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

29 June 2010

Submitted via the "Open to Comment" page at www.iasb.org

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

Dear Sirs

I am writing on behalf of AFME (the Association for Financial Markets in Europe) to respond to the IASB's 5 November 2009 Exposure Draft ED/2009/12: Financial Instruments: Amortised Cost and Impairment (the "ED"). AFME is, as you know, the principal UK trade association for firms active in investment banking and securities trading; it was established on 1 November 2009 as a result of the merger of LIBA (the London Investment Banking Association) and the European Branch of SIFMA (the US-based Securities Industry and Financial Markets Association), and thus represents the shared interests of a broad range of participants in the wholesale financial markets. We welcome the opportunity to comment on this ED.

While generally supportive of an expected loss approach to impairment, we would like to draw to your attention a number of significant concerns over the IASB's proposed model before addressing the specific questions set out in the ED.

Application of the expected cash flow approach

Our first concern relates to the complexity and cost of applying the expected cash flow approach and producing the related disclosures.

The proposal in the ED requires preparers to estimate the amount and timing of future expected cash flows over the life of all loans. While historical loss rate experience can be used in estimating future losses for portfolios of loans, this information will generally not help to predict the actual timing of any missing payments. The assignment of probability weightings to cash flows further increases the complexity and subjectivity of the proposed approach.

The disclosures required by the ED are, furthermore, extensive, and come on top of already extensive disclosures for financial instruments.

The proposed approach would therefore require preparers to completely overhaul their systems in order to accommodate processes that are not in line with the way management views the risk. This would result in substantial cost, which we believe would greatly outweigh any practical benefit. The nature of the system changes entailed by such an approach would also require significant additional time to be provided before implementation could be made mandatory.

Effective return of a financial asset or financial liability

A second major concern is the proposal to include the initially expected credit losses within the effective interest rate. The calculation of the EIR is already very complex, and introducing an impairment model with an EIR that takes into account expectations of credit losses would increase this complexity further.

Entities use separate systems and processes for determining the current EIR and for managing credit risk (and thus for determining expected losses). Developing a combined EIR would therefore require significant further systems development, as well as a longer implementation period for the proposed changes.

Further, whilst the EIR is calculated on an individual asset basis, estimates of expected losses are derived from statistical models which are calculated using open portfolios of loans and receivables. The estimates generated by these models are the expected losses of the portfolio and not those of any individual loan. Hence, we believe that it would not be appropriate for expectations of credit losses derived at a portfolio level to be treated as an adjustment to the effective interest rate of a specific loan.

The proposed co-mingling of losses and the EIR will create a new EIR that is made up of contractual cash flows and a subjective estimate of expected losses. While today's EIR can be depended upon, as it is calculated with known figures, the proposed new EIR will be "contaminated" with estimates about future losses. This contamination will lead to less transparent, and also less reliable, information in the financial statements. We therefore believe it would be more useful to present the expected loss information separately in the financial statements.

Conceptual issues

Another concern is the mismatch within the ED regarding the treatment of initial and subsequent expected losses.

Whilst we appreciate the conceptual argument that initial expectations of credit losses are built into the pricing of the loan, whereas subsequent changes are not, we are not convinced that this pricing mechanism is applied in practice outside the category of one-off large commercial loans. Further, the difficulty of estimating the timing of missed payments means that expected loss estimates are likely to change on a continual basis, and may simply reflect a revision of the original estimates rather than a particular change in the credit quality of an asset. The treatment of changes in estimates due to "better" information should therefore be consistent with the treatment of the initial estimate. We do not believe there is sufficient reason to mix an amortisation approach with an immediate recognition approach: one or other approach should be used consistently.

A further conceptual issue is the ability to have a debit balance for a provision against an asset, as can arise where expected losses arise early in the life of a loan. While this might

be consistent with the proposed model, we believe this indicates the model needs to be reconsidered if it is to achieve the goal of earlier recognition of credit losses.

Convergence with US GAAP

We find it unsatisfactory that the IASB and FASB have proposed such different models for the calculation of impairment. We appreciate that the underlying classification and measurement models are very different, but we do not accept that this should necessarily result in a different approach to impairment. In our view a common approach to impairment is critical to the ability to reconcile the two accounting frameworks and thus to continue progress towards a single set of accounting standards. We therefore urge the boards to work closely together to remove any differences in their respective approaches.

Proposed characteristics for an effective impairment model

As already stated, we are supportive of an approach to impairment which is based more on expected losses, but for the reasons outlined above we believe the IASB needs to reconsider its proposed model. Our members would support a model with the following characteristics:

- It should require use of the best evidence available to estimate future losses. This should incorporate the use of historical loss experience data and minimise the use of speculative forward looking information. Future expectations of expected losses should cover the period for which management can practicably and reasonably forecast given the availability of reliable and observable data.

- It should be based on an expected loss approach, using historic default data to determine probability factors which are then applied to the undiscounted loss estimates. This approach is more consistent with current credit risk management practices, more operationally feasible, and less subjective than the detailed forecasting of probability weighted cash flows required for the expected cash flow model.

- Expected losses should be determined at a portfolio level. The definition of portfolios for determining expected losses under IFRS should be aligned with the credit risk management practices of the reporting entity, and should therefore consider at what level credit risk is managed and how the entity's business model is organised. Such an approach would be consistent with IFRS 7 ("disclosure through the eyes of management") and with IFRS 9 (classification partly based on the business model), and would, we believe, facilitate a better understanding of credit risk by users of the financial statements.

- The approach must allow for the use of "open portfolios" (i.e. portfolios that are dynamic in the sense that existing loans mature and new loans are added) in order to align internal risk management practices with the proposed impairment model. It would be inappropriate for an IFRS impairment model to require only closed portfolios (i.e. those which contain only assets of a specific "inception date" and/or "maturity date" that subsequently "run-off" over time): this would typically result in a very large number of run-off portfolios and, in most cases, a disconnection with internal management of credit risk.

- The approach should require consistent treatment between the recognition of initial estimates of expected losses and subsequent changes to those estimates.

- Our members are supportive of keeping the current EIR and expected loss information separate. We believe decoupling the interest rate from the expected loss information would have a number of advantages, in that it would:

  - provide more transparent and understandable information for users;
  - align more closely with management's approach to credit risk;
  - avoid unit of account issues between expected losses calculated on a portfolio basis and EIRs calculated on an individual loan basis; and
  - be operationally more feasible, and thus potentially reduce the timeline required for implementation of the proposals.

Re-exposure of a revised IASB model

In addition to our concerns over the IASB's proposed model, and over the divergence between the IASB approach and the FASB approach to impairment, we are also unclear over the status of the output of the Expert Advisory Panel and how the IASB intends to incorporate this within the final standard. We therefore believe there is a real need for the IASB to reconsider and re-expose a revised model for the calculation of impairment before proceeding to a final standard; such re-exposure would not necessarily delay the overall timeline to implementation of a new standard as a less complex and more operationally feasible model might shorten the time required for implementation (see also our responses to Questions 8 and 9 below).

Responses to the questions in the ED

Our responses to the detailed questions set out on pages 8-13 of the ED are as follows:

Question 1 *Is the description of the objective of amortised cost measurement in the exposure draft clear? If not, how would you describe the objective and why?*
Question 2 *Do you believe that the objective of amortised cost set out in the exposure draft is appropriate for that measurement category? If not, why? What objective would you propose and why?*

We support amortised cost as the most appropriate measurement basis for assets held to collect contractual cash flows. However, as explained above, we do not agree that the objective of amortised cost that is set out in the ED is appropriate for the following reasons:

- we do not agree with including an initial estimate of expected credit losses in the effective return;

- the continuous re-estimation of cash flows required under the proposed model will lead to earnings volatility more akin to a fair value measurement; and

- banks focus on undiscounted principal losses when establishing provisions and disclose credit losses separately outside of net interest income; this is the approach currently taken by management, it is understood by users and it is, we believe, more transparent.

> ***Question 3***
>
> *Do you agree with the way that the exposure draft is drafted, which emphasizes 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?*

Given the complexity noted above, we believe any standard resulting from the currently proposed model will need to include examples and implementation guidance, including output from the Expert Advisory Panel, to enable preparers and users to appropriately interpret and implement the measurement principles. In particular, the inclusion of guidance and examples within the standard is preferable to having information of this nature provided by separate Staff Papers which lack authoritative status.

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

See our general comments (on pp.1-3) above on the principles set out in the ED and on the principles we would prefer the model to follow.

> ***Question 5***
>
> *(a) Is the description of the objective of presentation and disclosure in relation to financial instruments measured at amortised cost in the exposure draft clear? If not, how would you describe the objective and why?*
>
> *(b) Do you believe that the objective of presentation and disclosure in relation to financial instruments measured at amortised cost set out in the exposure draft is appropriate? If not, why? What objective would you propose and why?*

While we agree with the overall objective of the presentation and disclosure requirements set out in paragraph 11 of the ED, we disagree with some of the detailed requirements, as set out in our responses to Questions 6 and 7 below.

Question 6

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

As discussed above, we do not believe that initial expected credit losses should be presented as part of the effective yield. The additional requirement to separately present gross interest and interest net of initial expected credit losses will, moreover, be onerous to prepare.

In our view, credit losses should be presented separately from net interest income: this would be more transparent and would also provide more relevant information for users.

Question 7

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

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

We are concerned that the proposed disclosure requirements are very extensive and add to already extensive disclosures for financial instruments, resulting in information that could be difficult to understand. Moreover, much of the information required would not be used by management and would thus not accord with the "through the eyes of management" principle in IFRS 7.

A large institution would potentially have to aggregate thousands of portfolios to produce reasonably summarised information. Given that fact, we disagree with some specific aspects of the disclosure requirements proposed in the ED:

- The requirements in paragraphs 17 and 17(a) of the ED to explain inputs and assumptions are likely to lead to "boilerplate" disclosures and/or to information that is too voluminous and impractical to prepare.
- The sensitivity disclosures in paragraph 17(b) are highly subjective, difficult to interpret and potentially misleading, particularly when the underlying data is itself highly subjective. The reliability of the expected loss calculation will depend on the quality of the entity's estimation methodologies, procedures and review of actual losses versus estimates. Thus we believe disclosures that discuss management's processes surrounding the estimation and subsequent validation of estimated losses would provide users with a better understanding of an entity's estimates of expected losses than would the proposed sensitivity analysis.
- The requirement in paragraph 18 to disaggregate gains and losses resulting from changes in estimates will be difficult to produce and highly subjective.

- Although the definition of non-performing assets may aid comparability, it is prescriptive, and contrary to the "through the eyes of management" principle of IFRS 7. We do not believe, moreover, that a single definition of non-performing assets is appropriate as this could, for example, differ between products and markets. We therefore think it would be more appropriate for entities to disclose their policy for determining when a loan is non-performing and for the financial statements to include information on such assets on that basis; in accordance with IFRS 7, this would be consistent with what is reported to management.
- The information in the table set out in paragraph B24 (relating to paragraph 19) is focused on credit losses by loan "vintage", which is inconsistent with how credit risk and loss expectations are normally developed and managed in practice. Estimates of expected losses are typically developed using open loan portfolios. These expectations are developed over the portfolio as a whole and as such do not relate to specific loan vintages. Developing the operational processes and system capacity to generate such disclosures would be exceptionally resource-intensive and costly.
- To disclose the "loss triangle" required by the ED, a long-dated security which has been in the portfolio for the past 20 years would require a 20x20 matrix. The loss triangle would also be impracticable for open portfolios.

In addition to the above, the information required by paragraph 20 on stress testing does not seem to fit within the context of the standard. We find the scope of the information to be unclear, as it appears to relate more to macro concerns than to credit losses, while the optional nature of the requirement is unlikely to improve comparability of financial statements. Whilst potentially useful for regulatory and capital management purposes, we believe stress testing does not provide relevant information on the current financial position or performance of an entity, and there could be significant potential for users to misunderstand or misuse this type of information. We do not therefore believe that this information should be included in the financial statements.

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?

Based on the current proposals, a long lead time will be required for implementation given the extent of development/modifications required to systems and processes. As such, a mandatory effective date of three years from the date of issue of the IFRS will not suffice if comparatives are required (effectively this provides only a two-year lead time if prior year comparatives are to be required, as the necessary changes to systems and processes would have to be completed before the start of the earliest comparative period).

Furthermore, in setting the mandatory effective date, the IASB should take into account implementation requirements for other aspects of IFRS 9, and for the other relevant current IASB projects.

We note, however, that a mandatory effective date of three years from publication of the IFRS should be more achievable if, as suggested in this letter, the IASB were to move to a model which more closely aligns with management's approach to the assessment of credit losses and decouples credit losses from the effective interest rate, therefore requiring less extensive disclosures.

Question 9

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

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

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

We do not agree with the proposed transition requirements: although conceptually sound, they would effectively require full retrospective application, which would be extremely difficult to implement. In our view, it would not possible to apply the proposed model retrospectively without tainting the measurement through the use of hindsight.

If the IASB proceeds with the model as proposed, we therefore prefer the "alternative transition approach" (summarised on page 11 of the ED): this would be somewhat easier for preparers to implement, although still onerous for large banks with significant pools of assets measured at amortised cost.

We agree in principle that comparatives should be restated; however as noted above it will be onerous for preparers and will affect the lead time for implementation. Our preference is for the IASB to develop a simpler, more operationally feasible model which could then be applied retrospectively, allowing restatement of comparatives. Such simplification might also reduce the lead time required for implementation.

Question 10

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

As noted in our response to the previous question, we do not agree with the proposed transition requirements and hence do not agree with the related disclosure requirements.

Question 11
Do you agree that the proposed guidance on practical expedients is appropriate? If not, why? What would you propose instead and why?
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?

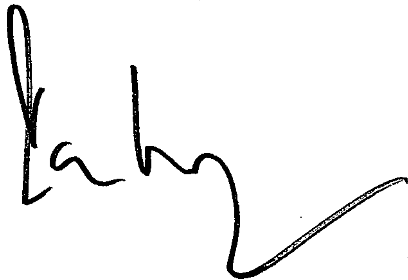
Our key observation is that practical expedients are not, in fact, practical if it is necessary to test them for materiality. In practice this means regularly testing the result from applying the practical expedient against the result from applying the full model, and thus requires calculation of both.

At least in the context of this ED, we believe the need for practical expedients indicates that the proposed model is overly complex, and that a more appropriate model would remove the need for practical expedients. In this regard we hope the IASB will pay close attention to the work of the Expert Advisory Panel, not only in considering operational simplifications to the IASB's proposed model, but also in considering alternative models which may result in a more practical model overall.

****

I hope the above comments are helpful. We would of course be pleased to discuss any points which you may find unclear, or where you believe AFME members might be able to assist in other ways.

Yours faithfully



Ian Harrison
Managing Director
Direct phone: 020 7743 9349
Email: ian.harrison@afme.eu