either inherent in a portfolio, but for which we are not able to obtain objective evidence of a loss event having occurred, or which based on our analysis of the market, economics, or industry we believe will be incurred in the near future. However, we do not support the Expected Cash Flow (ECF) approach proposed by the IASB for the following reasons:

Reduces transparency for financial statement users
Mixing interest revenue with initial expected credit losses reduces transparency for financial statement users. In our experience, industry analysts view the net interest margin (NIM) a key performance indicator for commercial and retail banks. By including expected credit losses for assets in the effective interest rate (EIR), 'hard' contractual data (interest rates) is combined with inherently subjective data (expected credit losses) that depends on an entity's own estimates in the same income statement line. This reduces the decision usefulness of the financial statements.

Inappropriate netting of revenues and expenses
Including expected credit losses in the EIR results in the inappropriate netting of revenues and expenses and therefore goes beyond the objective of establishing an improved impairment model for financial assets. The question whether certain potential losses (which may or may not occur) should be presented contra revenue must be considered in the Board's work on revenue recognition. We note that the revenue recognition Discussion Paper[1] proposes a revenue recognition model based on contractual rights, which is in contradiction with ED proposal to include expected credit losses in the revenue line.

Different amortised cost principles for assets and liabilities
As noted in paragraphs 1 and B1 of the ED, the amortised cost measurement basis is applied to both assets and liabilities. The effective interest method is defined in Appendix A of the ED a method of calculating the amortised cost of a *financial asset or financial liability* that uses the effective interest rate. In addition, the definition of

[1] Discussion Paper, Preliminary Views on Revenue Recognition in Contracts with Customers, paragraph S14

effective interest rate in the ED (Appendix A) does not differentiate between assets and liabilities.

Consistent with these definitions in the ED and current IAS 39, we are of the view that the principles to determine the amortised cost based carrying amount should be the same for both assets and liabilities. However the ED creates different approaches to measure amortised cost for asset and liabilities by requiring that for financial assets expected credit losses are considered in the expected cash flows and that expected cash flows for financial liabilities do not reflect the entity's own non-performance risk (paragraph B3).

Applying different principles to assets and liabilities that are measured on the same basis (amortised cost) is inconsistent with the IASB's objective to reduce complexity in the accounting for financial instruments by reducing the number of measurement categories. Effectively, two different amortised cost models are introduced which creates confusion for financial statement users about what the amortised cost model intends to represent. In addition it raises the question whether net interest income is still a meaningful measure of performance considering it is the result of two different measurement bases for assets and liabilities although both carry the banner 'amortised cost'.

To avoid this, consistent with current IAS 39, expected credit losses should remain outside the effective interest rate method until a specific loss event has incurred. Expected credit losses should be recorded in the income statement as an impairment charge separate from net interest income.

Inconsistent with how financial institutions manage credit risk
Performing financial assets carried at amortised are not managed on an expected cash flow basis where the timing and amount of credit losses are tracked. Nor is it required to do so under current regulatory regimes that require an expected loss based methodology such as Basel II which uses a one-year expected loss. Rather, financial institutions manage these assets on an expected loss basis that relies on statistical evidence to determine the amount but not the timing of expected loss. Interest risk on performing loans is generally managed separately from credit risk and credit losses are not managed as a function of revenue. We view credit losses generally as a cost of business and our business model is best reflected by presenting such losses separately from the net interest margin.

Inconsistency between credit losses expected at inception and subsequent changes
The ED differentiates between initial expectations of expected credit losses, which are included in the effective interest rate of the asset, and subsequent changes to the initial expectations. The ED proposes a catch up adjustment through the income statement for a change in expectations in the period of the change. We do not see the conceptual difference between the expectations at inception and subsequent changes that would justify this difference in accounting. Both reflect the entity's best estimate of expected loss. They should be treated consistently and accordingly both initial expectations and changes in expectations should be recognised in income statement over the remaining life of the portfolio.

We believe the next step for the IASB is to develop, together with the FASB, a view on what a converged impairment model should look like. If, after also considering the feedback received by the FASB on its exposure draft, the conclusion is that an expected loss impairment model is the way forward then the IASB and FASB should consider other expected loss impairment models (e.g., by the European Banking Federation and the Basle Accounting Task Force) that have emerged in response to the IASB model. Some of the features of these models could

assist in simplifying the application of an expected loss model (e.g., decoupling of EIR and expected credit losses and an approach that can be applied to financial assets managed on an open portfolio basis rather only closed portfolios)

Should you have any queries on our comments, please contact Marc Smit, Head of Group Accounting Policy, at marc.smit@nab.com.au.

Yours sincerely

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Appendix

Detailed Answers to Questions

> Question 1: Is the description of the objective of amortised cost measurement in the ED clear? If not, how would you describe the objective and why?

Yes, we believe the objective is clear. However, we believe that the objective should be broken down into objectives for amortised cost measurement before impairment and a separate objective for impairment of amortised cost assets. By combining these two concepts into one objective the proposal inappropriately nets expenses with revenues and reduces the decision usefulness of financial statements to users as interest income is commingled with credit losses.

> Question 2: Do you believe that the objective of amortised cost set out in the ED is appropriate for that measurement category? If not, why? What objective would you propose and why?

Yes, we do believe that objective is appropriate for financial assets at amortised cost for measurement purposes. However, note our concern regarding including the expected credit losses in EIR expressed in our response to question 1 and in our cover letter.

> Question 3: Do you agree with the way that the ED 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?

In general we agree that standards should emphasise principles rather than detailed implementation guidance or illustrative examples. However, we note that the need of the formation of an Expert Advisory Panel (EAP) to address some of the operational challenges is evidence that some of the principles in the ED require further articulation. We are concerned about the due process surrounding the output of the EAP. On implementation of the ED there may be a broad range of possible interpretations driven by operational considerations. The EAP output may narrow the range of possible interpretations and may need to be incorporated in the final standard. We note that the EAP meetings continue until late June 2010. It is not clear to us in what form the final conclusions of the EAP will be made available to constituents. Given the timing of the exposure draft, constituents will not be able to consider the comprehensive findings of the EAP in their comments.

> Question 4(a): Do you agree with the measurement principles set out in the ED? If not, which of the measurement principles do you disagree with and why?
>
> Question 4(b): Are there any other measurement principles that should be added? If so, what are they and why should they be added?

While we agree with the measurement principles, we disagree with commingling interest rates and credit risk into one revenue recognition model through EIR. We refer to our responses to questions 1 and 2 and the points raised in our cover letter. A key area that will require clarification is the type of information that must be considered when estimating future cash flows. We understand that paragraph requires historical data to be adjusted to reflect the effects of current conditions that did not affect the historical period and to remove the effects of conditions in the historical period that do not exist currently. It is not clear to us whether an entity is supposed to estimate future

cash flows based on information prevailing at the reporting date or on expectations of future changes beyond the reporting date.

We note that there is a conceptual difference in objective between estimating expected credit losses in the context of impairment and estimating expected cash flows to measure 'fair value'. In determining fair value, the objective is to reflect the perspective of market participants in an active market. Even though at times the market participants' perspective may be based on unobservable inputs, this concept provides a principle to fair value measurement that must be applied by all preparers. With respect to expected credit losses there is no such overriding principle (i.e., no objective to reflect the views of market participants). An entity's expectations regarding credit losses are inherently subjective and further articulation of what information should be considered is required to ensure consistent application among preparers.

Question 5(a): Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the ED clear? If not, how would you describe the objective and why?

Question 5(b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the ED is appropriate? If not, why? What objective would you propose and why?

The presentation and disclosure objective is clearly articulated and appropriate.

Question 6: Do you agree with the proposed presentation requirements? If not, why? What presentation would you prefer instead and why?

As mentioned above, we disagree with including expected credit losses in the EIR. We propose that – consistent with current IAS 39 - impairment remains decoupled from EIR. Accordingly, we do not support the breakdown of interest income into gross interest income, initial expected credit losses and gains/losses resulting from changes in expectations.

Question 7(a): Do you agree with the proposed disclosure requirements? If not, what disclosure requirement do you disagree with and why?

Question 7(b): What other disclosures would you prefer (whether in addition to or instead of the proposed disclosures) and why?

The ED provides a long list of required disclosures but does not link these requirements back to the objective of presentation and disclosure. We like to emphasise that a simple default position of 'the more disclosures, the better' for anything where the accounting is based on estimates does not necessarily provide decision useful information. We are concerned about the volume of disclosures, however we are unable to comment on cost / benefit aspects of these requirements until we have a better understanding of how to operationally implement the proposed model.

In particular we are concerned about the onerous nature of the origination and maturity (vintage) disclosures (paragraph 22) and the catch-all provision that further "quantitative and qualitative analyses" for gains / losses attributable to changes in expectations are required (paragraph 18b) without describing the nature of such analyses.

We question the need to disclose stress testing information in the financial statements. Financial institutions run various stress tests for various purposes (regulatory requirements, internal risk management etc.) and it is unclear what the benefit to financial statement users is of disclosing this information. Stakeholders such as regulators that require such information already receive this through regulatory reporting requirements.

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?

The operational complexities of implementing the proposals for large financial institutions are such that a three year timeframe would be necessary.

Question 9(a): Do you agree with the proposed transition requirements? If not, why? What transition approach would you propose instead and why? Question 9(b): Would you prefer the alternative transition approach (described in the summary of the transition requirements)? If so, why? Question 9(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 Q8) please describe why and to what extent.

Question 10: Do you agree with the proposed disclosure requirements in relation to transition? If not, what would you propose instead and why?

We believe that exemptions in the comparative disclosures would ease the transition process and reduce the overall cost of adopting the revised model. Providing relief for disclosures, such as the income statement impact of revision of estimates and reconciliation of statement of financial position for the comparatives would limit the cost and assist in making the three year transition period more practical and achievable.

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 need to include practical expedients in new accounting standards is some reason for concern. In our view, this is indicative of principles that are not yet fully articulated. With principle-based standards we would generally expect that there are several approaches possible to implement such principles. We would envision that a standard articulates principles, complemented with examples that illustrate possible implementations of such principles. The fact that the ED includes practical expedients that allow for a simplified implementation of the requirements provided certain conditions are met, illustrates that the proposed expected cash flow approach is more of a mechanical calculation approach than a set of guiding principals.

Another concern is that per paragraph B15 a reporting entity may only use practical expedients in calculating amortised cost if their overall effect in immaterial. In order to demonstrate that the impact of the calculations is not material it would be necessary to

perform the calculation in the first place. We therefore suggest that the reference materiality is deleted.

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?

See response to question 11. No other comments.